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Explaining Cayman's success through its role in the Anglo-American triangle

By Jan Fichtner April 26, 2017

The foreign capital booked in the Cayman Islands is enormous by any standard. Combined data for external banking activity, portfolio investment and direct investment show that over US\$4,000 billion have been invested from abroad. This huge value is nothing but astonishing, given that the Cayman Islands has a population of only about 60,000 people, a domestic economy of approximately \$3 billion, and because Cayman occupies a geographic location, which is quite remote from the centers of the global economy. However, this small Caribbean archipelago has in fact attracted more external assets than advanced industrial countries such as Japan, Canada or Italy, despite them having economies several hundred times Cayman's GDP. Thus, Cayman is big in global finance in absolute terms.

Research on the Cayman Islands

In some segments of international finance, the Cayman Islands is even among the largest jurisdictions worldwide. For instance, the Bank for International Settlements provides data on external loans and deposits of all reporting banks vis-à-vis individual countries. According to this metric, in 2015 Cayman had the third highest value in the world – over US\$1,300 billion in external loans and almost \$1,800 billion in external deposits. This puts Cayman on place three globally, after the United Kingdom and the United States. Besides banking, the Cayman Islands is also very large in portfolio investment.

In relative terms, Cayman's size in finance is even more surprising. Setting the amount of foreign assets in relation to GDP of a particular jurisdiction results in what I have called the offshore-intensity ratio, a rough yardstick of how intensively a jurisdiction acts as a magnet for foreign capital. With a value of over 1,500, Cayman has by far the highest ratio in the world – the British Virgin Islands (BVI) and Bermuda follow with values of roughly 1,000 and 200, respectively.

In a recent research paper, I have conducted one of the most complete studies on the position of the Cayman Islands in global finance. I have utilized all sources of publicly available data on the three major financial segments: banking, direct investment, and portfolio investment. In short, my argument is that Cayman is a key node in an Anglo-American triangle together with the United States, its major counterpart jurisdiction, and the United Kingdom, its sovereign power.

The status of the Cayman Islands as a British Overseas Territory should be seen as fundamental for the unparalleled success of this offshore financial center. Being a dependency that is under the sovereignty of the United Kingdom provides Cayman with political and economic stability. In contrast, competing jurisdictions, such as the Bahamas or Panama, have been rocked by political instabilities in the past. Stability is of paramount importance in order to create and to maintain investor trust. In addition, a crucial Cayman property that stems from British rule is the stable and business-friendly legal system based on English common law. What is less known is that it is still legally correct today to refer to the Cayman Islands and other British dependencies, such as BVI or Bermuda, as “colonies” of the United Kingdom.

Banking

The United States is among the largest counterparties in banking, direct investment as well as in portfolio investment. American and other foreign banks use Cayman intensively for intra-group transactions in U.S. dollar, such as overnight sweep accounts. However, according to the “Locational Banking Statistics” by the Bank for International Settlements (BIS), intra-group transactions by foreign banks have peaked in 2011 and are declining since then.

The “Consolidated Banking Statistics” by the BIS enable another perspective on the Cayman Islands banking center. They provide information on claims by foreign banks on counterparties (e.g. hedge funds) resident in Cayman. In Q3 2016 foreign banks had consolidated claims on counterparties resident in the Cayman Islands of over \$1,200 billion – a new time high. American banks are responsible for about 30 percent of that large value.

Surprisingly, Japanese banks account for over 40 percent, which is the highest share of all countries. These two very counterpart countries in banking are followed by Switzerland (9 percent), the United Kingdom (5 percent), Germany (4 percent) and France (4 percent).

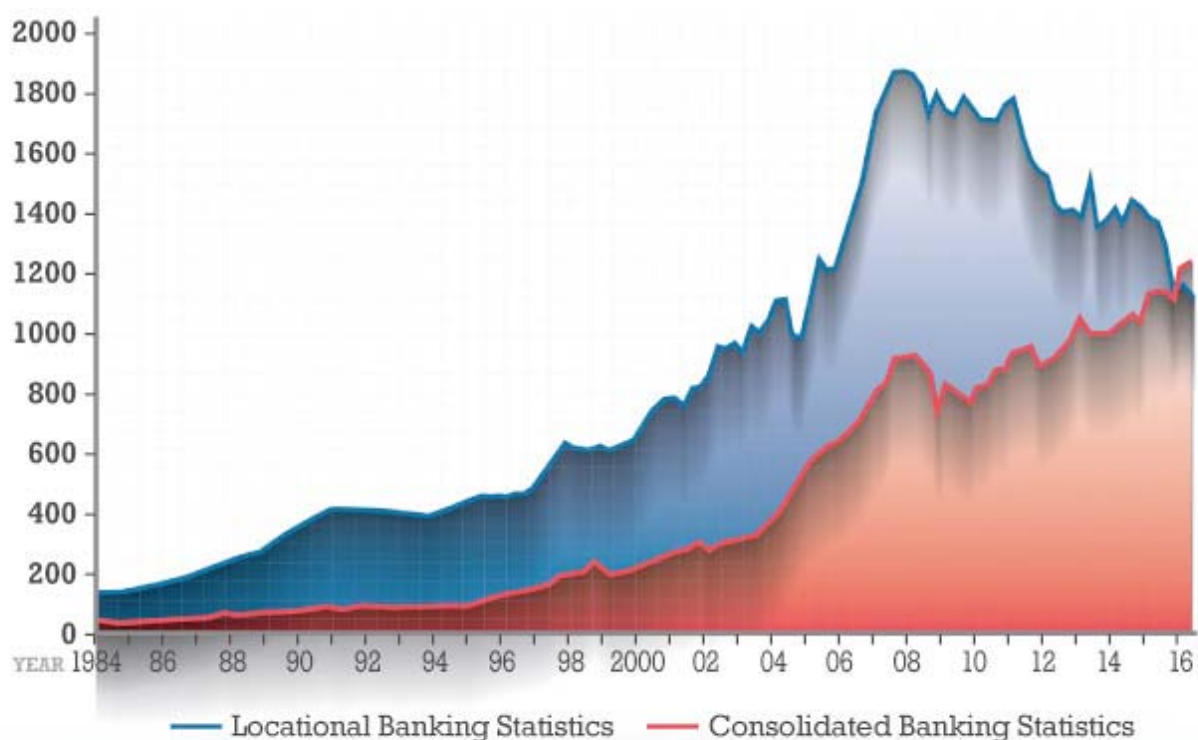


Figure 1: Cross-border claims on non-banks surpassed intra-group activity for the first time in 2016.

Figure 1 shows that in mid-2016 the Consolidated Banking Statistics, claims from foreign banks on Cayman entities, surpassed the Locational Banking Statistics, cross-border claims from banking offices located in Cayman, for the first time since statistics began in the 1980s.

In other words, intra-group activity in Cayman is declining while claims by foreign banks on non-banks, likely hedge

funds and other investment vehicles, resident in Cayman keep rising.

Direct investment

Banking is big in Cayman, but foreign investment is even bigger. The huge domain of investment can be separated in direct investment and portfolio investment. Portfolio investment is defined as equity or debt instruments that are held passively to make financial gains. The characteristic feature of foreign direct investment (FDI), by contrast, is the aim the investor to exert a certain amount of control over a foreign company.

The Cayman Islands is not reporting FDI data to the IMF. However, the outward direct investment statistics reported counterpart economies make it possible to derive data for Cayman. FDI into Cayman has grown from close to \$300 billion in 2009, when IMF statistics began, to over \$550 billion in 2015. This should be seen as a lower bound estimate, as the value is derived from outward FDI by participating jurisdictions, a value which some countries, such as China, do not report.

FDI is often associated with “greenfield” investment, i.e. the construction of new plants. This is clearly not the case in Cayman and other offshore financial centers, such as the BVI and Bermuda, because their domestic “real” economy is simply far too small to absorb large flows of foreign capital.

The United States is by far the largest source of FDI into Cayman. In 2015, the United States accounted for almost \$250 billion, i.e. about 47 percent of total inward FDI. From information by the U.S. Bureau of Economic Analysis, we can infer that the vast majority of U.S. FDI to Cayman is concentrated in just two segments: 1) holding companies (nonbank) and 2) finance (including depository institutions). Other significant sources of FDI are Hong Kong with \$56 billion, the Netherlands with \$53 billion and Brazil with \$52 billion.

Outward direct investment emanating from Cayman goes to Luxembourg (\$98 billion), the United States (\$93 billion), Hong Kong (\$85 billion), Singapore (\$58 billion), the Netherlands (\$49 billion), and China (\$48 billion). Luxembourg and the Netherlands are the two dominant global FDI conduits for multinational corporations, which explains their prominence here.

Portfolio investment

The largest segment of the Cayman offshore financial center by far, however, is portfolio investment. Again, the Cayman Islands do not participate in the portfolio investment statistics collected by the IMF, but data derived from counterpart economies is available.

According to this data, in mid-2016 Cayman has been the world's fifth largest financial center concerning foreign portfolio investment with an astonishing value of over \$2,640 billion – roughly \$2,000 billion in equity and investment funds and the rest in debt securities. Thus, Cayman has attracted less external portfolio investment than the United States, the U

Kingdom, France and Luxembourg, but more than Germany, the Netherlands and Japan.

There is one simple explanation for this. Cayman is the global jurisdiction of choice for hedge funds. These investment vehicles use Cayman as their legal domicile, the actual hedge fund managers work almost exclusively in the New York Boston area and in London, which makes hedge funds a quintessentially Anglo-American industry.

Data from the IMF and the U.S. Treasury allow the visualization of Cayman's role in international portfolio investment. Figure 2, using data for mid-2015, shows that the Cayman Islands primarily acts as a conduit to U.S. financial markets. Actually, Cayman is mainly used for what could be called some kind of "round-tripping" by American investors who invest in hedge funds that are legally domiciled in Cayman but which predominantly buy U.S. securities.

In fact, when excluding U.S. long-term debt, of which the central banks from both Japan and China hold more than \$ billion each, Cayman is the largest holder of U.S. securities in the world. See figure 2

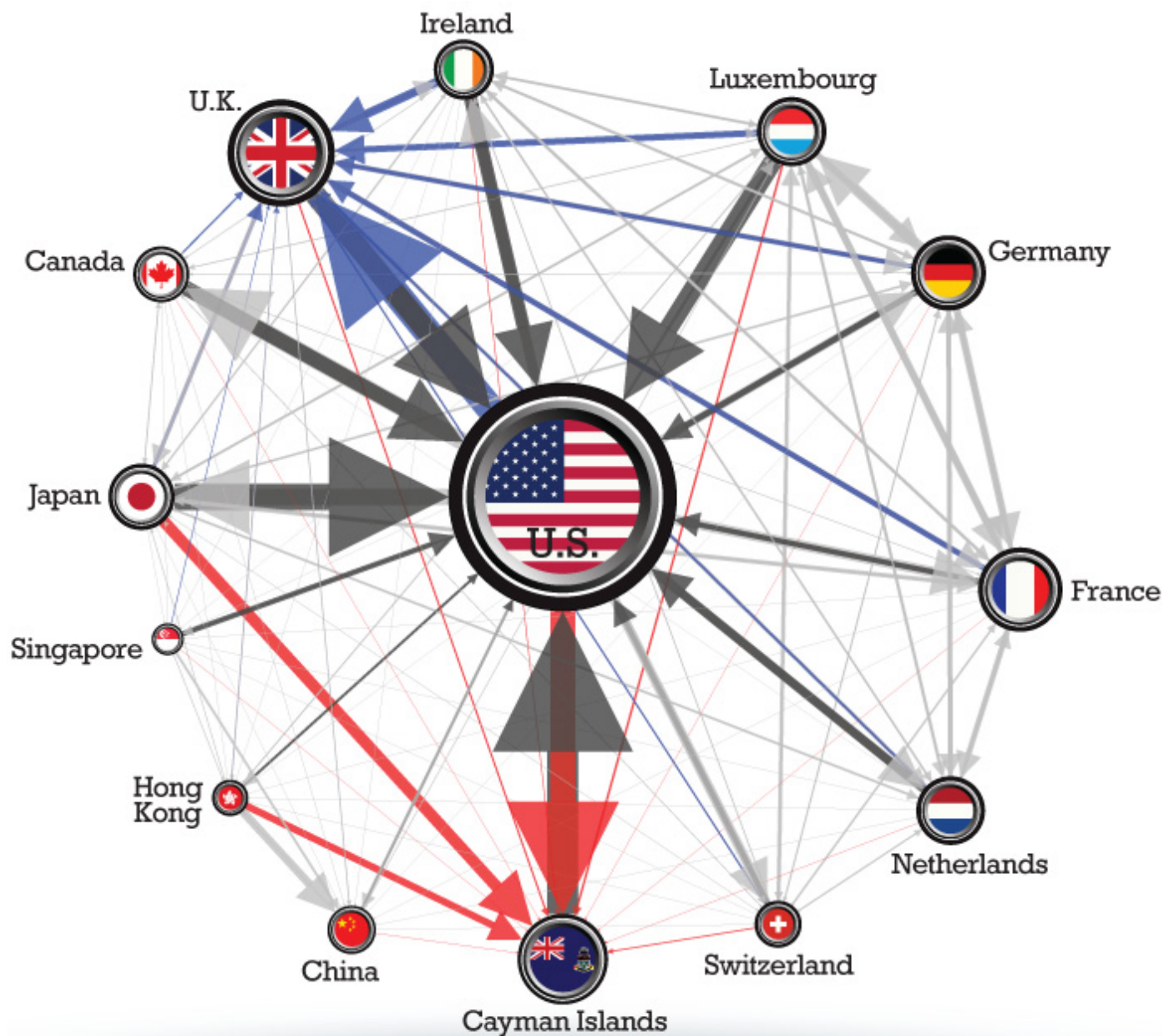


Figure 2

The high value of portfolio investment by Japan is remarkable too; it has risen strongly from \$547 billion in mid-2011 almost \$713 billion on year later. Thus, Japanese investment is more than two times the portfolio investment from Hong Kong, which amounted to \$337 billion. One reason for the high value of Japan is that Cayman has enacted special legislation to attract investment funds specifically targeted at Japanese investors. Nonetheless, this figure is certainly surprising. Similar to the role Luxembourg plays as the dominant investment fund hub for Germany, Italy and other European countries, Cayman arguably acts as the preferred investment fund domicile for Japan.

In recent years, Cayman has increasingly catered to investors from Greater China. A key event in that respect has been the initial public offering (IPO) of the Chinese e-commerce giant Alibaba through a holding company legally domiciled in the Cayman Islands. However, foreign investment in Chinese e-commerce is actually restricted considerably. How did Alibaba do it? The company used a legal structure known as “variable interest entity” (VIE).

The problematic aspect of this structure is how to consolidate the restricted businesses that are part of the VIE without violating Chinese rules on foreign investment. The solution devised by accounting was to mimic ownership through a series of contracts between the Cayman company and the VIE. These legal contracts give the Cayman holding enough facto control over the Chinese VIE that it is able to consolidate it under international accounting rules, even though Chinese laws actually prohibit foreign investment in this sector. Hence, this legal structure represents a grey area with significant hidden risk for investors in the Cayman company, because the whole structure rests on the willingness of Chinese authorities to tolerate it. In 2014, the Chinese e-commerce giant Alibaba (the Cayman holding, that is) raised record \$25 billion by going public on Wall Street, thus probably perpetuating the VIE structure given the sheer size of the IPO. However, investors in Alibaba have no de jure control over the Chinese corporation, as they only own shares in the Cayman holding.

Conclusion

The data presented above clearly shows that Cayman is not a random exotic small island financial center but a key component of contemporary global finance. My argument is that the Cayman Islands represents a central node in an Anglo-American financial triangle together with the United States and the United Kingdom. The United States is the largest counterpart economy of Cayman and the United Kingdom is its sovereign power. No other financial industry illustrates this Anglo-American triangle better than hedge funds, which are quintessentially Anglo-American. Hedge managers are extremely concentrated in New York and London, while most funds are legally domiciled in the Cayman Islands. Actually, in this respect Cayman could be seen as a branch of or a special bookkeeping device for Wall Street and the City of London.

However, the global hedge fund industry seems to have peaked recently or at least growth rates are likely to be low in coming years as investment flows are strongly shifting into index mutual funds and exchange traded funds. So how is the outlook for the Cayman Islands offshore financial center?

Brexit and the Trump Administration represent two factors that arguably are going to reduce international pressure on offshore financial centers to become more transparent. On the other hand, if the United States changes its corporate tax code in a way that creates strong incentives for U.S.-based multinational corporations to repatriate capital this could lead to an outflow of funds from jurisdictions such as Bermuda and the Cayman Islands.

The IMF has identified reputational risk as the biggest danger to the Cayman Islands financial center. One strength of Cayman is that the regulatory bodies react swiftly to new international requirements. The Cayman Islands could further enhance its international reputation and its status as a trusted jurisdiction that participates in global regulatory initiatives by, for instance, finally reporting complete data on foreign direct investment and portfolio investment to the IMF. As a jurisdiction with a domestic economy of just \$3 billion that has attracted foreign assets of well over \$4,000 billion clearly should do everything it can to maintain investor trust and keep its reputation with global regulators.

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