

International Financial Services & Commercial Banking Performance: Evidence from Caribbean Offshore Centers.

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Abstract

Capital is vital for the operation of firms. Much of the world's financial capital is channeled via offshore banking activity. Some have estimated the value of assets held in offshore banks to be as high as \$10 trillion, 70% of the value of new goods and services produced in the U.S in 2007. This study investigates the impact of offshore banking on the performance of local commercial banks. Balance sheet and income statements of Caribbean commercial banks are used to create indicators of banking performance. The data covers ten Caribbean islands between 1994 and 2004. Panel data techniques are used to show that local commercial banks in close proximity to offshore banking sectors hold more assets, are less profitable, and hold a larger share of its assets in securities.



What is Offshore Banking?

Offshore banking is the import of financial services from banks incorporated in an offshore financial center. Offshore banking is also the cross border intermediation of funds by financial institutions. The offshore financial center (OFC) is a jurisdiction providing offshore banking services.

Types of Financial Services

- Savings and Loans
- Hedge Fund Management
- Asset Trading
- Insurance Brokerage

Features

Offshore Institutions

- Zero or very low tax on profits
- Zero or very low capital requirements
- Zero or very low regulatory oversight
- Zero exchange rate restrictions

Creditors

- Zero or very low tax on capital gains
- Anonymity

Research Question

- How does offshore banking activity impact the financial sector?
 - Do local commercial banks located in OFCs perform differently from those located in non-OFC Caribbean Islands?
 - Does close proximity to offshore banking impact the performance of local commercial banks.

Methodology

Fixed effects regression analysis is used to identify the effect of offshore banking activity.

Estimating Equation

$$Y_{it} = \beta_1 OFC + \beta_2 (\log \text{ Km distance to the closest OFC})_{it} + \beta_3 (\text{Control Variables})_{it} + \lambda_i + \mu_t + \varepsilon_{it}$$

Performance Ratios (Y_{it})

- Return on Assets** - net income before tax as a share of total assets
- Return on Equity** - net income as a share of capital
- Net Interest Margin** - interest income less interest expenses as a share of total assets
- Interest Income to Interest Expense** - interest Income as a share of interest expense
- Capital to Assets** - paid-up capital plus reserves as a share of total assets

Impact of Offshore Banking

- OFC** -dummy variable equal to one for islands with an offshore banking sector
- In Distance to an OFC** - the log Km distance to the closest OFC

Control Variables

- Real GDP per capita** - real GDP per capita
- Inflation Rate** - the growth rate of the average price level
- Government Fiscal Policy** - government's capital expenditure as a share of GDP
- Infrastructure** - the log number of telephone lines per 1000 persons

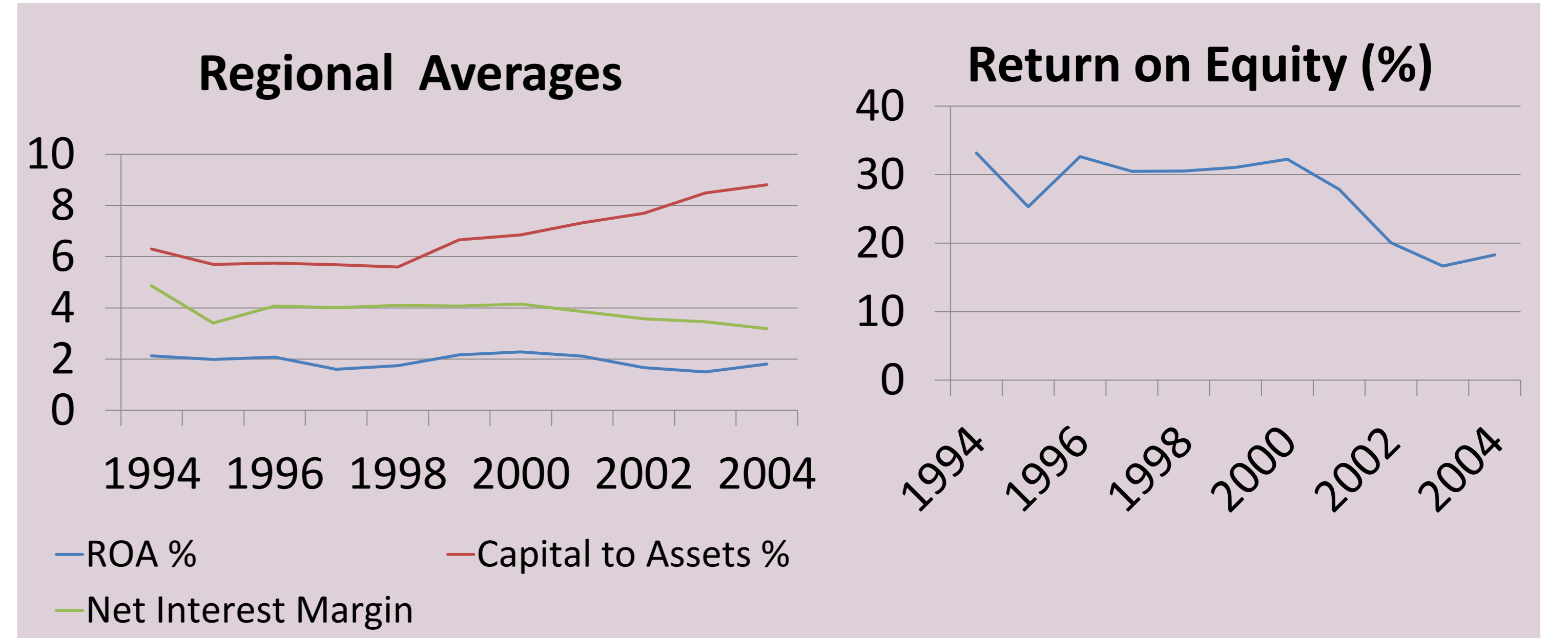
Residuals

- λ_i - country specific fixed effect
- μ_t - time specific fixed effect
- ε_{it} - error term

Performance Averages (1994-2004)

	The Bahamas	Barbados	Jamaica	Trinidad & Tobago	ECCU
Return on Assets (%)	2.50 (0.4)	1.00 (0.7)	0.90 (1.6)	2.30 (0.9)	2.10 (0.2)
Capital to Assets (%)	10.20 (0.04)	3.80 (0.02)	7.40 (0.03)	9.70 (0.02)	7.60 (0.01)
Net Interest Margin (%)	5.30 (0.52)	4.00 (0.48)	1.60 (0.33)	4.00 (0.41)	4.60 (0.20)
Interest Income to Interest Expense	2.56 (0.31)	2.72 (0.51)	1.90 (0.26)	2.04 (0.42)	2.29 (0.13)
Return on Equity (%)	28.39 (9.12)	59.16 (29.72)	6.45 (4.08)	23.01 (3.551)	30.20 (7.55)

1. Standard Deviations are show in parenthesis



U.S Commercial Bank Performance Ratios as at December 2004 :
ROA - 1.92% , ROE - 13.71%, NIM - 3.6%, Capital to Assets- 10.10%

Fixed effects regression results

Variables of Interest	Return on Assets	Return on Equity	Net Interest Margin	Interest Income to Interest Expense	Capital to Assets	Bank Assets to GDP	Loans to Assets
OFC	-0.8*** (-2.39)	-8.7* (-1.75)	-0.4 (-1.18)	-0.45*** (-3.61)	-2.4*** (-3.65)	8.6** (-2.12)	-3.2** (-2.6)
InDistance to OFC	0.02* (-1.92)	-0.15 (-1.10)	0.01 (0.59)	0.76** (-2.25)	0.08*** (-4.58)	-0.21* (-1.91)	0.02 (-0.542)
R ²	0.516	0.62	0.67	0.71	0.75	0.95	0.88
DW	1.6	1.55	1.46	1.02	1.29	1.01	1.39

- *** 1% significance, ** 5% significance, *10 % significance
- n=10, time period is 1994-2000
- t-stats are shown in parenthesis

Conclusion

- Caribbean commercial banks located in, or close to, offshore banking:
 - Are larger in asset value
 - Are less profitable
 - Are more inclined to solvency risk