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The Year of the Oxymoron

This is the Year of the Ox in China during which, appropriately, one is required to endure hardship without complaint and prosperity is to be gained by hard work and having patience. We should all try to emulate the Chinese message – although not complaining may prove to be just too much of a challenge in 2009. Certainly this could be called the Year of the Oxymoron in the West.

It was the American comedian, Groucho Marx, who said that military intelligence is a contradiction in terms; I can think of a few more examples in this year of financial catastrophe: “safe as houses”; “good as money in the bank”; they both ring hollow in 2009. As does coupling a AAA grade investment with the words “maximum safety” when pronounced by one or more of the leading credit rating agencies in this post subprime mortgage world of deadly derivatives.

Back in 2002, Warren Buffett had warned that derivatives were indeed “toxic” and “potential time bombs”. His business partner and very close friend, Charlie Munger, also added: “To say derivative accounting in America is a sewer is an insult to sewage”. It would seem that the rating agencies lost their sense of smell during the last few years. When will they get it back? Meanwhile, how should we rate their ratings? These agencies, after all, had the same mesmerizing effect on unsuspecting and

vulnerable investors (widows and orphans come to mind) as the pied piper of Hamelin had when he played his three hypnotic notes that entranced a town’s children in Robert Browning’s wonderful poem with its powerful moral message.

Some play hypnotic notes whilst others read from them. I recall past remarks made by the former Chairman of the Board of Governors of the Federal Reserve System in the United States of America, Alan Greenspan, who felt that the use of a growing array of derivatives “and the related application of more sophisticated approaches to measuring and managing risk are key factors underpinning the greater resilience of our largest financial institutions...Derivatives have permitted the unbundling of financial risks”. Mr. Greenspan said this in May, 2005, and then after having left office he admitted in 2007 that as Fed Chairman his use of the word “froth” in respect of a few problem areas in the US economy (when others were seeing a bubble) really had amounted to the same thing. It was just that he had used milder terms: “All the froth bubbles add up to an aggregate bubble”. In his book, *The Age of Turbulence*, Mr. Greenspan referred to lots of small, local bubbles that “never grew to a scale that could threaten the health of the overall economy”. Wonderful stuff.

But for me I will defer to John Maynard Keynes and repeat his view previously quoted in last

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quarter's Offshore Pilot Quarterly: "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation". At this point let me bring in Milton Friedman who wrote a (famous) paper in 1953 entitled *The Methodology of Positive Economics* in which he argued that it doesn't matter if assumptions are not realistic (Mr. Greenspan might draw comfort from this). The success of a theory, practical or otherwise, is whether or not it contributes – if only as a catalyst – to economists being able to predict changes in economic variables.

Friedman chose billiards to make his point. If spectators wanted to predict the motion of billiard balls in a game played by experts, they could make excellent predictions by assuming that the players know the complex mathematical formulae governing the movements of balls and can therefore make instantaneous estimates of the effects of hitting the balls at different angles. The reality, of course, is that the players are not capable of those mental feats but professionals seem to learn to act as if they were capable of calculating angles and velocities.

But what harm, you may ask, is done by attributing powers to these players that they do not in fact possess? Perhaps none in a game of billiards, but financial bubbles are another matter and they are certainly not a game.

Latin Lessons

There will be a total solar eclipse in July (6 minutes and 39 seconds) which will last longer than any other this century. Will our present economic eclipse prove to be just as exceptional? To get away from steady streams, whirlpools and the architecture of bubbles, one of the many things that emerges from these dismal days is just how important it is to stay within the boundaries of your professional abilities.

Readers who have visited my firm's website will know that for many years we have been advocates ad nauseam of this belief. And yes, the theme has been a constant in this newsletter

too. New readers need to be reminded of it and those who comprise my loyal readership over many years are asked to be indulgent.

My counsel to potential clients has always been this: *festina lente* (hasten slowly). Offshore structures must never be hastily put together because such behaviour can be the road to ruin. I am tempted to look to Latin again to remind myself of something. This time the phrase would be: *Tedium bonus est* (which, more or less, translates to "boredom is good"). Look carefully at dull businesses because by concentrating on core skills, eschewing variety, remarkable success can be achieved. It is worth remembering that in the 1950s practically every street corner in America had a restaurant or diner that served hamburgers, a staple meal that had reached a popularity plateau – until, that is, McDonald's arrived on the scene. It's amazing what you can do with basic ingredients.

I know of a bank that is not a household name, but understands what the fundamentals of banking are. It lends, for example, only half its deposits and never seeks funding from the money market. And although the returns on capital for shareholders are low, it is a family-owned bank that is looking at the long-term horizon and so never comes under pressure from, nor need it contend with, avaricious outside shareholders. As a family-run firm that believes in the concept that small can be beautiful and also is an avowed disciple of concentrating on your craft, I readily identify with the philosophy. The banker has heeded the wise words of Walter Bagehot, the British nineteenth century author and banker: "The business of banking ought to be simple. If it is hard it is wrong. The only securities which a banker, using money that he may be asked at short notice to repay, ought to touch, are those which are easily saleable and easily intelligible". Easily intelligible and subprime derivatives; Groucho Marx would surely have laughed at that one.

Crash Landings, Honesty and the Devil
When I was selecting a name for this newsletter



back in 1997 I decided on the descriptive word, pilot, because, in one sense, whether it's land, sea or air, a pilot is a navigator and a guide; it was my hope that through this newsletter I could attempt to take on that role, especially for those who are embarking on their first offshore journey. The newsletter would be a way to share my experience with the reader, some of whom might find it helpful because, coupled with business focus, there is no substitute for it.

Readers can find my illustration of this ten years ago in the March, 1998, OPQ when I wrote about the Order of the Hammer. A more vivid and contemporary example, however, is US Airlines flight 1549. After recently watching the aeroplane land on the Hudson River in New York I was reminded of that engineer and his hammer which I wrote about in 1998. The pilot of that US Airlines aircraft, Captain Chesley "Sully" Sullenberger III, who is not much younger than myself, has over 40 years of flying experience; he is both a glider pilot and a former air force fighter pilot.

The crash landing also reminded me of the advice I gave in the December, 2004, issue of the OPQ: "So look for experience in a practitioner. As an article by Dorothy Leonard and Walter Swap in the Harvard Business Review put it: 'We would all rather fly with a pilot who has taken off, flown and (especially) landed in all kinds of extreme weather than with one who has always enjoyed smooth conditions'. It applies, of course, to domestic and offshore pilots".

I have always said that those going offshore for the first time need to try and not pack their prejudices or perceptions about offshore financial services with their clothes. When considering risk, for example, weigh your assumptions alongside Lehman Brothers and the secure family-owned bank that has endured applying Bagehot's advice; that bank still operates. Size and competence don't always bear any relation with each other. Popular beliefs about offshore business is shown by the well-meaning comments I read from a US adviser who was giving investment

recommendations to Americans living overseas. The advice was comprehensive and included warnings against the weak regulatory regimes and the prevalence of dishonest practitioners to be found beyond the borders of the US. Assumptions which form the basis of a judgement can certainly lead to distorted conclusions. One example which I recently read about concerned a maestro violinist, disguised as a busker, who played in a subway station and none of the passers-by stopped to listen. Their ears did not expect to hear such music in those surroundings, and particularly not from someone without a bow tie. In other words, expectations and assumptions, rather than facts, took precedence. We have to use our eyes and our ears carefully before we decide on a course of action. If anything illustrates this, surely the world economy in 2009 does.

Integrity is not confined to one nationality either. Americans need not board a flight or ship to be at risk; take, for example, "the Jewish T-bill". This was the nickname given to New York's Bernard L. Madoff whose fraudulent activities could top \$50 billion, an amount which, in 2008, might have covered the US expenditure on the Iraq war for 4 months; or to put it another way, (as I did at a recent private lunch with a senior British Foreign Office official) the US Federal Bureau of Investigation reckons that there were just under 10 million crimes against property in the US in 2007. The total losses due to property crimes amounted to \$17.6 billion, which comes to perhaps 35% of what Mr. Madoff has apparently cost his victims. I'm still searching for his offshore counterpart who can rival what could turn out to be the largest-ever Wall Street fraud.

This would not have surprised Somerset Maugham, writer, spy and socialite, who once said that the "nature of men and women – their essential nature – is so vile and despicable that if you were to portray a person as he really is, no one would believe you". If, however, you still have some faith left in human nature, just throw out assumptions and appearances before making a business decision, either onshore or offshore.



Listen to the music and remember also that it just isn't true that the Devil (despite the pied piper of Hamelin) has all the good tunes.

So, if the incident on the Hudson River showed us the importance of experience it is worth remembering to twin competence with integrity. To quote from my firm's brochure: "A. Pierpont Morgan was asked in 1912 by the US House Banking and Currency subcommittee's counsel whether commercial credit should first and foremost be either based on money or property; his terse reply was: 'No sir: first thing is character'". What a ring his words have today on Wall Street.

It is important, as I have so often said, for your safety that the individuals who manage your affairs, notwithstanding the institutions they work for, have integrity. The size of the institution is not necessarily of consequence in matters of integrity and reliability, two issues which are paramount when engaging an offshore practitioner. It is the people behind the logo that count. Professionalism, not plush carpets, is what matters.

The brochure has undergone revisions over the years, but I would never dream of removing that piece of text from 1912.

Offshore Pilot Quarterly has been published since 1997 by Trust Services, S. A. which is a British-managed trust company licensed under the fiduciary laws of Panama. It is written by Derek Sambrook, our Managing Director, who is a former member of the Latin America and Caribbean Banking Commission as well as a former offshore banking, trust company and insurance regulator. He has over 40 years private and public sector experience in the financial services industry. Our website provides a broad range of related essays, including our other newsletter, Letter from Panama, which focuses on Latin America and is also written by Derek Sambrook. Additionally, his Latin Letter column appears in every issue of Offshore Investment.com, a British professional journal.

Engaging an offshore representative is an important decision and we advise all persons to seek appropriate legal and tax advice from professionals licensed to render such advice before making offshore commitments.

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