

The Bahamas: Selected Issues



THE BAHAMAS

SELECTED ISSUES

October 2017

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Approved By
Cheng Hoon Lim

Prepared by Qiaoe Chen

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THE STRUCTURE AND TRENDS IN THE BAHAMAS' OFFSHORE SECTOR ¹

A. Introduction

1. The Bahamas hosts the fourth largest offshore financial center (OFC) worldwide. The Bahamas ranks fourth after Hong Kong, Singapore, and the Cayman Islands. However, total assets of the Bahamian offshore sector have shrunk in recent years due in part to global efforts to strengthen tax transparency standards, as well as to changes in global risk appetite since the onset of the global financial crisis.

2. This paper assesses recent trends in The Bahamas' OFC and their contribution to the real economy. After describing the offshore sector structure, the paper discusses how the sector is adapting to global regulatory initiatives and how this adjustment is affecting the contribution of the sector to the real economy.

3. Despite a sharp contraction in the size of the offshore sector, the direct impact on the real economy appears to have been modest. The direct contribution of offshore banks to the real economy appears to have remained broadly stable, reflecting an orderly adjustment so far. Going forward, strong compliance with AML/CFT and tax transparency standards should help ensure that this orderly adjustment continues.

B. Offshore Financial Sector Structure

4. The Bahamas hosts one of the largest OFC in the world. Based on the BIS locational banks' cross-border positions data, The Bahamas' OFC ranks fourth after Hong Kong, Singapore, and the Cayman Islands, and has been included among the largest 24 Sink-Offshore Financial Centers in the world (Javier and others, 2017).² The evolution of the Bahamian OFC has been significantly influenced by domestic and international regulatory developments, attracting offshore banks and other types of international financial institutions as early as the 1960's.³ The Bahamas OFC currently includes bank and trust companies, insurance companies, investment funds, other financial and corporate service providers, non-bank money transmission business, and international business

¹ Prepared by Qiaoe Chen (WHD). The author thanks Sabrina Lando (LEG) and Alwyn Jordan, Karen V Rolle, and staff of the Research and Bank Supervision Departments of the Central Bank of the Bahamas for valuable comments and suggestions, and Latera O Carey-McPhee and Sharon G Branch of the Central Bank of the Bahamas, Jamel Bodie of the Insurance Commission of the Bahamas for key data and information.

² Javier and others (2017) use global corporate ownership network data to identify OFCs. Sink-OFCs are countries that attract and retain foreign capital through low or zero corporate taxes.

³ The Bahamas began to attract offshore banks through a no-tax and light-regulatory environment as early as 1960's. In 1989, with the passage of *The Trust (Choice of Governing Law) Act* and *The International Business Act*, The Bahamas began attracting trusts and International Business Companies (IBC). In 2000, the government issued new regulations to remove shell banks—institutions without a physical presence in any country—and meet Financial Action Task Force (FATF) requirements; consequently 199 bank licenses were withdrawn over the period of 2001-2005.

companies (IBCs) (Table 1), with total assets in the offshore sector reaching US\$332 billion at end-2016, significantly larger than the domestic financial system, which holds assets of US\$20 billion.⁴

Table 1. Structure of the Offshore Sector in the Caribbean as of 2015					
	Banks	Trust Companies	Insurance Companies	International Business Companies	Investment Funds
The Bahamas 1/	79	151	23	175,675	858
Barbados 2/	27	...	196	4,380	...
Bermuda 3/	4	27	1582	11,548	456
The British Virgin Islands 4/	...	177 ^{3/}	137 ^{3/}	1,308,056	1,656 ^{3/}
The Cayman Islands 5/	123	149	708	83,064	10,940
Curaçao 6/	35	12
Panama 6/	27

Sources: Country authorities' publications and Bank for International Settlements.
 1/ Data from Central Bank and Insurance Commission
 2/ Data from Central Bank and Financial Service Commission's reports, IBC data for 2013
 3/ Data from BVI Monetary Authority for Q3 2016.
 4/ Data from Statistical Office.
 5/ Data from BIS Note on its reporting banks and Central Bank publications.
 6/ CPIS data.

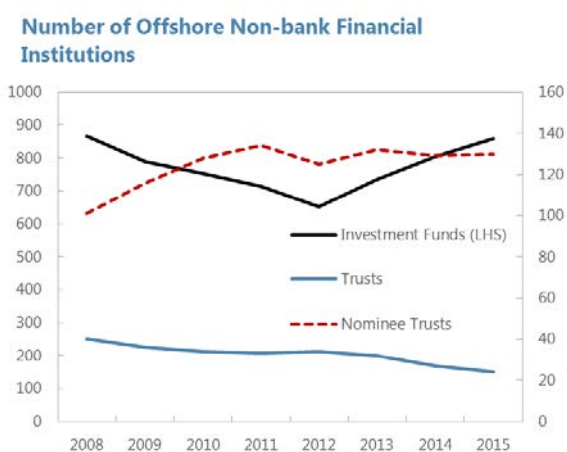
5. International banks are the most important institutions in the Bahamian OFC. Total assets of the international banks, including banks with trust licenses, reached about US\$175 billion by end-2016, distributed among 79 banks, with the top ten accounting for almost 80 percent of the OFC's assets. In terms of country of origin, the sector is dominated by banks from Brazil, Switzerland (16 licensed operations), Colombia, United States, Canada, and Argentina. Some banks are Bahamian-owned (12 licenses), but serve only non-residents just as the rest of the sector.

6. Investment funds are next in importance. There are 920 investment funds registered in The Bahamas at end-2016, with total assets under management (AUM) of about US\$ 135 billion.⁵ Other offshore financial institutions include captive insurers (with total assets of US\$1.2 billion), and

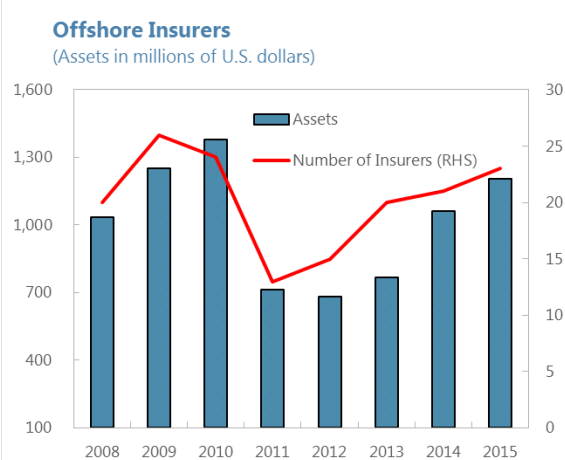
⁴ Other financial and corporate service providers offer accounting and auditing, estate planning, marketing and publishing, corporate & financial services. Domestic financial sector includes banks, pension funds, insurance companies, wealth management companies and credit unions.

⁵ As of end-2014.

trust companies. Most trust companies are nominee trusts, which only hold securities and other assets on behalf of clients of its parent bank or trust company.^{6 7}



Source: Central Bank of The Bahamas.



Source: Insurance Commission of The Bahamas.

7. The Central Bank of The Bahamas, the Insurance Commission, and the Securities

Commission regulate institutions in the onshore and offshore sectors. The Central Bank of The Bahamas (CBB) is responsible for the regulation of banks, trust companies, credit unions and non-bank money transmission businesses while the Securities Commission and the Insurance Commission supervise the investment funds, the financial and corporate services providers, and the insurance companies. CBB has adopted a risk-based supervision framework to supervise international banks and trust companies, focusing on compliance with AML/CFT requirements and other specific requirements for the offshore banks, such as the revised physical presence guidelines. CBB conducts risk assessments, on-site examinations, discovery reviews, meetings with senior officials and internal auditors, and analyses of financial statements. In addition, CBB also coordinates and cooperates with international and other local regulators through exchanges of information, as appropriate. The Securities Commission supervises investment funds in terms of licensing and has not established risk-based supervision yet. Although the Securities Commission does not require investment funds to submit financial statements, the CBB conducts an annual survey among these entities. The Insurance Commission imposes limited reporting requirements to offshore insurers. In addition, as part of the AML/CFT framework, the Financial Intelligent Unit also requires offshore financial institutions to report suspicious transactions.

⁶ There are also many IBC's structured to facilitate the protection of personal or institutional wealth.

⁷ Captive insurers, trust companies and investment funds are all dedicated to help clients manage their assets. Captive insurers are wholly owned and controlled by its insured clients; the primary purpose of captive insurers is to insure the risks of its owners, and its insured clients benefit from the captive insurer's underwriting profits. Offshore trust companies act as trustees for the designated person(s) to custodian and manage trust funds, execute wills or providing some banking business, while investment funds provide collective investment opportunities to investors.

8. Strict firewalls limit risks to domestic financial stability. The Bahamian regulatory authorities allow offshore financial institutions to conduct foreign-currency business only with non-residents. Furthermore, onshore banks cannot conduct business in foreign currency with residents without approval from the central bank.⁸ The offshore sector uses domestic banks to facilitate their payments in Bahamian dollars.

C. Global Regulatory Initiatives and the Bahamian OFC

9. Global regulatory initiatives have significant implications for the offshore sector.

Continued international efforts to strengthen AML/CFT regimes have been an important element in shaping the business of OFCs. International banking regulation changes after the global financial crisis also impacted international banks' global organization. More recently, the international community has also increased tax transparency requirements. The United States enacted the Foreign Account Tax Compliance Act (FATCA) which led to the development of a global standard on exchange of tax information. Following the United States, the OECD called for the establishment of the Automatic Exchange of Information (AEOI) in 2012. In 2013, G20 leaders requested the OECD to develop a Common Reporting Standard (CRS) to further support the AEOI. The resulting OECD's proposal, endorsed by the G20 Summit in 2016, assesses a jurisdiction against three criteria, one of which is the commitment to implement the CRS by 2018.⁹ The OECD will prepare a list of non-cooperative jurisdictions with G20 leaders possibly taking defensive measures. The Bahamas has committed to meet the CRS in 2018 and in that context, has committed to sign the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.¹⁰ Moreover, IBCs are also drawing increased international scrutiny that could lead to the implementation of greater transparency requirements regarding beneficiary owners. All these global efforts, including in the aftermath of the Panama and The Bahamas Papers, may make it more difficult to evade taxes and misuse the financial sector and opaque entities.

10. The Bahamas is taking steps to strengthen its compliance with international AML/CFT and tax transparency standards and ensure the integrity and sustainability of its OFC.

Following concerns raised by the FATF, the Financial Stability Forum, and the OECD in the early 2000s, The Bahamas launched a comprehensive legislative effort aimed at strengthening regulations concerning AML practices and supervision of the offshore sector. A 2013 peer review of The Bahamas' implementation of the Global Forum Standard for transparency and exchange of information assessed the country as largely compliant, with recommendations to address deficiencies pertaining to availability of ownership and identity information and accounting record-keeping obligations. In addition, The Bahamas' recent Mutual Evaluation, against the 2012 FATF

⁸ Offshore banks may use onshore banks to temporarily transfer foreign-currency funding from and to headquarters.

⁹ 53 jurisdictions have signed an agreement to automatically exchange information. Moreover, the Global Forum of the OECD is putting in place a peer review process to monitor the effectiveness of the AEOI. Additionally, to tackle tax avoidance, the OECD/G20 developed a Base Erosion and Profit Shifting (BEPS) project that comprises a comprehensive package of measures.

¹⁰ <http://www.oecd.org/countries/bahamas/the-bahamas-decides-to-sign-multilateral-tax-information-sharing-convention.htm>

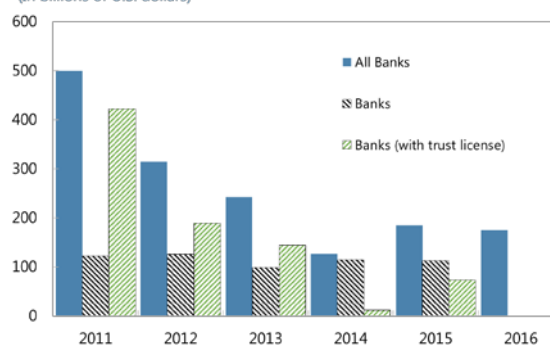
standard, highlights the need to swiftly address strategic deficiencies in the effectiveness of the AML/CFT framework and compliance with recommendations related to the understanding of ML/FT risks, transparency and beneficial ownership information of legal entities, ML/TF investigations and prosecution, and implementation of targeted financial sanctions. The CBB, the Insurance Commission, and Securities Commission are working together to address these deficiencies. A preliminary action has been to develop a penalties regime for AMF/CFT breaches.

11. Reflecting in part the impact of these global initiatives, the total assets of offshore banks in The Bahamas has shrunk significantly since 2011.

Total assets of the international banks, including banks with trust licenses, declined to about US\$175 billion in 2016 from a peak of close to US\$500 billion in 2011 and the number of international banks dropped by 12. U.S. banks borne the brunt of the decline in assets. In 2016, 11 mergers and acquisitions took place in the offshore banking sector and some European private banks withdrew from the market.

Assets of the Offshore Banking Sector

(In billions of U.S. dollars)



Source: Central Bank of The Bahamas.

12. Offshore banks have also faced restrictions or termination of correspondent banking relationships (CBR), but no major disruptions have been reported.

A Central Bank of The Bahamas survey, conducted in August 2016, showed that 26 percent of respondent banks—mostly international banks—indicated having faced restrictions or termination of at least one CBR.¹¹ Affected institutions noted difficulties in finding replacements but could still conduct business through existing relationships or the parent company. They did not report any resulting dollar-value loss in the level of correspondent banking transactions.

13. Some large banks have adapted to the new regulatory environment by shifting activities away from private banking/wealth management.

Based on the central bank's analysis, the imposition of tax amnesties in other countries has resulted in a sizable reduction in the overall assets under management (AUM) in The Bahamas as many clients have taken the opportunity to become tax compliant with their home countries. Large banks have increased their investment banking activities and moved away from trust and private banking/wealth management, while small banks still focused on private banking. Among the top ten banks, four concentrate in investment banking, with only the two largest banks offering corporate banking and private banking businesses. Some banks also outsourced various business functions to achieve operational efficiencies and synergies within their groups. During 2016, the Central Bank of The Bahamas approved 25 outsourcing arrangements.

¹¹ [Correspondent Banking Survey 2-Summary Findings](#) of the Central Bank of The Bahamas.

14. There appears to be also a migration from private banking to more tailor-made non-bank wealth management tools. Non-standard funds, such as the Specific Mandate Alternative Regulatory Test Fund, or SMART Funds, and Investment Condominium (ICON) have attracted interest in recent years. For example, out of the around 900 investment funds operating in The Bahamas, 65 percent are SMART funds, increasing from 296 in 2011 to 571 in 2015. Similarly, the buoyance of Private Trust Companies (PTC) and Family Offices coincides with the increase in SMART funds, but it remains unclear whether it is related to changes in global regulation or market innovation to create more flexible instruments for wealthy individuals. Some reports also indicate that these innovative products have attracted significant business from wealthy Latin Americans.¹²

D. The Bahamas OFC and the Real Economy

15. Offshore financial institutions contribute to The Bahamian economy through fiscal revenues, job creation, and expenditure in local goods and services. Because of the strict firewalls between offshore institutions and residents, these three channels are the only links to the real economy:

- *Employment.* Banks normally hire local employees to run their operations, while IBCs only hire one local person to manage their accounts. The Bahamas offshore banks & trusts provide around 1,000 jobs with an average wage that is about twice the average wage at domestic banks. Offshore banks total wage bill represented about 1.7 percent of GDP in 2016.
- *Government revenues.* Offshore institutions pay registration and license fees to the government. International banks pay companies fees based on their asset size and license category, and IBCs only pay fixed registration and annual fees. The government revenues generated from these sources reached less than 0.2 percent of GDP in 2016. This channel tends to be much more important in other Caribbean jurisdictions. For instance, British Virgin Islands collected more than 10 percent of GDP in taxes from the offshore sector in 2015, followed by the Cayman Islands with 2.8 percent of GDP (Table 2).

¹² A PTC is subject to a light-touch form of regulation compared with banks and trust companies. It does not need to obtain a license from the central bank. An ICON is designed to be fully compliant with Brazilian laws and to operate like a Brazilian product. A family office provides services to the family or families it represents, from dealing with domestic administrative matters to sophisticated support to a wide range of business activities, tax and estate planning, supervision of trusts and investments. A SMART fund is a flexible asset management fund product designed to cater to the specific needs of investors. Both the operational and regulatory structure of the fund are specifically designed by industry participants, subject to approval from the Commission.

Table 2. Caribbean OFCs Contribution to Jobs and Revenue

	Employees 1/		Government Revenue	
	number	Percent of total employees	Percent of GDP	Percent of total revenue
The Bahamas 2/	1093.00	0.60	0.13	0.7
Babados 3/	3969.00	...	1.10	4.5
Bermuda4/	2369.00	7.00	0.90	38.0
The British Virgin Islands 5/	406.00	2.10	11.00	51.4
The Cayman Islands	3536.00	9.00	2.80	35.0
Panama 6/	900.00	...	0.01	...

Sources: Country authorities' publications and IMF staff calculations.

1/ Employee number is only for the banking sector in the Bahamas and Panama.

2/ Contribution to government revenue by banks and trust companies, data for 2016.

3/ Data for FY2013.

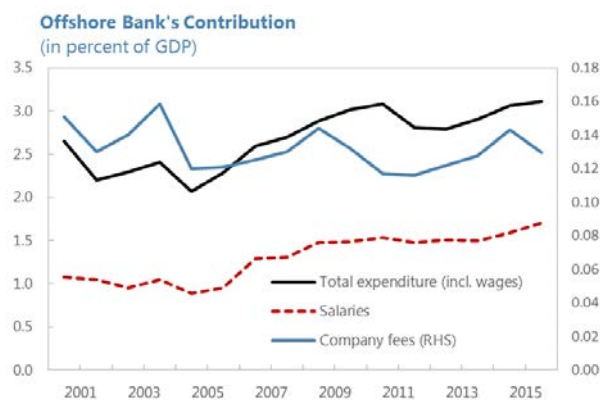
4/ Data for 2015.

5/ Data for FY2014, employee number is for the total financial sector.

6/ Revenue only from international banks.

- *Demand for local goods and services and spillovers.* Offshore institutions, especially financial institutions with presence in The Bahamas, directly demand local goods and services for their daily operations. Other offshore entities may pay for accountants, lawyers, or other service providers to help manage their activities and meet reporting requirements. Offshore banks spend on average 2.6 percent of GDP annually in local goods and services, including wages. In addition, OFCs indirectly stimulate output and employment in other industries when their clients visit The Bahamas.

16. Altogether, staff estimates a direct contribution to domestic demand of around 3 percent of GDP, which appears to have remained broadly stable despite a shrinkage of the sector.¹³ The estimate includes the combined contribution through the OFC's wage bill, their support to public demand through fees and taxes, and expenditure in local goods and services. The overall direct contribution has remained broadly stable over the last 10 years, as the bulk of it originate from the relatively stable local expenses and employment, which



Sources: Central Bank of The Bahamas, and IMF staff calculations.

¹³ This estimation does not include the contribution from non-bank offshore entities.

are not sensitive to the asset size of the system. An increase in fees paid to the government—which are based on the size of assets—since 2012 helped increase government revenues from these fees despite a decline in the size of assets in the system. The total contribution—including spillovers to the rest of the economy—is however likely to be higher, but at the same time more difficult to measure and to determine if it has also remained stable. Sacks and Britton (2007) used an input-output table of Hawaii as a proxy for The Bahamas (arguing that the economic structure of both islands is similar) and estimated that the offshore sector contributed about 9 percent of GDP in 2004.

E. Conclusions

17. OFC's direct contribution to the real economy in The Bahamas appears to have remained broadly stable despite a significant decline in its size. An orderly adjustment of the sector to global regulatory initiatives has contributed so far to manageable direct effects on the real economy, although it is difficult to determine the full extent of the impact—including spillovers. Offshore financial institutions, especially banks, have already reconsidered their strategies and some have adjusted their business models as part of their adaptation process to global regulatory trends and tax transparency requirements. The Bahamian financial regulators are also undertaking measures to meet international standards as well as to maintain a stable and business-friendly environment for the offshore entities.

18. Strong compliance with AML/CFT and tax transparency standards should help ensure the adjustment remains orderly and the effects on the real economy manageable. It is critical to work closely with the CFATF and the FATF to swiftly address the strategic deficiencies in the AML/CFT regime identified in the recent Mutual Evaluation Report (MER) and particularly ensure effective implementation of the AML/CFT framework. Heightened global focus on tax transparency also calls for efforts to promptly comply with international standards (such as the OECD's Common Reporting Standard). Continued monitoring of the status of correspondent banking relationships and effectively communicating efforts undertaken by banks and authorities to address perceived risks are also key to ensure an orderly adjustment in the sector to global regulatory initiatives.

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