

## The Methodology of the Financial Secrecy Index

*The Financial Secrecy Index identifies and ranks jurisdictions according to their level of financial secrecy and their share of the global market for offshore financial services. This note explains how we calculated the index.*

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### Summary

The Financial Secrecy Index uses a combination of qualitative data and quantitative data to create an objective measure of each jurisdiction's contribution to the global problem of financial secrecy.

Qualitative data based on laws, regulations, cooperation with information exchange processes and other verifiable data sources, is used to prepare an **Opacity Score** for each jurisdiction.

Secrecy Jurisdictions with the highest Opacity Scores are more opaque in their operations, less engaged in information sharing with other national authorities and less compliant with international norms relating to combating money-laundering. Lack of transparency and unwillingness to engage in effective information exchange makes a secrecy jurisdiction a more attractive location for routing illicit financial flows and for concealing criminal and corrupt activities.

Quantitative data is then used to create a **Global Scale Weighting**, for each jurisdiction, according to its share of offshore financial services activity in the global total. To do this, we have used publicly available data about the trade in international financial services of each jurisdiction. Where necessary because of missing data, we follow International Monetary Fund methodology to extrapolate from stock measures to generate flow estimates. Jurisdictions with the largest weighting are those that play the biggest role in the market for financial services offered to non-residents.

The Opacity Score and the weighting are combined by simple multiplication to produce a **Financial Secrecy Index** which ranks Secrecy Jurisdictions according to their degree of opacity and the scale of their trade in international financial services.

A jurisdiction with a larger share of the offshore finance market, and a high degree of opacity, may receive the same overall ranking as a smaller but more secretive jurisdiction. The reasons for this are clear – the ranking not only reflects information about which are the most secretive jurisdictions, but also the question of scale.

In this way, the Financial Secrecy Index provides an answer to the question: by providing offshore financial services and a lack of transparency, thereby facilitating and encouraging illicit flows and all the damage that they do to economies and to political systems, how much damage is each secrecy jurisdiction actually responsible for?

### **Which Secrecy Jurisdictions are included?**

The Financial Secrecy Index covers all 60 Secrecy Jurisdictions enumerated in the **Mapping the Faultlines** programme: see

<http://www.secrecyjurisdictions.com/secrecyjurisdictiondata/identifyingsj>.

The approach adopted by the Mapping the Faultlines programme overcomes the sampling deficiencies of the OECD blacklist (2000) and the rather arbitrary nature of the black/grey/white lists published by the OECD in 2009. For example, the latter listings entirely excluded the UK (despite the City of London being widely identified as a key player in offshore finance) and the USA (where questions are frequently raised over the transparency of a number of states, not least Delaware, Nevada and Wyoming).

Mapping the Faultlines draws from the range of existing lists of what are variously described as tax havens, offshore financial centres and Secrecy Jurisdictions, and then treats each one the same.

### **How are the Opacity Scores prepared?**

The Financial Secrecy Index uses 12 indicators (see **Table 1** below) to produce an Opacity Score for each secrecy jurisdiction. We have based the scoring process on data that is transparent and verifiable. All of the source data is available, with supporting notes and accompanying details about how and why these indicators were selected, at <http://www.secrecyjurisdictions.com>.

The indicators are assessed according to qualitative data that can be traced back to source documents, including laws, regulations, international treaties, and relevant reports published by international organisations. Data has also been verified and evaluated by specialists with knowledge of the selected jurisdictions.

**Table 1: The twelve indicators used for opacity scoring**

INDICATOR NUMBER	INDICATOR GROUPED BY THEME
<b>Knowledge of beneficial ownership</b>	
1	Is legal banking secrecy banned (i.e. Is there no legal right to banking secrecy)?
2	Is there a Public Trust and Foundations Registry?
5	Are details of the beneficial ownership of companies available on public record online for less than US\$10?
6	Are details of the beneficial ownership of companies submitted to and kept updated by a competent authority?
<b>Key aspects of corporate transparency regulation</b>	
4	Are company accounts available for inspection by anyone for a fee of less than US\$10?
11	Does the jurisdiction prevent company redomiciliation?
12	Does the jurisdiction prevent protected cell companies from being created in its territory?
<b>International cooperation</b>	
3	Does the FATF rate 90% largely compliant and with no non-compliant ratings?
7	Did the jurisdiction participate in the TJN Survey in 2009 (1=both questionnaires; 0.5 one questionnaire)?
8	Does the jurisdiction fully participate in Automatic Information Exchange (the European Savings Tax Directive)?
9	Has the jurisdiction at least 60 bilateral treaties providing for broad information exchange clauses covering all tax matters (either DTA or TIEA)?
10	Has the jurisdiction's authority effective access to bank information for information exchange purposes?

**Transparency Credits** have been awarded where there is evidence that the secrecy jurisdiction in question is transparent and / or meets acceptable standards for international cooperation. So for example, a secrecy jurisdiction which does not protect banking secrecy by law (the first indicator in *Table 1*) is awarded Transparency Credits. The potential Transparency Credits range between zero to 100. Zero means that the secrecy jurisdiction has been awarded no Transparency Credits during the assessment process. If the jurisdiction has been awarded 25 Transparency Credits its level of opacity is assessed at 75. An award of 100 Transparency Credits would mean that the jurisdiction

has been assessed as wholly transparent and engaged in international information sharing and cooperation (and consequently would no longer be assessed as a secrecy jurisdiction).

In the case of indicator 7, which relates to cooperation with civil society research, jurisdictions have been awarded Transparency Credits even if their cooperation is only partial. In the case of engagement in tax information exchange agreements (indicator 9), the OECD minimum threshold of 12 Tax Information Exchange Agreements is regarded as unacceptably low and a threshold of 60 bilateral treaties (either Double Taxation Agreements or Tax Information Exchange Agreements) has been set as the minimum threshold.

Once assessments have been computed (100 less Transparency Credits awarded) the results are arithmetically squared in order to emphasise more strongly any differences in transparency between jurisdictions. This greater emphasis is important, if we consider that even small differences in the secrecy on offer may drive significant volumes of illicit flows. Finally, the values are normalised by dividing through by 100, giving an Opacity Score which lies between 0 (absolutely transparent) and 100 (absolutely opaque).

### How are the Global Scale Weights prepared?

To rank Secrecy Jurisdictions according to both their degree of opacity and their relative importance in the global financial markets we have created **Global Scale Weights**. These capture the role of each jurisdiction in the global provision of financial services to non-residents; that is, how big a player is each jurisdiction.

The Global Scale Weights are based on publicly available data about the trade in international financial services of each jurisdiction. Where necessary because of missing data, we follow IMF methodology to extrapolate from stock measures to generate flow estimates.

This allows us to create a ranking of jurisdictions' importance in the total global trade in financial services. When this is subsequently combined with the Opacity Scores, it creates a measure of each jurisdiction's contribution to the ultimate global problem of financial opacity: the Financial Secrecy Index.

### Data

We begin with the best data available on an internationally comparable basis. The preferred source is the IMF's Balance of Payments Statistics (BOPS). For 2006, the year with most available data, the BOPS cover 113 jurisdictions for exports and 123 jurisdictions for imports. Then, following IMF research (Zoromé, 2007), we fill in missing values for these flows of financial services for other jurisdictions, by extrapolating from data on stocks of financial assets.

Data on stocks of portfolio assets and liabilities are taken from two IMF sources: the Coordinated Portfolio Investment Survey (CPIS) and the International Investment Position (IIP) statistics, of which the latter is part of the BOPS. CPIS data for 2006 covers 77 jurisdictions for total portfolio assets, and 242 jurisdictions for total portfolio liabilities, which are derived from reported assets. IIP data for 2006 covers 112 jurisdictions, and is filtered (again following Zoromé, 2007) to exclude foreign direct

investment, reserve assets, and all assets belonging to general government and monetary authorities.

We improve on the IMF extrapolation by using a panel of data rather than a single year on which to base the extrapolation, which appears to allow marginally more accurate estimation of flows from stock data. In addition, where the flow based on jurisdiction's own declaration is less than that implied by others' declarations of bilateral positions in the CPIS, we take the latter as being more likely to be accurate.

### **Construction**

With a full dataset of flows, we follow Zoromé (2007) in creating a measure of the relative openness to financial service trade, defined for each jurisdiction as the sum of their exports and imports of financial services, as a ratio to their GDP. This gives rise to a ranking of jurisdictions which resembles a list of the 'usual suspects', typically those smaller economies (often islands) that are highly specialised in the provision of financial services to non-residents.

Next, however, we change the denominator. Instead of focusing on how important financial services trade appears to be relative to jurisdictions' GDP, we consider each jurisdiction's contribution to the global total of trade in financial services. This allows us to measure the global importance of each jurisdiction: creating a set of Global Scale Weights. Unsurprisingly, perhaps, this creates a list dominated by the big players – not necessarily those with the most specialised (narrow) economies, but those whose contribution to the global provision of financial services is greatest.

Note that this weighting alone does not imply inappropriate behaviour by the jurisdictions in question. Arguably, those near the top should be congratulated on their success in the field of international trade in financial services (although of course they may also want to look at the relative openness measure and consider the extent of their reliance on this risky sector).

It is only in the subsequent step, where this ranking by scale is combined with the Opacity Score, that we create a Financial Secrecy Index which truly does offer a measure of the potential harm done by each jurisdiction.

### **Consequences and Implications**

Secrecy Jurisdictions provide an enabling environment which encourages and facilitates illicit financial flows and tax evasion. Some progress has been made by international organisations in tackling parts of this enabling environment, for example by introducing clauses into information exchange treaties that over-ride national banking secrecy laws. Progress has also been made with persuading Secrecy Jurisdictions to sign up to bilateral tax information exchange agreements, albeit that the minimum threshold established by the OECD in April 2009 was set at an extraordinarily low level and the agreements are based on the ineffective 'upon request' model of exchange.

However, little or no progress has been made towards tackling other forms of financial and legal secrecy. Trusts, for example, are used extensively in setting up complex ownership structures for tax evasion purposes. Similarly, offshore companies are widely used to avoid disclosure of ownership information. Protected cell companies, which have been marketed on the basis that they can be

*“used to construct what has been called an impenetrable wall against creditors and prying eyes”,* are allowed by many Secrecy Jurisdictions. This explains why the Financial Secrecy Index selects a variety of key indicators to highlight the different ways in which abusive practices are enabled by Secrecy Jurisdictions.

The Financial Secrecy Index is intended to highlight how Secrecy Jurisdictions undermine transparency in the global financial markets. We hope that the ranking of Secrecy Jurisdictions according to both scale and opacity will have a ‘shaming’ effect. Financial centres rely substantially on their reputation, and this could be damaged by a high Opacity Score. Insofar as this turns out to be the case, it should be viewed as a stimulus for reform.

The process of awarding Transparency Credits for good practice is intended to encourage Secrecy Jurisdictions to move in the direction of greater transparency. Jurisdictions with a high Opacity Score can improve their overall position by removing barriers to transparency, for example by abolishing banking secrecy legislation, or by requiring disclosure of ultimate beneficial ownership of companies. The Financial Secrecy Index will be reviewed and republished every two years, and Transparency Credits will be awarded in every case where a jurisdiction is verifiably moving towards greater transparency.

The detailed evaluations supporting the Index, as well as the procedures adopted for collecting and evaluating the data, are also intended as a valuable resource for regulatory agencies around the world. As a result, regulators may more easily decide when defensive measures are appropriate against Secrecy Jurisdictions, and which measures might be effective. Legitimate customers for financial services will be encouraged to move to the more transparent centres, leaving the less transparent vulnerable to loss of business and potential counter-measures. Conversely, we recognise that those engaged in shifting illicit funds into Secrecy Jurisdictions could well use this ranking to identify suitable places for their illegitimate needs. This being the case, the international community will have additional incentive to repair the faultlines in the global financial architecture that are exploited by these jurisdictions in the first place.

A jurisdiction with a larger share of the offshore finance market, and a powerful degree of opacity, may receive the same overall ranking as a smaller but more secretive jurisdiction. The reasons for this are clear – the ranking not only reflects information about which are the most secretive jurisdictions, but also the question of scale.

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