

The Economic Impact of the Banking Industry in the Cayman Islands

Prepared for the Cayman Islands Bankers Association

**By StratInfo
Miami, Florida**

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Preface

The Cayman Islands Bankers Association (CIBA) is proud to present the first ever analysis of the economic impact of the banking industry on the Cayman Islands. The banking industry in the Cayman Islands is one component of a diversified and significantly larger financial system. CIBA commissioned this study conducted by StratInfo, a U.S. economic and finance consulting firm located in Miami, Florida. The objectives of this study are: to quantify the contributions of the banking industry to the local economy; to identify other socio-economic contributions made by the banking sector; and to identify the Cayman Islands' main strengths as an offshore center and the challenges ahead.

The principal findings of this study are based on a survey administered to the members of CIBA, on the consultant's own independent research, and on their interviews with local industry representatives and government officials. CIBA and StratInfo wish to express their gratitude to the banks that participated in the survey, as well as to all the representatives of local firms and government officials that provided valuable insights. Their gratitude also extends to the Cayman Islands Monetary Authority (CIMA) for their very helpful comments and for the statistical and regulatory information they provided on the financial system.

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Contents

Executive Summary	1
Overview of the Cayman Islands economy	3
Overview of the Financial System.....	7
The Banking Industry in the Cayman Islands.....	10
The Offshore Banking Center.....	11
Insurance and Investment Funds.....	13
Linkages between Banking Activity and the Local Economy	15
The Impact of Banking on the Cayman Islands Economy	18
Challenges and Opportunities for the Banking Industry: Survey Responses	23
Annex: Tables	28
References.....	40

Executive Summary

This is the first study of the economic impact of the banking industry in the Cayman Islands. The focus of this analysis is mainly on the contribution to the local economy from the banks that have a physical presence in the Cayman Islands, as well as on some contributions arising from the other registered banks that have their physical office outside the islands. The banking industry is part of a comprehensive financial services industry that provides banking, insurance and investment services to a local as well as global client base.

The Cayman Islands' location, competitive advantages, and linkages to the global economy have provided a favorable environment for a dynamic financial sector. The Cayman Islands has maintained a relatively stable economic environment with steady growth and modest inflation. The growth of the financial sector has also benefited from a stable political system. Economic policies have nurtured a competitive services economy.

The financial system of the Cayman Islands is one of the pillars of the economy. Tourism is also an important sector in the economy. The three principal components of the financial system are banks and trust companies, insurance, and mutual and investment funds. This economic impact analysis is based exclusively on the contribution from the banking industry. The economic impact of the whole financial system would thus be significantly larger.

The banking industry is the principal component of the financial system. It services two distinct but highly interrelated markets: the domestic market (formed by residents and companies located in the Cayman Islands) and the offshore market (which encompasses persons and entities located anywhere in the rest of the world). In 2005, there were 305 banking entities which are differentiated by the type of banking license: A or B. Class A banks can engage in both domestic and in offshore banking activities; and Class B banks are limited to offshore banking activities – all their customers are situated offshore. Each type of banking class is further sub-divided into those institutions offering banking only and those offering both banking & trust services.

As part of their offshore activities, banks located in the Cayman Islands provide a wide range of services to the clients of their financial group – both corporate and individuals, to other financial and non-financial institutions, and to their own corporate group. The principal areas for offshore banking are: private banking and trust services; corporate services and capital markets transactions; and investment funds services.

The banking sector as defined in this study has numerous linkages with other components of the economy of the Cayman Islands. This study has addressed those links through the measure of the direct impact in terms of income earned by those employed by the banks, the banks' purchases of inputs from other sectors, particularly administrative and professional services, as well as the banks' payments of fees and indirect taxes to the government directly and through the regulatory agency, the Cayman Islands Monetary Authority (CIMA).

The economic impact of the banking industry is derived from a survey of the banks operating in the Cayman Islands. The survey was administered to banks and banks & trust companies holding

a Class A or B license and which were members of the Cayman Islands Bankers Association (CIBA). The principal findings of this study are:

- The banking sector employs 2,814 individuals, equivalent to 8.0 percent of total employment in 2005.¹ The overall impact of the banking sector represents about 25.0 percent of the GDP of the Cayman Islands. Total direct contributions are US\$407.0 million and the indirect and induced impact another US\$93.7 million, for a total impact of US\$500.6 million.
- The principal components of the banks' annual contribution are wages and salaries, inclusive of employee benefits, followed by other local expenditures. Wages and salaries account for 62.5 percent of the total economic impact. The direct contribution to the Government totals US\$ 32.2 million, or about 6.4 percent of the total impact. Travel expenditures by visitors represent about US\$5.9 million.
- The survey also sought the banks' views regarding the competitive advantage of the Cayman Islands banking industry and its challenges. Banks consider the financial/legal/labor infrastructure as the main reason for the establishment of operations in Cayman Islands. A second motivation had to do with the banks' own business and strategic reasons for establishing operations in the Cayman Islands. A tax-free environment and strict confidentiality of customer relationships were also considered important factors for doing business in the Cayman Islands.
- Among the challenges facing the banking sector is the shortage of local professionally trained employees and mounting difficulties to attract qualified staff from abroad. Respondents were displeased with more restrictive immigration laws that impose work term-limits. Banks were concerned with the negative impact on profitability from rising costs of doing business. There were also concerns about the increase in the regulatory burden as well as adverse trends in the international economic / regulatory environment. Negative perceptions about offshore operations in the international community have resulted in regulations that are more stringent. A number of banks expressed concern about competition from other jurisdictions, particularly those with lower costs.
- In the fast-changing and highly competitive global financial markets, and with economic and regulatory challenges facing the industry, the banks in the Cayman Islands need to be more aggressive in maintaining their competitive position. The Government should also re-assess its policies towards the financial sector in order to continue to support the successful development of such an important sector of the economy. The Government may also want to consider a more proactive outreach campaign to other regulatory agencies around the world to provide a better perspective on the structure and operations of the financial center and its positive economic impact.

¹ According to the Labour Force Survey (April 2006), the sizeable increase in employment in 2005 was influenced by the post-Hurricane Ivan reconstruction process, thus the percentage may understate the medium- and long-term employment impact of the banks.

Overview of the Cayman Islands economy

The Cayman Islands, consisting of three islands: Grand Cayman, Cayman Brac and Little Cayman, is a small, open economy with a population of 52,465 as of 2005 that is highly dependent on international trade in goods and services. Economic development of the Cayman Islands has evolved over two periods, the first through the 1950s, in which the mainstay of economic activity consisted of ship-building, turtle fishing, production of thatch rope, and other minor industries such as shark hides, lobster fishing and handicrafts. The second period started in the 1960s with the development of what are today the two principal industries: finance and tourism.² Finance and tourism are closely linked and have contributed to the dynamic growth of the economy, triggering a robust expansion in the construction industry as well as sizeable investments in physical infrastructure such as transportation, water, electricity, telecommunications, healthcare, and education.

Economic development has benefited from a stable political system. The Constitution of 1959 established the Cayman Islands as an overseas territory of the UK. The Governor, who is appointed by the Crown, presides over an eight-member Cabinet. Membership in the Cabinet consists of five ministers elected by and from within the elected membership of the Legislature and three Official Members who are senior civil servants appointed by the Governor. The legislative branch is represented by a unicameral Assembly with 18 representatives, three of whom are the Official Members of Cabinet and 15 are elected to represent the Islands' six districts for a four year term. A formal two party system has evolved comprised of the United Democratic Party (UDP) and the People's Progressive Movement (PPM). The legal system is based on British common law as amended by local statute.

Economic policies have nurtured a competitive services economy financed primarily through private sector investments. The Cayman currency, the CI\$, was first issued in May 1972, replacing the Jamaican currency. A Currency Board was established to supervise the issuance of currency. Initially, parity of the currency was set in relation to the British pound, but was changed in 1974 to the US\$ with a rate of C\$1 = US\$ 1.20. In January 1997, the Currency Board and the Financial Services Supervision Department were merged to form a new agency, the Monetary Authority. The mission of the Monetary Authority is to maintain a well regulated financial services industry.

Fiscal policy has maintained a conservative stance with the government focusing on the social and physical infrastructure needs of the economy and the private sector acting as the principal engine for growth. There is no direct taxation; however, the government raises its revenues from indirect taxes, fees and duties. The principal revenue components are import tariffs, licenses – mostly to financial services providers, and fees. As shown in Table A – 8a in the Statistical Annex, import duties represented 31.0 percent of total Government revenues in 2003, followed by company fees with 12.2 percent, and bank & trust company license fees with 8.9 percent.

² For an in-depth analysis of the historic development of the economy of the Cayman Islands see Sir Vassel Johnson, *As I See It: How Cayman Became a Leading Financial Centre*, The Book Guild Ltd, 2001.

Historically the Government has maintained an overall budget surplus with a moderate deficit from time to time.

As a small Caribbean island economy, the Cayman Islands is highly dependent on the import of goods and services due to its limited production capacity. Local industry relies on imported raw materials, intermediate goods as well as machinery and equipment for the production of goods and services. Due to these economic characteristics, the Cayman Islands incurs a deficit on its balance of trade – the difference between exports and imports of merchandise. During 1998-2003, the year prior to Hurricane Ivan, the trade deficit averaged 35.0 percent of GDP. The bulk of imports are from the U.S., 78.0 percent in 2004; however, these figures include transshipment of goods from third countries through the Miami Customs District with final destination to the Cayman Islands. The structure of imports by broad economic category consists of consumer goods 51.5 percent of the total, followed by transportation and fuel, 21.8 percent; intermediate goods 14.2 percent, of which, construction materials accounted for 10.4 percent; and capital goods with 12.5 percent.³ The trade deficit is mostly offset by the large surplus in services arising primarily from financial and tourism services. The factor services deficit reflects a steady stream of dividends, interest and rental payments to overseas creditors and investors. The net balance of these three – the merchandise, the services, and the factor income accounts, appears to have trended within manageable proportions covered easily through foreign capital inflows.

Tourism

In addition to financial services, tourism is an important sector within the economy of the Cayman Islands. The two industries are interrelated in that financial sector activity attracts many visitors on business who stay at local hotels, eat at restaurants, and visit other attractions. It has been estimated that about 40 percent of tourist traffic is associated with the financial industry as part of business travel which has subsequently generated leisure travel from individuals who first visited on business.⁴ The tourism industry has a well-established infrastructure in terms of hotel facilities, restaurants, shopping and transportation.

The inauguration in 1954 of what is now the Owen Roberts International Airport opened the door to the development of the tourism industry in the Cayman Islands. However, it was not until the 1960's that tourists started arriving in significant numbers. The growing importance of tourism led to the creation of the Cayman Islands Tourist Board in 1966 and to the Department of Tourism in 1974. In the 1970's, Cayman Airways began flying to Miami and then to Houston, eventually extending service to other nine U.S. destinations in the 1980's, thus broadening access to the lucrative U.S. market.

Nowadays, the Cayman Islands attract close to 2 million visitors per year, who arrive mostly by cruise ships. The modest hotels of the 1960's have given way to internationally known luxury hotels. According to the Cayman Islands Tourism Association (CITA), there were 2,690 hotel rooms and 2,562 condo rooms in Cayman Islands in 2003.

³ The figures on the structure of imports by economic category represent the average for 1992-1998, the latest period for which information is available.

⁴ Sir Vassel Johnson (2001), page 147.

Economic Trends: 2003-2005

The Cayman Islands has maintained a relatively stable economic environment with steady growth and modest inflation. GDP averaged an annual growth rate of 2.0 percent during 1999-2003, and its resilience to global cyclical swings was evidenced in 2001 when the economy managed to expand by 0.6 percent despite a global recession. With the concentration in construction, financial services and tourism, the economy created jobs at a fairly healthy rate of 5.7 percent per annum. During the same five year period, inflation averaged a moderate 2.8 percent. The strength of the economy also contributed to the buoyancy of government revenues. Tax revenues increased from 14.6 percent of GDP in 1998 to 17.2 percent in 2003. On the other hand, the economic expansion has contributed to the growth in imports, although during 1998-2003 merchandise imports as a percent of GDP remained at about 35 percent.

During 2003, the economy expanded by 2.0 percent, thus consolidating the recovery from the slowdown in 2001. Both financial services and tourism were up nicely. Growth in the financial services industry was broad-based with mutual funds, captive insurance businesses, and new-company registrations reflecting increased activity both on- and off-shore. Tourism benefited from cruise ship visitors which posted an increase of 15.5 percent, thus helping to offset a decline of 3.0 percent in air arrivals. Construction continued to add strength to the expansion with building permits up by 19.0 percent led by single and multi-family housing.

Impact of Hurricane Ivan and subsequent recovery in 2005

While the slowdown in the economy in 2001 was driven by global economic factors, another adverse shock occurred in 2004 with the impact of Hurricane Ivan in September of that year. Hurricane Ivan struck the islands with its greatest force on September 12. The storm wreaked major damage on the infrastructure and productive sectors of the economy. GDP posted a marginal 0.9 percent growth in 2004, while inflation accelerated to 4.4 percent as a result of the disruption in the supply of goods, including the upsurge in global energy prices.

The Cayman Islands infrastructure was compromised, at least in the short-term, by the very strong storm.⁵ The electric power grid, which is managed by the Caribbean Utilities Company (CUC) sustained extensive damage. The system was down for five days following the storm. The water supply and treatment network was compromised in terms of water plant failures, damage to water tanks, and to the water treatment facility. After power became available, the water utility was up but at a diminished capacity. The telecommunications sector, covered by Cable and Wireless, also sustained significant damages. The road and transportation network, including the airport and seaport presented additional challenges as the island economy began the process of rebuilding from the ravages of the storm. One of the palliatives to the challenges associated with the reconstruction effort was that many of the fixed assets damaged by the storm were insured, thus providing critical financial relief.

⁵ For an in-depth analysis of the damage see ECLAC, *The Impact of Hurricane Ivan in the Cayman Islands*, December, 2004.

Housing bore the brunt of the damage from the storm. It is estimated by the ECLAC study that 83 percent of homes, or 13,535 units, suffered significant damage or were destroyed, of which 80 percent had some type of insurance. Total estimated damage to housing was CI\$1.4 billion

The total cost of the impact from the storm was estimated by ECLAC to be approximately CI\$2.9 billion (US\$3.4 billion). Most of the losses, about CI\$2.4 billion, were associated with damage and destruction to property and structures, and the remaining portion, CI\$0.5 billion were losses in terms of production as well as an increase in the cost of provision of services. The sectors that suffered the greatest losses were commerce, with losses of CI\$0.4 billion in property and CI\$34.4 million in lost business revenues, and tourism, with losses of CI\$0.3 billion in property and CI\$0.2 billion in business revenues. Overall, the impact from the hurricane was estimated to be about 183 percent of GDP.

One of the positive outcomes from the natural disaster was the impetus to the local economy from the rebuilding efforts. Based on the ECLAC estimates of the damage, the repair could extend over a period of several years. The rebuilding activities contributed significantly to the rebound of the economy in 2005.

Impact of the hurricane on the financial sector

The impact to the financial sector from the hurricane was considered to be only modest. The financial system speedily recovered after the hurricane. It experienced only minor direct damage to facilities, although it incurred additional expenses associated with the temporary relocation of personnel and the need to outsource some critical services to other offshore locations. Some institutions did have to undertake construction repairs to their offices.

Overview of the Financial System

The financial system of the Cayman Islands is one of the pillars of the economy. The three principal components of the financial system are banks and trust companies, insurance, and mutual and investment funds. The scope of this survey is limited to the banking component and its contribution to the local economy.

The dynamic growth of financial intermediation activity has been driven by the development of the offshore financial center. As shown by the chronology of key financial sector legislation, the initial focus by the Government was on the establishment of a world-class banking industry in the 1960s. Building on the success of banking, the Government then introduced legislation in 1979 to support the development of insurance, and in 1993, continued to expand the scope of financial activity through the Mutual Funds Law. While the domestic market is well served by these three main components, the driving force of financial intermediation in the Cayman Islands has been the offshore business.

The offshore financial center provides services to clients that are located outside the Cayman Islands. An offshore financial center is “a center where the bulk of financial sector activity is offshore on both sides of the balance sheet.”⁶ Thus the offshore center creates liabilities to clients residing outside the Cayman Islands through the acceptance of bank deposits, the collection of insurance premiums, the offering of investment interests, and then re-deploys these funds on the asset side of the balance sheet in the form of placements of inter-bank funds, investments in financial or physical assets, and in loans to individuals, corporations, and governments also located outside the Cayman Islands. While the sources and uses of funds reside offshore, the management, administration, back-office and other operational support functions associated with these transactions are housed in the offshore financial center located in the Cayman Islands.

The success of the Cayman Islands in the development of an offshore financial center is attributed to the following factors:

- Political stability assured by its status as a self-governing British Dependent Territory. English common law as amended by local statute provides a strong institutional foundation.
- Stable economy with prudent Government policies.
- No foreign exchange controls as established by the Exchange Control Repeal Law of 1980. Financial transactions involving the conversion of currencies are not subject to any type of controls.

⁶ IMF, *Offshore Financial Centers: IMF Background Paper*, June 2000. Additional discussion on the role of offshore financial centers is also provided by Byles (2005).

- Absence of direct taxation; thus no income tax, no capital gains tax, no estate and inheritance tax, and no taxes on financial transactions. As a consequence, there is no need to file any type of tax returns.
- A strong bank secrecy law which was passed in 1976.
- Flexible financial laws governing offshore business with minimal regulatory burden.
- Ease of setting up an offshore operation in terms of expediency in processing of required licenses, efficiency in setting up a corporation, and other streamlined procedures.
- Excellent infrastructure in terms of telecommunications and other utilities, and reliable air service.⁷

The quality of the institutional and physical infrastructure has made the Cayman Islands an attractive location for establishing offshore financial businesses. In developing the financial sector legislation the Government has sought to establish a flexible regulatory environment that is more congruent with the globalization of financial markets and provides more efficient vehicles to manage the multi-jurisdictional structure of complex international financial transactions. At the same time, the Government has subscribed to international standards of regulatory enforcement and supervision and participated in various international regulatory agreements with the aim of maintaining appropriate fit and proper standards for all entities doing business in the Cayman Islands.

The principal regulatory agency for the financial system is the Cayman Islands Monetary Authority (CIMA), established in 1997. CIMA is the only financial sector regulatory agency, apart from the Stock Exchange Authority. According to the IMF, the Cayman Islands financial industry and regulators have “developed an intense awareness of the measures required to combat money laundering and the financing of terrorism” through legal reforms and new supervisory practices.⁸

⁷ Some of these factors were cited by the banks’ responses to the survey administered as part of this study and which is discussed in a subsequent section of this report.

⁸ See IMF, *Cayman Islands: Assessment of the Supervision and Regulation of the Financial Sector*, March 2005.

Chronology of Key Financial Sector Legislation

Companies Law (1960, Revised 2004)

Governs the establishment of corporations: resident and non-resident.

Building Societies Law (1964, Revised 2001)

Established the savings and loan societies that provide mostly housing finance.

Cooperative Societies Law (1964, Revised 2001)

Established financial institutions that operate as credit unions.

Bank & Trust Company Law (1966, Revised 2003)

Established two types of bank licenses: Class A to conduct business within the Cayman Islands (CI); and Class B to engage in activities outside the CI or offshore.

Cayman Islands Currency Law (1971)

Issued authority for new currency and created the Currency Board.

Confidential Relationships Law (1976, Revised 1979)

Protects confidentiality of financial transactions and prohibits persons from divulging privileged information. Establishes criteria when such information can be divulged.

Insurance Law (1979, Revised 2004)

Provided for four categories of licenses for domestic and offshore business, including the captive insurance company.

Exchange Control (Repeal) Law (1980)

Abolished all foreign exchange controls.

Mutual Funds Law (1993, Revised 2004)

Established mutual funds and their management including mutual fund administration.

Proceeds of Criminal Conduct Law (1996, Revised 2004)

Provides measures for detecting and establishes criminal penalties for money laundering.

Monetary Authority Law (1997, Revised 2004)

Established the Monetary Authority to: issue and redeem CI currency; regulate and supervise financial services (banking, insurance and investment funds); coordinate with overseas regulatory authorities; and provide advice to the Government on monetary and regulatory matters.

Companies Management Law (1999, Revised 2003)

Law governs provision of corporate representation and administrative services.

Money Services Law (2000, Revised 2003)

Governs provision of money transmission, cheque cashing, and currency exchange services.

Securities Investment Business Law (2002, Revised 2004)

Law governs the establishment of securities services providers.

Note: the dates in parenthesis refer to the initial passage of the law and the latest revision.

The Banking Industry in the Cayman Islands

The banking industry is the principal component of the financial system. It services two distinct but highly interrelated markets: the domestic market (formed by residents and companies located in the Cayman Islands) and the offshore market (which encompass persons and entities located anywhere in the rest of the world). A distinguishing feature of the banking system is that the size of the offshore banking center dwarfs the domestic market with total assets of US\$1.2 trillion in 2005 compared to US\$10.0 billion for the domestic banking system. In 2005, there were 305 banking entities which are differentiated by the type of banking license: A or B. Class A banks can engage in both domestic and in offshore banking activities; and Class B banks are limited to offshore banking activities – all their customers are situated offshore. Each type of banking class is further sub-divided into banking and banking & trust licenses. In addition to the standard types of banking licenses, there is a restricted license that permits the licensee only to do business with persons and companies listed in the license. As the regulator of the financial system, CIMA issues banking licenses and supervises all of the activities of the banking industry.

The number of banks operating in the Cayman Islands has declined from 427 in 2001 to 305 in 2005. There are several reasons for the drop off including the consolidation in the global financial industry through mergers and acquisitions, economic considerations such as licensing and other costs of doing business, increasing costs of the regulatory environment and compliance, which in some cases has led to the withdrawal of banks from the offshore business as well as competition from other offshore centers.⁹ In 2002, the Government implemented a sizeable increase in the fees for banking licenses, so that the average licensing costs for Class A banks jumped by 233 percent and for Class B banks by 273 percent. By substantially increasing costs, this measure has also contributed to greater rationalization in the use of banking licenses. Banks with more than one license have consolidated their activities thus canceling unnecessary licenses, while some Class A banks have switched to the Class B category, which costs substantially less.

Class A banks are active in both the domestic and the offshore markets offering traditional banking products as well as investment services such as administration of mutual funds. Some of the Class A banks cater to the domestic market where they also offer banking services to the providers of services to the offshore banking center – accountants, lawyers, and other professionals. Financial intermediation by local banks has played an important role in the economy of the Cayman Islands. Total loans and advances by the six primarily local retail banks represented 160 percent of GDP in 2004, almost three times the typical percentage for domestic banking in industrial and emerging market countries. Based on year-end 2005 postings (see Appendix Table A - 4), 33 percent of totals loans were personal real-estate related, followed by 26.5 percent for private sector commercial services providers, 19.1 percent for non-residents, and 5.1 percent to the public sector. Even though many of these loans are to domestic enterprises and individuals, it is very difficult to separate the international from the domestic components of their businesses. For example, a local professional firm that receives financing from a retail bank

⁹ See section on Challenges and Opportunities.

may provide the bulk of its services to offshore financial intermediaries; and a local retailer may in fact rely on cruise ship visitors for the bulk of its sales. Many real estate properties, commercial and residential, are owned or partially owned by foreigners, even though the financing is provided by a local institution.

Other than the six banks oriented towards the local market, Class A banks are mostly involved in offshore banking activities. They also provide banking services to other offshore financial institutions, particularly those that do not have a physical presence in the Cayman Islands – such as Class B banks, trust companies, captive insurance companies, and investment funds. These services include administrative as well as fiduciary services to other non-financial companies operating in the offshore financial center.

The Offshore Banking Center

In terms of size, the offshore banking center, which is comprised of Class A and B banks offering financial services to non-residents, overshadows the domestic retail-based banking market. Offshore banks provide a wide variety of services to their overseas clients, to other financial institutions, and to their own financial group. They service private banking and institutional clients, carry out investments for their financial group's holdings, manage structured products, and administer investment funds. Some Class A banks provide facilities for short-term placements such as overnight funds for overseas clients seeking a more favorable interest rate or the convenience of the time zone.

The offshore banking center includes banks that have a physical presence in the Cayman Islands and others that engage purely in offshore transactions without having to maintain a physical presence. In 2005, 90 Class B banks, out of a total of 284 maintained a physical presence. Only Class B banks have the option of maintaining their place of business in a location outside the Cayman Islands. Nevertheless, those banks that do not have a physical presence in the Cayman Islands are required to be represented by a Class A bank and their Board members and other representatives make periodic visits to the Cayman Islands including to the regulatory agency (CIMA) as required by the ongoing supervisory process.

A Class A bank, that represents other banks that do not have a physical presence, acts as the intermediary between the offshore Class B bank and the local regulatory authority. They process all regulatory filings with CIMA on behalf of the Class B banks and keep all their statutory records and licenses. Since representation of a Class B bank generates fee income, some banks have retained a Class A license in order to offer this service to other banks that do not have a physical presence.

The decision by a Class B bank to establish a physical presence in the Cayman Islands is driven by various business and regulatory factors. Having a physical presence provides the banks' clients the peace of mind that their banking information is securely housed in the Cayman Islands. For that reason, their clients also need to have a local office they can contact regarding their accounts. A number of banks are also actively involved in sourcing and investing funds for their financial group, which requires a local presence of trading and investment management

professionals. From a regulatory perspective, the Cayman Islands' banking law requires a bank that is not part of a financial group subject to some form of consolidated banking supervision in their home country to have a physical presence so that CIMA can more closely supervise its activities. Some home country regulators also require banks subject to their supervision that have offshore banking affiliates to maintain a physical presence in their offshore locations in order to facilitate the supervisory process.

Offshore Banking Services

Offshore banks provide a wide range of services to the clients of their financial group – both corporate and individuals, to other financial and non-financial institutions, and to their own corporate group. These activities in turn generate both net interest and fee income. The principal areas for offshore banking are: private banking and trust services; corporate services and capital markets transactions; and investment funds services.

Private banking & trust services

Banks in the Cayman Islands provide all private banking products and services to the worldwide clients of their home country banking group who prefer the advantages of an offshore location. Banks provide mostly the back office support of their clients' transactions, although some relationship banking is also available for clients who also want to deal directly with the bank in the Cayman Islands. In the case of a money management account, the management of those assets is usually performed by the parent company. Private banking clients are also attracted to the Cayman Islands because of its flexible and progressive trust jurisdiction, which is based on British Law. The trust is incorporated in the Cayman Islands, and the asset managers are spread around the world. A Class A or B bank or a pure Trust Company can serve as trustee, who takes on the administrative tasks with the asset management being handled by another entity within their global financial group. Some trust administrators in the Cayman Islands contract routine accounting work to other offshore locations. With the growing complexity of global finance, the increasing cost of regulatory compliance for each account, and with greater scrutiny of offshore banking activities, the threshold amount for establishing private banking accounts and trust services has risen substantially, thus providing greater value added opportunities for financial services institutions in the Cayman Islands.

Corporate services and capital markets transactions

Offshore corporate services are provided to clients of the financial institutions who also maintain an offshore corporation in the Cayman Islands. International corporations represent a wide range of business interests including those represented by trust accounts managed by offshore banks. Any offshore entity that is registered under the Office of Corporate Registry, such as insurance companies, ship and aircraft registries, as well as any other international businesses will need banking services. Banking services for special purpose vehicles that are created in relation to capital markets transactions such as securitization have been expanding rapidly. Offshore banks also perform banking operations for their parent financial group, such as management of their parent holdings' funding requirements, particularly in the Euro-currency markets.

Investment funds services

This segment of the offshore financial industry has experienced strong growth in the past several years. For those funds registered in the Cayman Islands, the offshore banks maintain the registry and subscription of shares, process and post all orders and trades, compute the Net Asset Value of the funds, and coordinate the audits.

Insurance and Investment Funds

Building on the success of the banking center, the Government sought to promote the expansion of the financial industry through the development of insurance and investment services. The institutional foundation for insurance and investment funds was established through passage of the Insurance Law in 1979 and of the Mutual Funds Law in 1993. By offering a flexible environment for insurance and investment activities and by focusing on its competitive advantages, the Cayman Islands have been able to attract a fast-growing segment of these industries. The offshore financial center has capably exploited a niche market for captive insurance companies and for mutual funds administration, particularly hedge funds – one of the most dynamic segments of the investment management industry.

Insurance

The Insurance Law provides for four license categories: two sub-categories for each of Class A and B insurance companies, which include the captive insurance company. A captive insurance company is a closely-held company whose insurance business is primarily supplied and controlled by its owners.¹⁰ The principal advantages of an insurance captive include lower costs of operations and greater capacity to absorb risk than the parent based in its home market. In 2005, the bulk of the 733 offshore insurance licenses were for captive insurance companies (see Table A – 5 in the Annex). According to CIMA, 38 percent of the captive insurance companies were in the healthcare industry – medical malpractice; 21 percent in workers' compensation; and 10 percent were in property insurance. These captive insurance companies are managed by top-tier insurance companies and are also very active in the re-insurance market. In the case of a large deductible, the captive insurance covers the risk directly by managing its own reserves, and then purchases reinsurance from large global insurance underwriters.

Investment Funds

Based on the reputation of the offshore center and on the passage of the Mutual Funds Law in 1993, the Cayman Islands has evolved as a dynamic player in the global funds market. As of December 2005 there were 7,106 mutual funds, up 20 percent with respect to 2004, and 158 fund administrators (see Table A - 6 in the Annex). Administrators can provide director, trustee and general partner services, transfer fund shares, calculate NAV's, and other back office administrative functions, as well as ensuring regulatory compliance. Because of its flexible

¹⁰ For additional information see Appleby Spurling & Kempe, *Cayman Islands International Business Guide*.

regulations that focus on disclosure, the offshore center has attracted investment funds that are geared for sophisticated and institutional investors. In recent years the strongest growth component has been the offshore hedge funds. While there is no strict definition of a hedge fund, it usually refers to a fund that holds a pool of securities and perhaps other assets and engages in a wide variety of investment strategies. Hedge funds may trade fixed income securities, convertible securities, currencies, futures contracts, options and other non-securities investments; and may or may not utilize hedging and arbitrage strategies.¹¹

The development of offshore investment funds business has been buttressed by the Cayman Islands Stock Exchange (CSX). The CSX commenced operations in 1997 and has become a leading exchange for the offshore mutual funds industry as well as for specialist debt securities, derivative warrants, depository receipts and Eurobonds. Broker members are comprised of Class A banks, while listing agents are represented by accountants, attorneys, and other business consultants. As a result of the Cayman Islands' implementation of the European Union Savings Directive (EUSD), the CSX was designated as a "recognized stock exchange" by the UK government, thus there is no withholding of taxes on interest paid to UK citizens. The CSX operates mainly as a listing exchange subject to regulatory standards that are consistent with international best practices.

¹¹ See U.S.SEC Staff Report, *Implications of the Growth of Hedge Funds*, September 2003.

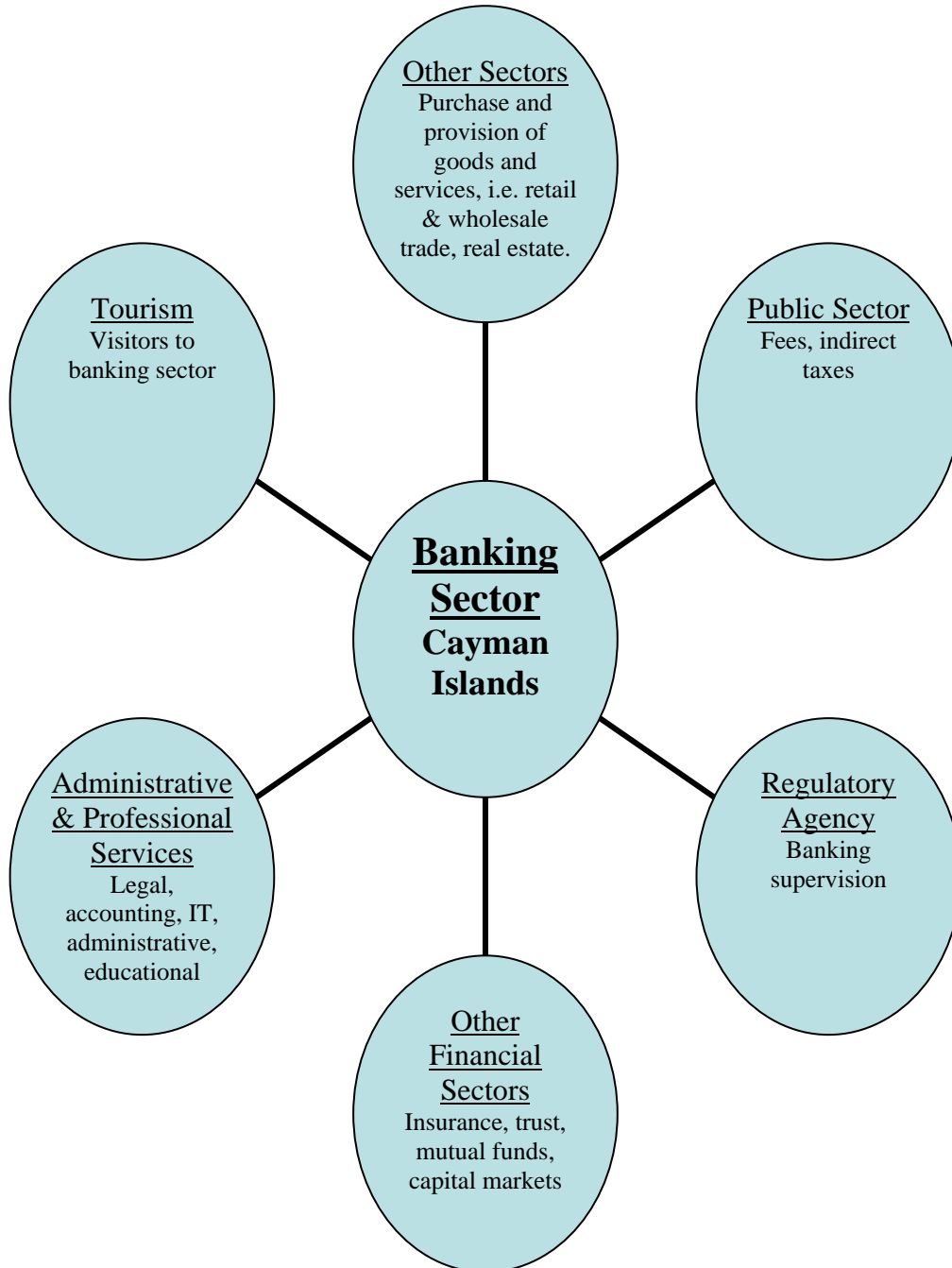
Linkages between Banking Activity and the Local Economy

The banking sector as defined in this study has numerous linkages with other components of the economy of the Cayman Islands. This study has represented those links through the measure of the direct impact in terms of income earned by those employed by the banks, the banks' purchases of inputs from other sectors, particularly administrative and professional services, and its payments of fees and indirect taxes to the government and also through the regulatory agency (CIMA). Chart I provides an overview of the key economic sectors and their linkages, which usually represent a two-way relationship in terms of the demand and supply of banking services with respect to each of those sectors / industries.

As part of the financial system, the banking sector is a provider of services to the insurance, pure trust, mutual funds, and other capital markets activities.¹² Banking services to these other financial intermediaries include establishment of deposit and operational accounts, transfer of funds, and account keeping. Associated with the banking system is a network of attorneys, accounting firms, IT specialists and administrative services providers, including specialized professionals whose services are provided to the banks on an outsourcing basis. Some banks have a comprehensive in-house capability for providing banking services to their clients, while others, with a more limited staff, rely on outsourcing of specific administrative and professional services. The public sector is a direct beneficiary of banking activities through the payment of fees, such as work permits, the annual registration fee for corporations, as well as indirect taxes. At the same time, the banks must make an annual payment of license fees which are collected by CIMA on behalf of the government.

¹² In the case of trust companies, this linkage refers to the pure trust companies which have not been included in the scope of this survey.

Chart I: Economic Linkages of the Banking Sector



The banking center in the Cayman Islands makes a significant contribution to the tourism industry. There are several categories of visitors identified in this study. First, visitors from the banks' head office or other affiliates who travel to the Cayman Islands on banking business. Second, there are other services providers from outside the Cayman Islands who visit the local banks. Third, overseas clients of the local banks visit the Cayman Islands to meet with their bankers. And fourth, in the case of the Class B banks without a physical presence, an officer from these banks is required to make periodic visits to the Cayman Islands, including to the Monetary Authority. This component of the economic impact has been estimated based on the survey responses.

The linkages to other sectors of the economy reflect their demand for banking services as well as the supply of goods and services from those other sectors to the banks. Class A banks, which are licensed to provide all types of banking services, offer deposit accounts as well as investment and lending services to local businesses and individuals. As mentioned in an earlier section, the banks make an important contribution in terms of financing of other productive activities in the economy (see Table A – 4). However, this study did not address the additional economic contribution to the local economy from the availability of financing to businesses and individuals, in terms of the additional output that was produced as a result of bank loans which allowed businesses to expand their production. Thus the economic impact estimates in this study underestimate the true extent of the banking system's contribution to the Cayman Islands economy.

There are other economic factors that can be attributed to the contribution of the banking sector to the local economy; however, their impact is not quantifiable. Some of these non-quantitative factors were reported by respondents to the survey. The banking sector through educational and other training programs has enhanced the quality of the local labor force. The success of the banking industry in the Cayman Island has been a draw for other financial industry activities such as insurance and investment banking. In other cases, such as the construction and real estate business, the linkage is already incorporated through the use of a multiplier factor that is applied to the measure of direct economic impact.

The Impact of Banking on the Cayman Islands Economy

The contribution of banking to the economy is measured in terms of income and of employment. In quantifying the economic impact of the banking sector, this study has focused on the aggregate contribution from entities holding bank and bank & trust licenses, both Class A and B banks, which represented 305 institutions in 2005. It does not include the economic impact arising from entities holding trust licenses, as well as the insurance, mutual funds and company management industries which would in turn add significantly to the overall impact from banking as estimated in this report. The survey does measure the contribution of banking services to the rest of the financial system through the purchase by the banks of services from these other intermediaries. While the survey administered as part of this study attempts to measure the principal contributions from the banking sector, there are other non-quantifiable factors that would normally be considered as part of the overall contribution but have not been reflected in the calculations performed by this study. This section describes the methodology and then presents the estimated values of the economic impact.

Design of the Survey

The principal findings of this study are derived from a survey of the banks operating in the Cayman Islands. Based on the scope of the banking sector identified for this analysis, the survey was administered to the Class A and B banks and banks & trust companies. The survey was directed at banks that are members of the Cayman Islands Bankers Association (CIBA). In the case of the Class A banks, the whole population of banks are also members of CIBA. The Class B banks surveyed were only those banks with a physical presence. Class B banks' membership in CIBA was comprised of 37 banks, and based on information obtained during on-site interviews and various published sources it was assumed that the profile of the Class B banks that are members of CIBA was representative of all Class B banks with a physical presence.

The survey questions addressed those activities of the banks that were directly related to their contribution to the local economy. These included employment, employee compensation, occupancy expenses, and other local expenses. The linkage of the banking sector to other services providers in the financial and other professional services sectors was represented by the information on other local expenses. In addition, the survey asked the banks' contribution to the public sector via license and other fees, as well as their expenditures on training of staff. The banks' contribution was further expanded to include the inflow of visitors from abroad and their expenditures during each visit. The questionnaire also obtained information on total assets and assets under management. However, some banks did not participate in the survey due to concerns about disclosure of information about their operations, and some of those institutions manage sizeable amounts of assets, which in turn raises the possibility that the economic impact figures contained in this report underestimate the true extent of the banking sector's impact.

In order to capture a statistically valid measure of the different factors explaining the economic impact of the banks, a survey response rate of about 70 percent for both Class A and Class B banks was established. This percentage was derived through the use of small sample statistical

inference.¹³ The survey results thus complied with the critical basis for statistical significance. A different survey form was used for each class of banks. Both survey questionnaires were identical except that in the case of Class A banks, respondents were asked to provide information on the number of Class B banks without a physical presence for which they acted as a representative. The surveys were sent to the full membership of CIBA which represents the population of banks used to calculate the economic impact.

Measuring the Economic Impact

The economic impact measures the total impact of the banking sector through the generation of income and employment and the subsequent multiplier effect on the other sectors of the economy based on the linkages described above. The multiplier effect is measured in two stages. The first stage measures the base of the economic impact or the direct impact, which represents the expenditures of the banking system in terms of payroll and the purchase of other local goods and services. The second stage measures the multiplier effect, or the indirect and induced effects of the initial expenditures. The indirect effect measures the income generated in those sectors that provide the goods and services purchased by the banks. And the induced effect represents the multiplier effect of the income generated by the indirect effect on the rest of the economy.

Direct Income Effect

The direct income effect is derived from the expenditures of the banking industry in their normal course of business. This is represented by wages and salaries paid to banking employees, including employee benefits, occupancy expenses, and other non-interest expenditures. While the payment by banks for banking license fees and work permits are a direct contribution, the effect on the local economy from such an increase in government revenues is not clear, as it depends on changing expenditure strategies by the government, and thus a multiplier factor for this component was not calculated. Another direct effect consists of local expenditures by visitors – bank officials, consultants, and customers, who visit the bank in the Cayman Islands.

Indirect and Induced Income Effects based on the multiplier

Two of the most widely used methods to estimate the indirect and induced impact are the income multiplier and an expanded economic input-output table that allows for the induced effect on consumption and investment to feed back into the input-output calculations. The selection of a particular method depends in part on the availability of information as well as other technical economic considerations. In the absence of an input-output table for the Cayman Islands, the Keynesian multiplier method was used. The value of the multiplier depends on the marginal propensity to consume and on the marginal propensity to import.¹⁴ Since the Cayman Islands is a

¹³ The determination of the critical mass for responses was based on the following formula: $n = (Z_a^2 \times s^2) / (C_i^2 + (Z_a^2 \times s^2) / N - 1)$; where n is sample size, Z_a is units of standard deviations, in this case a 95% confidence was used, s is the sample standard deviation, which in this case was based on the measure of average compensation per employee, C_i is the confidence interval for the interval, assuming a 5 percent tolerance around the mean, and N is the population size.

¹⁴ The formula for the income multiplier is as follows: $\text{multiplier} = (1 / (1 - \text{mpc} + \text{mpi}))$, where mpc is the marginal propensity to consume from disposable income, and mpi is the marginal propensity to import. In the case of the Cayman Islands there is no consideration for income taxes.

small island economy, the marginal propensity to import is relatively high, and represents a sizeable expenditure leakage factor; in other words, for every CI\$100 increase in direct income contribution, a large percentage leaks out in the form of purchases of imports, instead of an increase in demand for locally produced goods and services.

Since no current national income accounts estimates of consumption and disposable income was available, it was assumed that the marginal propensity to consume in the Cayman Islands would be similar to that of the OECD countries. One of the justifications for this assumption is that income per capita in the Cayman Islands of \$44,600 in 2004 is comparable to that of the OECD country group and would thus reflect similar consumption patterns. The corresponding marginal propensity to consume of the OECD countries has been estimated as 0.71.¹⁵ The marginal propensity to import is derived from the Economics & Statistics Office information available for 1991 on imports of goods and non-factor services as a percent of GDP. The calculated marginal propensity to import used in this analysis was thus 0.51, and is also based on the assumption that the average propensity to import is a reasonable approximation of the marginal propensity to import. Taking into consideration the above assumptions and analysis, the corresponding income multiplier for the Cayman Islands becomes: 1.25. Thus the indirect and induced effect represents an additional 25.0 percent of the initial direct increase in income.

Direct Employment Effect

An important contribution of the banking center is the employment created in management and staff support functions. The estimates of total employment in the banking sector are based on the results obtained from the survey. This study estimated the direct employment effect; however, since no detailed information on the sector breakdown of employment was available, the multiplier effect on employment in other sectors was not estimated. Based on the survey responses, in 2005, the banking sector employed 2,814 individuals, or 8.0 percent of total employment.¹⁶

Overall Economic Impact

The overall impact of the banking sector represents about 25.0 percent of the GDP of the Cayman Islands. The principal components of the economic impact of banking in the Cayman Islands are presented in Table 1.¹⁷ Total direct contributions are US\$407.0 million and the indirect and induced impact another US\$93.7 million, for a total impact of US\$500.6 million.

The principal components of the banks' annual contribution are wages and salaries, inclusive of employee benefits followed by other local expenditures. Wages and salaries account for 62.5 percent of the total economic impact. The direct contribution to the Government totals US\$32.2 million, or about 6.4 percent of the total impact. Travel expenditures by visitors represent about

¹⁵ See article by W. Joerding and S. Sheffrin (1989).

¹⁶ According to the Labour Force Survey (April 2006), the sizeable increase in total employment in the Cayman Islands in the Fall 2005 was attributed in part to the reconstruction process post-Hurricane Ivan, and thus transitory in nature, so that the percentage of the banking industry contribution to total employment of 8 percent may understate the underlying medium- and long-term contribution.

¹⁷ The actual survey responses are presented in Table A – 9.

US\$5.9 million. However as explained in an earlier section, this figure does not include visitors who may have traveled to the Cayman Islands on business and subsequently returned as tourists.

The survey also addressed the educational background of employees as well as the banks' own expenditures on training and education of its staff. About 55.0 percent of all employees are high school graduates, another 22.0 percent are college educated, and 23.0 percent have post-graduate degrees and professional qualifications (see Table A – 10). In addition, banks spend about 3.2 percent of their other local expenses in staff training and education. The percentage of the training budget is somewhat higher for the Class A banks, reflecting their retail focus (see Table A – 11). About 64.3 percent of all training and education expenses are allocated to locally-based programs.

Based on the estimated size of the economic impact, the banking industry plays an important role in the economy of the Cayman Islands. On the other hand, as revealed in the responses to the open-ended questions, the banks have expressed concerns about: the higher cost of doing business in the Cayman Islands; some Government policies such as immigration; and new regulatory measures aimed at global financial flows that are having unintended adverse consequences for financial centers such as the Cayman Islands. The continued success of the banking industry in the Cayman Islands will thus depend on how the financial institutions respond to these challenges. The industry needs to strengthen its competitive advantages and exploit new higher value-added opportunities in banking services. The Government could also assist the industry through a more proactive approach in promoting the financial services industry.

Table 1: Summary Economic Impact of Banks and Banks & Trust Companies: 2005						
(000s US\$ or as specified)						
	Estimated					
	Population Totals by type of Banks			Economic Impact		
	Class A	Class B with physical presence	Class B Without physical presence	Direct	Indirect & Induced	Estimated Total
Number of Banks	21	90	194			
Employment						
Management	824	441	NA	1,265		
Others	1,116	433	NA	1,549		
Sub-total employment	1,940	874		2,814		
Local Expenditures						
Salaries (incl. benefits)	161,345	88,914	NA	250,259	62,565	312,824
Occupancy	18,510	11,756	NA	30,266	7,567	37,833
Other Local Expenditures	58,296	31,162	NA	89,458	22,364	111,822
Travel						
Number of visitors	1,493	746	203	2,441		
Local expenditures	2,911	1,446	393	4,750	1,187	5,937
Sub-Total Expenditures	241,062	133,277	393	374,732	93,683	468,415
Government Fees						
License Fees	6,342	6,733	14,513	27,588	NA	27,588
Work Permit Fees	2,167	2,476	NA	4,643	NA	4,643
Total Economic Impact						500,646
% of GDP						25%

Challenges and Opportunities for the Banking Industry: Survey Responses

In addition to the questions addressing the banks’ income and employment contributions, the survey included open-ended questions designed to elicit the respondents’ opinions about the Cayman Islands’ strengths and challenges and about the non-quantitative contributions made by the banking sector. The first of the open-ended question dealt with the reasons for establishing a banking operation in the Cayman Islands; the second with challenges affecting the banking industry; and the third, with the non-quantitative contributions of the banking industry. This section presents an analysis of the responses to each of these three questions. Since the responses were in the form of written comments, an attempt was made to classify individually worded comments into general categories. Most of the responses fell within several broad categories which have been identified in each of the tables below, along with the percent of total comments submitted by all respondents that were considered to fall within each of the corresponding categories of issues.

Top Five Reasons for Establishing Operations in the Cayman Islands

Both Class A and Class B banks consider the financial/legal/labor infrastructure as the main reason for the establishment of operations in Cayman Islands (see Table 2 below). The financial and legal infrastructure refers to the laws, regulations and institutional structures that have contributed to the sound growth of the banking industry in the Cayman Islands. Many respondents were attracted by a sound legal and regulatory environment, Cayman Islands’ status as a United Kingdom Overseas Territory and its position as the 5th largest financial center in the world. The labor infrastructure refers to the availability of qualified employees as well as support professionals such as accountants, lawyers, and financial experts.

Table 2: Responses to First Open-Ended Question

What are the top five reasons for establishing your bank operation in the Cayman Islands?

	Class “A”	Class “B”	Total
Financial/Legal/Labor Infrastructure	28.1 %	29.4 %	28.8 %
Business/Strategic Reasons	28.1	22.4	23.2
Tax Free/Confidentiality Environment	14.0	22.3	19.0
Political/Social/Economic Stability	19.3	14.1	17.6
Physical Infrastructure: Communications /Transportation	10.5	11.8	11.3

The second motivation for both Class A and Class B banks had to do with their own business and strategic reasons for establishing operations in the Cayman Islands. The principal factors were

client-driven profitable opportunities. An offshore operation enhances a bank’s capacity to service its clients. Most are seeking to provide a much better service to their clients, with particular emphasis on asset protection. Some have established an offshore operation in response to client requests for such services and also in response to market competition.

A tax-free environment and strict confidentiality of customer relationships were mentioned in 19.0 percent of responses as a reason for choosing the Cayman Islands. This issue is also linked to the prior comment dealing with business / strategic reasons for establishing an operation in the Cayman Islands. This issue was more important for Class B banks, 22.3 percent, than for Class A banks, 14.0 percent.

Political/social/economic stability was identified as a strength of the banking center, cited by 19.3 percent of Class A banks’ responses and by 14.1 percent of Class B banks. A stable government and a disturbance-free society are essential elements for offshore financial operations. Other responses also underscored economic and currency stability.

The physical infrastructure was voted as the fifth reason with 11.3 percent of responses. Ease of communications and transportation are key elements for efficient operations.

Top Five Challenges Affecting Banking Operations in Cayman Islands

The responses to this question identified the main challenges facing the jurisdiction. Two issues garnered 28.2 percent each of all responses for a tie in first place: shortage of qualified personnel and high costs of doing business. These two issues, identified by 56.4 percent of total responses, affect the viability of doing business in Cayman Islands and its position relative to other competing financial centers.

Table 3: Responses to Second Open-ended Question

What do you consider as the top five issues affecting the environment for banking operations in the Cayman Islands?

	Class “A”	Class “B”	Total
Shortage of Qualified Personnel/Restrictive Immigration Laws	30.6 %	26.5 %	28.2 %
Higher Costs of Living/Doing Business	20.4	33.8	28.2
Domestic Regulatory Environment	14.3	19.1	17.1
International economic / regulatory Environment	16.3	8.8	12.0
Crime/Natural Disasters	14.3	7.4	10.3
Other	4.1	4.4	4.3

The shortage of qualified personnel refers to the limited pool of local professionally trained employees and mounting difficulties to attract qualified staff from abroad. Many respondents complained of more restrictive immigration laws that impose work term limits. The enforcement of term limits would result in a frequent turnover of personnel, the loss of key professionals and higher costs. Inability to attract qualified personnel with a long-term perspective also affects the quality of services offered to clients and the efficiency of bank operations and the banking center's ability to compete in the global markets. Class A banks, that offer a full range of services and represent other banks, were more concerned about this issue. Banking is a services industry where performance, and thus competitive advantage, is driven by the quality of its employees and the services they provide to their clients. Banks need access to qualified personnel but they also need to invest in the training and educational upgrade of their staff to ensure their competitive position.

A higher cost of living and of doing business was the main cause of concern for Class B banks, about one-third of their total responses had to do with high costs, while 20.4 percent of Class A banks concurred. Complaints centered around the negative impact on profitability from rising costs of doing business. Another common complaint had to do with the difficulty in recruiting and retaining key personnel, in view of an escalating cost of living. Class B banks also reported problems in finding adequate office space and housing, which is also reflected in the escalating costs of real estate.

The next two categories are interrelated. There is concern about increasing regulations and the international economic / regulatory environment. Negative perceptions about offshore operations in the international community have resulted in regulations that are more stringent. Most of the responses in the Domestic Regulatory Environment category referred to the increasing burden associated with regulatory compliance, particularly anti-money laundering. Banks worry about an erosion of client confidentiality and the compliance burden arising from more demanding *know-your-customer* regulations which adversely impact the banks' earnings capacity. These regulations also add to the banks' operational costs, particularly for those in an offshore location where they are subjected to greater supervisory scrutiny by their home country regulators. Banks have responded to the recent regulatory challenges in part by focusing on fewer but larger account relationships that offer wider margins based on a higher level of service.

Responses in the fourth category, International Economic / Regulatory Environment, were dominated by Class A banks, which have a physical presence in Cayman Islands. They expressed a concern about competition from other jurisdictions, particularly those with lower costs. Class B banks were mostly concerned about international perceptions. Some banks would like to see a more proactive approach on the part of the local authorities in promoting the banking industry. Some banks feel under attack from onshore regulators and fret about pressures from U.S. and European regulators that could impinge on confidentiality and tax advantages for their clients.

In the category of crime and natural disasters, Class A banks have greater worries. The aftermath of Hurricane Ivan has raised bank concerns about protection of physical facilities and financial data as well as their ability to resume business following a major storm, particularly in view of some experts that are predicting a new multi-year cycle of more active hurricane seasons. All banks shared a concern about crime escalation.

Non-Quantitative Contributions of the Banking Sector

Class A and Class B banks feel equally proud of their contributions to the quality of life and to the economic development of the Cayman Islands. Close to 71 percent of total responses mentioned the banks’ contributions to education, charity, and community activities, as well as in the attraction of additional business.

Table 4: Responses to Open-ended Question

Can you think of any other contributions from the banking industry to the economy of the Cayman Islands?

	Class “A”	Class “B”	Total
Contributions to Education, Charity and Community Activities	40.6 %	39.1	40.0
Attraction of Additional Business	37.5	21.7	30.9
Enhancement of Cayman Islands’ Image	12.5	17.4	14.5
Support of Tourism Industry	9.4	21.7	14.5

Based on the survey responses, the most important non-quantifiable contribution of the banking sector is to the socio-economic environment. The banking industry provides scholarships for local students to travel and study abroad. The industry also provides funds for the local training of students and updating the knowledge and skills of employees. These contributions result in a more proficient and better-paid workforce. The banking sector also contributes to the professional development of other professionals, such as lawyers, auditors, and high-technology experts, whose input is essential for the operations of the financial institutions. Donations to community activities and facilities that enhance the quality of life of local residents are also very important. Banks also sponsor cultural and sports events, promote cultural exchanges, and support local charities.

About 31 percent of all responses underscore the benefit of the banking industry in attracting additional businesses, such as insurance companies and investment funds. Class A banks provide credit and liquidity for the economy, and finance numerous local businesses and real estate developments as well as consumer purchases. Both categories of banks support the hedge funds and captive insurance business and influence business persons to make investments in real estate and other industries.

The other two categories received the same percentage of responses, 14.5 percent each. All banks engaged in offshore activities strongly believe that they enhance the image of the Cayman Islands abroad. The Cayman Islands enjoy considerable international prestige as the jurisdiction of choice for offshore banking operations and transactions. They raise the profile of the jurisdiction as a safe, stable destination with an excellent business climate. The banks support local marketing initiatives as a tourist and financial destination and help attract other companies.

The banks recognize their support of the tourism industry through the arrival of visitors who travel on business. Business travelers often return to the islands as tourists.

Conclusions and recommendations from the survey responses

The survey responses identified two key success factors for the banking industry in the Cayman Islands: a strong financial / legal / labor infrastructure and strategic business advantages of operating in the Cayman Islands. On the other hand, in the fast-changing and highly competitive global financial markets, the banks in the Cayman Islands need to be more aggressive in maintaining their competitive position. The Government should also re-assess its policies towards the financial sector in order to support to the continued success of the banking industry.

The banking industry is also faced with economic and regulatory challenges that could undermine its premier position as a global financial center. Having access to highly qualified personnel both locally and from abroad is a crucial competitive factor. As a services industry where those services are being delivered through rapidly emerging and complex technologies, the banking industry needs to tap a readily available supply of capable personnel. This is a challenge that needs to be addressed by both the industry and the Government. Perhaps the banks should consider investing more on staff training and education. Building on current collaborative programs with the Government, an enhanced banking educational program would increase employee productivity and thus strengthen the competitive advantage of the banking industry.

The growing encroachment by an increasingly restrictive regulatory environment is a direct challenge to an industry that relies on the free flow of capital to ensure the efficiency of financial markets worldwide. The banking industry has responded in part by reducing its offshore holdings and by concentrating more on higher net worth relationships. Since regulations usually evolve in response to industry outcomes, current regulatory practices may eventually become more market friendly, less intrusive and more effective in achieving their objectives. In this regard, the Government could consider a more proactive outreach campaign to other regulatory agencies around the world to better explain how the banking industry operates and its positive economic impact on the Cayman Islands.

In addition to the regulatory challenges, the survey responses reveal that the banking industry in the Cayman Islands has been under intense competition from other offshore centers. In this regard, greater Government and industry initiatives to identify areas for improvement would be very helpful. A comparative study of competing offshore centers that is updated on a regular basis would be a very useful tool in designing strategies to strengthen the banking industry in the Cayman Islands.

The survey has also revealed that while the banking industry is an important component of the economy, it also makes important community contributions. The social benefits generated by the banking industry need to be better communicated to the community. One important contribution accrues to the tourism industry as a result of travel directly related to the banking industry.

Annex Tables

Table A-1: Cayman Islands: Selected Indicators

	<u>2002</u>	<u>2003</u>	<u>2004</u>
Population (mid-year)	42,500	43,600	44,200
Caymanian	23,550	25,490	NA
Non-Caymanian (work permits)	18,951	18,111	NA
Gross Domestic Product (GDP) (figures in CI\$s million)			
At current prices	1,546.0	1,603.2	1,616.0
At 1986 prices	830.3	846.9	854.3
% change		2.0%	0.9%
GDP per capita			
At current prices (CI\$)	36,376	36,771	36,561
At current prices (US\$)	\$ 44,362	\$ 44,842	\$ 44,587
Inflation (CPI, annual average)	2.4	0.6	4.4
Exchange Rate (US\$ / CI\$)	\$1.219	\$1.219	\$1.219
Imports of goods (cif CI\$ million)	494.4	553.5	722.4
Imports as % of GDP	32.0%	34.5%	44.7%
Employment:			
Agriculture & Industry	4,918	NA	NA
Wholesale, Retail, Hotel & Restaurants	6,943		
Transport, Post & Communications	1,640		
Insurance, Financial & Business	5,398		
Public Administration	1,948		
Education, Health & Social Services	2,416		
Recreation, Community & Personal	4,082		
Other	9		
Total Employment	27,354	28,827	22,420
Building Activity: Approved Developments			
Number of units:			
Residential	327	385	359
Apartments / Condominiums	88	129	111
Hotels (incl. expansion)	5	-	1
Commercial / Industrial	83	101	69
Government	21	12	6
Other	424	504	427
Total	948	1,131	973
Value of permits:			
Residential	60,629	80,041	67,483
Apartments / Condominiums	81,985	65,876	153,684
Hotels (incl. expansion)	9,699	-	45,000
Commercial / Industrial	58,813	36,059	140,565
Government	819	55,051	3,879
Other	24,353	29,432	45,698
Total	236,298	266,459	456,309

Source: Economics and Statistics Office

Table A-2: Tourism Arrivals

(000s)

Year	<u>Air</u>	<u>% Change</u>	<u>Cruise Ships</u>	<u>% Change</u>
1992	241.8	1.9	613.2	29.2
1993	287.3	18.8	605.7	(1.3)
1994	341.5	18.9	599.4	(1.0)
1995	361.4	5.8	682.8	13.9
1996	373.2	3.3	800.3	17.2
1997	381.2	2.1	866.6	8.3
1998	404.2	6.0	871.4	0.6
1999	394.7	(2.4)	1,035.5	18.8
2000	354.1	(10.3)	1,030.9	(0.4)
2001	334.1	(5.7)	1,214.8	17.8
2002	302.8	(9.4)	1,574.8	29.6
2003	293.5	(3.1)	1,819.0	15.5
2004	259.9	(11.4)	1,693.3	(6.9)
2005	167.8	(35.4)	1,799.0	6.2

Source: Economics and Statistics Office

Table A-3: Cayman Islands: Banking Licenses & Total Assets

	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Class A:					
Banking only	4	4	4	3	3
Banking & Trust	<u>27</u>	<u>26</u>	<u>23</u>	<u>20</u>	<u>18</u>
Total Class A	31	30	27	23	21
Total Assets (US\$s millions)		150,105	127,718	169,714	170,982
Class B:					
Banking only	243	213	192	180	169
Banking & Trust	<u>153</u>	<u>140</u>	<u>130</u>	<u>119</u>	<u>115</u>
Total Class B	396	353	322	299	284
Total Assets (US\$s millions)*		817,391	911,846	1,057,621	1,057,571
Addendum:					
Class B banks with a physical presence	82	98	111	N/A	90

Source: CIMA

Table A-4: Cayman Islands: Banking License Fees

(000s CI\$)

	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Class A:					
Banking only and Banking & Trust	1,951	6,295	5,555	4,983	4,743
Class B:					
Banking only and Banking & Trust	6,590	21,904	18,653	17,833	16,800
Banking & Trust					

Source: CIMA

Table A-5: External Assets and Liabilities of All Banks

(US\$ millions)

	<u>2000</u>	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>
Assets	781,546	848,511	1,037,031	1,057,359	1,003,365
Liabilities	766,935	828,096	1,020,989	1,043,717	991,658

Source: CIMA

Table A-4: Cayman Islands Domestic Banking Activity (Six (6) Local Retail Banks)			
Thousands (000) \$USD	Dec-03	Dec-04	Dec-05
Credit to the Public Sector:	41,820	460,929	148,776
Credit to Private Sector			
Private Sector - Commercial			
Production			
Agriculture	324	205	476
Fishing		166	-
Mining and Quarrying	1,670	3,986	2,725
Manufacturing	1,238	1,827	4,142
Construction	89,531	61,637	102,724
Services			
Hotel, Restaurant and Bar	72,993	98,865	85,811
Transportation, Storage and Communications	14,298	28,818	25,348
Utilities (Electricity, Water)	43,352	34,530	34,815
Education	701	644	521
Insurance and Pension Funds	410	1,066	215
Real Estate, Renting and Other Business Activities	145,709	170,462	212,416
Financial Intermediation	138,010	132,703	327,601
Recreational, Personal and Community Services Activities	24,518	23,125	23,762
Other Professional Services	68,170	51,739	56,378
Trade & Commerce			
Sale & Repair	16,840	22,754	20,566
Wholesale	12,544	17,336	5,839
Retail	63,320	68,311	78,630
Total Private Sector - Commercial	693,628	718,174	981,969
Private Sector - Personal			
Domestic Property			
Real Estate Mortgage Loans	656,360	820,917	872,788
Land & Real Estate	38,125	101,586	53,262
Home Improvements/Renovations	12,360	15,026	24,396
Domestic Appliances and Furnishings	1,561	1,760	2,392
Bridging Loans	3,338	-	4,042
Motor Vehicles	21,463	30,698	52,404
Education & technology	1,359	1,141	3,388
Miscellaneous			
Medical	450	499	1,249
Insurance and Professional Services	1,688	1,879	1,755
Travel	327	433	886
Consolidated Debt	54,524	59,543	48,419
Other	176,579	128,045	143,410
Total Private Sector - Personal	968,134	1,161,527	1,208,391
Total Residents of the Cayman Islands	1,703,582	2,340,630	2,339,136
Non-Residents	875,163	763,523	552,527
Total Loans and Advances	2,578,745	3,104,153	2,891,663

Source: CIMA

Table A-5: Insurance Activity

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Agents' Licenses	115	113	116	109
Offshore Insurance Licenses	600	644	693	733
Gross written premiums (US\$ mill)	4,177	4,939	5,602	6,720
Net retained earnings (US\$ mill)	581	253	494	934
Gross assets at year-end (US\$ mill)	17,733	19,247	22,282	26,677

Source: CIMA

Table A – 6: Mutual Funds

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
<u>Funds</u>				
Administered	641	592	616	598
Licensed	51	48	67	79
Registered	3,593	4,168	5,249	6,429
Sub-Total	4,285	4,808	5,932	7,106
<u>Mutual Fund Administrators</u>				
Exempted	13	10	7	7
Full	85	82	83	87
Restricted	132	103	83	64
Sub-Total	230	195	173	158

Source: CIMA

Table A-7: Companies Registered in Cayman Islands

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Ordinary Companies:				
Non-Resident				
Beginning of period	14,421	14,676	15,104	13,462
New Companies	768	692	674	595
Companies closed	513	264	2,316	750
End of Period	14,676	15,104	13,462	13,307
Resident				
Beginning of period	3,983	4,081	4,382	4,763
New Companies	310	439	530	650
Companies closed	212	138	149	367
End of Period	4,081	4,382	4,763	5,046
Exempt Companies				
Beginning of period	45,030	45,448	47,430	50,618
New Companies	5,795	5,941	7,480	8,694
Companies closed	5,377	3,959	4,292	4,229
End of Period	45,448	47,430	50,618	55,083
Foreign Companies				
Beginning of period	1,061	1,054	1,162	1,290
New Companies	143	182	208	271
Companies closed	150	74	80	92
End of Period	1,054	1,162	1,290	1,469
Total Companies				
Beginning of period	64,495	65,259	68,078	70,133
New Companies	7,016	7,254	8,892	10,210
Companies closed	6,252	4,435	6,837	5,438
End of Period	65,259	68,078	70,133	74,905

Source: General Registry of Companies

Table A – 8a: Summary of Government Revenue

(000's CI\$)	<u>2001</u>	<u>2002</u>	<u>2003</u>
<u>Tax Revenue</u>			
Taxes on Property	15,932	14,292	17,663
Domestic Taxes on Goods & Services	107,249	144,644	146,336
of which:			
Company Fees	37,265	38,603	39,893
Bank & Trust Licenses	8,949	33,318	28,902
Work Permit Fees	23,438	23,706	24,750
Tourism Accommodation Taxes	9,649	8,026	7,524
Motor Vehicle Taxes	4,721	4,869	4,790
Taxes on International Trade and Transactions	106,222	106,704	117,643
of which:			
Import Duties	95,256	91,907	101,491
Travel & Cruise Ship Tax	7,148	9,584	11,035
Other Taxes	7,208	9,870	12,102
Sub-Total Tax Revenue	236,611	275,510	293,744
<u>Non-Tax Revenue</u>			
Entrepreneurial and Property Income	9,652	6,572	4,267
Administrative Fees and Charges	35,522	29,888	26,598
of which:			
Postal Charges	3,790	3,741	3,494
Medical Fees	11,927	4,539	7
Garbage Fees	3,224	3,169	4,323
Fines and Forfeits	1,242	1,337	1,318
Other Non-tax Revenue	1,137	145	254
Sub-Total Non-tax Revenue	47,553	37,942	32,437
Capital Revenue	937	30	27
Grants	-	-	19
TOTAL Revenues	285,101	313,482	326,227

Source: Economics and Statistics Office

Table A - 8b Public Sector: Operating Statement				
CI\$s 000s	6 Mths Cash 2002/03	12 Mths Cash 2003/04	12 Mths Accrual 2004/05	
			CI\$s 000s	% Structure
Coercive Revenues				
Levies on international trade				
Import Duties	45,727	94,488	101,448	34.5
Other levies on international trade	7,050	21,604	18,804	6.4
Total Levies on international trade	52,777	116,092	120,252	41.0
Domestic Levies on goods and services				
Law firm operational licenses	-	-	1,020	0.3
Work Permits fees	10,500	24,330	23,052	7.9
Immigration non-refundable repatriation fee	900	-	891	0.3
Traders licenses	2,000	3,811	3,985	1.4
Local co. and Corp. mgmt. fees	800	1,251	4,982	1.7
Other company fees - Resident	691	1,768	1,061	0.4
Other company fees - Non-resident	4,604	4,442	7,558	2.6
Other company fees - Exempt	25,416	32,081	35,047	11.9
Other company fees - Foreign	657	850	1,184	0.4
Banks and Trust Licenses	31,005	23,811	23,260	7.9
Insurance Licenses	5,476	5,504	5,420	1.8
Mutual Fund administrators	10,232	11,966	11,986	4.1
Partnership fees	964	1,137	1,719	0.6
Trust registration fees	35	71	42	0.0
Liquor licenses	-	14	450	0.2
CUC - license	250	506	567	0.2
Licenses	-	7,764	8,053	2.7
Annual ship tonnage charges	350	400	592	0.2
Local vessel licenses	55	-	-	-
Ship registration fees	125	-	278	0.1
Hotel licenses	35	-	165	0.1
Firearms licenses	27	-	22	0.0
Special marriage licenses	52	-	1	0.0
Fisheries licenses	3	-	3	0.0
Spear gun licenses	5	-	17	0.0
Public transport - operator licenses	-	-	13	0.0
HPB fees	-	-	3	0.0
Motor vehicle charges	-	5,422	4,797	1.6
Roads development fund charges	-	-	1,750	0.6
Tourist accommodation charges	5,000	8,268	7,677	2.6
Misc. stamp duty	8,300	19,758	5,490	1.9
Package charges	-	-	196	0.1
Total Domestic Levies on goods and services	107,482	153,154	151,281	51.5

Table A - 8b Public Sector: Operating Statement (Continued)

CI\$s 000s	6 Mths Cash <u>2002/03</u>	12 Mths Cash <u>2003/04</u>	12 Mths Accrual <u>2004/05</u>	
			CI\$s 000s	% Structure
Levies on property	-	-	20,599	7.0
Fines	-	-	1,505	0.5
	-	-	22,104	7.5
Total Coercive Revenue	160,259	269,246	293,637	100.0
Revenue				
Sale of Outputs to others	22,981	33,950	150,200	94.1
Investment revenue	1,005	2,614	5,997	3.8
Donations	-	-	172	0.1
Other operating revenue	-	3,598	3,194	2.0
Total Operating Revenue	23,986	40,162	159,563	100.0
Operating Expenses				
Personnel costs	67,055	154,286	259,437	57.3
Other operating expenses	74,086	149,411	193,288	42.7
Total Operating Expenses	141,141	303,697	452,725	100.0
Overall Surplus / (Deficit)	43,104	5,711	475	

Source: Office of the Financial Secretary

2004-05: figures taken from Annual Plan and Estimates - Entire Public Sector, accruals basis

2003-04: figures taken from Annual Plan and Estimates - Core Government, cash basis

2002-03: summarized information on cash basis - core Government

Table A – 9: CIBA Survey Results

(000s US\$)

	Class A Banks			Class B Banks (w presence)		
	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Employment						
Management	481	526	601	131	114	109
Others	<u>844</u>	<u>814</u>	<u>890</u>	<u>109</u>	<u>109</u>	<u>103</u>
Sub-total employment	1,325	1,340	1,491	240	223	212
Government Fees						
License Fees	4,899	4,881	4,530	1,856	1,861	1,870
Work Permit Fees	1,686	1,571	1,878	724	730	688
Local Expenditures						
Salaries	96,131	105,829	115,246	19,870	21,065	21,560
Occupancy	13,141	14,807	13,222	2,927	2,588	2,822
Other Local Expenditures	40,851	43,634	41,640	30,800	28,738	27,501
Travel						
Number of visitors	845	1,033	1,037	144	147	178
Local expenditures	1,577	1,848	2,071	281	271	345

NOTE: Survey response rate for Class A banks was 71.0% and for Class B banks was 69.5%.

Table A – 10: Educational Background

(percent of total employees)

	<u>Up to High School</u>	<u>Junior College</u>	<u>College</u>	<u>Post- Graduate</u>	<u>Professional Qualifications</u>	<u>Total</u>
Class A Banks	57.9	6.6	12.9	3.4	19.2	100.0
Class B Banks	31.8	14.4	28.7	7.7	17.4	100.0
Total	55.1	7.4	14.6	3.9	19.0	100.0

Note: percentages are based on survey responses

Table A – 11: Training and Education

(percent)

	2003		2004		2005	
	<u>% of other Expenses</u>	<u>of which: % local</u>	<u>% of other Expenses</u>	<u>of which: % local</u>	<u>% of other Expenses</u>	<u>of which: % local</u>
Class A banks	3.9	66.6	4.0	67.8	3.4	61.4
Class B banks	3.2	72.2	1.9	69.9	2.2	88.5
Total	3.8	67.3	3.7	68.0	3.2	64.3

Note: percentages are based on survey responses

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