

A PORTRAIT OF SUCCESS:

THE RISE OF THE CAYMAN ISLANDS AS AN OFFSHORE FINANCIAL CENTER*

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Abstract

During the last 30 years, while much of the Caribbean has experienced increasing economic hardships, the Cayman Islands have continued to prosper. In 1998 United Nations Office for Drug Control and Crime Prevention acknowledged the Caymans as the fifth largest financial center in the world. This paper examines some of the factors that have contributed to the Cayman's rise as an offshore financial center (OFC) and explores the history of Cayman's relations with the United States. The analysis will show that the Cayman Islands have a unique history that has facilitated their emergence as the Caribbean's premiere OFC. An understanding of the Cayman traditions suggests that the Cayman financial community will probably continue to flourish and that the particular character of Cayman society will likely ensure its continued place as the region's frontrunner OFC.

Key words: Caribbean economy and finance; offshore financial Centers (OFC); history and traditions of the Cayman Islands.

Resumen

Durante los últimos 30 años, mientras la mayor parte del Caribe ha sufrido apuros económicos, las Islas Caimán han continuado prosperando. En 1998, las oficinas de las Naciones Unidas para el Control y la Prevención de las Drogas reconoció a las Islas Caimán como el quinto centro financiero más grande del mundo. Este trabajo examina algunos de los factores que han contribuido a su auge como centro financiero de ultramar (OFC) y explora la historia de las relaciones de las Islas con los Estados Unidos. El análisis demuestra que las Islas Caimán tienen una historia única que ha facilitado su emergencia como el principal OFC caribeño. Comprender las tradiciones de las Islas también sugiere que su comunidad financiera continuará floreciendo y que el carácter particular de la sociedad caimanés asegurará su presencia regional como un OFC puntero. *Palabras clave:* economía y finanzas caribeñas; centro financiero de ultramar; historia y tradiciones de las Islas Caimán.

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UN RETRATO DEL ÉXITO

EL AUGUE DE LAS ISLAS CAIMÁN
COMO CENTRO FINANCIERO DE ULTRAMAR

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Résumé

Pendant ces trente dernières années, alors que la plus grande partie de la Caraïbe a souffert de graves difficultés économiques, les îles Caïmanes ont continué à prospérer. En 1998, le Bureau des Nations Unies pour le Contrôle et la Prévention de l'Abus des Drogues a reconnu que les îles Caïmanes constituaient le cinquième centre financier du monde. Ce travail examine quelques-uns des facteurs qui ont contribué à l'essor des îles Caïmanes en tant que centre financier OFC ("Off-Shore") et examine la relation de ces îles avec les États Unis. L'analyse démontre que les îles Caïmanes ont eu une histoire unique, qui a facilité son "émergence" comme principal OFC caraïbe.

Comprendre les traditions des îles suggère également que la communauté financière des îles Caïmanes poursuivra sa réussite et que le caractère particulier de la Société des îles Caïmanes assumera sa présence régionale comme un OFC de pointe.

Most-clés: Economie et finances caraïbéennes; Centres Financiers off-shore; Histoire et traditions des îles Caïmanes.

Samenvatting

Gedurende de laatste 30 jaren bleven de Cayman Eilanden economisch bloeien, ondanks het feit dat het merendeel van het Caraïbisch gebied in een economische crisis verkeerde. In 1998 erkende het kantoor van de Verenigde Naties voor Controle en Voorkoming van Drugs de Cayman Eilanden als het vijfde meest grote financieel centrum van de wereld. Dit artikel analyseert de factoren die hadden bijgedragen tot het succes van de Cayman Eilanden als overzeese financieel centrum (OFC) en onderzoekt de geschiedenis van de betrekkingen tussen deze eilanden en de Verenigde Staten. Er wordt gesteld dat de Cayman Eilanden een unieke geschiedenis hebben die heeft bijgedragen tot dit succes. Ook wordt gesugereerd dat de financiële gemeenschap van de Cayman Eilanden zal blijven bloeien en dat het specifieke karakter van deze maatschappij een garantie vormt voor het blijvende succes van dit financieel centrum. *Kernwoorden:* Economie en Caraïbische financien; overzeese financiële centra; geschiedenis en tradities van de Cayman Eilanden.

The Cayman Islands... one of the most important offshore jurisdictions, is generally judged to be the fifth largest financial center in the world, behind London, New York, Tokyo and Hong Kong
United Nations Office for Drug Control
and Crime Prevention, 1998

As local agriculture and industry have steadily declined in most Caribbean countries during the latter half of the last century, almost every island nation in the region has attempted, on some level, to develop a financial sector (Maingot, 1994). Results of these efforts have varied widely, and in many cases failed to elevate the nation's standard of living above third world levels (CIA, 2001). A few Caribbean Islands however, have achieved marked success and matured into major world financial centers. Nowhere is such a phenomena more clearly illustrated than in the case of the Cayman Islands. The British Government estimated bank assets in the Cayman Islands in 1999 to be US\$ 671 billion (Foreign and Commonwealth Office, 1999b), making it a leading world financial center, as described by the US above. Not only have the Caymans cultivated a thriving financial sector, but the population of the islands has achieved wealth in the process. According to Caroline Doggart, "The prosperity is widely distributed," and the estimated GDP of US\$ 30,120 (Foreign and Commonwealth Office, 1999b) "is the highest in the Caribbean and well above Canadian, UK, and US levels" (Doggart, 1997).

This paper examines some of the factors that have contributed to the Cayman's rise as an offshore financial center (OFC) and explores the history of Cayman's relations with the United States. A brief overview of the history of offshore finance is presented as a background, as well as the Cayman Islands' entry into this arena. Additionally, certain events in the island's history are evaluated with regard to their impact on Grand Cayman's status and evolution as an OFC. In this context, the strategy of Cayman's leaders in the face of increasing regulatory pressure by the United States and other world powers is then investigated. This analysis will show that the Cayman Islands have a

unique history that has facilitated their emergence as the Caribbean's premiere OFC. An understanding of the Cayman traditions suggests that, even in the face of renewed scrutiny by US authorities, the Cayman financial community will probably continue to flourish. Though emulating tactics employed by Cayman's leadership may assist other Caribbean nations competing as OFCS, the particular character of Cayman society will likely ensure its continued place as the region's frontrunner OFC.

THE RISE OF THE OFFSHORE FINANCIAL CENTER

By the end of the nineteenth century, wealthy aristocrats around the world had come to realize the danger posed to their assets by social upheaval and governmental transitions. Recognizing the potential to capitalize on this anxiety, the Swiss developed banking laws, that combined with the country's political stability, created the first and most well known modern tax haven. Switzerland began to accumulate large sums of money from wealthy élites in Russia, Germany and South America, who were seeking both security and secrecy (Doggart, 1997). By the end of World War II, however, American scrutiny and threats of sanctions on the Swiss for their role in hiding ill gotten Nazi assets prompted those with money to hide to look for alternatives. For Americans in this position, the Caribbean presented an ideal geographic opportunity.

Much of the Caribbean tax havens' reputations as facilities for laundering criminal proceeds stem from their use by organized crime in the 1960's. Palan and Abbott sum up the view succinctly:

The turning point for the Caribbean tax havens came in 1959 when Castro ousted one of Meyer Lansky's principal business associates and closed the syndicate casinos and drug trafficking facilities [Palan and Abbott, 1996].

While most modern analyses generally look at the complex economic and political trends that spurred the spectacular growth in offshore finance, the view that places like the Cayman

Islands exists only as a medium for shady and often illegal transactions persists.

The Bahamas [and other OFCs] must do things which are not allowed in the US because to do things which are allowed in the US is non-competitive, since in every instance the US does it better than the Bahamas do. The Bahamas are therefore compelled in banking and trust operations to appeal to unallowable activities and by inference to appeal to activities disallowed in the US [Hudson, 1998].

While Mafia proceeds may have played a significant role in motivating Caribbean countries to establish themselves as tax havens, the transition from tax havens to Offshore Financial Centers lies at the heart of the modern success stories. In other words, the true turning point for the Caribbean financial industry came when the region became a location not just for the storage of secret funds, but rather as a locale for conducting a complex array of international financial transactions. Such activity is defined as follows:

markets where operators are permitted to raise funds from non-residents and invest or lend that money to non-residents free from regulations and taxes [Hanzawa, 1991].

US government policies, not organized crime, initiated the events precipitating the evolution of many tax havens into OFCs.

Growth of offshore finance can be directly linked to the economically restrictive policies enacted by the US in the 1960s and 1970s that prompted investors to utilize the less prohibitive European markets. In short, US banks found that they could maximize their profits by establishing branches overseas and conducting their international finances in non-US currencies. Susan Roberts estimates the annual growth of offshore banks, primarily of US origin, to be 23.4% between 1972 and 1982.

Explanation for (this growth) lies in the development of the Euro-markets. In fact the history of the world's OFCs and the Euromarkets are parallel. The Euromarkets are the quintessential offshore

market. They arose 'offshore' of the United States as an exogenous market in US dollars [Roberts, 1995].

Two economic policies prompted American financial institutions to look for opportunity abroad. The Interest Equalization Tax, in effect, from 1963 to 1974, attempted to control the amount of US capital leaving the country. As a result, American banks found it necessary to establish offshore branches where they could issue foreign loans without restriction. A similar effect was produced by the Voluntary Foreign Credit Restraint Program, in effect between 1965 and 1974, which limited the size of loans extended by US banks but did not apply to their foreign subsidiaries (Johns, 1983). The Federal Reserve also placed a ceiling on interest rates with Regulation Q. Inflation during the 1970s pushed international interest rates higher than the artificially imposed maximum in the United States and once again, banks were motivated to issue loans through their foreign branches where they could collect higher returns. Some regulations, like a 1963 revision to the Federal Reserve Act, which allowed banks to expand in countries where they already had a presence without securing government permission, seemed to actually encourage the growth of the Euromarkets. The European financial markets grew in size from an estimated 57 billion dollars in 1970 to 661 billion in 1981 (Roberts, 1995).

Much of the capital inflows accounting for the massive growth resulted from huge deposits into European banks by OPEC nations enjoying the high demand and prices for oil during the seventies. OFCs became a useful instrument for banking institutions to recycle this capital, often in loans to Latin American countries with higher interest than permitted by US regulations. In other words, banks used places like Cayman as a "tax efficient center to book loans via Eurodollars (Euroloans), often to third world countries" (Roberts, 1995). Some assessments assert that up to 50 percent of Latin American debt is still "residing in the tax havens" (Ronen and Abbott, 1996), a statistic that is important in analyzing the US approach towards finance centers like the Cayman Islands. Anthony Ginsberg explains how banks began to find a presence in the Caymans useful during this period:

The driving force behind attracting so many of the world's major banks is the growing need to exploit every tax and technical opportunity available to maintain or boost profitability in a highly competitive industry. For this reason many banks use a Cayman Islands branch to supplement the operations of their New York branch and international banking facility. By booking certain business in the Cayman Islands, they gain exemption from taxes, which allows them to accumulate tax-free income and to time the repatriation of profits for maximum benefit rather than to avoid taxation altogether. In addition, banks are free from reserve requirements and other regulatory restraints, which reduces their overall cost of funds. These results can be achieved without any physical presence of costly overheads in the Cayman Islands [Ginsberg, 1991].

More recent growth of the Caribbean financial community in the 1980's is also related to US policy, but in this case, an embracing of offshore finance rather than a condemnation was the impetus. The US adopted an "if you can't beat them, join them in approach," in the 1980s driven largely by the New York financial communities desire to establish itself as an international banking facility (Ronen and Abbott, 1996). Similar responses prompted transnational banking in Tokyo and Singapore. However, even as these metropolitan centers commenced competing in the realms of international banking, financial institutions still found themselves in need of satellite locations that could facilitate certain transactions that were difficult or expensive at home. Offshore centers can therefore be seen as a cluster of no-tax or low-tax jurisdictions surrounding the centers of world trade. Mark Hampton describes New York's impact on the offshore community:

London's preeminence as the world's leading finance center was gradually diminished as finance activities in New York and Tokyo grew in size. These three cities now consist of what Hamilton (1986) dubbed the "three-legged stool" of world finance (p. 111) at the top of a global hierarchy of finance centers. Each of these primary centers has a network of satellite OFCS servicing the catchment area. When deposits are attracted to an OFC they are then passed through

to the deeper capital markets in the big three global finance centers. Johns (1983) describes this OFC role as being a “turntable” for funds (p. 225). Examples of this include the (Channel Islands) which serve London, and the Caribbean OFCs which serve New York.

The advent of the Euromarkets and New York’s ascendance as a financial center, while integral to Caribbean OFC expansion, were actually part of the much more complex process of globalization, which truly lies at the heart of phenomenal growth of the Cayman Islands and other offshore communities. Globalization of finance occurred when investors, entrepreneurs and businessmen throughout the world began utilizing advances in telecommunications to seek out jurisdictions that were the most conducive for maximizing profits. Johns explains the theory underlying this trend:

Like water finding its own level, entrepreneurial business, when constrained in one place, will emerge in another. When restrictions in one place become too costly, too discouraging, and perhaps too punitive, the businessman will look elsewhere... As one door closes another is opened [Johns, 1983].

Improved technology provided entrepreneurs with the ability to utilize foreign jurisdictions for certain segments of their operations and allowed the tax havens to play a crucial role in ‘global financial deregulation’ (Palan and Abbott, 1996), changing the very nature of capitalism. Susan Roberts explains:

The 1970s and 1980s saw a massive reorganization and growth in the international financial system. The development of entirely new markets — fueled by deregulation and technological advances — was a rapid and enormously complex process. Marxian and non-Marxian analysts agree that these financial innovations enabled capital to be much more flexible [Roberts, 1995].

With this increased mobility of capital, many multinational companies have found it beneficial to minimize their links to any one country (OECD, 1998b). Such companies will employ the servi-

ces of a number of different nations in which to conduct their various capitalistic operations, seeking out the most profitable environment in each case.

For example, a Cayman company may be set up by a multinational firm as a leasing or rental company, leasing or renting equipment to foreign affiliates. The lease or rent payments are thus amassed in the Cayman company, reinvested tax-free, and may be repatriated at a convenient time [Roberts, 1995].

Thus, micro states like the Cayman Islands have realized that in the face of economic globalization, their "best resource for development is their jurisdiction" (Hudson, 1998). With so little investment required, capitalizing on self-government in the hopes of implementing an offshore industry is "one of the most popular state strategies in the modern global political economy" (Palan and Abbott, 1996). OFCs, more than just a response to financial globalization, have also facilitated the transnational evolution capital.

The tax havens have become nothing less than the cornerstone for the process of globalization and in many respects have acted as catalysts for the expansion of financial service activities...(they) provide the grease, smoothing the transformation of the world economy from national to global [Palan and Abbott, 1996].

Unfortunately for the OFCs, the process of economic globalization has not always been compatible with political globalization. Governmental agencies responsible for enacting regulations are of course inclined to stand in opposition to jurisdictions that allow individuals and corporate entities to elude their regulatory authority. Johns cites 13 different areas of legislative inequities that can produce friction between different nations (Johns, 1983). Among these are taxation, banking laws, foreign exchange regulation, company laws, and regulations governing the buying and selling of stocks and commodities. From the policy makers' standpoint, centers such as the Cayman Islands represent a regulatory void and undermine their efforts to regulate financial activity. Alan Hudson explains this view:

In the case of economic globalization, commodity flows cross borders while rules do not; this is a landscape characterized by tendencies towards competitive deregulation and regulatory underprovision [Hudson, 1998].

In the case of the Cayman Islands, this has pitted the island's financial community against the governmental juggernaut of the United States of America, which has historically demonstrated the ability to extend authority beyond its borders, especially with regards to the Caribbean. Cayman's ability to court the favor of the region's hegemonic power while continuing to prosper as an OFC is exceptional. An understanding of this feat must include a discussion of the historical background that in many ways shaped the Cayman Islands as the natural leader in Caribbean Offshore finance.

THE MAKING OF AN OFC

Historical writing on the Cayman Islands is scarce and generally lacking in depth. Though the government has made an attempt to preserve the country's past through the establishment of a national trust and national archives, its efforts have been primarily geared towards recording significant names and dates as well as retaining important photographs and artifacts. Ulf Hannerz offers perhaps the most complete analysis of Cayman's social and political experience in his 1974 work, *Caymanian Politics* (Hannerz, 1974). His accounts of Caymanian history illustrate the foundations for the peculiar social structure of the islands that eventually provided some of the key ingredients for success in the offshore finance industry. While characterizations of the Caribbean's social make-up are usually based on the effects of plantation society (Mintz, 1966), the Cayman Islands are part of small subset of Caribbean nations with a distinctive set of similarities. Hannerz defines this categorization.

Here, however, we will be concerned with another Caribbean. It has intimate links to Plantation America and shares much of its

traditions, but it has no large plantations and is oriented instead toward the sea. Scattered islands in the eastern Caribbean could be considered part of it, and in the past, the Bahamas and Bermuda further to the north shared several of its characteristics. In the western Caribbean, it may be seen in a historical network of English-speaking societies, constructed between the seventeenth and the nineteenth centuries, with economies which have involved piracy, wrecking, fishing, turtling, seamanship, log cutting, smuggling and small-scale agriculture in mixes which have varied over time and between different territories. In this network the Cayman Islands form one link [Hannerz, 1974].

In examining the particular case of the Cayman Islands, I will focus on four historical legacies of the territory and their significance to the nation's success as an OFC: political stability, industry based on transnational relations, close relations with the United States and opportunistic merchant class leaders.

1. POLITICAL STABILITY

No other factor is more likely to drive investors from a region than political instability. With its primary purpose as protecting assets, even the slightest hint of social or political disturbances that might threaten the security of foreign capital, can prove detrimental to a tax haven or OFC. History has proven the potential of social upheaval in the Caribbean to separate American Investors from their assets permanently. Haiti, in the nineteenth century, and Cuba more recently, are the embodiments of this imperial nightmare. The conditions that foster instability, stark racial divisions and inequities as well as persistent class struggles, are largely absent in the Cayman Islands.

The CIA factbook breaks down Cayman's racial demographics as follows: mixed 40%, white 20%, black 20% and various other ethnic group 20% (CIA, 2000). Because the Caymans never offered the potential for large scale capitalistic endeavors, such as sugar plantations, there was almost no early settlement by wealthy aristocratic capitalists or the related importation of slaves

(Hannerz, 1974). In fact, there was very little settlement in the Cayman Islands before the twentieth century and those individuals who did attempt to carve out a living in the isolated islands were mainly adventurous men looking for opportunity, not unlike the American pioneers of the West in the 1800s. The small population and small number of women made the maintenance of a purebred group of whites difficult.

The result, instead of a racial pyramid with a narrow white apex and a broad black base, as in the typical plantation society, has been roughly a diamond-shaped racial distribution, broadest-in-the-middle, colored category. Perhaps this in itself leads to a decrease in the importance of the boundary between the colored majority and the small black minority [Hannerz, 1974].

In addition to creating a racially heterogeneous society, the nature of the early settlement of the Cayman Islands also built a community with much less class division than nations with a more plantation-influenced society. The social construction of Cayman must surely have impressed early investors with the likelihood of continued stability in the islands.

Yet the Caymanian social hierarchy became more compressed than that of a wealthy plantation society. The islands have never afforded a leisure class of land owners, to a great extent absentee and oriented toward a comfortable life in a European metropolis... And many whites have been of sufficiently modest means to make their style of life little different from that of the former slaves and their descendants [Hannerz, 1974].

Although slavery did exist in the Cayman Islands, its proportions were much less significant than in countries like Jamaica. Furthermore, land was so readily available that slave owners were unable to retain any domination of former slaves after abolition, as the latter, they were able to establish their own homesteads in the eastern and western ends of the island (Hannerz, 1974).

Current promotional materials issued by the Cayman government with the aim of attracting investors continue to highlight the islands "stable political environment" (Roberts, 1995).

2. HISTORY OF TRANSNATIONAL INDUSTRY

The absence of plantations in the Caymans not only affected the social and racial composition of the islands, but also created an unusual approach to gainful opportunity among the local population. The land's inability to support agriculture meant that economic survival depended on direct transactions with foreign entities. The Cayman government has made no attempt to disguise their island's inherent shortcomings.

From the earliest accounts of habitation of the islands in the 17th century to the mid 1960's when development started in earnest, there was nothing in the way of natural resources or large enough tracts of arable farming land to develop any sustainable livelihood for the people who lived there [Monetary Authority, 2001c].

The early settlers on the island were therefore forced to take advantage of their strategic location, which made them a valuable stopping point for merchant ships plying the Western Caribbean. The resulting history of piracy and wrecking, the practice of removing crew and supplies from stricken vessels in exchange for one half of the cargo, illustrates the Cayman traditions that were later invoked by the financial community (Hannerz, 1974). Piracy and wrecking, which occasionally involved deliberate contributions to the demise of the vessel in question by the Caymanian wreckers themselves, illustrate a local realization of the economic opportunity presented by the island's want of imperial presence and supervision. Wrecking, in particular, taught the early settlers that, in an environment with such little imperial regulation, they could profit from cooperative efforts and even dictate the terms for such transactions. Hope Waddell, a Presbyterian missionary on board a schooner that ran aground off the East End of Grand Cayman in 1845 recorded his impressions of the locals who arrived to 'assist the ship':

A fleet of canoes was making for us, and soon surrounded our helpless craft; when a host of wild, ruthless-looking colored men sprang up the sides, like pirates or boarders greedy for prey. The head man, advancing to the captain, with one word of pity and two of business, agreed to take everything ashore, on the usual terms of a half for their trouble [Hannerz, 1974].

Although dealings with maritime visitation to the island gradually evolved into supplying materials and labor to the shipping industry, the early Cayman economy was based on exploiting the islands' usefulness to a diverse group of seaman from abroad.

3. EARLY UNDERSTANDING OF IMPORTANCE OF US RELATIONS

There is little doubt on the part of anyone with knowledge of the Cayman economy of the crucial role of the United States in providing the capital responsible for the island's prosperity. The tourism industry in Cayman is overwhelmingly reliant on American visitors whose per capita expenditures in the islands in 1990 were \$11,945 USD (Sutton and Payne, 1994). With the tremendous expansion of hotels and cruise ship stopovers in the last decade, one can only assume a dramatic rise in that figure. Although the banking and finance industry operates in the international arena, American capital also underlies this second tier of the Cayman economy, which as earlier discussed, exists in many ways as a subsidiary of the New York financial community. A description of the Cayman Islands on a current website makes the following assertion:

Despite close historic and political links to the United Kingdom and Jamaica, geography and the rise of tourism and international finance in the Cayman Islands economy has made the US its most important foreign economic partner [virtualsources.com, 2001].

The statements of American banker John Matheweson during his 1999 sentencing for crimes related to assisting hundreds

of Americans in tax evasion while working for a Cayman based bank, reveal the significance of US money to offshore finance in the Caymans. Mathewson asserted that up to 98 percent of deposits in Cayman banks come from American investors and went on to say, "The truth is that without the US client, there wouldn't be a banking industry in the Cayman Islands" (Allen, 1999).

The people of the Cayman Islands, however, recognized the significance of the United States in their financial well being long before the advent of international finance. Cayman's strategic location on Caribbean sailing routes provided means for the population to provide for themselves in the 1700s. However, by the late 1800s, steamships had drastically reduced the number of ships making stops in the territory. Hence a tradition began that would persist through most of the century, creating a society that encouraged the men of the islands to travel abroad in search of employment, while the local economy became largely dependent on the remittances these men sent home to their families.

In the nineteenth century, the Cayman Islanders thus became the argonauts of the Western Caribbean. They went to the Central American cays to catch turtles and to the Bay Islands in search of new land. Later, they came to the Gulf ports to get work on American ships, to Florida to build a rail road, to deserted American shores to unload bootleg liquor, and to Panama to work for the American Military [Hannerz, 1974].

Thus, Cayman's ties to America were strong.

There were business links, there were kinsmen with whom one kept in touch and there was the belief that the United States was the real land of opportunity to Caymanians [Hannerz, 1974].

So it was the United States that offered Caymanians opportunity in the twentieth century and Caymanians came to understand that their reputation as highly competent seamen and hard workers could earn them a privileged status with US governmen-

tal agencies. The Cayman people demonstrated a clear understanding of the importance of this standing in their reluctance to join Jamaica in its bid for independence in 1962. John Connell's narrative explains the link.

Of all the six dependent territories the most opposed to any movement towards independence is certainly the Cayman Islands. As in Anguilla, there has been an economic element in this stance. Three decades ago, when Jamaica gained independence, the Cayman Islands opted to remain a dependent territory, fearing that independence might prevent special United States visa privileges that enabled Caymanian sailors to work on American ships and elsewhere in the USA [Connell, 1999].

The allegiance of Caymanians to America, along with their propensity to rally behind US causes surely stems in large part from knowing where 'their bread is buttered.' The islands' widespread adoption of America's anti-Castro sentiment in the 1960's gives testament to this attitude. Hannerz depicts events in 1963 surrounding the landing of Cuban passenger plane during the height of the Cuban scare:

As the issue was being debated at the Administrator's office, however, a carload of policemen arrived. They reported that they had lost control of the airport, which had been taken over by a large number of Caymanians. The Cuban plane had been encircled by people, some armed with sticks and iron rods, others unarmed, including school children who had been let out of their classes. One transport owner, who was also a member of the Legislative Assembly, had efficiently brought people to the airport, where Roy McTaggart also arrived and took charge, instructing the people through a bullhorn [Hannerz, 1974].

In the end the crowd forced all of the Cuban passengers to reboard the plane which then returned to Havana and would be the last flight from Cuba to land in Grand Cayman that year. US officials must have been impressed with the grass roots loyalty and vigilance of the Cayman people in defending American interests.

4. TRADITION OF MERCHANT CLASS POLITICAL LEADERSHIP

As earlier discussed, the early population of the Cayman Islands was characterized by an elite class of a merchant nature.

The Cayman elite has been bourgeois rather than aristocratic. Its economic margins have never been large enough to allow it to stop looking for new angles [Hannerz, 1974].

Hannerz elaborates on the fundamental social distinction between Cayman and many Caribbean islands:

Whites of limited incomes, and whites imbued with an entrepreneurial spirit, may be found in (plantation based islands) as well. But they do not form the white group as they do in the Caymanian society.

The influence of this elite class was increased by the lack of British authority in the Caymans, creating a social order that "was not so much a colonial order descending on the territory from above, but one which powerful men of the islands created themselves (Hannerz, 1974)."

Not only did this merchant class comprise the upper social echelon in Cayman, but faced with a governmental vacuum created by British disinterest in the territory, these men of comparative wealth, also formed the political leadership of the island. The British government did not even bother to clarify Cayman's status as a dependency of Jamaica until 1863, and even then, took several decades before they assigned any colonial servants to the island (Hannerz, 1974). With no trained legal professionals in the islands, it was the leading merchants who assumed the position of Justices of the Peace. These positions eventually evolved, for many, to a place in Caymans primary governing body, the Legislative Assembly.

In that form of Legislative Assembly, which continued until 1959 and was known as the Justices and Vestry, the competition for seats was usually limited. Many of the merchants were automatically

assured of membership by virtue of being JPs who did not have to stand for election [Hannerz, 1974].

Cayman governmental and public policy has thus always been oriented towards the needs of business and trade. The impact of this tradition on the nation's ability to compete as an off-shore center can not be underestimated.

The existence of an elite coalition of public and private interests has been crucial to the competitiveness of the Caymans. There are strong links between leading figures in law, accountancy, banking, and insurance and the state (elected officials and civil servants). This allows the state to respond to information from those directly engaged in the financial sector concerning how the Island might improve their position as circumstances change (particularly as regulations in competitive centers are altered) [Roberts, 1995].

The capitalist tendencies Cayman's legislators who even by the admission of the British Government, "have a large measure of self government," and retain control of the regulation of financial services (Foreign and Commonwealth Office, 1999b), played a major role in the nation's cultivation of the banking and finance industry.

The history of the Cayman Islands allowed them to write their own laws to their advantage. They took the opportunity to produce modern company and trust legislation tailor-made for international purposes [Ginsberg, 1991].

The Cayman Islands Monetary Authority is currently the singular most important organization in regulating financial activities on the island, and the consistency of its members, almost all with past and current links to private financial institutions, testifies to a continuation of tradition (Monetary Authority, 2001d). The remainder of this paper will focus on how these individuals have steered the course of government policy to facilitate Cayman's unparalleled success. For, in truth, the difficult task lies not in establishing a tax haven or OFC, but rather in the careful

implementation of initiatives that respond to the numerous forces in the global economy. This challenge is outlined in a 1998 United Nations report (United Nations, 1998).

The balancing act at the international level is to impose safeguards against and obstacles to illegal activities without at the same time constraining or obstructing legal transactions. So long as there are difficulties in distinguishing between the licit and the illicit, there are real tradeoffs between an approach that over-regulates and one that under-regulates. The balancing act for the offshore financial centers themselves is to attract customers through the provision of banking confidentiality and other kinds of legitimate services that protect money without also acquiring a reputation for "dirty banking" [United Nations, 1998].

A NATION COMMITTED TO SUCCESS

The Cayman islands were in dire need of new revenue sources by the 1960s as the demand for merchant seaman had dwindled, depriving the population of its primary source of income. Continuing the longstanding tradition of capitalizing on the island's geographic vantage point, the local élites embarked on a plan to bring foreign money into the island.

In the 1960s faced with this situation, Caymanian business leaders and politicians embarked on a deliberate strategy to develop the islands' economy based dually on tourism and by augmenting the haven role, offshore finance... (Hence) The 1960s were a time of laying the political and legislative foundations for an offshore financial sector [Roberts, 1995].

Beginning in the 1950s and intensifying in the 1960s and 70s, the leadership of Cayman collaborated on numerous developments that set the stage for Cayman's entrance into the world of offshore finance. The Cayman Islands Monetary Authority proudly lists the achievements that lay the ground work for Cayman's rise to the premiere Caribbean OFC (Monetary Authority, 2001).

- 1952 - Two hotels are completed, bringing the island's total to three. This humble beginning of what would eventually become one of the largest concentrations of luxury hotels in the Caribbean provided a vital link to the development of tourism and finance.
- 1952 - Owen Roberts airport opens and provides the island a direct link with the United States. The availability of direct flights to the Cayman Islands, which now receives over 70 direct weekly flights from Miami, as well as numerous others from a number of US cities (Monetary Authority, 2001c), has been an essential ingredient in the island's growth.
- 1953 - Barclays opens a branch in Georgetown establishing the first commercial bank in the islands.
- 1960 - The Cayman Government institutes the Companies Registry function under the Companies Law. This piece of legislation represents one of the island's first steps in becoming an offshore finance center and confirms Susan Roberts assertion that, "the Cayman Islands... began as an offshore center focused on offshore company and trusts. Offshore banking soon developed, however" (Roberts, 1995).
- 1963-1964 - Royal Bank of Canada and Canadian Imperial Bank of Commerce open branches in Grand Cayman.
- 1965 - The Cayman government awards the islands telecommunications contract to Cable and Wireless which had provided Grand Cayman with modern telephone service, connected with the rest of the world, by 1967. The telecom giant has continued to keep the island up to date with communications and, "through product development and continued investment, contributed to the development of the islands" (Monetary Authority, 2001c).
- 1966 - The Banks and Trust Companies Law is enacted, setting the wheels in motion for foreign investment. Also that year, the government recognizes the need to control the island's mosquito population and creates a department dedicated to this goal.
- 1971 - Cayman passes the currency law, which allows them to introduce their own monetary unit, backed by foreign

reserves. The decision to fix the Cayman currency to the US dollar shows an early understanding of the financial center's link to the American economy.

- 1979 - The financial sector begins the process of diversification with the Insurance law. Within ten years the Caymans would host the world's second largest captive insurance center (Sutton and Payne, 1994).
- 1992 - Cayman's financial regulatory agencies are merged into the Financial Services Supervision Department.
- 1993 - The financial sector further diversifies, reacting to modern investment trends, with the Mutual Fund Law. This law expanded the services that Cayman could offer and represents a continued effort to "attract institutional and sophisticated high net worth investors" (Palan and Abbott, 1996).
- 1996 - The Currency board and the Financial Services Supervision Department merge into the Cayman Islands Monetary Authority, which is designed to handle the increasingly complex demands of regulating Cayman's financial activities.

THE UNITED STATES GOVERNMENT POSES A CHALLENGE TO THE OFC

Though the American banking community may have been the primary contributor to the growth of Caymans offshore industry in the 1970s and 1980s, the US government proved to be its most powerful adversary. Alan Hudson offers some insight into two incidents that would define the strategy of American regulators in dealing with Caribbean tax havens like the Cayman Islands (Hudson, 1998). These events also served to educate Cayman's leadership on the influence and tactics of American policymakers and the impact that these organizations could have on the island's financial industry.

As Castro's revolution closed the multitude of casinos and other institutions utilized for obscuring criminally produced funds, the tax havens of the Bahamas, and to a lesser degree, the Cayman Islands provided a natural refuge for transactions that could

not take place within the jurisdiction of American lawmakers (Block, 1991). As a result, US government officials, particularly those involved in regulating monetary activity, came to view these islands as accessories to financial crime.

The USA, particularly the Treasury and Justice Departments, has long been opposed to the development of the Bahamas and Cayman OFCS. The OFCS have allowed dollar banking to take place beyond the regulatory reach of the USA with adverse consequences for the country [Hudson, 1998].

The Bahamian and Cayman branches of Castle Bank were the primary targets of the investigation launched by the IRS dubbed 'Operation Tradewinds', which was initiated in 1965 and continued into the 1970s (Block, 1991). Initially, the probe into Castle Bank centered on the Bahamas operation which, "was involved in a complex web of financial transactions, laundering money from the Mafia, hiding funds from the IRS, and counted clients such as the eccentric billionaire Howard Hughes, the casino operator Meyer Lansky, the Colombian drug baron Robert Vesco, the Bahamas' Prime Minister Lynden Pindling, the CIA, and possibly Richard Nixon (Hudson, 1998)." US authorities found an opportunity to penetrate the organization however, through the Cayman branch of Castle Bank and set a precedent with their actions against it in 1976.

Bahamian independence prompted Castle Bank executives to prepare for a rapid transfer of operations to the Cayman Branch, which included providing it with duplicates of all documents from the Bahamas. IRS investigators felt that this move presented an opportunity to penetrate the bank, and in January of 1976, Tony Field, manager of the Cayman branch, was subpoenaed at Miami International airport while awaiting for a flight to Cayman. Field faced prosecution in the United States that threatened his continued rights to enter the country without fear of imprisonment. US lawmakers were less than sympathetic to his dilemma that providing American officials with confidential information would constitute a violation of Cayman Secrecy laws and could result in prosecution against him there (Hudson, 1998).

We regret that our decision requires Mr. Field to violate the legal commands of the Cayman Islands, his country of residence. In a world where commercial transactions are international in scope, conflicts are inevitable... This court simply cannot acquiesce in the proposition that US criminal investigations must be thwarted whenever there is conflict with the interest of other states.¹

Although Cayman authorities agreed to allow Fields to testify, the Island's financial community reacted to the situation by enacting the Confidential Relationships (Preservation) Law, in 1976, designed to make their existing secrecy laws even stricter. American officials viewed this move as provocative, and the Cayman financial community would soon realize the counterproductive results of attempting to exert their own authority against the United States government.

If the Castle bank case hadn't taught Cayman Islands the perils of being uncooperative in US criminal investigations, events surrounding a probe into the Bahamas and Cayman Branch of the Bank of Nova Scotia in 1982 would have left little doubt in the minds of Cayman bankers that their industry was far too closely linked to the United States to allow them to make an enemy of the region's hegemonic power.

When the Georgetown and Nassau branches of the Bank of Nova Scotia refused to provide the US Justice and Treasury documentation pertaining to a tax fraud and narcotics case, the agencies leveraged fines against the bank's Miami branch that eventually reached a total of \$100,000.00 dollars per day. "In effect, the Miami agency was held to ransom" (Hudson, 1998). A British Banker in Cayman summed up the reality faced by the island financiers following their second failed attempt to oppose American authority:

I think it exposed the Confidential Relationships Law for the weak weapon that it was. I mean it's all very well for you to sit here and say 'it's a criminal offence in the Cayman Islands so I can't tell you', but the US courts just rode roughshod over the whole of that and

¹ US vs. *Field*, US Court of Appeal, Congressional Record, 25 June 1976.

said 'OK, if you don't want to tell us you will pay a fine.' The fine was something phenomenal, nobody's balance sheet can stand that for long, and therefore, what happens? The bank says 'to hell with it. If we have to leave the Cayman Islands, it's cheaper.' And it was within the power of the courts to make that order. So I think it made a lot of people re-examine what they were doing, why they were actually fighting these requests for information, you know, is it economically sensible? You're taking on Uncle Sam who has a hell of a lot of muscle. You either pull yourself away from him altogether or recognize that you're going to have to run your business in a way that's not going to expose you to this sort of activity.²

In addition to comprehending the scope of US power over their financial community, Cayman leaders were seeing the effect of American policymakers' animosity on the island's reputation. A senate report issued in 1983 entitled 'Crime and Secrecy: The Use of Offshore Banks' identified the Cayman Islands as one of the worst jurisdictions for illegal financial activity.

From the standpoint of criminal uses, the Cayman Islands represent a critically important jurisdiction. Many Department of Justice officials consider it the primary haven for US criminals moving money offshore... Whatever the status of current negotiations, and there has been a series of meetings, some quite recent, US officials consider the Caymanians fundamentally uncooperative [Committee on Governmental Affairs-Congress Senate, 1983].

US officials probably did not anticipate the rapid turnaround that the Caymans would make with cooperative efforts. While they may not have understood the driving force underlying the actions of Cayman's merchant based leaders, they did recognize the influence of the territories locally elected leaders, described in the report as "the all-important Executive Council, which decides on information requests" (Committee on Governmental Affairs-Congress Senate, 1983).

² Wood — research interview, Cayman, 1994, cit. in Hudson, 1998.

Members of this Executive Council, committed to the financial industry's prosperity, no doubt had a close eye on the Swiss who, in the early 1980s, agreed to increase cooperation with the US lawmakers in the wake of numerous scandals including the laundering of Philippine government money by ruler Ferdinand Marcos (Palan and Abbott, 1996). Instead of crumbling however, the Swiss banking industry continued to flourish, revealing to calculating Caymanians that, "indeed the secret of a successful tax haven is discretion (Palan and Abbott, 1996.)". In other words, the financial community was beginning to become aware of the benefits of cooperation with the United States, which beyond preventing punitive action and negative press, could contribute to attracting "high net worth individuals with money not only to invest but also to spend" (Palan and Abbott, 1996).

THE DAWNING OF A NEW ERA

Although the language in the 1983 Senate Report was pessimistic with regards to Cayman's potential to improve its status as a money laundering center, the negotiations mentioned in the report led to a landmark event for US relations with Caribbean tax havens. The Mutual Legal Assistance Treaty (MLAT) was signed by the United States, Great Britain and the Cayman Islands in 1986. This piece of legislation served as a model for what would eventually be adopted by the other Caribbean OFCS (Sutton and Payne, 1994). Ronald Reagan's letter of submittal, introducing the treaty, describes its significance as follows:

The treaty covers mutual legal assistance in criminal matters. In recent years, similar bilateral treaties have been concluded and entered into with Italy, the Netherlands, Switzerland and Turkey, and have been signed with Canada, Columbia, Morocco and Thailand... This particular treaty represents a major breakthrough in United States' efforts to enlist the cooperation of Caribbean "bank secrecy" jurisdictions in the investigation and prosecution of transborder crime [Committee on Foreign Relations-Congress Senate, 1987].

The Mutual Legal Assistance Treaty was the beginning of a new era in Cayman's relations with international regulatory authorities and United States. Though the Cayman Islands would continue to face scrutiny for their role in contributing to financial crime and tax evasion, they had learned the value of becoming a regional leader in regulatory legislation and cooperative efforts. Within less than a decade the financial community was able to elevate its status from that of the most harmful offender to what Anthony Maingot describes in 1994 as, "the most one can hope for in terms of regulation at this point" (Maingot, 1994).

The MLAT was the beginning of an ongoing effort to enact legislation that would maintain favorable status with US officials. The Cayman approach centered on the premise that the key to a successful banking industry was not necessarily eradicating all practices frowned on by the United States, but rather in having a system that was viewed as preferable to that of its competitors, and by realizing what measures would eventually be forced on all the OFCs, and then being the first to enact such policies. The 1998 US State Department's International Narcotics Strategy Report illustrates the desired effects of these efforts (Monetary Authority, 2000).

The Cayman Islands remain diligent in its anti-money laundering efforts... The (island's) Proceeds of Criminal Conduct Law which criminalized money laundering for all crimes was considered a monumental step when it was enacted in 1996 [Department of Treasury, General Accounting Office, 1998].

In 1998 the United States General Accounting Office listed the failure of almost all tax havens to allow US regulators to conduct on-site inspections as one of the major obstacles in the prevention of money laundering. The jurisdictions reviewed in the report included the Caymans, the Bahamas and Panama, none of whom permitted such inspections (Department of Treasury, General Accounting Office, 1998). A report released the following year also examined the banking practices of these jurisdictions, but was broadened to include the Caribbean tax havens of Anguilla, Antigua, Barbados, Monsterrat, the Netherland

Antilles, St. Vincent and Turks and Caicos. While the Bahamas, Panama, and the seven other Caribbean financial centers were once again cited for non-compliance with on-site inspections, the Cayman Islands were noted as being the only Caribbean tax haven to permit US regulators entrance to their financial institutions (Department of Treasury, General Accounting Office, 1999).

The same 1999 report also cited shell corporations, also known as paper companies, as primary vehicles of financial crime and a top priority for American government officials. The 2001 'Levin Report', presented to the Senate, focused on problems posed by banks falling into this category and asserted that they facilitate money laundering by functioning as correspondents to major US banks (Office of Carl Levin-Congress Senate, 2001). Not surprisingly, the Cayman Islands have recently introduced legislation to eliminate so called brass plate banks. The Cayman Islands Monetary Authority issued a press release on this measure titled "Jurisdiction first to tackle so-called 'Shell Banks'", which contends that the "new policy requires all private banks to establish a properly staffed principle office in the Cayman Islands where it will maintain its books and records" (Monetary Authority, 2001).

Even British officials, supposedly entrusted to oversee Cayman governmental action, often appear as bystanders while Cayman policymakers negotiate directly with United States government agencies. The 1999 British commissioned 'Review of the Financial Regulation in the Caribbean Overseas Territories', suggests that UK representatives were informed of US-Cayman mediations after the fact.

We understand that the Cayman Islands Government and the (US Dept. of Justice) had commenced negotiating an extension to the treaty that would enable the Cayman Islands, through the Chief Justice, to provide information on relevant securities matters to the SEC (through the DOJ) even where the SEC is acting in a civil or administrative role [Foreign and Commonwealth Office, 1999b].

The most striking example of Cayman's determination to preserve its reputation is the recent commitment given to the

Paris based Organization for Economic Development and Cooperation (OECD), to provide information in investigations involving tax evasion, noted in the British report mentioned above.

Furthermore it is understood that the Cayman Islands have given a commitment to the OECD to address criminal tax matters by exchanged information effective for the first tax year after Dec. 2003 [Foreign and Commonwealth Office, 1999b].

Although the OECD is an international organization, Cayman authorities are acutely aware that this organization and its offspring the Financial Action Task Force (FATF) are vehicles for American regulators attempting to create a multilateral appearance. The US 'National Money Laundering Strategy for 2000', hints at the possible consequences of failing to cooperate with international organizations like the OECD.

Once financial crime havens have been identified, appropriate countermeasures must be implemented. In this regard, the United States prefers to take multilateral action in support of multilateral determinations, though we reserve the right to act unilaterally when necessary to protect our financial system or other national interests [Department of Treasury/Department of Justice, 2000].

Furthermore, much of the strategy outlined in the report, which includes, "apply increasing pressure on jurisdictions where lax tax controls invite money laundering," is directly based on findings of the OECD and FATF.

While the refusal to recognize tax evasion as a crime and the concurrent reluctance to assist in related investigations has long stood at the core of the tax haven model, Cayman leadership recognized the determination of US authorities to initiate reform within the OFCs, and seized yet another opportunity to prove their superiority to their Caribbean competitors. *The Wall Street Journal* describes the Cayman strategy:

The concession ensures that the tiny Caribbean territory will avoid being named in a "blacklist" of tax havens that the Paris-based

Organization for Economic Cooperation and Development plans to release next week... For the Caymans and the other five (non-Caribbean) jurisdictions, the agreements amounted to a calculated bet that staying on the good side of the developed countries will be a marketing plus and that competitors will not have a chance to siphon off too much business before they too, are forced to yield... [Allen, 2000b].

The same article illustrates the effectiveness of Cayman's decision with a quote from the US Treasury Secretary who asserts that the commitments "represent an important milestone in the effort to ensure that the global mobility of capital does not subvert national interests." Once again, the Caymans managed to distinguish themselves as leaders in financial regulation, an image they enhanced by offering assistance to financial centers with less advanced policy structures.

The approach of the Cayman Islands is to participate fully and constructively in the international process of establishing new international law and norms in regard to tax related economic competition. The Cayman Islands encourages all jurisdictions to participate in this process and would be pleased to engage in dialogue with any jurisdiction in this regard. The Cayman Islands commitment to the OECD is part of our involvement in the process. The terms of our commitment to the OECD is a matter of public record and we would be happy to share the full text of this commitment with any of the delegations gathered here [Monetary Authority, 2001].

Imbedded in the Cayman ideology of cooperation is the belief that the long-term growth of their financial industry lies not with individuals seeking to hide money from government authorities, but rather with major banks and institutions that utilize offshore jurisdictions for certain segments of their operations. The Financial Times reports in 1997 that "Business in the (Cayman) offshore center is increasingly dominated by mutual funds, eurobonds issues and other types of non-personal banking" (Luce, 1997). This sentiment was articulated by Cayman

government minister Truman Bodden, who in the wake of the decision to comply with *OECD* initiatives on tax matters, asserted that 85% percent of Cayman banking comes from firms and banks conducting “institutional business”, and added “I am certain this is not going to materially affect us” (Allen, 2000). Reports describing a 1999 Russian money laundering scandal involving the Bank of New York that briefly mention the Cayman Islands branch as a depository used by the New York institution, support Mr. Bodden’s claim. The Senate’s recent focus on correspondent banking indicates an acknowledgement on the part of US authorities that the bulk of money flowing to the major *OFCS*, is channeled through American banks (Minority Staff, 2001).

Catering to established financial institutions requires maintaining an image not associated with illicit transactions or criminal activities. Favorable reviews in government reports and advisories become an essential component of successfully attracting investors at the institutional level. With a clear understanding of the weight of such publications, the chairman of the Cayman Islands Monetary Association directed his comments at *OECD* officials at a conference following the country’s advance commitment to cooperate on the tax issue.

Language is very powerful. The Book of Proverbs teaches that words can play a decisive role, whether for good or evil. They can be as destructive as sword thrusts or the means of healing... Temperate language is essential in the process we are now engaged in, if there is to be progress [Monetary Authority, 2001].

Cayman’s dedication to favorable relations with the US and other developed nations has yielded spectacular results in this regard. The rhetoric used in US and international reports, even when citing deficiencies in Cayman’s regulatory structure, consistently praises the territory’s efforts in combating financial crime and refers to the Cayman Islands with a unique appreciation. The Financial Crimes Enforcement Network (FinCEN), a division of the US Dept. of Treasury, issued a series of advisories on tax havens named in a blacklist published by the *FATF*. While Cayman was included on that list (and the FinCEN report discussed

several issues requiring attention by Cayman authorities), the language in the report is markedly different from the advisories on other named Caribbean Tax havens. The Caymans are treated like a friendly partner rather than a target for punitive action.

Senior Cayman Islands officials have indicated their intention to take a series of steps to address the deficiencies identified above. The United States Treasury welcomes this news and looks forward to a period of rapid improvement in the counter-money laundering regime in the Cayman Islands [Department of Treasury, FinCEN, 2000a].

The report also notes that the Cayman Island's "record of cooperation with criminal law enforcement authorities in the United States is excellent." Even the FATF blacklist, issued after "United States and European officials grew concerned that bank secrecy and weak regulation in some nations contributed to the devastating financial turmoil in Asia and Latin America in the late 1990s (Kahn, 2000)" (which identified the Caymans as one of a number jurisdictions with deficient regulation), distinguished the country's achievements in the release.

At the same time, the FATF notes that the Cayman Islands have been leaders in developing anti-money laundering programs throughout the Caribbean region. It has served as president of the CFATF, and it has provided substantial assistance to neighboring states in the region. It has demonstrated co-operation on criminal law enforcement matters and uncovered several serious cases of fraud and money laundering otherwise unknown to authorities in FATF member states. In addition, it has closed several financial institutions on that basis of concerns about money laundering [OECD-FATF, 2000a].

The inclusion of the Cayman Islands on the FATF blacklist in June 2000 however, was a blow to the island's financial community, and in the minds of Cayman officials, inconsistent with the OECD decision to list the Cayman Islands as a cooperative jurisdiction in their report issued the previous month. Furthermore, Caymanians felt the list betrayed the relationship they had forged

with the United States, clearly the most influential member of the FATF. A 1996 GAO report delineates the role of the FATF in US efforts to curb money laundering.

The United States is working with other countries through treaties and arrangements to establish global anti money-laundering policies, mainly through the Financial Action Task Force [Department of Treasury, General Accounting Office, 1996].

The Cayman government demonstrated their understanding of the US role in including them on the blacklist in their public response to the report, which accused the FATF of failing to closely examine the regulatory practices of the islands. Calling the FATF designation "astonishing and contradictory" the Cayman Islands Monetary Authority wrote:

Repeated requests that FATF conduct an on-site evaluation of Cayman's anti-money laundering system, including one sent on June 16th to Joseph Myers, Chairman of the FATF Review Group for the Americas, and a US Treasury Department Official were disregarded, as were requests to be given adequate time to respond to aspects of the FATF report (which was not agreed upon by the Cayman Islands) [Monetary Authority, 2000f].

Cayman's indignation did not however, prevent their government from recognizing the potential damage that remaining on the blacklist could do to their offshore industry. Such a designation undermines the reputation that has made them the preferred OFC of many of the world's top financial institutions.

The action does not punish the named countries or cut them from the world financial system. But it effectively warns banks and brokerage houses to scrutinize all financial transactions with customers in these countries as possibly linked to crime or high risk transactions [Kahn, 2000].

In effect, the FATF report increased the liability of firms choosing to do business in the Caymans, particularly those located in

the United States. The FinCEN advisory, issued shortly after the FATF report, informed companies doing business in the Caymans that they must consider insufficient regulation identified by the FATF in determining their requirement to file a "Suspicious Activity Report" (SAR) with the US government (Department of Treasury, FinCEN, 2000b).

Therefore the Cayman government wasted no time in taking action to procure its removal from the blacklist. Within four months of the FATF report the Caymans released a report on their progress titled, "All FATF anti-money laundering criteria met" (Monetary Authority, 2000).

We have worked diligently over the past few months to ensure that the regulations and laws of this jurisdiction meet or exceed both the 40 FATF recommendations and the 25 criteria adopted by the FATF on February 2000. We are in full compliance with these standards, and it was our hope that the FATF would report publicly on its review, and then take prompt actions to remove us from the list of 'non-cooperative' jurisdictions. We look forward to hearing about the 'de-listing' procedure and timetable from FATF... As one of the major international financial centers, we take our anti-money laundering regime very seriously. There is no reason to penalize the Cayman Islands by keeping us on a list of 'non-cooperative' countries when our recognized track record on anti-money laundering efforts, as well as the recent legislative actions to warrant this continued classification [McCarthy, 2001].³

The Cayman press release listed six new regulations and enhancements to existing laws enacted within three months of the FATF review. In February of 2001, the Cayman Islands Leader of Government Business, Kurt Tibbetts reported:

Last month, we had a useful meeting with the FATF Americas Review Group, and provided them with a legislative timetable to address a few remaining areas of concern to them. It is our belief

³ George McCarthy - Chair of CIMA.

that by March 2001, the regulations and laws of the Cayman Islands will meet (or in some areas exceed) both the 40 FATF recommendations and the 25 criteria adopted by the FATF in February of last year. We note the FATF President's statement that the FATF does not want to keep jurisdictions on the list 'any longer than necessary' and therefore hope to be removed from the list shortly thereafter [Monetary Authority, 2001b].

EMBRACING DEPENDENCY

It is ironic that in promoting an industry that relies on such close links with the United States, the Cayman Islands have found an advantage in maintaining their colonial ties with Great Britain. While some Caymanians may hold a certain amount of loyalty to the Crown, the islands' determination to remain a dependent territory stems from much more practical concerns.

There is little call for independence. Instead the European connection is seen as an advantage that can be successfully exploited to realize tangible benefits [Sutton and Payne, 1994].

The protective blanket of British Dependency enhances the Cayman Islands' image of political and social stability. The Cayman government is well aware that institutional investors often prefer to conduct offshore business in territories that are technically governed by a European power. The Bahamas provided the Caymans with a host of new clients and a clear example of the benefits of remaining a Crown colony (Palan and Abbott, 1996). After declaring independence, the former leader in Caribbean banking experienced a decline in their financial industry, slipping from the fourth largest center to the eleventh. Furthermore, the Bahamas have experienced almost no growth since the late 1980s. In a response to a United Nations initiative providing assistance to countries seeking independence, Berna Thompson, a member of the Legislative assembly, summarized the Caymanian commitment to preventing even the slightest hints of severing ties with England.

The UN has a responsibility to investigate whether colonies would want to become independent. At one time, this was a useful exercise, as there were some colonies, which were oppressed by the mother countries; but there are very few, if any, colonies which still fall into this category. In the case of Cayman we are fully committed to remaining a crown colony... Even the discussion of independence is out of the question... If the foreign press headline say, 'UN Commission returns from Cayman following negotiations for independence,' you can bet we'll see investors' money leaving the Cayman Islands immediately after. We can't allow them any room to suggest that independence can even be discussed [Connell, 1999].

Besides providing investors with the comfort of knowing that their money resides in the safe confines of the British Empire, Cayman's status as a dependent territory also provides a basis and legitimacy for much of their banking structure. The Bank Secrecy laws in the Cayman's, including the controversial Confidential Relations Preservation Law, are derived from similar British statutes (Foreign and Commonwealth Office, 1999b). In this sense, the Cayman's are unlikely to shoulder the blame for system that the US views as contributory to international crime. In effect, their relationship with the UK allows the Cayman government to respond to American criticism by saying "how can you criticize us for adopting our banking laws when we are just following the example set by our sovereign mother country."

Perhaps more importantly, Cayman's colonial status provides a shield from overt action or intervention on the part of the American government.

In other words, the European territories are to a significant degree off-limits in respect of the traditional unilateral exercise of US power in the Caribbean. The way forward is accordingly through consultation and cooperation to establish a common understanding of the importance of offshore development, leaving the implementation of policy to the respective powers and the local governments [Sutton and Payne, 1994].

So while Cayman continues to skillfully negotiate numerous agreements with the US, the OECD and FATF, the ultimate responsi-

bility of determining the soundness of Cayman's OFC, lies in the hands of the British Government. The United States, therefore, has continued a practice established during the Second World War, of exercising its political influence in prompting Britain to govern her Overseas Territories in a manner consistent with American interests (Johnson, 1984). The Review of the Relationship between the United Kingdom and the Dependent Territories, otherwise known as the White Paper, completed by the British Government in March 1999, was in part, a response to US and international pressure for the UK to be more proactive in regulating the financial practices of her colonies (Sutton and Payne, 1994). Foreign Secretary Robin Cook, in introducing the review to Parliament, acknowledged that one of its primary objectives was to "ensure the United Kingdom could discharge its international responsibilities in respect to those Territories" (Foreign and Commonwealth Office, 1999a). The review itself summarized Britain's efforts at fulfilling this obligation:

We will therefore be requiring all Overseas Territories by the end of this year, to meet in full international standards on money laundering, transparency, cooperation with law enforcement authorities, and independent financial regulation [Foreign and Commonwealth Office, 1999a].

While the language of the White Paper may have seemed ominous to the Cayman financial community, the extensive British review of their offshore activities delivered the desired results of the Caymanian strategy of dependence. Mounting international concerns with offshore finance meant a close examination and subsequent series of recommendations for reform was inevitable for all the OFCs. Cayman officials had several reasons to believe that the United Kingdom would produce the most favorable evaluation of their regulatory structure.

To begin with, the British Government was initially responsible for encouraging the dependent territories to develop offshore finance. The British had attempted to redefine their role in governing the Overseas Territories by promoting banking as a method for the colonies to achieve economic independence.

Uncomfortable in their anachronistic role as colonial masters and unwilling to continue subsidizing their remaining possessions, the UK and Holland appear to support offshore aspirations [Hampton, 1994].

British OFCs are keenly aware that it would be hypocritical for the UK to condemn the offshore industry. A report describing a recent conference in Barbados typifies the unwillingness on the part of the British colonies and former colonies to allow the UK to forget its role in the rise of offshore finance in the Caribbean.

The Caribbean nations and territories say they were encouraged two decades ago by Britain and others to set up financial services industries to build self-sustaining economies and are now being betrayed. "We were pushed to do it," said Bobby Khan, corporate affairs director for Frank. B. Armstrong Ltd. [*Caribbean Update*, 2001].

The same report also highlights the most compelling incentive for the Britain to adopt a gentle approach when dealing with financial regulation in the dependent territories.

In Barbados, which charted its course about 15 years ago, the financial services industry provides direct employment for about 2000 people. It also gives a boost to other industries such as construction and provides about a third of government revenues... A collapse could have dire social and economic consequences, Khan said. Economic hard times could bring with them corruption and crime.

While a crisis in Barbados would no longer fall directly on the shoulders of the British government, economic hardship in the Cayman Islands and the other Commonwealth countries could place considerable strain on the resources of Great Britain. Additionally, the White Paper granted non-reciprocal citizenship rights to the dependent territories, providing even further motivation for UK officials to ensure continued prosperity in the

Dependent Territories. Robin Cook explains why the British Government felt it was in a position to offer colonial subjects unrestricted entrance into Britain.

We do not expect this change in status to result in any substantial number taking up permanent residence in the United Kingdom. 70% of the citizens of the Overseas Territories have a higher per capita income than the United Kingdom and their residents have no incentive to leave on a permanent basis [Foreign and Commonwealth Office, 1999a].

In view of British interests, there is certain logic in the approach taken towards the Cayman financial sector in the *Review of the Financial Regulation in the Caribbean Overseas Territories*. This extensive evaluation of every component of the Cayman offshore industry represented the fulfillment of the British pledge to meet her international responsibilities and ensure Cayman's compliance with international standards of banking and finance. The review appears to have been conceived with the notion of the relationship between Britain and the territories outlined in the White Paper. This alliance is based more on a cooperative partnership, aimed at promoting the colonies well being than on the UK's role as a governing body. The White Paper's introduction lists the four principles underlying this relationship:

- Self-determination
- Mutual obligations and responsibilities
- Freedom for the territories to run their own affairs to the greatest degree possible
- A firm commitment from the UK to help the territories develop economically and to assist them in emergencies [Foreign and Commonwealth Office, 1999a].

The lengthy Review published several months after the White Paper, elicited the type of official praise for Cayman's regulatory system that the financial community has found so effective in luring major investors.

By the creation of CIMA in 1996, the Cayman Islands commenced a positive process of developing a structured resourced regulatory function, and a visible commitment to achieving international standards and good practice. We consider that CIMA, staffed as it is with a number of experienced and skilled regulators, some with international regulatory experience, provides a firm foundation for the attainment of those international standards with which it does not already comply [Foreign and Commonwealth Office, 1999b].

Endorsing CIMA in the review also demonstrated Britain's general approval of bank secrecy and other practices integral to offshore finance. According to the report, "the mission statement of CIMA requires it to:

- Regulate and supervise the financial services in order to maintain a first-class financial system.
- Safeguard the interests of depositors, trust beneficiaries, policy holders and mutual fund investors from undue loss.
- Contribute to public confidence in the financial system by promoting sound corporate governance, prudent business practices and compliance with laws and regulations.
- Promote and maintain monetary stability and preserve the value of the Cayman Islands currency and advise the government on banking and monetary matters.

Possibly more significant than the UK seal of approval for Cayman's regulatory infrastructure, was the report's recognition of Britain's decision to leave the regulation of the offshore industry in the hands of the Cayman government. The 1999 report openly acknowledged that the UK does not "retain responsibility for... financial services." Throughout the review, the British desire for Cayman's regulatory agency's 'autonomy' and 'independence' was evident.

In our view operational independence means the ability of the regulatory authority to act in the best interests of regulation (systemic, national and protective of customers) free from political

and private sector interference, (so avoiding the danger of regulatory capture) but with proper political accountability.

If one were to entertain an analogy where the United States represents Cayman's father and the United Kingdom her mother, Father is unquestionably the provider and courting his favor is the key to material gains. When discipline is eminent however, standing behind mother is an effective way to soften the punishment.

DIVERSIFICATION AND FORTIFICATION

The financial industry in the Cayman Islands continues to profit from the country's upright reputation and its connection to England, but the key to Cayman's long-term success comes from its leaders' persistent efforts to create an industry capable of weathering the changing tides of the world economy. Unlike many tax havens that have attempted to capture a share of a particular segment of the offshore market, Caymanians have protected their economy through diversification. In addition to banking, the Caymans host 502 captive insurance companies, over 2000 mutual funds, nearly 50,000 registered companies and "a significant number of trusts and limited partnerships" (Foreign and Commonwealth Office, 1999b). While the Caymans may no longer be the first choice for individuals hoping to keep their financial transactions hidden from government authorities, the financial center continues to grow by offering an array of services "that are growing in scope and scale and that are increasing in demand for legitimate business reasons" (Sutton and Payne, 1994).

Cayman is by no means alone in its endeavor to expand and improve its financial services. Even in 1994, Caribbean OFCs were struggling to obtain a competitive edge.

The region's offshore banks are having to invest heavily in information technology to become more efficient. Established financial centres, such as the Cayman Islands, Bermuda and the Bahamas, are becoming more innovative in the products and services they provide [Globe and Mail, 1994].

As with regulatory reforms, the Caymans seem to be a step ahead of their competitors in finding new ways to enhance the territory's role in international finance. The Cayman Islands Stock Exchange epitomizes the resourcefulness and ingenuity of the nation's entrepreneurial leaders.

By making full use of the efficient and sophisticated listing regime of the Cayman Islands Stock Exchange (CSX), the world's leading financial institutions have helped to make it one of the fastest growing international stock exchanges. The CSX has established itself and its credibility over the last couple of years. The combination of sophisticated listing facilities, pragmatic approach and efficient service make the CSX an attractive listing venue for institutional products in which it specializes... In July 1999, the CSX was granted approved organization status by the London Stock Exchange. The CSX was able to demonstrate that its regime for listed securities meets all the detailed criteria for inclusion on the list of approved organizations. This is the first time an offshore stock exchange has been added to the list. The CSX now joins such institutions as the New York Stock Exchange, Nasdaq and all official exchanges in Europe and Japan [Corporate Finance, 1999].

Accompanying their desire for a heterogeneous financial sector, Cayman's leaders have strived to promote business that contributes to the wealth and infrastructure of the islands. While electronic advances have assisted offshore jurisdictions by providing effortless means of moving money, they also make tax havens vulnerable to sudden divestment. Islands where the banks and offshore companies have little or no presence are in a particularly precarious position. A visitor stepping off a cruise ship in Georgetown will immediately realize that Cayman does not fall into this category. Cayman's capital city, with dozens of modern buildings and numerous others currently under construction, offers international investors, reasons for doing business in the Caymans that go far beyond lenient tax laws.

Cayman has founded their OFC on the belief that "tax haven strategy is not about offshore finance alone... but works as a package combining, finance, tourism and construction" (Palan

and Abbott, 1996). And in the Caymans, where the average tourist earns over \$100,000.00 USD per year (James, 1997), and where million dollar homes and condominiums are being built at an astonishing rate, it appears that the islands' administrators have perfected such a program.

It is not hard to understand why Cayman's legislators have concerned themselves with ensuring that the island's banking and finance spurs development. Take for example members of the legislative assembly Kurt Tibbets of Eugene Ebanks, who own an auto dealership and charter boat service respectively.⁴ Like their merchant class predecessors, these men have a vested interest in the continued flow of wealth and people into the islands.

For the Cayman Islands, success has bred success. By investing in the infrastructure of their financial center and evolving services less dependent on secrecy, the Caymans have managed to thrive in an international climate that has adversely affected many of its competitors (United States, 2001). A recent financial report indicates that even in years where the Cayman's financial authority tightened its regulatory control, the offshore community continues to climb.

In terms of the quantity and quality of business through the Islands, the result of all these changes so far has proved to be highly beneficial. The Government's statistics show that in the first nine months of the year 2000 there has been more measurable economic activity in the financial services industry than in the whole of 1999 [Maples and Calder, 2001].

THE FUTURE

While the United States and the developed countries will continue their efforts to police financial activity on a global level, offshore finance will endure. As national boundaries become less significant in international commerce, a jurisdiction like

⁴ Elvina, Enrico and Nelson Christian, research interview, april 2001.

Cayman, with regulations and services tailor made for the global entrepreneur, will find an abundance of customers.

The combined efforts of the US and the other developed nations will no doubt make it more difficult to hide the proceeds of criminal activities and tax evasion. Tax havens that have based their industry such practices may be in serious jeopardy. However, by allowing its banks to harbor "billions and billions" of dollars on "which no tax has been paid to a foreign government (*Caribbean Update*, 2001)", American officials have condoned the legal use of offshore centers. As long as the United States retains its influence over the Caribbean, offshore finance will continue.

The US economy in its desperate search for capital to promote its economy has itself become somewhat of a tax haven for foreigners who invest their money in US banks. No US tax is levied on interest earned in bank deposits made by foreigners. This influx of foreign capital is then used by the US banking system to stimulate the US economy through funding US, corporations, homeowners, real estate development, and research technology.

Many foreign investors to the US economy are able to purchase US corporations, real estate, and bonds at realistic prices as a result of using low-tax bases around the world.

US companies are in turn able to access foreign capital through such markets as Eurobonds and offshore-equity markets...

As much as the developed countries may want to prohibit their taxpayers from using tax havens, they cannot without damaging their own national economies or destroying their capital markets [Ginsberg, 1991].

Offshore centers like Cayman also take comfort from the knowledge that the third world debt channeled through their banks produces returns that are destined to return to countries like the United States.

With such colossal and growing investment portfolios on their books, the vast majority of which are earmarked for the First World, the advanced countries have been careful not to alienate the tax

havens. This has been most evident in the case of the United States where policy makers, faced with an increasing budget deficit, have been unable to afford the cost of lost investment that would inevitably follow any international crackdown [Palan and Abbott, 1996].

If US regulators are forced to tolerate the existence of tax havens, it does not serve their interests to promote a proliferation of such centers. Increased numbers of jurisdictions with bank secrecy make the task of lawmakers, attempting to trace the financial trails of criminal activity, exceedingly difficult. From this perspective, United States regulatory agencies have a motivation to limit the number of OFCs and use their influence to ensure that the majority of offshore activity takes place in a select group of locations that have demonstrated a willingness to cooperate with investigations. In the Caribbean, the Cayman Islands are evidently, the favorite son in this regard.

Other Caribbean nations can learn from the success of the Cayman Islands, and the compatibility of finance with tourism makes it a logical pursuit for islands with limited resources. The Cayman Islands, however, has a unique character, which offers it some advantages unavailable to their competitors. Businessmen, who have capitalized on their islands' history while securing its position as the regional leader in finance continue to propel Cayman's growth. As the Cayman financial center continues to grow and improve its services, smaller Caribbean banking centers may find it increasingly difficult to compete. If these islands attempt to capture the business driven out of Cayman by the recent enhancements in regulation, they will find themselves facing the unrestrained wrath of the OECD, the FATF and numerous US agencies, and those without the protection of colonial status, may be especially targeted. Though it may be a fine line that separates legitimate business from illegitimate in the world of offshore finance, recognizing where that line lies and basing their industry on activities that fall into the first category has driven Cayman's success. The men and woman at the helm of the Cayman OFC will undoubtedly continue to exploit both the advantages provided to Cayman by her unique history and the strategic opportunities that they have created. The remarkable

achievements of one of the smallest nations in the Caribbean afford the people of the Cayman Islands a well-founded confidence in the future of their nation.

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