



# Offshore Financial Centers for Financial Inclusion

A Marriage of Convenience

June | 2017

Sam Mendelson  
Daniel Rozas



**FINANCIAL INCLUSION**  
EQUITY COUNCIL

CENTER for  
FINANCIAL  
INCLUSION

**ACCION**



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# Foreword



The words “offshore” and “tax-haven” are often taboo rhetoric within the investment space. With this paper, the Financial Inclusion Equity Council (FIEC) explores how equity impact investors use offshore vehicles, including the operational, legal, tax, and reputational issues involved. Through interviews with FIEC members, we seek to better understand the scope of offshore usage in impact investments and the factors at play when impact investors select a fund domicile. How prevalent are offshore funds? How many are domiciled in territories considered to be “tax-havens”? What are the reasons for setting up an offshore fund? What are the operational and tax advantages? What are the legal and ethical issues involved?

The idea for this paper began with a conversation at the annual FIEC meeting in 2016, and follows on the work of a Netherlands Platform for Inclusive Finance report titled [Paying Taxes to Assist the Poor? Balancing Social and Financial Interest](#). I would like to thank the Netherlands Platform for Inclusive Finance for their cooperation and guidance on this report. The report authors, Daniel Rozas and Sam Mendelson, did a tremendous job of pulling out the relevant themes and tensions after conducting many interviews with FIEC members and other relevant industry players. My sincere appreciation goes to all of the FIEC members and other interviewees for taking the time to share their insights and perspectives.

FIEC creates a forum for equity investors in the financial inclusion space to have an open dialogue and this paper illustrates important elements of this topic, including administrative efficiency, tax liabilities, and the importance of transparency and ethics. We are pleased to share these findings with members of FIEC, and the larger impact investing field. It is my hope that this paper will be the beginning of a conversation, and I look forward to continuing the dialogue on offshore financial centers.



*Deborah Drake*

Director, Financial Inclusion Equity Council

# Introduction



This paper was commissioned by the Center for Financial Inclusion at Accion (CFI) and Financial Inclusion Equity Council (FIEC) to better understand, especially in the aftermath of the so-called Panama Papers,<sup>1</sup> the prevailing attitudes and practices among FIEC members on the use of offshore financial centers (OFCs) and the ethical issues surrounding obligations to pay – or minimize – tax when invested in low-income countries.

This paper is based on phone interviews with representatives of 12 FIEC members based in the United States and Europe, one development finance institution (DFI), as well as informal conversations with other industry stakeholders. In November 2016, we held an in-person discussion with equity investors, managers and others during European Microfinance Week in Luxembourg, where we shared the preliminary findings of this paper and collected additional contributions from the group. Because of the sensitivity of the subject, interviews and discussions were conducted off-the-record with anonymity assured.

The findings presented in this paper are concertedly neutral and do not advocate or criticize any position. This is not an academic paper, and does not claim to be representative of attitudes of all microfinance or impact equity investors, or even of all FIEC members. It is simply a qualitative survey of the opinions of experienced equity investors and their institutions.

The revelations of the Panama Papers drew opprobrium from across the political spectrum. The populist zeitgeist which swelled during the research for this paper (notably through the “Brexit” and Trump votes) has been characterized, among other things, as a revolt against an internationalist elite that protects its privilege at the expense of the majority. Moreover, recent revelations that many multinational corporations have used exotic, if legal, offshore mechanisms to avoid tax have upset a broad spectrum of voters and political leaders.

Based on our research and interviews, there is no basis for arguing that the use of OFCs and special purpose vehicles (SPVs) by impact equity investors in any way reflects the type of unrestrained avarice described in the media. But within the context of the times, it is worth exploring the practices and the thinking within the impact investment community on the proper use of OFCs in supporting financial inclusion.

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<sup>1</sup> The Panama Papers refers to a global scandal that unfolded in 2016 with the publication of a large trove of documents from a Panamanian law firm exposing tax avoidance and wealth shielding schemes of a large number of prominent individuals. See, for example, [“What are the Panama Papers?”](#) from The New York Times.

# Setting the Scene



## What Are Offshore Financial Centers (OFCs)?

“Offshore” has become a bogey word as protectionist populists all over the world rail against companies avoiding paying their fair share of tax by using exotic offshore arrangements. Scores of major multinationals have felt the lash of public opinion and have been shamed (or pressured by chastened shareholders) into re-structuring their tax liabilities. Investors in financial inclusion, who position themselves as socially responsible, are sensitive to suggestions of tax avoidance.

The jurisdictions considered OFCs typically have several features in common. They’re often islands and they usually have small populations. They have strong geographical or cultural links to the investor and/or investee countries that they tend to serve, including special arrangements that enable foreign investment.

What is also characteristic is that the scale of investments made via offshore vehicles dwarfs the local economies, and in some instances is a major factor in overall cross-border investment into the investee countries. The small Indian-ocean island of Mauritius accounts for 40 percent of all foreign direct investment in India,<sup>2</sup> despite having an economy and population no larger than a single neighborhood in a large Indian city. That has in turn spurred the growth of a specialized industry in Mauritius providing legal, administrative, and financial services that support investments of every type.

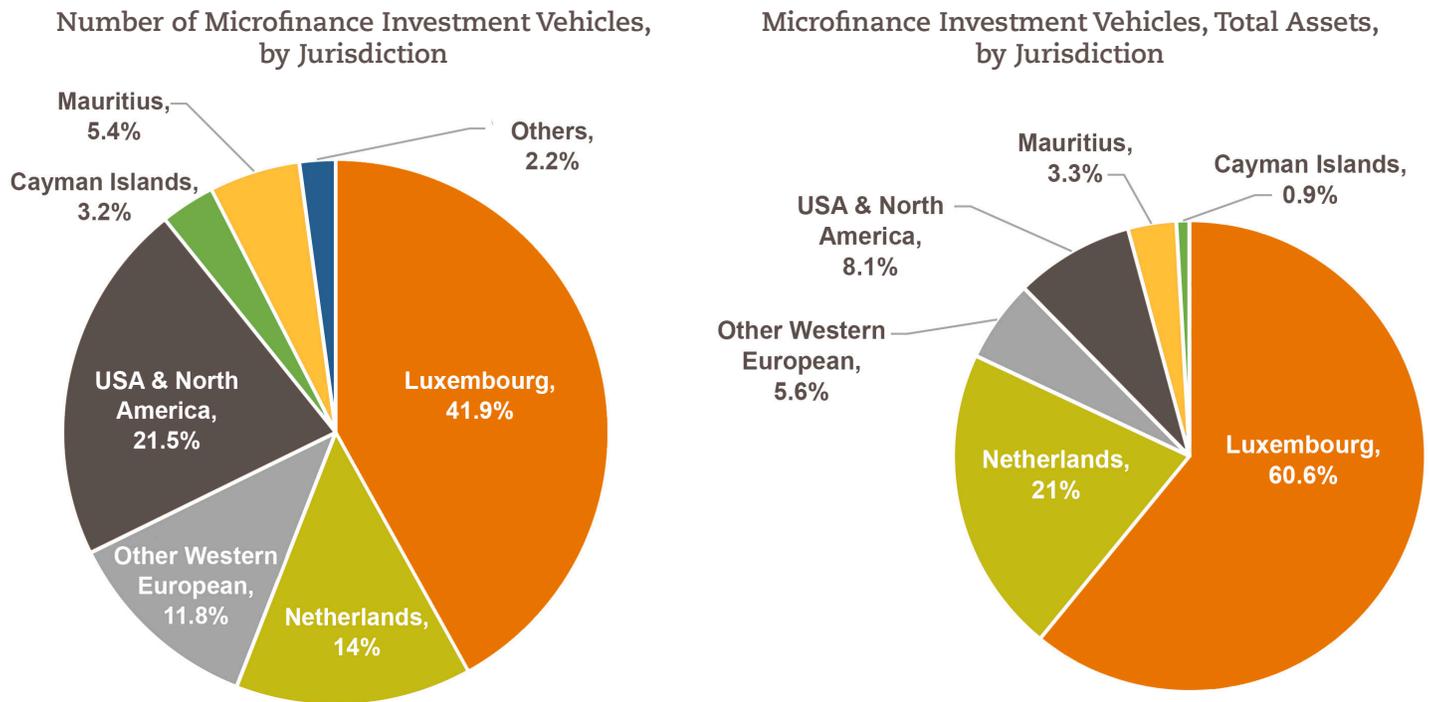
While definitions of OFCs may vary, perhaps the most apt definition is the list of conditions devised by the Association of European Development Finance Institutions (EDFI),<sup>3</sup> which draws heavily on the definition developed by the International Monetary Fund:

1. Large numbers of financial institutions engaged primarily in business with non- residents;
2. External assets and liabilities disproportionate to domestic financial intermediation designed to finance domestic economies;
3. Low taxation of non-residents with limited or no activities “onshore,” and
4. Stable commercial, legal, and regulatory infrastructures, which facilitate cross-border investments.

<sup>2</sup> Reserve Bank of India, Factsheet on Foreign Direct Investments (FDI), April 2000 to December 2011. [http://dipp.nic.in/English/Publications/FDI\\_Statistics/2011/india\\_FDI\\_December2011.pdf](http://dipp.nic.in/English/Publications/FDI_Statistics/2011/india_FDI_December2011.pdf)

<sup>3</sup> EDFI, Guidelines for offshore financial centres, European Development Finance Institutions, Brussels, Oct 2009. <http://edfi.eu/publications/edfi/publication/45-executive-summary-of-edfi-guidelines-for-ofcs.html>

Indeed, each of these elements is present in the portfolios of FIEC members and many other impact investors. In practice, this involves just three jurisdictions: Luxembourg, Mauritius, and the Cayman Islands, which together account for 50 percent of all registered funds and 65 percent of all outstanding assets within the impact investing industry, the vast majority of these in Luxembourg.<sup>4</sup> There are also a handful of non-Dutch funds that domicile in the Netherlands, but these are dwarfed by Dutch-based funds.



Source: Symbiotics 2016 MIV Survey, Market Data & Peer Group Analysis

### Tax Treaties and OFCs

OFCs may also have tax treaties—agreements between the OFC and a set of countries that govern the levels of taxation levied on investments between them, and usually make investments from the OFC subject to less tax than if they were made from another country. Tax treaties can also be the catalysts for the OFC jurisdiction to become a financial center in its own right.

For example, until a change in 2016, Mauritius had a tax treaty with India that significantly lowered the tax burden for foreign investors placing funds in India. That was the catalyst for the emergence of Mauritius as an investment hub, originally for investments bound for India. But once developed, the financial infrastructure in Mauritius has now become its own selling point. Thus, Mauritius is now also a hub for investors in multiple countries in Africa, despite having no tax treaties in place with those governments.

In almost all other cases, jurisdictions chosen for investment are the investor’s or co-investor’s own country, the investee country, or in rare cases, a country chosen for geographic convenience, having at least several of the above elements.

<sup>4</sup> Symbiotics, 2016 Symbiotics MIV Survey Market Data & Peer Group Analysis, 10th Edition, September 2016. <http://symbioticsgroup.com/wp-content/uploads/2016/09/Symbiotics-2016-MIV-Survey-Report-1.pdf>

# Offshore Investing by FIEC Members



Equity and debt fund managers who invest in financial inclusion and microfinance must choose among a range of possible domiciles. These funds pool amounts from investors in (sometimes multiple) high-income countries into special purpose vehicles that invest in financial institutions (and other companies) in emerging and frontier markets. Most fund managers invest in multiple countries, though a few (e.g. India-focused funds) focus on one country. When multiple countries are involved, both for sourcing funds and especially for placements, there are multiple possibilities for choice of domicile, and several factors play into the decision.

This section discusses three key considerations FIEC members (and probably many other impact investors) use when choosing to domicile: administrative efficiency, tax liabilities, and transparency and ethics. While tax tends to dominate public thinking about OFCs, the reality is that, among FIEC members, administrative infrastructure of specialized OFCs often drives decisions to domicile. This infrastructure includes attributes such as physical accessibility, human resources, banking connections, clear regulation, reputation, and even favorable time zones. And it's not just a question of what the OFCs offer, but also what others don't. Simply put, many investee countries are unsuitable for domicile.

It is impossible to discuss OFCs without discussing tax. Though the opaque environments and anonymity of some OFCs can facilitate tax avoidance and money laundering, for FIEC members, such features are not only irrelevant, but also downright problematic. Fund managers have little incentive to pursue tax avoidance strategies that would undermine their reputation as socially responsible investors. However, views on what that means exactly differ substantially, especially on one key point—whether it is appropriate to use an OFC solely for the sake of benefiting from tax treaties, even if it provides no operational benefit (and possibly even an additional cost). We have found significant differences among FIEC member perspectives on this question.

Finally, there is perhaps a somewhat unexpected issue: OFCs may actually be viewed not as tax havens, but as havens of transparency and reputation. FIEC members were nearly unanimous that OFCs' longstanding role in providing domiciles for investment vehicles gives comfort to investors of every stripe. Simply put, an investment memo naming a Mauritius, Luxembourg, or Caymans domicile is unlikely to raise eyebrows or questions from prospective investors.

## Administrative Efficiency

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***“There can be economy only where there is efficiency.”***

*-Benjamin Disraeli, British politician and writer*

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Belying the dominant narrative in the media that incorporation in an offshore center or “low tax jurisdiction” is driven primarily by tax minimization, the consensus among FIEC members interviewed was that administrative efficiency is the primary driver.

Administrative efficiency contains several elements. Among the most important is the truism that many low-income countries lack the financial services infrastructure, including the human resources, to manage inflows and outflows at a level of proficiency and risk acceptable to investors. In many of these countries, setting up a fund is just a non-starter.

This was most notably an issue for investments into Africa. One FIEC member agreed that, compared to Mauritius (a common OFC for investment into African countries), there might be “some options, but they’re limited... Only Botswana [could be an option] because they have an investment zone set up.” But this isn’t enough. Even if the legal structure is in place to permit the creation of an investment vehicle, without the ecosystem of auditors, lawyers, accountants, fund custodians and technologists, investors may not be willing to take the first-adopter risk of going into an untried target market without confidence that the administrative capacity is there. It’s about risk aversion as much as anything else.

“It’s much harder to invest directly into an [African] country,” said a fund manager, because it would be “lacking the proper trust, business and capabilities” of Mauritius, which has “plenty of service providers and where it’s much easier to set up.” Several respondents also said that investing directly into local financial institutions in certain African countries was not viable. Fund managers need investees “with knowledge of fund administration requirements. Fund accounting is a particular type of beast and requires a specialized skillset,” said one manager. Said another, “Some countries have focused on this as part of their service economy to provide fund administrative services.” One respondent was clear about the impossibility of incorporating a fund in a particular target market: “From a service economy standpoint, there is zero fund administration accounting knowledge.”

The prime OFCs also offer clarity and predictability of policy and treatment. FIEC members regularly cited a lack of clarity and predictability of local regulatory requirements in their target investment markets. Regulatory issues are very different in every country, so there is an advantage to using an established regulatory framework in a country which specializes in offering offshore financial services. For such OFCs, maintaining stable policies and regulations is a selling point in its own right.

Several other factors were cited for the administrative or efficiency imperative. The presence of embassies in the jurisdiction, bank linkages, cash management facilities, and remittance corridors were all cited as factors in choice of offshore incorporation.

Banking relationships are particularly crucial. Certainly, familiarity with fund transfers to and from multiple countries is a basic requirement. But for banks increasingly concerned with anti-money laundering (AML) requirements, accounts that routinely feature transfer to or from countries outside the investment mainstream can trigger additional attention. And while a large fund may justify the additional resources the bank needs to satisfy its AML requirements, a small fund may find itself “too small to succeed.” One respondent cited being forced to close bank accounts at short notice, with no reason provided. For this manager, established and trusted OFCs such as Mauritius, Caymans, and Luxembourg have banks that are comfortable with such practices.

Location is important too. Multiple respondents cited convenience as a factor in choice of OFC, which includes geographical proximity, time difference (reducing the need for overnight waits for transfers or decisions), travel accessibility from investors’ domiciles, and shared language. One fund manager directing investments to African microfinance institutions framed the fund’s location as matter of perception: “This was seen as an African fund, and so we wanted the fund to be in Africa. Mauritius was seen as closest to Africa.”

Finally, an impact investment fund includes investors from many countries. Their investments are going to many target countries as well. Incorporation in any one source country or investee market would have no obvious advantage. So the funds need what respondents described as “a central point that is neutral to investors in multiple countries.” The OFC provides a focal point through which debt, equity and sub-debt, provided at different times, through funds of varying terms, from a range of investor types, can be managed for deployment across several countries. From an administrative perspective, coordinating this in one neutral place is valuable to fund managers.

## Tax: A Burden or a Privilege?

***“In this world nothing can be said to be certain, except death and taxes.”***

*-Benjamin Franklin, American politician, inventor and author*

A cynic might view the emphasis respondents placed on administration as a distraction from the central tax issue. After all, it is not surprising that fund managers sensitive to perceptions of tax minimization would emphasize non-tax reasons for incorporating in OFCs. However, many respondents are so aware of the opprobrium that tax minimization can attract that they heed their investors' wishes to ensure that their fund pays its “fair share.” With administrative considerations, the decision process emphasizes practical matters (e.g., conducive financial ecosystem, smaller compliance burdens, or geographic proximity), but when it comes to tax, decisions are driven as much by philosophy as other considerations.

The crucial philosophical question is this: what is the purpose of the tax and what is the difference between appropriate tax avoidance and unethical tax evasion?

Aside from their existence, the other certainty regarding taxes is that they shall always be complicated. This brief paper cannot possibly tackle the full ramifications and complexities of tax law applied to social investments via OFCs, so it helps to simplify. For a social investor, taxes can roughly be divided into three categories. First, investors must pay tax at the source in their own jurisdictions. Second, taxes are paid at the destination—by investees, in the form of taxes on payroll, income, or other aspects of their operations.

For the most part, taxes at both source and destination fall outside the scope of this paper. Instead, we focus on the third, middle piece of the puzzle—the taxes levied either on the fund entity or on repatriated investment income (such as dividends and capital gains). This is where offshore vehicles and related issues come into play.

### What Is Double Taxation?

Double taxation is when the same income stream is taxed by multiple jurisdictions. For the type of equity investments made by FIEC members, this entails tax by the jurisdiction where the investor is domiciled, where investee is domiciled, and possibly the jurisdiction where the intermediary entity is based. A Double Taxation Treaty (DTT) can be agreed upon between countries to recognize that tax has been paid on an income stream already, and avoid subjecting that income to supplementary taxation in the other jurisdiction.

FIEC members expressed two clear philosophies concerning taxation. One side, represented mainly by North American fund managers, focused on minimizing tax through all available legal avenues. To these respondents, their fiduciary duty to the investors all but required them to seek out structures and vehicles that would legally attract the lowest tax levy possible. For the other side, represented mainly by European managers, the objective was tax justice—tax should be paid where economic activity takes place. These managers also emphasized the developmental function of paying taxes in countries where tax administration and quality of collections is underdeveloped.

The practical result of these differing points of view emerges when income or the foreign asset itself is repatriated, either through dividends or sale of equities. The first stage is the application of withholding taxes by the jurisdiction from which they are being repatriated. This tax may be reduced or altogether waived if there is a tax treaty between the destination jurisdiction and the one to which funds are being repatriated, even if this destination is only an intermediary waypoint before the funds are further transferred on to the investor's own domicile.

One European manager said the company board “has made the decision to pay its fair share,” avoiding “exotic structures like creating a deduction somewhere to avoid tax imposition in another country.” This is a function of perception – or reputational risk – on the one hand, and agreed ethics on the other. “We want to be tax effective, but don’t want to be seen to be avoiding taxes...it doesn’t look great [to pay lower tax in the richer investor country versus a higher tax in the poorer target country].”

Another respondent said his investors see the obligation to pay tax in an investee country as an ethical imperative. Yet another said “we would have a problem with using [double taxation] treaties to avoid tax *altogether*, and would not use a pass-through vehicle which adds *no value*... but the double taxation regime is designed for this situation, and we have nothing against using [treaty provisions that avoid double taxation]” (emphasis ours). The objective isn’t to avoid tax treaties per se, but rather to avoid using a fund/vehicle for the sole purpose of tax avoidance. The point is particularly relevant if the taxes being avoided would otherwise be going into the public funds of low-income countries that are struggling to transition from opaque to more transparent economies.

### An Ocean Apart

Attitudes towards tax burdens were strikingly different between European and American respondents. Generally, the U.S. attitude prioritized the fiduciary duty to investors, and that it was permissible – even incumbent – on fund managers to minimize the tax to investors. “[Investors] are investing in enterprises, not the government, so they don’t see the issue [as problematic],” replied one U.S. manager.

*“Investors are expecting us to be as tax efficient as legally possible. If there are legal, allowable incentives (to attract investment), it’s silly not to make use of incentives in place, and [we are under] no obligation to pay more than what is the minimum required.”*  
– U.S. fund manager

By contrast, European fund managers spoke of the positive obligation to pay tax in target countries, and to be seen as doing so as well. Avoidance of “exotic” tax arrangements paralleled avoidance of “exotic” domiciles.

*“We want to be responsible and transparent.”*  
*“We would have a problem with using treaties to avoid tax altogether.”*  
– European fund managers

At the risk of stretching the point, these attitudes reflect political differences on both sides of the pond: a more neoliberal, Anglo-Saxon approach in the U.S., and a social democratic view in continental Europe, in which the “impact” of the investment mandates more than infusion of funds per se, but also support for the institutions and the countries in which they work. Indeed, one European fund manager pointed with pride to the work the fund has done to ensure investee organizations and clients are paying local tax through corporate income tax and loan interest, noting, “We have become a tax collector for many [investee] inland revenue departments.” None of the American respondents cited any such view.

This emphasis on the positive impact of tax paid in target countries was cited by many FIEC members. Indeed, because microfinance and financial inclusion operations more broadly deal with clients who often work in the informal economy, taxes that arise out of these activities help partly to formalize an often significant part of the economy. Additionally, funding the government through tax payment helps pay for the physical, social, and political infrastructure that assures stability and provides a foundation for economic growth. One European fund manager even boasted of having won awards for “best taxpaying company” in two investee countries.

This notion of “paying a fair share” in tax has led a number of FIEC members to adopt explicit policies to ensure that they will not enter into transactions whose sole purpose is to avoid tax. Some cited examples where they declined investment opportunities because the investee or a co-investor insisted on structures whose sole purpose was to avoid tax.

### NpM’s Recommendations to Its Microfinance Investor Members

The 2013 NpM paper, [Paying Taxes to Assist the Poor? Balancing Social and Financial Interests](#), provides a clear summary of attitudes to tax from a European perspective. Tax avoidance is generally seen as behavior that might go ‘against the spirit of the law,’ and is a ‘grey area’ between tax planning (which is legal) and tax evasion (which is not). The paper notes that tax practices which are potentially harmful to developing nations are not limited to large multinational corporations, but can include other entities with international practices, such as microfinance investors.

The two broad principles the NpM team detailed (that stakeholders should invest in the country where the activities take place; and that deliberate structuring of funding vehicles with the sole purpose of avoiding taxation is wrong) are in strong alignment with the expressed views of the European interviewees in this paper. In terms of implementation, NpM recommended to its members three requirements to meet these principles:

- A.** the *fit for purpose* requirement: only use legal structures that are instrumental in serving the needs of microfinance clients;
- B.** the *responsibility* requirement: use legal structures that don’t violate the interests of other stakeholders, and
- C.** the *disclosure* requirement: disclose the reasons for selecting specific legal structures upon stakeholder request.

On the other side of the Atlantic, the emphasis was on the investor and the investee. The role of government and its tax assessments are seen more as a burden that gets in the way of the primary objective—social investment to benefit end-clients. The most important way this arises is the practice of leveraging tax treaties to minimize the tax bill assessed on the investment income. A few respondents mentioned using shell corporations set up for the sole purpose of taking advantage of a tax treaty for just one investment, even when this entailed an additional administrative burden. In each of these cases, the intermediary company was set up in a jurisdiction outside both the fund domicile and the investee country.

The reasoning of these North American fund managers is that these tax treaties are in place for a reason, and they would be violating their fiduciary responsibility to the investors and reducing the funds available to the investee if they did not leverage these opportunities to reduce the fund’s tax burden, so long as the added administrative burden was reasonable. From this perspective, such transactions are simply reducing or eliminating the burden of double taxation. Both the investors at the source and investees at the target still pay the taxes they’re assessed.

## The Development Finance Institution View

Development finance institutions (DFIs) comprise the largest investors in microfinance and financial inclusion, and a handful of these – multilateral and bilateral – make up the lion's share of total investment, a fair portion of which is channeled through OFCs. What is the representative DFI view? Here is an abridged interview with a representative of an investment team at a major DFI.

*“Usually when we invest in a fund, we work via fund managers, and it is they who propose the domicile through their investment memoranda. If the due diligence passes muster, we go ahead with it. We don't often get proactively involved in where the fund is based. We're not prescriptive.*

*Our investments via OFCs are framed by the European Development Finance Institutions (EDFI) Guidelines,<sup>5</sup> these will always inform our rationale for any equity investment transaction—and especially on our know you client (KYC) process. From time to time, we've pulled out of a proposed investment either on advice of counsel, or because as a team we just agree that it doesn't 'smell right'—the reputation of the OFC is not good or establishing KYC for the shareholder is too complicated. We have withdrawn because of the use of a tax haven with a bad reputation, and withdrawal may depend on leverage—how many investors are involved, and are we significant enough that the fund managers will be willing to adapt to address our concerns? Overall, we are guided by:*

- *What is permissible under local laws in investee country*
- *What is permitted by regulations in our own country*
- *What is agreed upon with EDFI, and*
- *International black lists*

*Some jurisdictions we know are usually going to be fine anyway—Mauritius or Singapore, for example, we know are investor-friendly, they have the frameworks and expertise to address issues and to handle SPVs with multiple investors from various markets. By contrast, there are African target markets where we know there will not be the layers of institutional expertise, investor protection, and mechanisms to avoid double taxation. And though we avoid double taxation, to be clear: **we consider paying local tax part of our impact.**”*

<sup>5</sup> The Association of European Development Finance Institutions (EDFI) comprises 15 bilateral institutions operating in developing and reforming economies. The Guidelines for Offshore Financial Centers outline rules for determining whether an OFC is appropriate for investment by an EDFI member, including on harmful practices, committed jurisdiction, transparency, exchange of information, financial sector integrity, and capital flight.

## Offshore vs. Onshore

Though most FIEC members rely on at least some offshore vehicles, not all do. A number domicile their funds in the country where the fund manager is headquartered, which in several cases happens to overlap with the jurisdiction of the majority of the fund's investors. In those situations, the tax and regulatory environment is already conducive for managing the fund, and the added burdens of an intermediary jurisdiction are reduced. In most of these cases, the funds are also structured so there is no tax assessed on the fund itself, with tax on the income being assessed only on the investors.

In one instance, a FIEC member established both the fund and a base of operations in a jurisdiction that applies a tax on the fund itself, in part due to the way the fund is structured. This was the only such case among the interviewed FIEC members. However, for the fund manager, the cost of this tax was easily outweighed by the enabling environment of the jurisdiction—geographical proximity to the fund's target countries, a transparent and well-regarded legal system, and strong banking links to both investee and investor countries.

## The Role of Investors

Selecting a domicile may be the responsibility of the fund manager, but it is the investors who set the parameters. And when it comes to tax implications, a major consideration is the tax status of the investors, which can differ greatly. Some investors, such as DFIs, foundations, and non-governmental organizations (NGOs) may be entirely tax exempt. Institutional investors, such as pension funds and insurance companies have their own tax and reporting obligations. For a fund manager, having a diverse set of investors may dictate selecting a jurisdiction that does not assess tax, or at a minimum, has no withholding tax on repatriated funds.

In a jurisdiction like the U.S., NGOs are prohibited from holding income-generating assets deemed to generate unrelated business taxable income (UBTI), without risking their nonprofit status. In those cases, the manager may set up a special “blocker corporation” to absorb the tax burden, thus shielding the NGO from the prohibited income.

# Transparency: From Tax Haven to Safe Haven?



***“Ethics is knowing the difference between what you have a right to do, and what is right to do.”***  
-Potter Stewart, Associate Justice of the United States Supreme Court

The concept of offshore financial services can elicit notions of opacity and even unethical behavior. Since considerable efforts have been made in recent years to disincentivize countries from offering opaque banking services, and the change in the Organization of Economic Co-operation and Development’s so-called “gray list” of “uncooperative tax havens” from seven countries in 2002 to none today reflects the importance placed on this issue by other states, regulators, financial institutions, and supranational bodies.

The steady, if not growing, threat of global terrorism and the broader issue of money laundering behavior have resulted in the proliferation of anti-money laundering/combating the financing of terrorism (AML/CFT) requirements for financial institutions and vehicles. These regulations have made some jurisdictions less attractive, due to onerous requirements, while other more established OFCs have been able to differentiate themselves by their familiarity with the new laws.

## Decorating the Welcome Mat With Red Tape: USA and Luxembourg

Among FIEC members, it was a common understanding that they should avoid structures involving U.S. jurisdictions at almost any cost. Indeed, this view was extended to U.S. funding itself, since having any link to the U.S. within the fund structure triggers reporting requirements and administrative burdens not just for the fund manager, but also for other investors. As one manager put it, “a lot of non-U.S. investors won’t even talk to you if there’s a U.S. presence.”

A somewhat similar view also applied to Luxembourg, but for different reasons. First, its own AML/CFT requirements have increased, creating ever-growing administrative burdens on funds. However, Luxembourg was also singled out for its high cost of business, since all fund-related activities (e.g., legal support, fund custodianship, etc.) must be performed by Luxembourg entities, resulting in fees that are uneconomical for small and medium-sized funds.

Indeed, a common refrain among FIEC members was that selection of jurisdiction should not include anything too “exotic.” This means that established offshore financial centers – Mauritius, Luxembourg, and to some extent the Cayman Islands – have become comfort zones, places where most social and development investors have done business before. Put another way, the value proposition of OFCs to funds includes, ironically, their transparency.

Transparency is important to the funds. The investors into these funds have no need or interest to hide their operations. For the fund managers, the use of an established offshore jurisdiction is a *de facto* accreditation in the eyes of investors, regulators, and financial institutions. Transparency separates the legitimate from the illegitimate.

This transparency has three facets: transparency to the target country and especially its regulators; transparency to the source country (and its investors, in particular); and transparency to the broader public: reputation.

The first is a basic KYC issue. For most regulators, private equity investments in financial firms pose risks that deserve close scrutiny. That the immediate source is a special purpose vehicle in an offshore jurisdiction usually has few consequences. It is instead the source investors that are important, and this is information that nearly all FIEC members must provide when seeking regulatory approval for an investment. However, there are some exceptions.

Colombia, given its long-standing struggle with narco-trafficking and the money laundering that goes with it, is far less tolerant of investments coming from offshore financial centers. Two separate FIEC members brought up instances when potential investments in Colombia were rejected by the regulator – one from a fund in Luxembourg, the other from the Cayman Islands.

For one fund, regulatory approval proved more complex because it was domiciled in the fund manager's home country rather than an OFC. An African country regulator's demand for a true copy document proved surprisingly challenging to fulfill, since the fund's home jurisdiction had moved to e-documents. By contrast, Africa-focused funds operating from Mauritius, with its extensive and regular transactions with multiple countries in Africa, regularly cited the ease of operations as an advantage.

But transparency can lead to absurd consequences, particularly if sophisticated funds are subject to KYC requirements clearly intended to weed out either nefarious or incompetent competitors. One respondent told of transactions where a regulator required validated school grade transcripts of the respondent organization's board members. "The trend is much more of querying who [their] investors are," he says. There was strong consensus among respondents on this point. AML/KYC demands are growing, and this is at least one of the goals of using OFCs—not to avoid the regulators, but to outsource some of the reporting burden to entities that specialize in this service and have the relationships to do it efficiently.

There are also exceptions for KYC. One FIEC member cited constraints as a bank under confidentiality laws from disclosing its investors, making it unable to fulfill the KYC requirements of regulators in some target countries. However, the established regulatory environment of the bank's home jurisdiction can act as a suitable stamp of approval.

# Takeaways



This paper is not the first nor likely the last effort to deal with the use of offshore financial centers in the financial inclusion sector, but it has illustrated some important elements:

First, the importance of administrative efficiency was cited unanimously. As long as the handful of existing OFCs continue to deliver, they will continue to play a role in cross-border investing, including for financial inclusion. And their shift away from opaqueness and towards transparency – at least for the types of vehicles employed by FIEC members – is likely to strengthen that position.

Second, the potential standard-setting role of DFIs is also worth recognizing – the EDFI guidelines are thus likely to influence the way OFCs are used going forward, putting in place clearer guidelines on appropriate and inappropriate use of OFCs and tax treaties, especially within the context of socially responsible investing.

Third, perhaps the most problematic question goes back to the ethics of paying tax. This is where different philosophies emerge and where there is no consensus. Nor is convergence likely. If anything, we're likely to continue seeing the "Atlantic gap," with the shareholder-value perspective among American managers on one side and the tax-justice perspective of European managers on the other. Perhaps this is an area that will also see greater efforts to delineate positions, and thus help fund managers differentiate themselves.



The Financial Inclusion Equity Council (FIEC) is the first membership organization to bring together the leading private entities that make equity investments in financial inclusion institutions in the developing world. FIEC members seek both social and financial returns from their investments in these institutions, which provide a range of enabling financial services to the financially excluded. Through the council, members seek ways to improve their oversight of their investees, enhance the performance of their investments and develop best practices and standards for the industry. The Center for Financial Inclusion at Accion (CFI) acts as the secretariat for the FIEC.

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The Center for Financial Inclusion at Accion (CFI) is an action-oriented think tank that engages and challenges the industry to better serve, protect and empower clients. We develop insights, advocate on behalf of clients and collaborate with stakeholders to achieve a comprehensive vision for financial inclusion. We are dedicated to enabling 3 billion people who are left out of – or poorly served by – the financial sector to improve their lives.

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