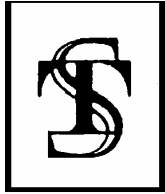

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OFFSHORE PILOT QUARTERLY

Commentary on Matters Offshore

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Suicide Month

When I was growing up there, October was traditionally known as suicide month in Rhodesia (now Zimbabwe). This was because by then the build up of oppressive, sticky heat, just ahead of the rainy season, became intense. I'm sure that there were suicidal thoughts on another continent thousands of miles away with a famous street called Wall Street this October also, although temperature would not be a factor.

Light has been shone on magic and the Harry Potter tactics of the wizards of Wall Street have not stood up to scrutiny. They used to enjoy dress-down days on Friday (I remember this national habit from living in Miami) but now they are enduring dressing downs from regulators and the public every day of the week. John Bryant, founder in the US of Operation HOPE, a non-profit organisation that helps educate poor people about finances, has said that "It takes less credentials to be a mortgage broker than a pimp on a street corner in Harlem because a pimp needs references".

But as Claudius observed in Hamlet: "When sorrows come, they come not single spies, but in battalions" and a combination of many things has contributed to the 2008 global downturn. It was the United States of America's housing market that caused the first tremor to be felt and which exposed, among other things, the subprime scandal. At this point it's worth remembering the words of US Senator Carl Levin who has referred to the "deceptive banking practices" of tax havens that cheat his government of taxes (see the September issue of the Offshore Pilot Quarterly). Doubtless US tax payers are over the moon in seeing their taxes applied to the losses created by deceptive banking practices onshore.

Those mortgage brokers who did act immorally and deserve Mr. Bryant's opprobrious comment were confronted with a clash between commission and conscience in contrast to my own approach which means that I eschew any offers of commission from every quarter because of the dangers of compromise; besides which, when things go wrong, clients might question your motives for fee-generating recommendations that you made. Where do the credit rating agencies stand?

The US Securities and Exchange Commission has said that the agencies did not properly manage the inherent conflicts of interest when assigning top ratings to bonds that were backed by subprime mortgages and other assets. The issuers of securities pay the rating agencies for the grades given and the ratings analysts are more often than not managed by the same people who operate the business side of such firms. Christopher Cox, the chairman of the SEC, has been very clear. "There have been instances in which there were people both pitching the business, debating the fees and were involved in the analytical side".

Perhaps I am missing something here, but how can such a perilous state of affairs be allowed to exist? It might be uncertain at this stage what future controls will be put in place (Europe has called for tighter regulation) but one thing is already certain: the 3 big agencies in particular (Standard and Poor's, Moody's Investors Service and Fitch Ratings) have been dealt a severe credibility blow. Ringing in their ears might be Cassio's plaintive cry in Othello: "Reputation, reputation, reputation! O, I have lost my reputation! I have lost the immortal part of myself, and what remains is bestial".

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Probably, the most profound impact on the public – after their stock market losses – must surely be disillusionment. So many assumptions about the financial controls in place, the skills of the people at the helm, followed by the sight of once mighty banks and investment institutions sinking like holed ships beneath the waves, has left investors wondering who they can trust. John Maynard Keynes said, "The difficulty lies not so much in developing new ideas as in escaping from old ones". It's a good point, but I doubt if too many people will have any difficulty in accepting new ideas about cleaning up financial markets.

There have been unheeded voices of dissension over the last couple of years who have described the investment bankers as being in a high stakes game of poker; unfortunately, when the wrong card was played there were no winners. Those fund managers, for example, who watched mortgaged-backed securities earn double-digit returns in 2005, yet still said that they were too risky, were scoffed at and accused of having outdated ideas. The Prince of Prudence was the late Tony Dye, known in financial markets as "Dr. Doom" in the late 1990s because of his grim predictions. In 1998 (although 2 more years would pass) he warned of an impending disaster in the case of technology stocks.

Timing, as we know, is everything and makes assessing risk that much more difficult. Mr. Dye, however, used the analogy of being invited to join a train that you were sure would crash at some stage during its ten-station journey. Perhaps you could risk half the journey; but if safety was paramount, Mr. Dye advised not to board the train in the first place.

French Lessons

In the June, 2006, OPQ I included some comments on the US current-account deficit which illustrated that the government was copying what Americans were doing with their credit cards: spending more than they had. Back in 2005 the deficit stood at some $800 billion with much of it being financed by US Treasury bonds purchased by the Japanese and the Chinese. This led me to quote Ludwig von Mises, the 20th century Austrian economist, who hit the nail right on its head: "It may sometimes be expedient for a man to heat the stove with his furniture. But he should not delude himself by believing that he has discovered a wonderful new method of heating his premises".

What about today's national debt? It has reached $9.5 trillion with the estimated cost of unfunded public commitments (including entitlements such as Social Security and Medicare) standing at just under $53 trillion at the moment; that equates to $175,000 for every American. New York's debt clock has already been given an extra digit to accommodate a $10 trillion figure.

All of this comes at an awkward time for America. American capitalism faces a crisis that questions the long-held beliefs espoused by the so-called "Washington consensus", which advocated open markets and deregulation as the economic solution. US house prices, for example, have fallen faster than during the last century's Depression. Certainly, regulatory failures were partly to blame for the credit crunch and a loose monetary policy let Americans accumulate debt which, at the same time, contributed to the housing bubble that has since burst with calamitous consequences. I suggest, however, that any continuing professional development training for regulators and the private sector's key executives, right across the broad spectrum of financial services, should include a compulsory requirement to read history.

18th century France would be a good place to start. The story concerns a collection of debts owed by a highly leveraged borrower with a poor credit record which are turned into marketable securities, the motivation being that without financial innovation and free capital markets the borrower's goose, as they say, would have been cooked. The result was that at the beginning of the century (1719-20) the French financial climate had turned around: shares in the Compagnie des Indes (the Mississippi Company), which we will discuss in further detail, rose 1,000 per cent. But less than 2 years later, the shares plunged to just 10 per cent of their previous value.

Let's look at the background. Due to the War of Spanish Succession in 1714 the French public debt exceeded 100 per cent of national income and the required reductions of interest and principal led to a collapse of confidence, quickly followed by a recession. To the rescue came John Law, a Scottish economic theorist, who apparently lived by his wits at the gambling table; he had never been involved in public finance. But he had charm and persuasive powers that beguiled the French Regent. At the heart of the plan was to exchange government debt (government paper was selling for discounts of up to 75 per cent) for shares in the Mississippi Company which held monopoly trading rights to the French colonies. The government would then issue a new

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series of bonds that paid 3 per cent in exchange for its existing obligations which paid between 4 and 5 per cent. In this way the government's costs of servicing the debt would drop considerably.

To make the exchange attractive, Law would add the inducement of a more liquid security with the possibility of speculative gains (in effect, repackaging debts, that could be classified as subprime, as marketable securities). There was one final piece to put in place: the establishment of a central bank in order to provide a monetary boost that would stimulate the trading of the shares. But there was just one snag: the trading rights to the French colonies were practically worthless and so the proposed exchange had no merit.

The plan, however, was an absolute success. The value of the substituted shares rocketed and the French economy moved back into the black. This financial fantasy play continued (as such fantasies do) until the realisation had sunk in that the asset underpinning the Mississippi Company's share value was doubtful government debt. The anticipated dividends never materialised and, meanwhile, those Parisian speculators involved (like others today) were relying heavily on borrowed money. As John Maynard Keynes also reminds us: "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation".

In 1720 the share value fell to earth and the investors paid the price; as a result of this catastrophe the French government decided that paper money, banks and stock markets were very dangerous. Trust only returned in the 19th century. But the French, like everyone else, forget the past, as their participation in the subsequent and disastrous first Panama canal project was to prove, bringing political and financial turmoil.

The run up to the final moment when reality hits us should be viewed in much the same way as John Kenneth Galbraith saw things: "Faced with the choice between changing one's mind and proving there is no need to do so, almost everyone gets busy on the proof". Analysing the facts is the easy part; in life, however, it's analysing your perceptions that's really hard to do.

Before the Desert Disappeared

In the September OPQ I also wrote about, in the context of double standards, the lack of transparency which exists in some official US corporate ownership records and which has caused Michael Chertoff, the US Department of Homeland Security Secretary, to despair. I went on to add that the US, for some, qualifies as a tax haven and it now seems that the Brazilian government sees it that way also. Its National Congress has adopted a law, effective from next January, that widens the definition of tax havens that would put the US state of Delaware on any future blacklist; this is the same state with the 2000 companies that enabled \$1.4 billion of anonymous money to pass through the banking system as reported in the September OPQ. The expanded tax haven definition includes any jurisdiction whose authorities or registries do not provide public information about an entity's stockholders, shareholders or its members, such as Delaware (not to mention the lower profile states of Nevada and Wyoming). Although, at the time of writing, a new list of tax havens still has to be issued by Brazil's Federal Revenue Service, Delaware can now expect to stand in the dock alongside well known havens (other provisions of the new definition, however, will probably now exempt Panama).

Meanwhile, the Organisation for Economic Co-operation and Development's report, "Tax Co-operation: Towards a Level Playing Field – 2008 Assessment by the Global Forum on Taxation", states that bearer shares continue to be banned in an increasing number of countries. But, as we can see, you don't need bearer shares to be anonymous.

In the last OPQ I also mentioned Simon, an ex-financial services regulator, who was on a visit to Panama at the time. We shared several conversations during his stay after that initial cup of coffee and the final one took place at the time the story broke about the Brazilians labelling Delaware as a tax haven. We did have a good laugh about that and if you put aside everything else, including hubris, one can imagine how some egos in the US government could be bruised (starting with Senator Levin). Losing touch with reality, clearly, does not just apply to investors.

The Financial Times in a May, 2008, article referred to "specialised insurance" in the Turks & Caicos Islands. According to an October, 2005, article in the British professional journal, Offshore Investment.com, for which I write, the islands are recognised as a market leader in producer-owned reinsurance companies. In addition to the comments made under the heading, "Slitting Throats", in the last OPQ, the clues to this success will be found by the astute in a 1992 insurance book entitled, "Money on the Table",

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which was written by two US insurance specialists, John S. Mailho and Gary Fagg.
In this comprehensive book reference is made to insurance regulations and a law that was fashioned to meet the special requirements of producer-owned reinsurers. "Working closely with the private sector", the authors wrote, "the government adopted regulations to achieve its goal of becoming the foremost site in the world for producer-owned reinsurers. Few, if any, sites can match the number of reinsurance companies domiciled in the Turks and Caicos Islands. Credit for this accomplishment is due largely to Derek Sambrook, the first Superintendent of Insurance. He took time to understand the nuances and needs of the industry and then shaped the regulations to meet those requirements. The Superintendent took the mandate that the Ordinance and Regulations must bend to the protection of the consuming public, but anything beyond that simple premise does not serve a useful purpose".
In appreciating the far too generous comments made about me and the insurance legislation I drafted, let me be clear: any success is not due to one individual but to the freedom allowed for a realistic approach to be taken in the first place.
Perhaps it was because I was there for 3 years, rather than 5 years. Let me explain. Milton Friedman, economist and Nobel laureate, once said that "If you put the federal government in charge of the Sahara desert in five years there'd be a shortage of sand". Not just the US government.

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