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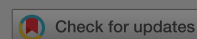
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The anatomy of the Cayman Islands offshore financial center: Anglo-America, Japan, and the role of hedge funds

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ABSTRACT

The Cayman Islands is a key node in contemporary global finance, yet it is severely under-researched. This paper compiles the first ‘anatomy’ of the Cayman offshore financial center (OFC), utilizing all sources of publicly available data about the three main segments: banking, direct investment, and portfolio investment. The analysis is performed both diachronically to see when large inflows occurred and geographically to

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explanation for the unparalleled rise of the Cayman OFC by seeing this jurisdiction as one node in an Anglo-American triangle together with the USA and the UK, Cayman's sovereign power.

KEYWORDS: Cayman Islands offshore financial centers tax havens Anglo-America hedge funds Japan

INTRODUCTION

‘Small place, big money’ was the apt title of one of the first analyses concerning the position of the Cayman Islands in the international financial system (Roberts [1995](#)). Twenty years later, the archipelago south of Cuba is, of course, still small in geographic terms. The amount of foreign capital booked in the Cayman offshore financial center (OFC), however, has become bigger in this period of time – much bigger. Significantly improved availability of data concerning OFCs and their counterpart countries during the last two decades allows for a better understanding of the role that the Cayman Islands plays in international finance. This tiny group of islands in the Caribbean with roughly 58,000 inhabitants and a domestic economy of less than US\$3 billion has attracted foreign capital of over US\$4100 billion if we take into account banking assets, direct investment and portfolio investment; note that the total stock of external assets is likely much higher, because there are no data available for trusts (see Harrington [2016](#)). Setting the amount of foreign assets in relation to the GDP of a particular jurisdiction results in a specific ‘offshore-intensity ratio’ (Fichtner [2015](#)). According to this ratio, the Cayman Islands is by far the most intensive OFC in the world with foreign assets amounting to over 1500 times Cayman's domestic economy. Moreover, the Cayman Islands is not only large in relative terms, but also in absolute ones; the small Caribbean archipelago has attracted more external assets than advanced industrial countries. Several hundred small island OFCs exist in the world. As the Cayman Islands is a well researched. and as the Cayman Islands is a well researched. (et al. [2014](#)), of asset-backed Cayman

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2007, Cayman had even been the largest jurisdiction concerning the issuance of collateralized debt obligations (CDOs), according to Culp and Forrester (2010). Hedge funds as well as opaque CDOs have contributed to the development of the global financial crisis and thus such financial ‘innovation’ has serious consequences for international financial stability (Lysandrou 2012; Lysandrou and Nesvetailova 2015; Wójcik 2013a, 2013b). Utilizing all sources of publicly available data, this paper compiles the first ‘anatomy’ of the pivotal Cayman OFC. The aim is to perform a fine-grained analysis of the three main segments of cross-border finance: (1) banking, (2) direct investment, and (3) portfolio investment. This in-depth case study of the Cayman Islands OFC is highly complementary to recent studies in Economic Geography, e.g., on the role of advanced business services for offshore finance (Wójcik 2013a), on offshore jurisdictions and foreign direct investment (FDI) (Haberly and Wójcik 2015a, 2015b), and finally on the political geography of offshore banking (Haberly and Wójcik 2014). In order to further our understanding of the extremely ‘successful’ development of the Cayman OFC, this paper introduces the Anglo-America/Anglosphere approach from international relations (IRs) and International Political Economy (IPE) to the analysis of the Cayman OFC. Furthermore, I analyze the important role of Japan, which has escaped virtually all existing studies about the Cayman Islands.

The remainder of this paper is organized in six sections. In the first section, I briefly discuss the existing research about the Cayman Islands. The second section analyzes the development of the oldest segment of the Cayman OFC – banking. The following two sections are dedicated to the large domain of investment. Specifically, in the third section I scrutinize the comparatively small but growing segment of direct investment before analyzing the major segment of portfolio investment, including the crucial hedge fund sector, in the fourth section. The fifth section introduces the Anglo-America/Anglosphere approach to the research on the Cayman OFC. Finally, the sixth section concludes by discussing avenues of future research as well as some policy implications.

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advancing our understanding of the Cayman Islands and its role in the international financial system. Roberts' ([1995](#), 237) conclusion that the Caymans have created the image of a respectable up-market OFC and 'strategically positioned themselves at the nexus of the circuits of fast and fungible financial capital' is still valid today. Furthermore, Roberts ([1995](#)) argues that the status as a dependent territory of the UK is of central importance for the success of the Cayman Islands as an OFC, because this status guarantees political stability. She identifies a series of 1960s laws designed to attract foreign capital as a cornerstone for the development of the Cayman OFC. Rapid growth began in the 1970s after the end of the Bretton Woods system and the concomitant transition to free exchange rates, which included the abolition of capital controls by most Western countries. According to Roberts ([1995](#)), the number of foreign banks active in the Cayman Islands grew at an annual average rate of 23% between 1972 and 1982. This is primarily due to the rapid development of the Euromarkets in the City of London (Palan [1998](#); Burn [1999](#)), which subsequently included OFCs such as the Bahamas and the Cayman Islands (Ridley [2007](#)). Hudson ([1998a](#)) has compared the Cayman Islands and the Bahamas and concludes that the specific development of these OFCs can only be explained by analyzing the behavior of transnational actors (e.g., American and Canadian banks and lawyers) and important counterpart countries (primarily the USA). Moreover, he emphasizes the key role of trust by foreign financial actors in the particular OFC, which takes time to develop and in practice limits the mobility of capital (Hudson [1998b](#)). Hudson ([2000](#)) confirms the view by Roberts ([1995](#)) that the status as a British dependency has been beneficial to the Cayman Islands, because the independence of the Bahamas in 1973 led to a flight of capital from there to Cayman.

Besides Economic Geography, IR and IPE have contributed significantly to the research about offshore finance in general and the Cayman OFC in particular. Palan ([1998](#), 635) coined one of the most recent definitions of offshore (finance):

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Palan et al. (2010), too, stress the importance that the Cayman Islands is a British dependency; in fact, it is still legally correct to refer to the British Overseas Territories as 'colonies' of the UK (Hendry and Dickinson, 2011, 4). Moreover, Palan et al. (2010) report that in 2008 Cayman was the fourth largest international banking center in the world, however, concentrating only on short-term financing. An important point that Palan et al. (2010) highlight is that most OFCs, and Cayman in particular, act as secrecy jurisdictions. Secrecy through opaque financial structures played a key role in the corporate scandals of Enron, Olympus and Parmalat as well as in the near-collapse of the large hedge fund LTCM, which all had significant subsidiaries in Cayman. According to the Tax Justice Network, the Cayman Islands is number five in the 2015 Financial Secrecy Index, which combines a secrecy score with a global scale weight in financial services exports (TJN 2015a; Cobham et al. 2015). Cayman's relatively high secrecy score of 65, however, is lower than those of other major OFCs, such as Switzerland (73) or Singapore (69), reflecting regulatory improvements in recent years (TJN 2015b).

The analysis of the Cayman Islands OFC by Freyer and Morriss (2013) focuses primarily on legal aspects, but nonetheless represents one of the most comprehensive endeavors to trace the development of this jurisdiction since the 1960s. Their core argument is that the success of the Cayman OFC stems primarily from what they call the 'collaborative policy-making process' that includes local politicians and regulators, foreign experts (mainly lawyers from Canada and the USA) as well as British officials. Moreover, Freyer and Morriss (2013) argue that the high reliability of the Cayman legal system, based on English common law, and – even more important – its ability to 'innovate' have been crucial for the rise of the Cayman Islands to one of the largest financial centers in the world. A central example that Freyer and Morriss (2013) discuss is the creation of the Cayman Islands Monetary Authority (CIMA) in the mid-1990s; the legislation for CIMA was developed together with the leading Cayman law firm Maples & Calder (founded by two British lawyers in the 1960s) and the Bank of England. Finally,

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citizens and corporations to shift financial activities to the Cayman Islands. In addition to the obvious motivation to save taxes, another reason was to simplify transactions with third countries; the good reputation of the Cayman Islands for stability, legal certainty, and compliance with international standards also seems to play an important role for the success of this jurisdiction (GAO [2008](#)). In 2009, the IMF has assessed the regulation of the Cayman Islands financial center. The locally available expertise in matters of financial law and accounting – mainly provided by large international advanced business services firms – is identified as an important competitive advantage of this jurisdiction. The greatest danger to the success of the Cayman Islands OFC, according to the IMF ([2009](#), 11), is ‘reputational risk’ – the potential loss of confidence by foreign investors. Finally, the OECD found Cayman to be ‘largely compliant’ with international standards of tax information exchange (OECD [2013](#)).

The various studies presented here have analyzed a range of important aspects concerning the development of the Cayman Islands OFC. However, the most obvious research gap is that there is no publication that has systematically compiled all available data about this OFC – both diachronically to see when large inflows occurred and geographically to determine what role certain countries play in different financial segments. Such an ‘anatomy’ of all relevant financial data is a fundamental prerequisite for a profound and comprehensive analysis of this pivotal OFC. The Cayman OFC can be analytically separated in three distinct yet interrelated segments: banking, direct investment, and portfolio investment.

OFFSHORE BANKING

Banking represents the historical foundation upon which Cayman has built its OFC. During the 1960s, the Cayman Islands enacted a series of laws tailored to attract financial... decision that... under British... independent... her copying... Through its... w. This is of... tors from

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English legal tradition law evolves in a bottom-up fashion from individual case decisions, thus significantly facilitating transnational finance. The key difference between common law and civil law is that in general Anglophone common law only stipulates what is prohibited, whereas civil law (France, Germany, Japan etc.) identifies what is permitted (Vlcek [2008](#)). The consequence is that new financial ‘innovations’ (such as ABS, CDOs or hedge funds) can be set up easily, because strict regulation is only put in place in case of conspicuous misconduct or strong pressure from powerful foreign actors.

The Bahamas was one of the biggest offshore banking centers in the 1960s. When, however, Nassau experienced political instability in the late 1960s, leading to the independence of the Bahamas from the UK in 1973, Cayman was ready and took over much of the fleeing business (Hudson [1998a](#); Freyer and Morriss [2013](#); Ridley [2007](#)). During the 1970s and 1980s, Cayman experienced rapid growth in offshore banking due to the liberalization and deregulation of finance pursued primarily by the USA and the UK as well as the development of the Euromarkets – themselves a kind of offshore market, because Britain decided to withhold regulations on the trading of foreign currencies in the City of London (Burn [1999](#)). Data on cross-border banking in the Cayman Islands began in 1983 and come from the Bank for International Settlements (BIS). The BIS collects two kinds of statistics, the Locational Banking Statistics (LBS) and the Consolidated Banking Statistics (CBS), each using a different methodology. The LBS capture the positions of all banking offices resident in the reporting countries (44 in 2015, including Cayman) vis-à-vis counterparties located in over 200 countries. Thus, the LBS are based on the principle of residence. Note that in the LBS banks record their positions on an unconsolidated basis, including intragroup claims and liabilities between subsidiaries of the same bank. The CBS, on the other hand, are based on the nationality of banks. These statistics capture the consolidated positions of internationally active banking groups headquartered in the reporting countries (31 in 2015). Data on intragroup claims and liabilities between subsidiaries of the same bank in the Cayman Islands (CBS) are not available. The CBS, on the other hand, are based on the nationality of banks. These statistics capture the consolidated positions of internationally active banking groups headquartered in the reporting countries (31 in 2015). Data on intragroup claims and liabilities between subsidiaries of the same bank in the Cayman Islands (CBS) are not available.

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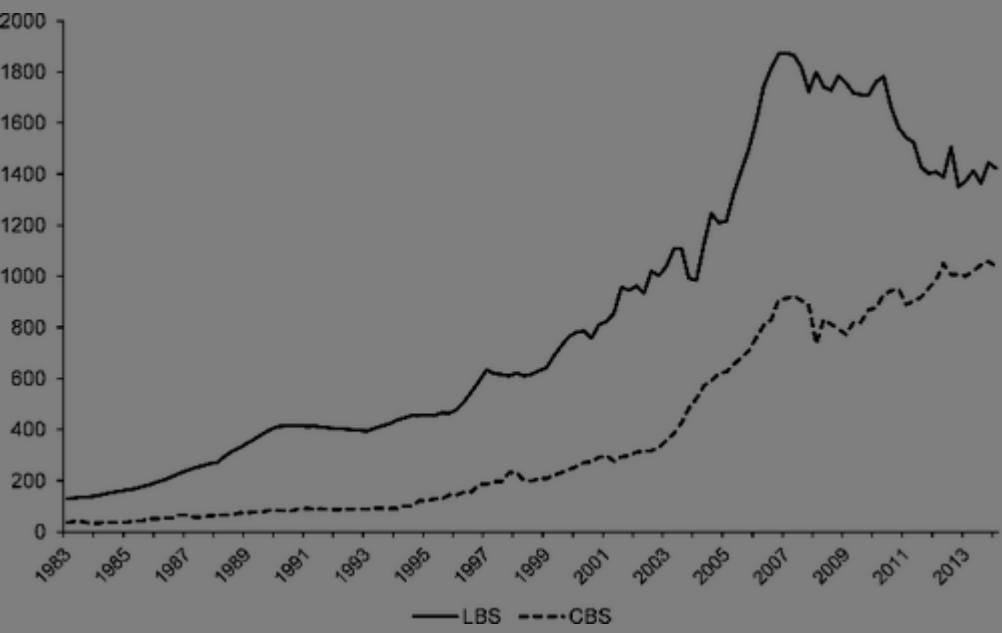
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Figure 1 Development of the Cayman Offshore Banking Sector, 1983–2014 (billion US\$).



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From 1983 to 1991, the international claims of bank subsidiaries resident in the Cayman Islands (LBS) grew much faster than the consolidated claims of internationally active banking groups from the countries participating in the CBS on counterparties resident in Cayman. From the early 1990s until the mid-2000s both measures grew with approximately the same pace; LBS increased from about US\$415 billion to roughly US\$1125 billion while CBS increased from around US\$90 billion to over US\$600 billion. Then, however, LBS grew by 50% in just two years to a peak of over US\$1800 billion in 2007–2008, when the global financial crisis began, before stabilizing at around US\$1400 billion from 2012 until today. The financial crisis did not stop the upward trend of the Cayman Islands in CBS. Consolidated foreign claims briefly declined from over US\$900 billion in 2007 to US\$735 billion in late 2008. However, since then claims have increased steadily to a new all-time peak of US\$1060 billion in 2014, or roughly 350 times Cayman's GDP. These are astonishing dimensions for such a tiny jurisdiction

with only 500,000 inhabitants. The Cayman Islands' offshore banking sector is in the third largest jurisdiction in the world, with assets under management of over US\$1.5 trillion in 2015.

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Table 1 External loans and deposits of reporting banks vis-à-vis individual countries, March 2015 (billion US\$)



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The banking statistics by the BIS provide other useful information about the Cayman offshore banking sector as well. For example, 68% of the claims reported by banking offices located in the Cayman Islands are intragroup, 26% are to non-banks and only 6% are to other banks – and over 91% of all claims are in US dollar (BIS [2015a](#)). These numbers seem to confirm the findings by the IMF ([2009](#)) that the largest factor for the Cayman banking sector is US banks that transfer client's funds to overnight sweep accounts in the Cayman Islands (over 57% of all assets in 2008). Such sweep accounts are profitable for banks and their clients (mostly large corporations) because they reduce reserve requirements and because excess funds in checking accounts can automatically be ‘swept’ overnight in instruments such as Eurodollar deposits, repurchase agreements or money market funds (FDIC [2009](#)). Cayman acts as a pure conduit for foreign banks in this segment; or, in the words of Gonzalo Jalles, the CEO of Cayman Finance, ‘a significant part of the banking assets registered in Cayman are US banks placing overnight deposits in their own Cayman registered branch. The money is effectively being transferred between accounts in NY and not being exposed to how a local banker in Cayman decides to invest it’ (Klein [2013](#)).

Historically, overnight sweep accounts in OFCs such as the Caymans developed because Regulation Q prohibited US banks from paying interest on demand deposit accounts. Regulation Q was repealed in 2011 and this may partly explain the drop in Cayman LBS from US\$1800 billion in 2011 to about US\$1400 billion since then (see Figure 1). ... sweeps to ... banks to ... of data on ... the IMF ... the same ... 2015 total ... ted to ... second

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balance, overnight sweep accounts of US banks in the Cayman Islands increase the complexity of the US financial system, reduce reserve requirements of US banks, and potentially increase client's risk because Cayman accounts are not insured by the US Federal Deposit Insurance Corporation.

LBS data can also be used in another way, to analyze (unconsolidated) cross-border positions reported by banking offices located in the BIS reporting countries vis-à-vis counterparties resident in the Cayman Islands. According to these data, the unconsolidated claims by BIS reporting banks to the Cayman Islands measured US\$1840 billion in March 2015. Interestingly, over 56% of these claims are on non-banks and only 44% on banks (BIS [2015a](#)). In addition, a surprisingly high share of 17% is denominated in Japanese yen (70% in US dollar and 7% in euro). This is a strong indication that Japan plays a significant, yet hitherto not analyzed role in the Cayman OFC. Then there are also the CBS, which are reported by nationality of banks. The consolidated positions on counterparties resident in Cayman allow for a precise geographical analysis of the Cayman offshore banking center. Specifically, I use consolidated claims on an ultimate risk basis including other potential exposures. In March 2015, these consolidated claims on counterparties resident in the Cayman Islands amounted to US\$1074 billion (BIS [2015b](#)). Before we turn to a granular geographical analysis, it is important to note that the vast majority of the claims are on ‘non-bank financial’ (over 73%), which in all likelihood is mainly hedge funds and other investment vehicles. [Table 2](#) shows the claims of the ten largest countries.

Table 2 Consolidated claims on the Cayman Islands by nationality of reporting banks, March 2015 (billion US\$)



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Cayman economy precludes significant inflows of greenfield FDI. Hence, foreign portfolio investment is much larger than FDI and the vast majority of Cayman direct investment has to be related to finance. [Table 3](#) shows the ten largest counterpart countries of the Cayman Islands for both inward direct investment (IDI) and outward direct investment (ODI). The data are from the Coordinated Direct Investment Survey (CDIS) by the IMF. The Cayman Islands does not participate in the CDIS. However, IDI and ODI counterpart values allow the IMF to derive data for Cayman.

Table 3 Inward and outward direct investment stocks of the Cayman Islands, 2014 (billion US\$)



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CDIS data are available only since 2009. Cayman direct investment has more than doubled in just five years (IMF [2015](#)). However, comparable to banking we do not know if these numbers reflect genuine growth or just better reporting. In 2014, total Cayman IDI amounted to about US\$550, or over 180 times the GDP of the Cayman Islands – a very high value. Note that Cayman direct investment is likely even higher than these numbers suggest, because we do not have the corresponding direct investment data from other large OFCs, such as Bermuda, the British Virgin Islands (BVI) or Jersey. Cayman ODI (US\$540 billion) is lower than IDI; the difference of US\$17 billion is either Cayman direct investment into non-reporting OFCs or outward portfolio investment. We can assume this because given the tiny size of the domestic Cayman economy virtually all inward investment (portfolio and direct investment) has to leave the jurisdiction again, possibly changing its form while passing through. Thus, the Cayman Islands and other OFCs with minuscule GDPs are pure entrepôt jurisdictions concerning investment.

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categories accounted for 80% of Cayman IDI from the US, 1) holding companies (nonbank) and 2) finance (including depository institutions) with over 40% each – all categories pertaining to manufacturing are negligible (US\$185 million). The USA is also the largest destination for Cayman ODI (US\$100 billion). The Netherlands is the second largest source of Cayman IDI and the third largest destination for Cayman ODI (US\$54 billion, respectively, US\$76 billion). The Netherlands is the dominant global direct investment conduit, specializing in ‘Special Purpose Entities’ (SPEs). Weyzig ([2013](#)) has conducted an in-depth case study about the Netherlands and found that Dutch SPEs allow multinational enterprises (MNEs) to avoid paying withholding taxes in many developing and EU countries and enable profit shifting through royalty payments. [Table 3](#) shows that the Cayman Islands is involved in this process via direct investment to/from the Netherlands. Luxembourg, another large global direct investment conduit, plays a similar role as the second largest destination for Cayman ODI (US\$88 billion). UNCTAD ([2015b](#)) estimates that developing countries face tax revenue losses of US\$100 billion per year due to the role of OFCs and SPEs in international direct investment.

Brazil and China also use the Cayman Islands as a direct investment conduit; in fact, Cayman is the largest destination of Brazilian FDI (IMF [2015](#)). A combined China-Hong Kong would be the second largest destination for Cayman ODI. Cayman ODI to China-Hong Kong has more than doubled from 2009 to 2014 (US\$41 billion to US\$94 billion) (IMF [2015](#)). Chinese MNEs have been found to channel direct investment through OFCs (directly and also indirectly via Hong Kong) not only to minimize taxes (‘round-tripping’) but also to conceal the ownership of assets and to gain access to foreign capital markets (Vlcek [2013](#); Buckley et al. [2015](#)). The BVI (also under UK sovereignty) is by far the largest offshore jurisdiction concerning Chinese direct investment; in 2013 an astonishing US\$780 billion had flown from there to China-Hong Kong (IMF [2015](#)). The

International Consortium of Investigative Journalists has revealed that – with the help of advance relatives of China's highlighting the role of the Cayman Islands from China that s on PriceWater by Chinese corporat ustries such

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interest entity' (VIE). VIEs allow Chinese corporations to publicly list abroad, usually in the USA, and thus to gain access to foreign capital. The legal structure works as follows: The Chinese corporation is separated into two parts – the businesses that are open to foreign ownership are transferred to a so-called wholly foreign owned enterprise (WFOE), the restricted businesses are put in the VIE, which is owned and controlled by Chinese individuals. Then, an offshore holding company is created that owns the WFOE, typically in the Cayman Islands because until 2014 it had been the only OFC allowed to publicly list corporations in both the USA and Hong Kong (Sutherland and Anderson [2015](#)). Subsequently, the Cayman holding lists its shares in the USA. However, the problematic aspect had been how to consolidate the restricted businesses that are part of the VIE without violating Chinese rules on foreign investment. The solution devised by accounting firms was to mimic ownership through a series of legal contracts between the Cayman company and the VIE. These contracts give the Cayman holding enough de facto control over the Chinese VIE that it is able to consolidate it under current accounting rules, even though Chinese law actually prohibits foreign investment in this sector. Thus, this legal structure constitutes a grey zone with considerable hidden risk for investors in the Cayman company, because the whole structure rests on the willingness of Chinese authorities to tolerate it. In 2014, the Chinese e-commerce giant Alibaba (the Cayman holding, that is) raised a record US\$25 billion with its initial public offering (IPO) in the USA, thus probably perpetuating the VIE structure given the sheer size of the IPO. However, investors in Alibaba have no de jure control over the Chinese corporation, as they only own shares in the Cayman holding. Alibaba describes the situation to investors in a registration statement to the US Securities and Exchange Commission (SEC) as follows: 'You may face difficulties in protecting your interests, and your ability to protect your rights through the US federal courts may be limited because we are incorporated under Cayman Islands law, we conduct substantially all of our operations in China and most of our directors and all of our executives are Chinese citizens.'

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Haberly and Wójcik ([2015b](#)) have found that Cayman is part of the ‘Anglo Alliance’ direct investment network, acting as a strong link between the ‘Pax Americana’ and the ‘Greater China’ subnetworks. This section has shed new light on the specific characteristics of Cayman direct investment. However, even though it already measures about half a trillion US dollar it represents the smallest of the three financial segments. The largest segment by far is portfolio investment.

PORTFOLIO INVESTMENT

Equity and debt instruments (e.g., shares and bonds) that are held for financial gain (i.e., are below 10% of voting rights) represent the bulk of global cross-border portfolio investment. The most comprehensive data source for this segment is the Coordinated Portfolio Investment Survey (CPIS) by the IMF. In mid-2015, 70 jurisdictions have participated in the CPIS, including Cayman. However, the Cayman Islands reports only portfolio investment held by banks thus excluding the vast hedge fund sector (Lane and Milesi-Ferretti [2010](#); Zucman [2013](#)). This renders the official Cayman CPIS data virtually useless. In addition to the reported assets, the IMF also publishes derived portfolio investment liabilities. These data are derived from the 70 reporting countries and cover 234 jurisdictions. Especially for non-reporting OFCs or underreporting jurisdictions, derived portfolio investment liabilities are extremely useful. For mid-2015, the Cayman Islands reported (outward) portfolio investment assets of US\$61 billion (IMF [2016](#)). The derived portfolio investment liabilities, however, reveal that Cayman (inward) portfolio investment is over US\$2574 billion – 42 times more than the official Cayman data suggest. Thus, at mid-2015 the Cayman Islands have been the sixth largest financial center in the world concerning cross-border portfolio investment. The USA has been the largest jurisdiction with US\$9790 billion, followed by the UK (US\$3728 billion), France (US\$3045 billion), Germany (US\$2545 billion), and Switzerland (US\$2355 billion). The Cayman Islands' role as a financial center for hedge funds) and the fact that the Cayman Islands' financial center plays a central role in the global financial system, especially in the Asia-Pacific geography, is well documented. The Cayman Islands' financial center is the counterpart of the USA's financial center in the 'offshore' industry, and its 'financial center' status is a key factor in its 'financial center' status (i.e. the



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The countries participating in CPIS have reported US\$2574 billion of portfolio investment into the Cayman Islands in mid-2015. The largest counterparty by far has been the USA with US\$1206 billion (or 47%), followed by Japan (US\$558 billion), Hong Kong (US\$343 billion), the UK (US\$91 billion), and Luxembourg with US\$83 billion (IMF [2016](#)). These five countries are responsible for almost 90% of total portfolio investment into Cayman. Due to the severe underreporting of the Cayman Islands, CPIS data are not useful for determining the destinations of Cayman portfolio investment. Japan is the only major counterparty of Cayman that reports portfolio investment liabilities, an encouraged item of CPIS; in mid-2015, Japan measured US\$51 billion of inward portfolio investment from the Cayman Islands. Thus, less than one tenth of the Japanese portfolio investment of over half a trillion US dollar to Cayman has flown back. A substantial share has probably ended up in the USA. According to US Treasury data, the value of US securities held in Cayman amounted to a staggering US\$1506 billion in mid-2015, making the Cayman Islands the third largest counterpart jurisdiction behind Japan and China (Treasury [2016](#)). In fact, when excluding long-term US Treasuries, of which the central banks (or other public institutions) from both Japan and China hold more than US\$1000 billion, Cayman is the largest holder of US securities in the world. US portfolio investment into Cayman amounted to US\$1206 billion. Hence, Cayman portfolio investment into the USA is US\$300 billion larger than vice versa. It is reasonable to assume that a substantial share of this difference can be ascribed to investors from Japan and Hong Kong that use Cayman as a conduit for portfolio investment into the large American equity markets. In 2003, the Cayman Islands Monetary Authority (CIMA) has created the Retail Mutual Funds (Japan) Regulations in order to enable Japanese financial institutions to launch hedge and mutual funds domiciled in Cayman eligible for Japanese investors. The process included several visits by CIMA personnel to Japan and substantial research to align these specific Cayman regulations to Japanese laws (Solomon Harris [2006](#)). Thus, Cayman acts as a fund

conduit when they invest in China (Japan T). The CPIS data (for an) onal portfolio that have significant valent to

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Cayman Islands and all portfolio investment into this jurisdiction is shown in red. The USA as the dominant country in cross-border investment is put at the center of the graph and colored dark grey (as well as the portfolio investment into the USA); all other jurisdictions are shown in light grey. Jurisdictions have been arranged for maximum visual clarity. The figure makes clear that the USA is still the undisputed center for international portfolio investment, followed by the UK. France, Germany, and Japan play a much smaller role as destinations of portfolio investment. China (for which CPIS data became available for the first time in mid-2015) is still small in portfolio investment due to strong restrictions for foreign investors (see Fichtner [2016](#) for four novel visualizations of global finance). **Figure 2** shows that Cayman is one of the largest global nodes for portfolio investment, but primarily acts as a conduit for investment into the USA, either via American 'round-tripping' or from Japan and Hong Kong. Luxembourg, Switzerland, and the UK also report notable portfolio investment into Cayman but on a much smaller scale than compared to the USA, Japan, and Hong Kong. In mid-2015, portfolio investment from Cayman to the United States (US\$1506 billion) has actually been the largest individual cross-border stock of portfolio investment in the world, ahead of US portfolio investment into the UK with US\$1336 billion (note that reserve holdings, such as the large amount of US Treasuries held by Japan and China are excluded in CPIS). This massive holding of portfolio investment by Cayman residents can only be understood by analyzing the financial geography of the Cayman hedge fund industry.

Figure 2 The Cayman Islands' position in international portfolio investment, mid-2015.



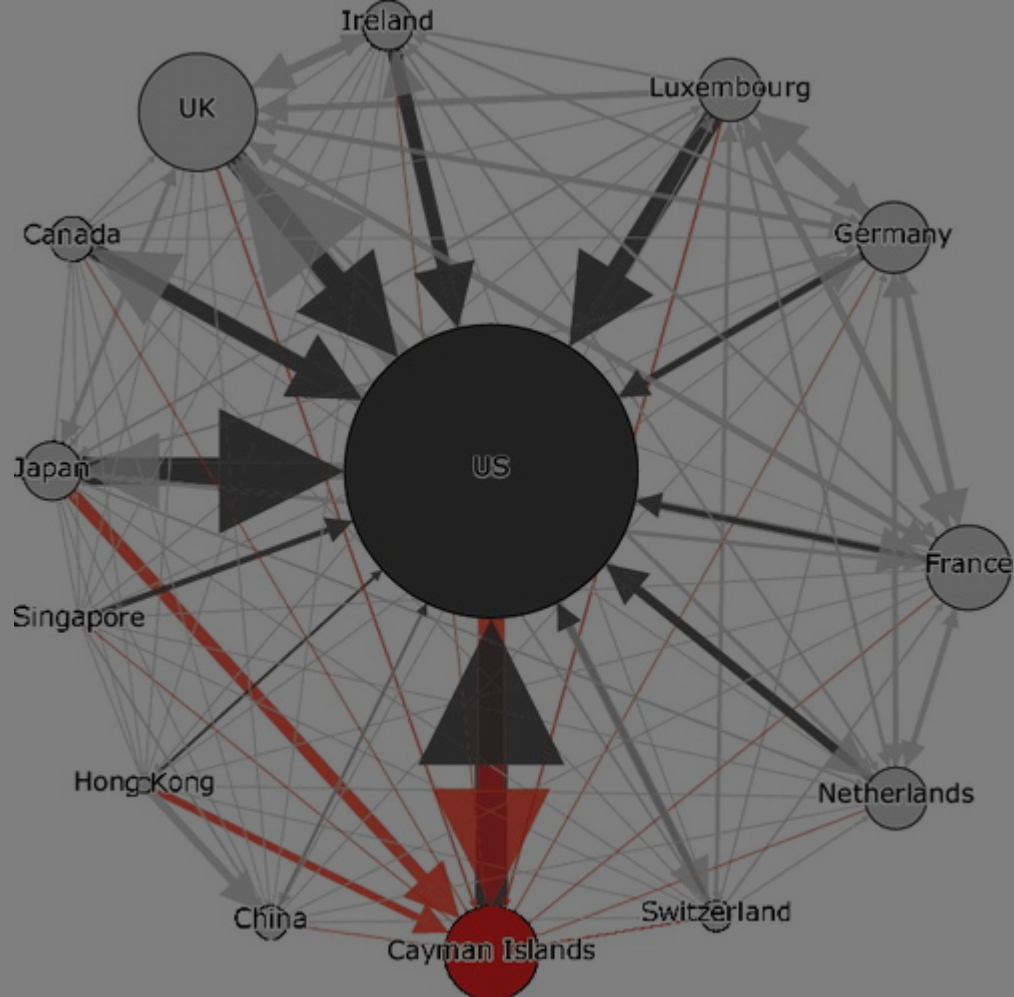
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Until recently, data on the global hedge fund industry had been exclusively collected by private companies such as Hedge Fund Research (HFR). In 2011, the International Organization of Securities Commissions (IOSCO) began publishing biannual hedge fund surveys. These surveys, however, only cover large hedge funds with assets of more than US\$500 million. In 2014, over 50% of the 1486 large hedge funds surveyed have been domiciled in Cayman (IOSCO 2015) – for large UK hedge funds the value is even 69% (FCA [2015](#)). According to the consulting firm OliverWyman, in 2013 about 60% of total hedge fund assets have been legally domiciled in the Cayman Islands – 14% in BVI, 12% in Delaware (Clarkson et al. [2014](#)). Hence, both sources indicate that Cayman

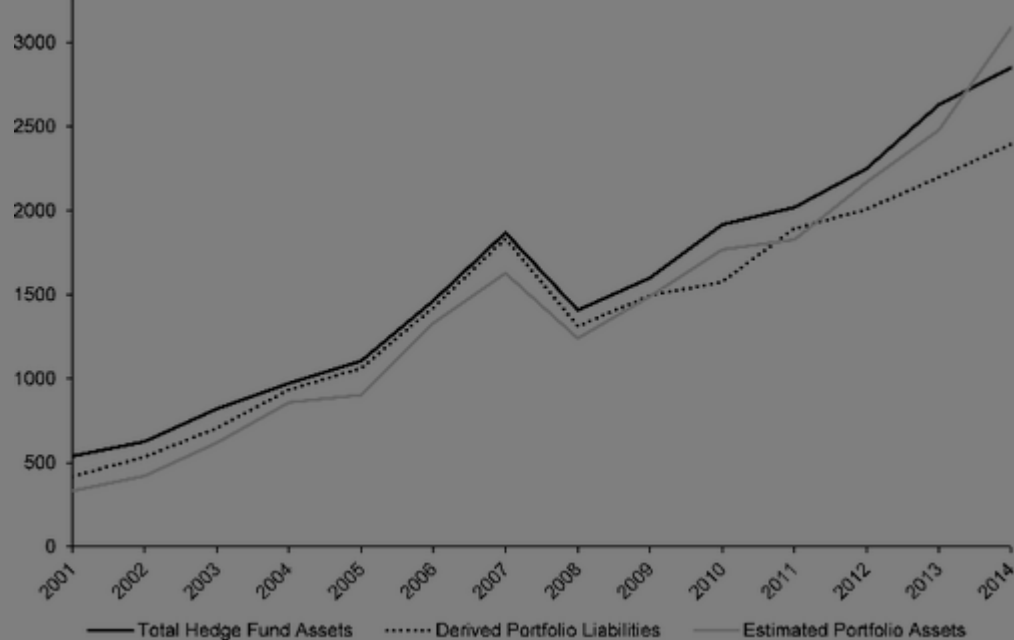
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The result is astonishing; all lines have moved extremely close together from 2001 to 2014. This suggests that 1) Cayman has been able to maintain its role as the leading domicile for hedge funds throughout this period, and 2) that the hedge fund industry is significantly larger than the data from HFR indicate. Calculations by the author based on CIMA's Investments Statistical Digest suggest that the Cayman hedge fund industry had approximately US\$2030 billion in assets under management in 2013 (net asset value of master funds and stand-alone funds divided by 0.82 in order to adjust for the 18% of non-reporting funds; see CIMA [2014](#)). Thus, if Cayman accounted for 60% of total hedge fund assets in 2013, the global hedge fund industry should have amounted to nearly US\$3400 billion instead of US\$2630 billion – this is consistent with estimates from eVestment for mid-2013, which put global assets under management by hedge funds at US\$3411 billion (Baert [2013](#)). The remaining difference between Cayman hedge funds assets of US\$2030 billion and Cayman portfolio investment of US\$2200 billion is probably attributable to the estimated 15% of global private equity assets that are domiciled in Cayman (Clarkson et al. [2014](#)). Hedge funds domiciled in Cayman because sophisticated enables group virtually the world large po

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Tiger Global. This fund created shell companies in Cayman with firm names including the legal suffices of European countries, such as the Dutch 'NV' or the German 'GmbH'. Then 'Blau GmbH', 'Fest NV' and other shells build up short positions in several listed corporations, whose shares fell significantly after negative research reports emerged, which could have been ordered by Tiger Global, netting the fund substantial profits (Johnson [2014](#)). Paradoxically, Cayman regulations have to be loose to a certain extent to give hedge funds enough 'flexibility', but at the same time, the regulatory infrastructure has to be sophisticated to maintain the image of a trustworthy up-market OFC to investors and to avoid pressure by foreign countries.

Probably due to foreign pressure, the Cayman regulator began publishing yearly investment statistics in 2008. These data allow for a granular analysis of the financial geography of Cayman's giant hedge fund sector, which comprised over 11,300 funds at end-2013 (CIMA [2014](#)). I do not use data on all registered funds, but only on master funds to avoid double-counting through funds of hedge funds (detailed data on stand-alone funds are not available). Master funds had net assets of US\$1230 billion in 2013, which represents about 60% of total Cayman hedge fund assets. About 75% of master fund assets have been invested in 'North America' (Canada and the USA) and only 19% in 'Europe' (probably mainly in the UK). Thus there is a strong concentration of hedge fund investment in the USA (investment in Canada is likely minor). Hedge funds require a range of services to function, such as net asset calculation as well as registrar and transfer agency services. CIMA data show that the vast majority of these services is being provided in just three jurisdictions, all of which are English-speaking: the Cayman Islands (34%), Ireland (28%), and the USA (22%). Finally, there is detailed information about the location of hedge fund managers; these data are crucial because they show where the investment decisions are actually being made. Again, we find a significant geographic concentration in English-speaking, or Anglophone, countries. The United States is clearly dominant: an extraordinary 70% of all master fund assets have been managed by US-based firms.

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assets: New York-Boston (including Greenwich and Westport in Connecticut) and London. From research about the world city network we know that New York and London are the two dominant global financial centers (Taylor et al. [2011](#); Taylor and Derudder [2015](#)); Wójcik ([2013b](#)) – drawing on Strange ([1998](#)) – uses the term ‘the New York-London axis’, or simply ‘NY-LON’, to describe the joint dominance of these to interconnected financial centers (see Norfield [2016](#) for an insightful analysis of London's role in global finance). The extreme concentration of global hedge fund managers in these two greater regions, however, seems unparalleled (with the possible exception of the investment banking industry, which is also concentrated in NY-LON – and strongly connected to hedge funds). The Anglo-America or Anglosphere approach from IR and IPE seems especially apposite to explain the joint dominance of the USA and the UK in global finance. Moreover, this approach provides a plausible explanation for the huge size and the specific anatomy of the Cayman OFC that this paper has dissected.

THE ANGLO-AMERICA/ANGLOSPHERE APPROACH

The Anglosphere approach by Vucetic ([2011](#), 7) builds upon constructivism and conceptualizes the community of the English-speaking countries as based on a shared racialized Anglo-Saxon identity, ‘a social kind that exists because people believe it exists’. Vucetic bases his analysis on historical case studies about crucial interactions between the core countries of the Anglosphere (USA, UK, Canada, Australia, and New Zealand). He deliberately chose episodes that directly concern the field of national security as this domain is commonly theorized to represent the least-likely case for cooperation between sovereign states in an ‘anarchical’ system of IRs. He argues that it clearly is a puzzle for most conventional IR theories how the ‘Anglo-American war



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the existence of a specific Anglo-American model of capitalism. Hall and Soskice (2001), and Amable (2003) argue that the Anglophone economies constitute a distinct socio-economic model – ‘liberal market economies’ or ‘market-based economies’ in which financial markets play a pivotal role. Moreover, the legal systems of all Anglophone countries and territories are based on common law, which facilitates financial activities within this Anglo-American transnational space. Green (2015) has shown that an ‘Anglo-American developmental sphere’ was crucial to the development of the pivotal Euromarkets in London, which, in turn, led to a ‘transatlantic regulatory feedback loop’ that induced wider international financial deregulation. Thus, Anglo-America has played a key role for financial globalization. The revelations about the unparalleled cooperation by the Anglophone countries in the extremely sensitive field of intelligence (dubbed the ‘Five Eyes’) have corroborated the cogency of the Anglo-America/Anglosphere approach significantly (McGregor 2013).

Virtually all international socio-economic statistics treat the Anglophone countries solely on the grounds where they are located geographically, i.e., the UK is seen as part of ‘Europe’, Australia as belonging to ‘Asia-Pacific’, and Cayman, BVI and others as ‘Caribbean’. The Anglo-America/Anglosphere approach, on the other hand, suggests that these states and territories generally have much more in common with other Anglophone countries than with neighboring countries and, thus, should be analyzed together. Research by Heemskerk and Takes (2016) supports this view. Utilizing community detection through modularity maximization, they analyze how the largest one million global corporations are connected through interlocking directorates. They find evidence for the existence of a globally dominant ‘North Atlantic & Commonwealth Community’, which integrates the Anglophone countries. Applying the Anglo-America/Anglosphere approach to the Cayman Islands opens new avenues for explaining the extraordinary size and the unique anatomy of this central OFC. The fact that Cayman is under British sovereignty has been seen as central by Roberts (1995)

and Hudson (2000). This article discusses the role of the Cayman Islands in the United States’ financial system, its local economy, and the global financial system (Reuters 2016). It also demonstrates the role of the Cayman Islands in the global financial system, such as

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BVI, Bermuda, Jersey or Cayman, which makes them qualitatively different from (aspirant) OFCs that are independent, such as Panama, Belize or the Seychelles.

The development of the Cayman OFC is inextricably linked with its sovereign power, the UK. In the 1960s, the Colonial Office assisted Cayman (as well as the BVI and others) with the adoption of British laws in order to establish OFCs, reportedly to avoid being left with financially dependent territories in the Caribbean (Picciotto [1992](#); Freyer and Morriss [2013](#)). However, British support for the Cayman OFC continued after London ended development aids to Cayman in the mid-1970s, supposedly because it was thought that Cayman and other British OFCs brought more business to the City of London than they caused tax avoidance in the UK (Freyer and Morriss [2013](#)). London also played a key role in repeatedly assisting negotiations with Washington when the USA complained about conspicuous deficiencies in Cayman regulations. Arguably, only this tripartite relation has made it possible that Cayman became the domicile of choice for the hedge fund industry and the largest holder of US securities (excluding Treasuries) in the world. Thus, the Cayman Islands can be conceived as a quintessentially Anglo-American OFC. A final key link between Anglo-America and the Cayman OFC is the advanced business services-offshore nexus identified by Wójcik ([2013a](#)). Virtually all leading advanced business services firms, such as PriceWaterhouseCoopers, KPMG, Ernst&Young, and Deloitte, as well as most large global law firms are Anglo-American, i.e., have the majority of their operations in Anglophone countries (primarily in NY-LON) and are often the result of mergers between American and British firms. Anglo-American advanced business services firms have played a pivotal role for the ascent of the Cayman OFC. In fact, two former heads of the Cayman regulator CIMA have been recruited from such firms, which are involved in the creation of most Cayman laws pertaining to finance (Freyer and Morriss [2013](#)). The nexus between the UK, advanced business services, and Cayman can be also be inferred from the very high value of British services exports to the Cayman Islands, which has been consistently higher than British exports to any other jurisdiction, including Hong Kong.

The explanation for this is also different from that of other jurisdictions (e.g., Jersey etc.). According to the OECD, the Cayman Islands are a tax haven.

In this article

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British Empire' in finance, which is centered on the City of London. This concept is indeed very useful to highlight the ancillary role of the UK 'colonies' for the strong position of the City of London in international finance (see also Norfield [2016](#) on this point); however, I would be skeptical to include Hong Kong and Singapore, because both are clearly not under the sovereignty of the UK anymore, and also compete with the City in certain financial segments. The Anglo-America/Anglosphere concept has the advantage to stress the strong trans-Atlantic financial integration of the City with New York (i.e., NY-LON). Whereas the term 'Second British Empire' would suggest that London is firmly in control I would argue that in many cases there is a joint Anglo-American leadership in international finance (see Fichtner [2016](#) for a study of the persistent structural power of Anglo-America in nine key segments of global finance). The analysis of the Cayman Islands OFC in this paper shows that while it is an important factor that this jurisdiction is under UK sovereignty, Cayman primarily caters to the interests of American (and to a lesser degree also Japanese) investors and is not as strongly connected to the City of London.

CONCLUSION

Economic Geography, IR and IPE as well as economics have increasingly engaged the important topic of offshore finance in recent years. The objective of this paper is to analyze one of the largest and most central OFCs in great detail – the Cayman Islands. In particular, I contribute to the literature by dissecting the anatomy of the Cayman OFC in a very precise and fine-grained manner. This novel dissection of the Cayman OFC reveals that in all three financial segments – offshore banking, direct investment, and portfolio investment – the largest counterparty is the United States. American banks utilize Cayman intensively for overnight sweep accounts and other intra-group transactions. This is particularly true for the Cayman Islands, which is heavily catering to the US market. The Cayman Islands is the largest OFC in the Caribbean, with 50% of US direct investment in the region. In this article

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Cayman regulator has created specific regulations to set up investment and hedge funds for Japanese investors.

Cayman is qualitatively different from most other OFCs, especially from many small aspirant ones. The primary aim of the Cayman Islands seems not to be to attract illicit financial flows (although there is probably a significant amount of black money in Cayman), but to function as a conduit for large international financial institutions, enabling them to reduce taxes as well as evade ‘onshore’ regulation. In that regard, Cayman is probably more comparable to Luxembourg, which acts as a major hub for European investment funds and large MNEs, than to Switzerland, which mainly attracts private funds or the Netherlands, which acts as the largest direct investment conduit. The Cayman Islands is one of the largest OFCs in the world, but, more importantly, it is a central node of contemporary global finance. This tiny group of islands in the Caribbean acts as the global domicile of choice for the hedge fund industry. Other financial ‘innovations’ for which Cayman has played a key role are opaque CDOs that contributed to the financial crisis as well as dubious VIEs used by many Chinese corporations to get access to US capital markets. Most of these ‘innovations’ bring clear benefits to Cayman and certain financial actors, while entailing significant hidden costs and risks for other groups and countries, thus impairing the transparency and the stability of global financial markets. The global financial crisis has caused a temporary decline of the Cayman OFC; however, all three financial segments hit new all-time highs in recent years.

A novel contribution to the analysis of the Cayman OFC by this paper is the introduction of the Anglo-America/Anglosphere approach. Cayman represents one node in a triangle with the USA and the UK – or with NY-LON to be more precise in geographical terms. No other financial industry illustrates this better than hedge funds, which are quintessentially Anglo-American. Hedge fund managers are extremely concentrated in NY-LON;

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and China (including Hong Kong) to Anglo-American financial markets. Cayman's 'strength' in this context is that it combines relaxed regulation with relatively sophisticated financial authorities that are able to react quickly to international developments. In this way, Cayman enables indirect access to the crucial US financial markets that may be particularly suited for investors from Asia, especially China. Future research should analyze the role of Anglo-America for offshore finance, focusing on key OFCs such as Bermuda, BVI, Delaware and Ireland, and their link to NY-LON.

Furthermore, studies on the nexus between Anglo-America, advanced business services firms (e.g., the Big 4 accounting firms), and offshore finance are crucial.

Finally, a few policy implications arise from the findings of this paper. At the very least, all large OFCs such as Cayman should have to participate fully in CDIS and CPIS (without being able to exclude sectors, such as hedge funds) or face serious consequences. Only complete reporting enables regulators and researchers to analyze the complex global network of direct and portfolio investment. In addition, the introduction of mandatory country-by-country-reporting for large multinational corporations would bring much needed transparency concerning their financial activities in OFCs. A more ambitious measure would be to create a comprehensive global financial register as proposed by Piketty ([2014](#)) and Zucman ([2015](#)), including mandatory participation for tax havens. This would remedy the fact that cross-border financial stocks involving trusts (an Anglo-American common law specialty) are almost completely unaccounted for (Harrington [2016](#)). Large 'up-market' OFCs, such as Cayman or Luxembourg, seek to minimize reputational risk and are therefore generally receptive to reforms – if foreign political pressure is strong enough. Thus, the amelioration of offshore finance ultimately depends on the political will of the OECD countries, and particularly that of the USA and the UK.

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No potential conflict of interest was reported by the author.

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Jan Fichtner is postdoctoral researcher in the CORPNET project at the University of Amsterdam where he focuses on the re-concentration of corporate ownership through the rise of very large passive asset managers, such as BlackRock and Vanguard. His research interests lie in International Political Economy, particularly Global Finance (structural power, financialization, hedge funds, offshore financial centers).

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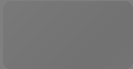



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