Page 2915 - 2926 **DOI:** https://doij.org/10.10000/IJLMH.117787

INTERNATIONAL JOURNAL OF LAW MANAGEMENT & HUMANITIES

[ISSN 2581-5369]

Volume 7 | Issue 3

2024

Offshore Banking in India

Sumit Kumar Sharma[1]

Abstract

Offshore banking, a prominent sector within the financial industry, is particularly appealing to emerging markets due to its relatively lax regulatory environment compared to domestic financial markets. Offshore Financial Centres (OFCs) offer a plethora of advantages including favorable tax structures, financial stability, and confidentiality, which attract both individuals and corporations. However, the practice also poses several risks such as diminished financial security, increased regulatory scrutiny, restricted access, and susceptibility to fraud. The concept originated with banks on the British Channel Islands, evolving into a significant global financial intermediary. Offshore banks primarily serve non-residents and operate in foreign currencies, leveraging minimal taxation and enhanced privacy to attract deposits and investments.

In India, the establishment of an OFC has been proposed to bolster the nation's financial sector, inspired by successful models in places like Hong Kong and the Cayman Islands. The Reserve Bank of India introduced Offshore Banking Units (OBUs) in 2002, which function within Special Economic Zones (SEZs) to facilitate international banking activities. These OBUs operate under a different set of regulations compared to domestic banks, offering services like project financing and syndicated loans in foreign currencies.

The potential benefits of establishing an OFC in India include greater access to international funds, enhanced financial intermediation, and improved banking expertise. However, the practical challenges are significant, given India's current economic conditions and the intense global competition among financial centers. Key policy changes, such as the internationalization of the rupee and relaxation of exchange controls, are necessary to realize this vision. The implications for India's economy include the need for robust regulatory frameworks to manage the influx and outflow of international funds, ensuring stability and growth within the domestic financial system.

***Keywords**: Offshore banking,. Offshore Financial Centres Special Economic Zones (SEZs).*

I. Introduction

One of the key concepts in the financial industry is offshore banking. When compared to the sometimes tightly regulated financial markets present in emerging countries, offshore banking is a more and more desirable choice. Offshore banking is a widely practiced industry, based on

[1] Author is a LL.M. student at National university of study and research in law, India.

 [ISSN 2581-5369]

the volume of transactions and the number of Offshore Financial Centres(OFCs). OFCs are still in demand because of a number of factors, including as their easy-to-use financial system, welcoming regulatory environments, and ability to participate in illegal activities like money laundering.

It appears that offshore banking is an especially appealing solution for the occasionally highly regulated and emerging financial markets of developing countries. It consists of people who are experiencing significant growth rates and who specifically need investment capital. Currently, OFCs are a prominent and growing type of middleman for developing countries.

Leading Indian banks have been advocating for the creation of an OFC in India for a while now. A thorough examination reveals that offshore banking has benefits and drawbacks for an economy. It has been suggested by some that India ought to take the appropriate steps to become a global financial hub. The emergence of the Euro market mechanism and its innovations in financial services are relatively new. Their activities are extremely intricate and technical, and only a small number of people outside the exclusive world of international bankers fully understand what they entail and the effects they will have on the economies of the nations that fall under the purview of this market mechanism. That implies that having an offshore banking centre in India has both advantages and disadvantages.

Therefore, an overview of the concept of offshore banking, including its history, definition, legality, advantages, and disadvantages, is covered in the first section of this paper. The analysis of offshore banking centres in the global market is covered in the second part. The impact or ramifications of having an offshore banking system, particularly in relation to India, are covered in the third section of the paper.

(A) Meaning

The notion of offshore banking refers to the financial practise of either storing assets, which are often in the form of hard currency, in a bank account for safekeeping or borrowing funds or loans from a bank located in an offshore financial centre. The offshore bank's ability to accept deposits and extend credit to parties outside of the country in which it is physically situated is restricted. The geographical isolation of the offshore bank is where the phrase "off-shore" originates.[2]

“Offshore Banking is the cross- border intermediation of funds and the provision of services by

[2] *Offshore Banking Definition*, Offshore Banking - History, Advantages And Services, https://www.offshorebanking.info/offshore_banking_definition/(last visited Nov. 14, 2023).

banks residing in Offshore Financial Centres (referred as OFCs)."[3] Basically, offshore banks conduct business primarily with other financial institutions and in currencies other than the currencies of the countries where OFCs are located and hosted.

To put it simply, offshore banking refers to having a bank account that is situated outside of our nation of residence. A domestic bank is any bank located in the nation where you currently reside and work. Usually, banks with headquarters in Singapore, Hong Kong, Switzerland, and other nations provide this service. These nations, which are all heavily regulated, view financial services as their most valuable export and offer a number of benefits to offshore banking customers.

(B) Origin

This idea started with the banks that were founded on the British Channel Island, which is "offshore," or away from the UK's shoreline, and where many people used to deposit their money in order to receive tax benefits.

To entice more investment, these establishments were designed to be tax havens. Currently, tax deposits are not required in a large number of the jurisdictions home to offshore banks. Hence, offshore banking refers to a bank branch established outside of its home nation in order to benefit from various tax and regulatory advantages.[4]

a. *Legality of Offshore Banking*

Although experts in the field rarely question the "legality" of offshore banking, it is a legitimate global banking vehicle. However, there is frequently confusion regarding the procedure and its legitimacy. Due to tax evasion and money laundering, offshore banking has frequently been linked to the black market and organized crime; however, legally speaking, offshore banking does not shield assets from interest-related personal income tax.

Due to the standardized regulation and management of offshore jurisdiction by international bodies like IMF and OECD, the business of offshore banking has earned respect as an important commercial vehicle.[5] It is a "legal vehicle through which personal, international and global banking activity may be conducted under the umbrella of enhanced confidentiality, security and privacy."[6]

---

[3] Alberto Musalem & Luca Errico, *Offshore Banking: An Analysis of Micro- and Macro-Prudential Issues*, 1 IMF WORKING PAPERS5, XXXX(1999).

[4] Julia Kagan, *Offshore Banking Unit (OBU): Definition and How They Work*, Investopedia(Oct. 23, 2009), https://www.investopedia.com/terms/o/offshore-banking-unit.asp.

[5] *Offshore Banking Legality*, Offshore Banking - History, Advantages And Services, https://www.offshorebanking.info/offshore_banking_legality/(last visited Nov. 14, 2023).

[6] Supra note 4.

b. ***Advantages of Offshore Banking***

Offshore banking offers several advantages. These advantages typically include : -

1. *Favourable tax structures*: There are several tax advantages to using offshore banking. It is able to keep the money out of the tax system in our country. Usually, offshore banks pay interest without withholding any taxes. People who wait to submit their taxes until everything is finished, who do not pay taxes on their international income, or who think they can illegally avoid paying taxes by hiding their interest income would benefit from this.

2. *Protection from financial instability*: For a variety of reasons, offshore banks can offer access to politically and economically secure areas. First off, a lot of offshore jurisdictions are situated in secluded or isolated regions, which reduces the likelihood that political unrest or economic downturns will have an impact on them. Second, the assets of depositors are frequently safeguarded by robust legal and regulatory systems found in offshore countries. Third, compared to domestic banks, offshore banks are frequently subject to less government supervision, which can provide them greater freedom to adapt to shifting economic conditions. Residents who live in areas where political unrest and financial instability may occur may find this useful. For instance, in an effort to stop a currency run during the Argentine economic crisis of 2001, the government frozen bank accounts.

3. *Maintains confidentiality*: Offshore banks offer more anonymity as compared to that of onshore banks. To draw in additional capital, these establishments were designed to resemble tax havens. At the moment, tax deposits are not required in a lot of the jurisdictions that host offshore banks. Thus, an offshore banking facility is a bank branch that is established outside of its home nation in order to benefit from certain tax benefits and other legal issues.. For instance, a lot of offshore banks let customers open accounts using numbered accounts or pseudonyms. This further complicates the process for outsiders to locate and identify the owners of offshore bank accounts.

4. *Lower restrictions and regulations*: Offshore banks can operate as distinct legal entities or as a part of a larger financial institution with a foreign headquarters. Because of this, they are not as regulated as domestic banks. This is due to a few factors. Firstly, compared to onshore countries, offshore jurisdictions frequently have laxer restrictions. The previously described pattern could be explained by the competition that exists amongst offshore jurisdictions as they compete to draw in foreign investment and

financial services. Furthermore, because offshore banks are typically located in distant or remote areas, supervising them can be difficult. Furthermore, because of the complexity of their ownership structures, it may be difficult to locate and identify the beneficial owners of offshore banks. Depositors may be exposed to a variety of possible risks in offshore jurisdictions when regulatory safeguards are lacking. For example, it is possible that offshore financial institutions will decide to offer larger loans or make more acquisitions of high-risk assets.

c. **Disadvantages of Offshore Banking**

Offshore banking may have a number of disadvantages, including: -

1. *DIMINISHED FINANCIAL SECURITY* : Compared to their onshore counterparts, offshore financial institutions have less financial security because they are not subject to the same financial rules. It would appear from this that using an offshore bank account could provide less protection for your financial assets. For instance, the capital reserves needed by onshore and offshore banks could differ. This implies that they might be more prone to failing during times of economic recession.
2. *INCREASED REGULATORY MONITERING* : Governments all throughout the world are stepping up their regulatory oversight of offshore banks. Money laundering and tax evasion are two common uses for offshore banking. Consequently, there is an increased probability that governmental organisations may look into and assess offshore businesses.
3. RESTRICTED ACCESS : Governments all over the world are putting increasing pressure on offshore banks to comply with regulations. It is widespread practise to use offshore banking for tax evasion and money laundering. This could lead to an increase in the number of government agencies investigating and vetting offshore institutions.
4. *IN FAVOUR OF THE BLACK MARKET* : Governments everywhere are putting more and more regulatory pressure on offshore banks. This is due to the fact that money laundering and tax evasion commonly employ offshore banking. Consequently, there may be an increased likelihood of government agencies looking into and evaluating offshore companies.
5. *FRAUD RISK* : Offshore banks are more susceptible to fraud and scams than onshore institutions. This is because thieves usually target them in an attempt to evade paying taxes or to launder money.

(C) Role of Offshore Banking Centre

The term "OFC" refers to a jurisdiction or nation having financial centres made up of financial institutions that do business with non-residents and/or in “foreign currency on a scale out of proportion to the size of the host economy. Non-resident owned or controlled institutions play a significant role within such financial centres.”[7] International Monetary Fund (IMF) defined OFC as “a centre where the bulk of financial sector activity is offshore on both sides of the balance sheet, (that is the counterparties of the majority of financial institutions liabilities and assets are non-residents), where the transactions are initiated elsewhere, and where the majority of the institutions involved are controlled by non-residents.”[8]

When we talk about the origin of these centres, it can be traced back to 1960s and 1970s. Governments at the period attempted to control capital outflow by enforcing onerous domestic rules. Financial institutions were eventually enticed to transfer deposits and borrowing activities to less regulated institutions at offshore centres that had fewer controls and limits as a result of these restrictions, which give the government more control over monetary policy..[9]

(D) Role of Offshore Financial centres

The general perception is that individuals and corporations use OFCs because of confidentiality and minimal taxes. However, there are a number of bona fide objectives of OFCs such as:

- Costs are reduced under businesses when OFCs provides shared services within a multinational group or centralized group services.
- Facilities such as legal protection from unjustified claims and management of financial affairs confidentially are provided.
- Global investments are provided with more opportunity through effective movement of capital and resources.
- Since OFCs are low tax jurisdictions, they reduce the impact of transfer pricing rules in home countries by helping the corporations save significant taxes.
- For overcoming strict exchange control regulations, the use of intermediary holding company is permitted by OFCs.

(E) The Selection of OFCs

---

[7] Neha Sinha & Ankita Srivastava, *Offshore Financial Centres and Tax Havens – An Overview*, 988,990-995 INTERNATIONAL TAXATION- A COMPENDIUM).

[8] Monetary and Exchange Affairs Department, *Offshore Financial Centres IMF Background Paper*, (JUNE 23 ,2000)

[9] Supra note 7.

According to IMF, only those jurisdictions will be considered as OFCs where the following conditions are satisfied:

- Where a large number of financial institutions mostly dealt with non-residents
- Financial systems with external assets and liabilities out of proportion to domestic financial intermediation designed to finance domestic economies.[10]
- Where services like low or zero taxation, anonymity and banking secrecy, light financial regulation are provided.

However, the selection of an offshore financial centre depends upon many factors and they are generally classified into two categories i.e. tax factors and non-tax factors. Tax factors include basic tax rates, low or nil withholding taxes, tax incentives, Anti-avoidance rules, stability of tax laws, treaty network etc. Non-Tax factors include commercial and financial infrastructures, political and economic stability, government practices, access to capital markets, currency stability, ease in formation, Set up and ongoing costs, legal infrastructure, availability of competent professional staff, reputation of country etc.

II. Offshore banking centres

There are offshore banking centres in London, New York, Tokyo etc. Hong Kong is also an offshore banking centre. However, as compared to the above, it is not considered as major OFC although banking is important to its economy.[11] But when it comes to offshore banking and its explosive growth, Hong Kong's financial sector is among the biggest in Asia. Hong Kong is projected to become one of the biggest OFCs globally in the near future.

The Bahamas Islands are among the top OFCs in the Caribbean. The Bahamas was placed 10th internationally due to the fact that there are more than 400 banks operating in and out of the islands, which supports the country's status as one of the most significant offshore banking hubs in the world. Switzerland, the UK, the USA, and Japan are close allies of the Bahamas. In 2005, the Cayman Islands' OFC has total 305 banking institutions. Compared to the US $10 billion owned by domestic banks, offshore banks made up the OFC's asset base, which totaled US $1.2 trillion.[12]

In Latin America, Panama's OFC is considered as most advanced and prosperous. It is the entity which is tax exempted offshore. Panama's OFC consists of more than 100 banks, which

---

[10] Supra note 8.
[11] *Offshore Banking Centres,* Offshore Banking - History, Advantages And Services, https://www.offshorebanking.info/offshore_banking_centers/(last visited Nov. 14, 2023).
[12] I*d.*

represent more than 32 nations in the USA, Asia, and Europe. Cyprus has advanced significantly as an OFC in Europe. The tax system is favourable, with a 10% corporate tax, no foreign currency restrictions, and no taxes on dividends and money received from the sale of securities, among other things.[13].It is commonly acknowledged that Switzerland's OFCs invented offshore banking and its distinctive features of asset protection and financial secrecy. Switzerland, which is home to hundreds of Swiss bank offices and is known as the banking hub of Europe.

(A) Offshore banking centres in Indian context

As was covered in earlier chapters, offshore banking refers to the practice of a bank branch operating outside of its home nation in order to take advantage of tax and other legal benefits. But the idea has evolved since then. The emergence of onshore financial centres is one of the largest shifts in offshore banking. Strong economies and sound financial systems that provide a range of offshore banking services and products are known as offshore financial centres. In India, it's slightly different and the new trend which emerged is Offshore banking units (OBUs). RBI in November 2002 came up with the concept of OBUs which would essentially be on-shore operations of Indian banks catering solely to off-shore business.[14] On 17th July, 2003, India's first offshore banking unit was introduced by State Bank of India (SBI) at Andheri (East) in Mumbai.

(B) Offshore Banking Units

Official Business Units (OBUs) are essentially domestically located foreign branches of Indian banks. For OBUs, it would be necessary to locate in an export-oriented zone. An Open Banking Unit (OBU) is an Indian bank branch located in a Special Economic Zone (SEZ) that has special set off laws to encourage exports from the region, as defined by the RBI. Its overseas banking operations comprise assets and liabilities denominated in foreign currencies.

Only principal-to-principal exchanges between OBU and any approved dealer in India are permitted for foreign exchange operations..[15] These units are currently located in Mumbai SEZs and are operated by four public sector banks: State Bank of India, Union Bank of India, Punjab National Bank, and Bank of Baroda. SEZs were created by the Indian government to give export production a hassle-free, globally competitive environment.[16]

OBUs were allowed to open in Special Economic Zones (SEZs) for the first time. Although

---

[13] Supra note 11.
[14] Supra note 4.
[15] *Id.*
[16] *BANKING INDUSTRY IN INDIA: AN OVERVIEW*, https://shodhganga.inflibnet.ac.in/bitstream/10603/33365/8/08_chapter%201.pdf(last visited Nov. 14, 2023).

they are located in India, they function as practically foreign branches of Indian banks.. "These OBUs would be exempted from cash reserve requirements and would be able to provide finance to SEZ units and SEZ developers at international rates of interest. RBI has granted exemption from CRR requirements to the parent bank with reference to its OBU branch."[17]

OBUs are branches of international banks or other subsidiaries. They don't perform retail commerce; instead, they offer wholesale banking services. Some examples of wholesale banking services include the provision of short- and medium-term instruments like negotiable capital notes and certificates of deposit; additionally, there are project financing, merchant banking services, syndicated loans for bonds denominated in foreign currencies, and equity shares.

India provides some distinct advantages in attracting OFCs because it has a big market, stable political government and economic performance, and technical manpower as well that can provide employment in these centres. An further advantage is that the Indian market would start somewhat earlier than the Tokyo market and conclude earlier than the New York market, giving international money market dealers a crucial time link. Since many Indian firms are permitted to seek foreign financing and since Indian corporations are operating abroad, creating an offshore unit will assist in utilising the available resources in this scenario..[18]

Some Indian Banks like State 'Bank of India, Bank of Baroda, Bank of India, and Indian Overseas Bank', have set-up OBUs for deposit taking and final lending at 'Hong Kong, Cayman Islands, Colombo, Bahrain' etc. In order to facilitate both offshore and onshore banking, Union Bank of India, Bank of Baroda, and Indian Bank jointly launched IBU International Finance as a deposit taking firm in Hong Kong.. "The advantages for the Indian banks from these ventures are: Sizeable profits (as these ventures involve relatively low operating costs); country's balance of payments will strengthen through repatriation of profits from the venture; with multi-currency deposit bases, the banks would be able to serve better the needs of their customers who have set-up joint ventures abroad in the form of foreign currency finance."[19]

[17] *Reserve Bank of India, Annual Report of RBI 2002-2003, 171*, https://www.rbi.org.in/Upload/AnnualReport/Pdfs/56232.pdf(last visited Nov. 14, 2023).
[18] Supra note 16.
[19] *Id.*

(C) "Offshore Banking Centre In India"

Financial experts have been asking to establish an OFC in India. One of the arguments in favour of off-shore facilities was put forward by the Chairman of SBI. He visualized India as a financial centre of the model of London which would "allow free international money and capital flows and facilities for dealing in international money and exchange and financing of international trade, assume a significant role in the Eurocurrency market, generate a capital market where money instruments including bills, acceptances, certificates of deposits, bonds, shares and the rest of the new-fangled representations of stock market assets would be promoted, underwritten, issued and traded internationally."[20]

However, there are certain problems with regard to this argument. As we know that the growth of London as the premier international financial centre was a unique phenomenon. It was the result of a number of favourable historical developments which is impossible to be copied elsewhere. At that time London was developing, there were no competitors and pound sterling was ruling currency for reserves and transactions.

India is in a completely different condition right now. Numerous financial hubs are in competition. In the global economy, India's is not the strongest.. "India accounts for less than 0.5 percent of total world trade. The rupee is only a minor currency, not even used on a significant scale for invoicing India's own trade, leave alone world trade and payments. Our balance of payments and external debt conditions are precarious at present and they are not expected to improve much in the foreseeable future."[21] Given the circumstances, it is impractical to imagine India as a developing global financial hub that will liberalise exchange restrictions and integrate the domestic and international financial markets.

Prospective Advantages- The potential advantages that India can derive from an OFC are- greater access at better terms to international funds, earnings from international business, scope for financial intermediation for other developing countries, prestige and status, opportunity to develop international banking expertise.

(D) Implications For the Economy

The implications of an OFC for the economy of India arise from the major policy changes which are required for nurturing an offshore centre. "All the offshore centres owe their existence and growth to the freedom from fiscal restraints and absence of exchange controls. Under the

[20] PCD Nambia, *"International Finance Centre in India"*, 1981, XXXX.

[21] S. K. Verghese. (1982). Off-Shore Banking Centre in India: Problems and Prospects. *Economic and Political Weekly*, *17*(13), 492–503. http://www.jstor.org/stable/4370823

prevailing form of exchange controls, it would be well-nigh impossible to develop an international banking centre because free movement of foreign funds in and out of the country and their easy exchangeability are essential to its growth"- admitted by the proponents of the centres.[22] "Unlike Bahrain and Singapore, India's domestic market, including the massive domestic monetary system would provide the proposed centre with a wide variety of support".

Internationalization of the rupee is another policy change requirement. It is considered as a first step that would lower the exchange control barriers and it would be possible only if forward cover facilities are developed by the RBI by providing last resort facilities. The rupee must have its own prestigious place among the currencies traded internationally.

Certain developments have made clear that central banks are powerless to control the exchange markets. Jelle Zilstra observed, "We cannot safely adopt as a principle that exchange rates should be left to their own devices. Rates of exchange will not manage themselves or rates of exchange are too important to be left alone".[23] The meager resources which the RBI can command may not possibly last long under the present market situation with the potential of enormous volume of speculative funds that can cross the exchanges to take advantage of the interest rate differential. The impact of such fund flows on our monetary policy, interest rates, exchange rates and foreign exchange reserves can be well imagined. The laissez-faire policy of many OFCs has adversely affected their ability to mobilize savings for domestic growth. As these centers are small islands with little genuine domestic businesses complete reliance on entrepreneurship and overseas funds may not have much detrimental effects on their economy.[24]

Other potential disadvantages of OFC in India are: its effects on the domestic credit market and the effect on control over the growing external debt burden. The problem on domestic credit and monetary policy arises from the potential leakages from offshore to onshore and the interlinking of exchange rates and interest rates of India with that of the Eurocurrency markets. The supervisory costs and technical skills involved in monitoring the multi-tier credit and exchange market will be huge and enormous.[25]Various sectors of Indian economy are still in varying degrees of development and growth.

III. SUGGESTIONS

- **Provide a complete and clear regulatory framework for OFCs :** The current OFC

---

[22] Supra note 20
[23] Jelle Zilstra, *Central Banking with the Benefit of Hindsight*, 1981, XXXX.
[24] Supra note 21.
[25] *Id.*

regulatory framework in India is unclear and fragmented. This creates uncertainty for domestic and global investors. The government should create a comprehensive and precise regulatory structure that covers OFC licencing, operations, and oversight.

- **Promote transparency and accountability in OFCs :** OFCs are frequently thought of as secretive jurisdictions that are useful for tax evasion and money laundering. By mandating that OFCs implement worldwide standards like Know Your Customer (KYC) and Anti-Money Laundering (AML) rules, the government should encourage accountability and openness in these organisations.
- **Attract foreign investment and expertise to OFCs :** OFCs have the potential to be very effective in luring international capital and experience to India. In order to entice foreign banks and financial institutions to operate in OFCs, the government needs provide a favourable climate. This can entail offering tax breaks and other advantages.
- **Develop OFCs as Regional Financial Hubs :** OFCs could grow into important hubs for the local financial industry. To encourage more foreign investment, the government ought to spend money on infrastructure and other amenities in OFCs. Additionally, the government ought to encourage collaboration between India's OFCs and other OFCs in the area.

IV. CONCLUSION

The function of OFCs in the global economy is significant.. Although OFCs have been criticized for arbitrary tax advantage, aiding money laundering, terrorism financing etc., such jurisdiction have undertaken certain steps to tackle such issues and therefore they will continue to play an important role in international financial system. Tax advantages provided by the OFCs are also to be considered. Regarding confidentiality, the vast majority of OFCs have put in place anti-money laundering regulations and laws in addition to information sharing agreements with tax authorities in cases of tax evasion.

However, when it comes to Indian economy, OFC in India is not likely to confer much benefit when we consider factors such as oversees funds, foreign exchange earnings, employment generation, banking expertise etc. Its adverse impact on interest rates, exchange rates, and domestic money management will be significant. External debt will increase because of indiscriminate permission to companies from India to borrow abroad. This will increase the level of burden upon the country and will find it difficult to manage our economy according to the objectives.