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Rock of Ages

The first book in a series featuring the amateur detective, Isabel Dalhousie, who lives in Edinburgh, Scotland, is entitled "The Sunday Philosophy Club". It's written by Alexander McCall Smith who is perhaps better known in Europe for another series of books about (this time) an African private detective, also a woman, Precious Ramotswe, who lives and works in Botswana and have since been turned into a television series by the British Broadcasting Corporation called "The No. 1 Ladies' Detective Agency".

What the author intentionally does in his writing is to imbue it with philosophy, whether it's a Sunday or not, addressing moral dilemmas and changing values. All of us in the financial services industry have certainly experienced changing values and this newsletter may be a commentary on matters offshore, but inevitably, that involves matters onshore too, both of which have a common denominator: human behaviour.

Adam Smith, when writing *Wealth of Nations*, drew upon the town of Kirkcaldy, 10 miles north of Edinburgh which, at the time, only had a few lanes but a main street more than two miles long. He grew up there and that very long, main street would have provided him with a wealth of knowledge, not about nations perhaps, but most certainly about the conduct of commerce and human behaviour. Actually, the role of small Scottish towns in shaping commerce, politics and culture was a major influence that convinced him of the importance of economic individualism and the dangers of "the wretched spirit of monopoly".

Adam Smith's writings have at their root philosophy, rather than economics, and he believed that it was the philosopher's ability to illustrate his principles with examples from ordinary life and history that mattered. As the late philosopher Karl Popper put it, there is both common sense philosophy and academic (professional) philosophy; the *Offshore Pilot Quarterly* is only interested in the former.

There should be codes of behaviour in business which prevail like the Pyramids or rocks in a river which are impervious to the passage of water. In the fifth century BC the Greek Philosopher Empedocles described the universe as being in a state of things constantly coming together and splitting apart again, and that should be so because it is how progress is made; like water, the flow of ideas is constant; like rocks in a river, however, the codes of behaviour should stay in place, no matter how strong the current may be.

Today we are confronted with what amounts to nothing less than template platitudes, amply supplied in our electronic age by social media. Business websites are one thing, but Twitter and Facebook are not compatible with every business – despite what conventional wisdom suggests, with ample evidence of people attempting to hammer square pegs into round holes. In any business where craftsmanship is its essence, time-consuming Twitter, which calls for a deployment of resources to maintain an active presence, can prove to be a distraction; and if your widget stands out you can stand back because it is likely that word will spread, including via social media, any way. Word of mouth: is there any finer way of selling your product?

Perhaps you recall that back in the late 1990s the perception was that e-commerce would transform retailing completely. Bricks and mortar shops would disappear in the wake of online shopping; for some who founded companies on this premise, without premises, the result was dismal failure because what has actually happened is that e-commerce complements, rather than replaces, the shop on the street. It must surely be a question of balance; after all, although ownership and market structures can change, the core product remains. Coca-Cola is an obvious example and so is Heinz, the food company founded in 1876, just one hundred years after the American War of Independence.



It was back in the dotcom boom days (or should that be daze?) that Count Anton-Wolfgang von Faber-Castell was asked why Faber-Castell, one of the world's biggest pencil makers, and now in business for over 250 years, was still selling pencils and pens; surely the business would be finished in a few years? It is many of these dotcoms, however, that are dead, but people still buy pencils. Lego is yet another case, except with an illustrative twist. The business was started back in 1932 by Ole Kirk Kristiansen, a Danish carpenter. From making wooden toys he progressed to perfecting small wooden (now plastic) bricks. Then the company branched out into theme parks, clothes, watches and other ventures; sound familiar? Business theorists call these activities "adjacencies", which in Lego's case ended in abject failure. Like the wounded Swiss banking giant, UBS, is doing, it eventually cut its losses and went back to the basic business which had made it a success. Additional services should complement, not consume, a business, in the same way e-commerce and shops in the street function in harmony.

Success in business, however, is never assured and doesn't stop you falling victim to the hand of fate; but rock-solid values, sensible business strategies, and ignoring the assumptions spread by social media, can reduce the risk considerably.

The Machinations of Mephistopheles

The Italian academic, Giuseppe Felloni, who has studied banking for 30 years and is researching Banco di San Giorgio, a Genoese bank which operated for 398 years successfully before Napoleon's invasion of Italy (hand of fate) led to the suppression of independent banking, is right to describe a bank as a simple creation that stands between the depositor and the borrower, both of whom share a credit relationship in which "All these elements must be in equilibrium". But banking has been the victim of "adjacencies" after retail bankers let go of the reins, allowing a risk-taking investment banking culture to take over. Whereas the traditional London banker, perhaps a little smug as well as snobbish, would have died of shame if he had to deny his customers access to their accounts, all bets were suddenly now off as banking products grew more complex and high-wire strategies used by traders became more bold and mystifying. Now, perhaps, some of those young investment bankers, steeped in

subprime sorcery, might agree with Charles Dickens when he wrote in his Victorian novel *Great Expectations* (with its haunting ring of truth today): "Credit is a system whereby a person who can't pay gets another person who can't pay to guarantee that he can pay".

Although southern Germans were traditionally more progressive in banking practices, sophisticated finance has never sat comfortably in Germany, which today is the anchor for the European Union's dire economic mess; there's a message here. It had been the Genoese who were the innovators and Banco di San Giorgio became as powerful as the republic of Genoa itself; it was the world's first modern public bank, a prototype for the Bank of England. But in Germany, Johann Wolfgang von Goethe, the writer and also privy councillor at the court of Weimar, was well aware of the perils of monetary missteps that could lead to the debasement of currencies. In part two of his play, *Faust*, which he finished 99 years before the inflationary collapse of the Weimar Republic, Mephistopheles convinces the emperor to use undiscovered gold beneath his lands as putative collateral for promissory notes to pay the army. But when the emperor and his court find that they can print money at will, they create an inflationary spiral which leads to civil chaos.

History has shaped Germany's banking doctrine, unlike those countries who have relied on the equivalent of undiscovered gold, and used debt to create demand. Between 2001 and 2008 half the recorded economic growth in the US, for instance, arose from borrowing against the rising value of houses. The money was mostly spent not on long-term capital investments but, for example, cruises to Tahiti, the latest car model and other items without lasting value.

Bankers also fell fowl of basic principles. The Romans established a precise judicial doctrine concerning the demand deposit contract, to be found in the *Corpus Juris Civilis*, the legislative code created by Emperor Justinian. A demand deposit was never to be construed as a loan to the bank from which it can profit, unlike funds placed on time deposit when the customer relinquishes his claim to the money for an agreed period of time and both the banker and the depositor profit. So banks in ancient Rome operated with a 100 per cent reserve for demand deposits, but

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over time the rules were eroded until by the 19th century demand deposits were used for loans, a practice originally considered fraudulent under Roman law and bankers who breached the rule could be charged with theft. A further development, in order to circumvent anti-usury laws, saw the distinction between deposits and loans on the balance sheets of banks removed which facilitated the introduction of fractional reserve banking (only a portion, say, 10 per cent of a deposit, need be held in reserve by a bank); the remainder could be used for other purposes solely for the bankers' benefit.

Sir Mervyn King, governor of the Bank of England, speaks of the daunting shift from an economy powered by credit to one that is built on investment, such as in the time of the Industrial Revolution. He fears that the role of collateral has not been understood (nor adequately regulated or documented) while during the past five years of the Great Recession the principle of secured lending has moved into new territory, the nature of which we are discovering with our torch as we walk along in the darkness.

The Path of the Sun

In Chicago during the Great Depression the First National Bank of Englewood published a statement of its accounts, as complete as possible, in a double-page advertisement in a local newspaper, the Southtown Economist. The accounts listed every bond the bank owned with its market price and the one used on the books of the bank; every (unnamed) customer loan was published, detailing each maturity. What was important to John Milton Nichols, the bank's president, was transparency which he believed to be the hallmark of a banker. He at first refused to join the newly-formed Federal Deposit Insurance Corporation because he feared it could lead to irresponsibility on the part of bankers and depositors; his nickname was "100 per cent" due to the level of liquidity he kept available to pay depositors; he described liquidity as "the first virtue" of banking.

Mr. Nichols's small bank no longer exists, but his principles, thankfully, still survive. Across the Atlantic ocean, Stafford Railway Building Society (savings and loan in the US) in the West Midlands region of England, which I read about, has for 135 years provided mortgages from its one branch. It remains

independent, avoiding previous merger manias and customers are weighed by experienced negotiators rather than by applying standard credit-scoring methods. Not more than 75 per cent of a property's value is loaned: financial stability, not chasing profit at all cost, is the goal. The society has survived the Great Depression and in 2009, as the economic downturn really began to bite, it had assets of approximately US\$280 million, turning a profit of around US\$2 million; last year the figures were, respectively, US\$325 million and US\$1.7 million; a very respectable result given the times. Consider Northern Rock, a building society-turned bank in the UK and a victim of complex derivative products, which had to be bailed out by the government with loans at one point of approximately US\$160 billion and deposits of some US\$38 billion; that's frictional, not fractional, reserve banking. What would emperor Justinian's view of this, from a moral perspective, have been?

This brings us back to moral dilemmas, not just changing values, both of which Botswana's Precious Ramotswa, the intrepid detective, must tackle. Adam Smith was committed to developing the mind, but he recognised that manners were an essential lubricant in commercial intercourse, just like Christian Brothers College, some 62 miles southeast of Botswana, in Bulawayo in (now) Zimbabwe does, and which McCall Smith and also David Coltart, the country's present Minister of Education, Sport and Culture, attended. It devotes its efforts to providing an enlightened education and inculcating in its students the belief that "manners maketh man", as William of Wykeham, the 14th- century Chancellor of England, said and believed.

The enlightened mind brings me to the subject of hats. Fifteen years ago this month, I wrote the first Offshore Pilot Quarterly that featured the Panama hat in the context of misconceptions (in this case that the genuine ones actually come from Ecuador), but Harry Eyres, English writer and poet, speaks of the importance of wearing many metaphorical hats in order to achieve breadth of perspective. McCall Smith, for example, also holds a doctorate in law, is a musician and has travelled. The Roman philosopher Seneca described two kinds of citizenship: the one we have by an accident of birth and one by which "we measure the boundaries of our citizenship by the path of the sun". Yes, we live in a global community today where

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products travel across international borders, but do our minds make the same journey? Parochialism is a danger because it narrows our vision, encourages assumptions and diminishes any hope of being enlightened. Rudyard Kipling was right to ask the question: "And what should they know of England who only England know?"

As classmates at that College in Bulawayo, Sandy (as he was known to me) McCall Smith and I did share an interest in short-story writing and I sometimes rode his horse; we also wore old-fashioned riot helmets once when we travelled in the back of his father's car during the Rhodesian racial riots of the 1960s which led to a unilateral declaration of independence by prime

minister Ian Smith, an Ex-Royal Air Force pilot during World War Two (shot down over the Western Desert and again over Italy); that declaration was to change my own life radically.

Henry Mencken once said that the aim of public education "is not to spread enlightenment at all; [just] to breed a standard citizenry, to put down dissent and originality". I can only say that, thankfully, neither Sandy nor I had to test the assertion. As young boys, anyway, we were already wearing school trilbys, not to mention riot helmets, and although today I sometimes don a Panama hat, I like to think that it's not the only one I wear.

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