De-Risking in the Barbados Context

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Abstract

De-risking has the potential to develop into a threat to Barbados posing a challenge to the country's continued development and economic stability if left unchecked. Early indications are that the de-risking phenomenon may have already begun to erode Barbados' competitive position as a leading IFC in the Caribbean region. Any sustained loss of IBC business for Barbados will undoubtedly lower government tax receipts, negatively impact employment, and could impact the level of FX availability in the domestic financial system.

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Defining the Problem and Framing the Discussion around De-Risking and Barbados

To understand the impact of de-risking in the Barbados context, the problem needs to be examined from multiple perspectives. De-risking has often occurs when domestic financial institutions experience sudden and significant declines in access to correspondent banking services. Unlike other countries in the Caribbean region and beyond, Barbados has not been impacted by de-risking in the usual manner. For Barbados, de-risking has not manifested as a direct threat to financial inclusion and access to the global payments network, as has been the experience in other Caribbean countries, such as Belize. Rather, de-risking has profoundly influenced the behaviour of the domestic banking system and has developed into a significant threat to the international business and financial services (IBFS) sector, a pillar of Barbados' economic growth and development model.

The number of correspondent banking relationships (CBRs) terminated over a defined period has emerged as a popular but simplistic indicator to measure the impact of de-risking on a country. For Barbados, over the three-year period 2013–2016, the aggregate commercial banking sector lost a mere four correspondent banking relationships. This represents an immaterial loss of CBRs in the context of five commercial banks, each with multiple correspondent relationships, as well as the ability to utilize parent bank resources to facilitate cross-border transactions.

The minimal loss of CBRs, while encouraging, belies the true impact on Barbados. Increased scrutiny from correspondent banks and the need to deploy greater resources to manage the potential money laundering and terrorist financing (ML/TF) risk presented by some client segments have materially altered the business strategy of most of Barbados' domestic commercial banks. Confronted by external as well as internal pressures and reduced profitability, banks have proactively decided to exit relationships with clients they deem to be either too risky from an ML/TF perspective or to provide an inadequate rate of return. Available data suggest that Barbados commercial banks have exited more than 60 client relationships since 2013, primarily with higher-risk clients in the IBFS sector and money/value transmission (MVTs) service providers.[1] Additionally, one commercial banking group with operations throughout the Caribbean and headquartered in Barbados decided in 2013 to exit approximately 5000 client relationships due to a culmination of factors related to de-risking and changes in Financial Action Task Force (FATF) anti-money laundering (AML) guidance. These include:

[1] The Barbados Money Laundering and Financing of Terrorism (Prevention and Control) Act defines MVTs as The business of accepting cash, cheques or any other monetary instrument or other store of value and paying a corresponding sum in cash or in another form to a beneficiary, by means of a communication, message or transfer or through a clearing system to which the money or value transmission service belongs

- Heightened scrutiny from its primary U.S. correspondent bank;
- Highly publicised investigation by the U.S. Department of Justice into its operations via transactions with its U.S. correspondent bank; and
- Increased compliance costs associated with maintaining relationships with perceived higher-risk clients.

This de-banking of clients has undoubtedly had a material impact on the profitability of Barbados' commercial banking sector in what is already a challenging environment, characterised by low interest rates, weak loan demand, and elevated credit losses related to core lending activity. Further to this purging of clients, domestic institutions have also become much more selective in on-boarding new clients from the IBFS sector. Barbados' commercial banks now generally prohibit the onboarding of MVTs, and decisions on onboarding new IBFS clients have reverted to corporate head offices in some instances. In one unique instance, a Barbados commercial bank with a Canadian parent bank now requires potential clients in the IBFS sector to have a material relationship at the head office or another major branch worldwide in order for the client to be considered for on-boarding.

Over time, such business strategies will undoubtedly prove counterproductive and damaging to both the domestic commercial banking sector and to Barbados' reputation as an international financial centre (IFC).

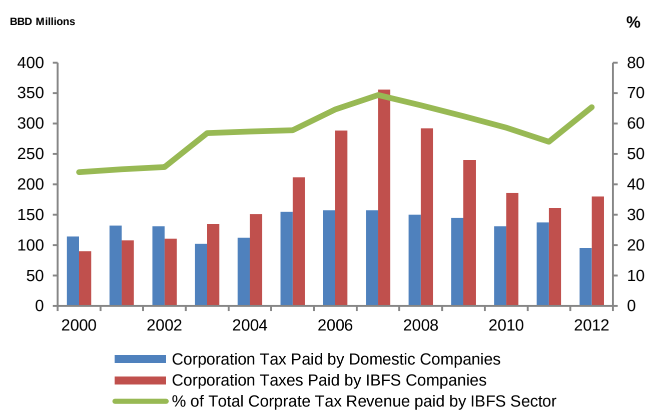
Beyond the logical outcome of lower profitability due to severed client relationships, de-risking has the potential to present even greater threats to Barbados' financial system and continued economic development. As a small, import-reliant economy, it is crucial that financial institutions have adequate supplies or access to foreign currency to meet client demands. The termination of IBC clients by commercial banks may impact this supply of foreign exchange (FX) and hinder their ability to effectively compete for FX business locally. Additionally, declines in FX supply may over time force commercial banks to run large mismatched currency positions in efforts to compete and meet client demand. Migration to such a strategy could in turn expose their operations to significant FX risk and increases the possibility of large losses being sustained in adverse scenarios.

A sustained retreat from the IBFS sector would also significantly impact Barbados' reputation as an IFC and impede its ability to compete with other regional IFCs such as the Bahamas and the BVI. Confronted by mounting challenges of establishing and retaining banking relationships will, over time, incentivise IBCs to consider other jurisdictions as domiciles for their business. Anecdotal evidence already points to this migration, with the Barbados Financial Services Commission observing some Barbados-registered captive insurance companies being forced to establish banking relationships in other Eastern Caribbean territories such as St. Lucia due to the challenges of establishing banking relationships in Barbados.

The IBFS Sector: An Economic Pillar of Barbados

The negative impact of de-risking and the challenges it poses to the IBFS sector are a serious threat to Barbados' economy. Over the past two decades, the IBFS sector has gained in both importance and the size of its contribution to the economic growth and development of Barbados. To illustrate its importance, over the 12-year period 2000–2012, the IBFS sector has on average accounted for approximately 57 percent of total corporate tax receipts of the Government of Barbados. The IBFS sector also provides the government with a valuable source of revenue diversification. This was underscored in the years directly following the financial crisis and resulting global economic downturn. The effects of these events had a lagged impact on Barbados, with local corporate profitability and related corporate tax receipts declining two to three years after the initial global downturn. By this time, the profitability of the IBFS sector had already begun to rebound, and tax receipts from this sector had returned to growth.

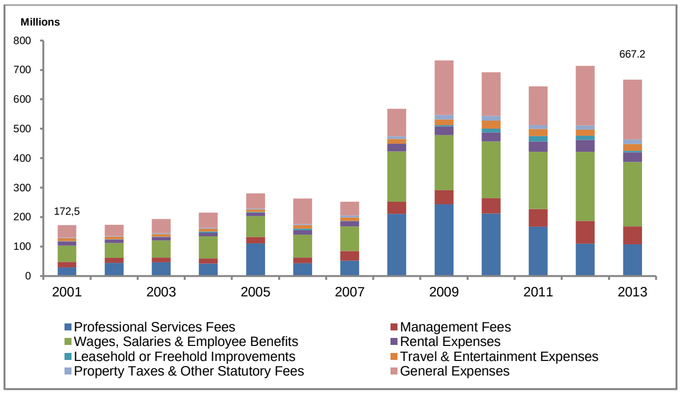
Figure 1: Components of Corporation Tax Receipts 2000–2012



Source: Central Bank of Barbados 2012 and BIBA report

The IBFS sector also plays a significant direct role in the Barbados economy, as evidenced by aggregate expenditure. Over the period 2001–2013, aggregate expenditure of the IBFS sector is estimated to have grown by approximately 286 percent to US$667 million in 2013. To provide some context, total economic activity of Barbados as represented by GDP is estimated to have been US$4.3 billion in 2013. This indicates that IBFS sector expenditure accounted for approximately 8 percent of Barbados economic activity in 2013. Figure 2 highlights the growth in IBFS expenditure during the period 2001–2013 and the primary drivers of this expenditure growth.

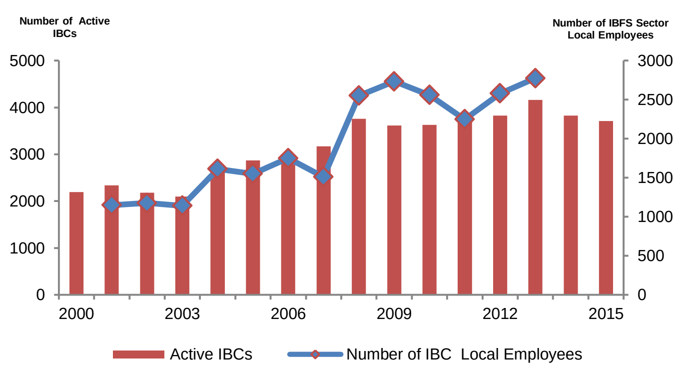
Figure 2: IBFS Sector Expenditure



Source: Central Bank of Barbados 2013 and BIBA report

The growth in corporation tax receipts and expenditure of the IBFS sector has been fueled by substantial growth in the number of registered IBCs over the past several years, peaking at 4,161 in 2013 based on available data. As the IBFS sector has grown, it has also made a material contribution to the continued development of Barbados' human capital. This is evidenced by the IBFS sector adding approximately 2,775 local employees in 2013. This represented approximately 2% percent of the Barbados labour force at that time.

Figure 3: Total Registered IBC Companies and Number of Local IBC Employees



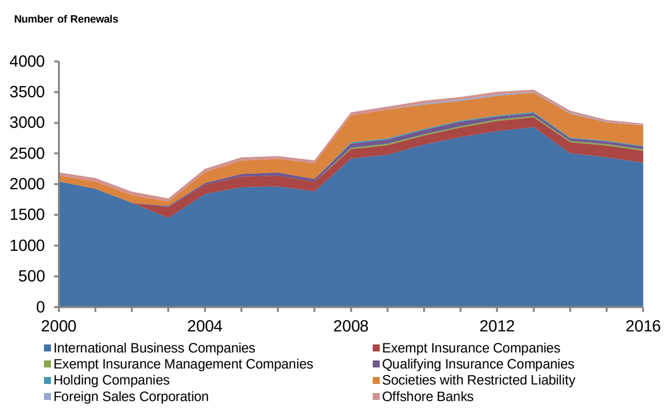
Source: Central Bank of Barbados 2015 and BIBA report

Notably, growth of the IBFS sector has slowed in recent years, manifested by three consecutive years of decline in the number of new IBCs registered annually. The decline in IBC formation could be attributable to a mix of factors, including:

- De-risking trends globally and growing challenges for IBCs to establish and maintain banking relationships both domestically and abroad
- Revisions to Canadian tax legislation which have eroded some of the tax benefits previously afforded to Canadian businesses and individuals utilising Barbados based IBCs to manage their tax liability
- Initiatives by G-10 countries to address tax revenue slippage and improve their own fiscal positions following a deep global recession[2]

In addition to observed declines in new IBC registrations annually, IBC annual renewals have also shown gradual declines since 2013, as shown in Figure 3. Over the three-year period 2013–2016, annual IBC license renewals declined by 15.6 percent to 2,986 renewals in 2016. Most of the declines in annual renewals were attributable to lower annual renewals by the IBC category of companies, which declined by 581 (17.9 percent) between 2013 and 2016.

Figure 4: Annual Renewal of IBCs by Category



Source: Central Bank of Barbados 2016 and BIBA report

The dominance of the IBC, captive insurance and societies with restricted liability (SRL) categories in the IBFS sector partially obscures the devastating decline in Barbados' international banking sector. The number of licensed international banks has declined dramatically over the four-year period 2012–2016. Figure 4 illustrates declines that commenced

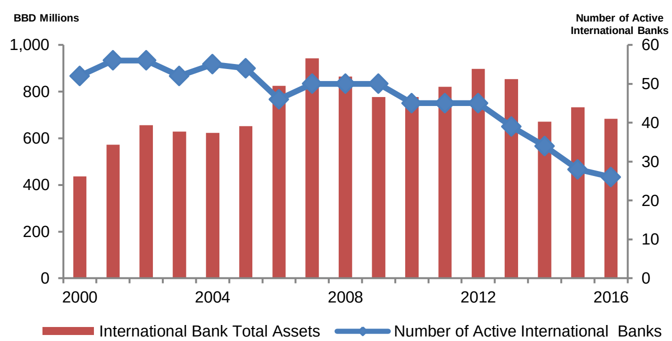
[2] Examples of these G-10 revenue collection initiatives include; FATCA implementation by the USA, as well as the Common Reporting Standard (CRS) and Base Erosion and Profit Shifting (BEPS) initiatives being pioneered by the OECD.

around 2012, when 45 licensed international banks existed. By year end 2016, registered international banks had declined to just 26, representing a 42 percent decline over the period.

While some international banks sought to convert to registered IBCs, most chose to completely wind up their operation. This ultimately led to lower direct revenues from license fees and corporation taxes as well as displaced workers, all negatives for economic activity.

Changes to Canadian tax legislation announced by the Canadian Revenue Agency in 2011 were the initial catalyst for the dissolution of many offshore banks. The added pressures of de-risking appear to have further exacerbated the problems faced by many international banks. In its 2014/15 report,[3] the Banking Sub-Committee of the Barbados International Business Association (BIBA) highlighted the significant challenges that the offshore banking sector was encountering because of de-risking both internationally and from domestic financial institutions. The report identified the sudden increase in AML/KYC requests from both local and international correspondent banks, often coupled with very short response deadlines. This resulted in some accounts being suspended or closed if responses were deemed inadequate or too slow in coming.

Figure 5: Number of Licensed Offshore Banks and Total Assets



Source: Central Bank of Barbados 2016 and BIBA report

The USA as the Newest "On-shore" IFC

The previously highlighted changes in global AML/CFT standards, coupled with developments in the global financial system such as a drastically diminished tolerance for AML/CFT control weaknesses or failures in financial institutions by G10 regulatory authorities, have profoundly impacted the competitiveness of many IFCs, including Barbados. The largest financial institutions are progressively retreating from doing business with companies based in IFCs perceived as tax havens.

[3] The BIBA 2014/15 Annual Report is available at: http://biba.bb/biba-2014-2015-annual-report/.

However, this perception does not mesh with reality, as many IFCs, including Barbados, have continually committed to implementing best standards and practices. Among these are a comprehensive regulatory framework and effective oversight, collection and exchange of tax information across borders, and participation in various independent attestation programs such as the FATF's Mutual Evaluation program and the OECD's peer review process. Despite these efforts, IFCs and the companies who operate within them continually face the challenges of de-risking.

Some businesses have seemingly managed to circumvent the challenges associated with de-risking by relocating their businesses. There has been growing anecdotal evidence of IBCs and trusts relocating from IFCs such as Barbados to U.S. states such as Delaware, Nevada, Florida, and South Dakota. For example, as a registered corporation in a U.S. state such as Delaware, companies face fewer challenges in establishing banking relationships and are in some instances afforded additional privacy because some U.S. states like Delaware do not enforce as stringent beneficial ownership information requirements as established IFCs around the world.

Conclusion

De-risking has the potential to develop into a threat to Barbados, posing a challenge to the country's continued development and economic stability if left unchecked. Early indications are that the de-risking phenomenon may have already begun to erode Barbados' competitive position as a leading IFC in the Caribbean region. Any sustained loss of IBC business for Barbados will undoubtedly lower government tax receipts, negatively impact employment, and could impact the level of FX availability in the domestic financial system.

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