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The Governance of the Black Holes of the World Economy: Shadow Banking and Offshore Finance

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Abstract

This paper focuses on regulatory challenges posed by the two interconnected structures of the global financial system – the economy of tax havens (or offshore financial centres), and the shadow banking system. The financial crisis of 2007-09 has revealed that tax havens structures and shadow banking entities play a central role in the practise of financial institutions reliant on financial innovation. Thriving on complexity, opaque networks and driven by arbitrage, the two phenomena pose tremendous challenges to national and international regulators aiming to restore the financial cycle in the recessionary environment. In this paper, we analyse ‘the state of play’ and the current plans for the governance of tax havens, offshore finance and the shadow banking industry. We find that although offshore financial centres and shadow banking are outside the scope of academic economics, they have attracted a lot of attention on the part of financial researchers and regulators. Along with other macro-prudential and system risk concerns, the regulation, or governance of these ‘black holes’ of the global economy is increasingly assuming a central place on the agenda of financial regulators. In what follows, we explore the reasons behind this development.

Introduction

Recent financial history can be interpreted as a spiral of financial and economic crises, and a set of regulatory responses to them. Over the past few decades this process has shown that the global financial system is adept at establishing alternative legal and quasi-legal spaces that circumvent national systems of taxation and financial regulation. About half of the global stock of money is routed through offshore financial centres (OFCs), many of which are considered to be tax havens. The vast majority of wholesale banking takes place in unique quasi-legal spaces of the Euromarket and its various descendants. More recently, the global financial crisis of 2007-09 has revealed the scale of the phenomenon of ‘shadow banking’ (SB), or a complex network of financial intermediation that takes place outside the balance sheets of the regulated banks, and thus remains invisible to the regulatory bodies.

In the USA on the eve of the crisis, the scale of the shadow banking industry was estimated to be one and a half time larger than the ‘visible’ banking sector. In Europe, recent estimates suggest that SB practices have actually grown in scope after the crisis of 2007-09, while other studies suggest that SB has historically played

an important role in the financing of the economy in emerging markets (Ghosh et al 2012; Bakk-Simon et al. 2012). The two intertwined phenomena of OFCs and SB are drawing attention of the global and national regulators.

Analysing the two phenomena, this work offers a distinct contribution to the study of economic governance processes. On the one hand, the major players shaping the regulatory discussions of offshore and shadow banking are easily identifiable and fit well within the scope of other analyses presented here. These include the core industrialised countries, the US, the EU, the UK and to a lesser extent, at least for the time being, China. They are advised by research arms of their Treasuries, their central banks, as well as other international governing bodies and think tanks, such as the Bank for International Settlements (BIS) and the OECD. Consultations and debates unfold under the umbrella of established forums, including the IMF, the BIS, the Financial Stability Board (FSB) and Financial Action Task Force (FATF), but also among quasi-public bodies such as the OECD and the G20. Importantly, the players area also accommodates private stakeholders of financial governance, including banks, hedge funds, and international professional services companies (large accounting and law firms and a spate of specialised consultancies). Civil society organisations, such as the Tax Justice Network or Finance Watch, also play a major role. In most existing accounts of structural configurations in finance, the power of the key players and their vested interests are *imputed* rather than being researched in depth. Yet perhaps unsurprisingly, evidence suggests that the large banks, non-bank financial institutions, accounting and law firms seek to limit regulation, on grounds of cost, scale, efficiency, utility and so on.

Therefore, what is missing in existing analyses of financial power is a clearly defined paradigm of regulation and governance. One major reason for this is the fact the ‘black holes’ have been largely ignored in mainstream discussions. In it notable in this instance that many key advisory and (some) regulatory bodies such as the BIS, or research departments of the central banks, have for the time-being, managed to escape to a degree the traditional political restraints they encountered in the past. In fact, they have emerged at the forefront of research in, as well as proposed solutions for, for the twin problems of tax and regulatory avoidance. Much of what is known about SB phenomenon is a product of innovatory work of a group of researchers, initially at the Federal Reserve, led by Zoltan Poszar, who then

moved to the IMF and is currently a senior adviser to the U.S. Treasury. The Bank of England practically gave a free hand to Andrew Haldane for blue-sky thinking about regulation and the purpose of banking today. Claudio Borio, a senior economic at the BIS, a staunch critic of deregulated finance before the crisis, emerged as powerful thinker in the post-crisis regulatory scene. These and other research units are behaving, for now, as is expected of them: they are relatively open minded, prepared to entertain a diversity of opinions and theoretical paradigms. Yet at this stage it is unclear for how long this trend will continue.

The work supports our own earlier analysis (Nesvetailova & Palan 2010) which suggested that the so-called neoliberal paradigm has bifurcated between private and public facets of governance. Private actors, by and large,¹ continue to believe, or at least publicly promote, the conventional neoliberal notions about the balance between the public and the private, the state and the market. Whereas public governing bodies have long abandoned the neoliberal paradigm, relying instead on a pragmatic choice of regulatory tools and most recently, on economic stimuli that contradict the orthodoxy (McCulley and Pozsar 2013). The size and importance of offshore and SB raises further philosophical questions concerning the legitimacy, relevance and efficiency of the solutions that are being proposed. Aggressive tax avoidance perpetrated by multinational corporations, rich individuals and banks are now high on the public agenda. The casino-like behaviour of the financial industry is source of consternation and ridicule. Any proposal to regulate these two realms is likely to be received well. At this point, however, we cannot predict how effective the proposed solutions might be.

In the short space allowed by this work we can only present a sketch of the ongoing efforts for a global regime of regulation of these ongoing efforts. This is partially because of the complexity of the issue, partially because the new principles and approaches to governing financial innovation are in discussion stages, with many proposals remaining as points of contention, internationally and nationally. Here it is noteworthy that while the authorities in the EU and the USA, and the international financial institutions such as the IMF and the BIS have launched serious consultations on the regulation of these quasi-legal financial spaces; the attitude of

¹ With few notable exceptions, such as financier George Soros.

China and other rising powers to these proposals remains unknown. In what follows, this work discusses the state of play and current plans for the governance of tax havens, offshore finance and the shadow banking industry.

Accounting For the Black Holes of the World Economy

Existing debates on international financial governance tend to focus on the role of official structures and institutions in overseeing global financial stability and managing crises. Rarely do debates on governance and regulation take specific account of the so-called 'black holes' of the global economy, namely, offshore financial havens and the shadow banking system. However the statistics associated with offshore financial hubs and the scope of shadow banking practices suggest these financial 'black holes' play a central role in today's global economy. In one way or another, about half of the global stock of money passes through offshore jurisdictions, which is equivalent to about one third of all global FDI (Palan, Murphy and Chavagneux, 2010). Recent estimates place the amount of accumulated wealth registered in offshore havens at about \$US 21 trillion, or at nearly 18% of the aggregate global wealth (as opposed to global GDP, estimated at around \$US70 trillion) (Henri 2012) .

The figures for the shadow banking industry are no less staggering. According to the data from the Federal Reserve, in 2007, on the eve of the global financial meltdown, the size of SB in the USA was \$18 trillion, or \$6 above the volume of the regulated banking system. In the aftermath of the crisis, the volume of shadow banking system has gone down to an estimated \$15.8 trillion (Pozsar et al 2010). Recent data from the Financial Stability Board (FSB) puts the size of the global SB at around \$67 trillion at the end of 2011, or what is about half of all bank assets world-wide (FSB 2012).

The regulatory challenges posed by these quasi-legal financial spaces are enormous. Neither economic theory nor policy instruments were designed to handle these phenomena. Economic policy is designed to deal with the world as interpreted by economic theory. Yet a world economy that consists of diverse sovereign entities, each with its own government, political systems, institutions and structures, and each

having the right to write their own laws, is very different from the abstractions used in standard economics (Palan 2013). The logic of action of economic agents that inhabit the former is different, often spectacularly so, from the logic of action of economic agents that inhabit the abstract world of international economics. For instance, in the abstract world of international economics, agents maximise utility by improving their competitive position: they seek utility, improve efficiency, productivity and search for welfare gains. In this framework, market pricing is seen as one of the most successful mechanisms of coordination and resource allocation that humans have ever devised. According to the orthodoxy, as systems of information, markets transmit and coordinate knowledge about the needs and desires of individuals as consumers, and encourage producers and service providers to respond to those needs. The financial markets, specifically, bring together two categories of financial agents, savers of capital and consumers of capital. Efficient markets, so the theory goes, ensure the most efficient allocation of capital resources between these two categories. In principle, one would want to ensure a degree of market freedom, so that economic agents can perform their tasks most efficiently. Regulations, the theory suggests, are normally designed to direct such utility-maximising actors towards politically agreed goals.

The real world of the economy is very different. It is not only the case of the considerable transaction costs that are invisible in a Walrasian market. Economists, for instance, habitually argue that capitalists are in the business of maximizing profits, but they neglect to ask whether businesses are seeking to maximize pre-tax or post-tax profits. Considering that corporate taxation in many OECD countries may reach 30 or even 40 per cent of declared pre-tax profits, this is not a trivial question. Maximization of pre-tax profits tells us nearly nothing about what businesses, and in particular, their owners and share-holders, truly care about, which is *post-tax profits*. Theoretically, the difference may appear marginal. It is not. The quest for post-tax profits has led to the development of a service economy with lucrative lines of business in tax and regulatory avoidance. This service sector, run by highly skilled professionals such as lawyers and accountants, is now so large and sophisticated that it functions as an economy in and by itself. Politically, it also emerged as a powerful international lobby group. It is a service economy that is founded on the desire of economic agents to avoid or evade taxation or regulations. The main

source of income to this service economy is the business of avoidance and evasion. This business of regulatory avoidance, otherwise known as financial innovation, is now considered one of the main purposes of international finance. Regulatory bodies are only beginning to take account on these trends.

The quest for post-tax profits is linked to another important idea, or habit of thought, of mainstream tradition in political science and economics. 'There are no free lunches', Milton Friedman famously argued. In economics there is nothing that is 'free,' since somebody has to pay for it. That may true, but an alternative economic paradigm, known as evolutionary institutionalism, is predicated on the assumption that was captured by Giovanni Dosi: 'there are always a lot of free lunches, provided you are able to discover and grab them' (Dosi 1991, 6). In other words, there are many opportunities out there, and both opportunities and penalties are not allocated equally or democratically among people and businesses. Economic actors seeking to maximise post-tax profit might not be as concerned with improving their competitive position or raising efficiency or productivity as suggested by standard economics. Instead, they tend to spend much time and money seeking to grab any free lunches available.

To over-simplify somewhat, the rise of the offshore world and shadow banking industry can be seen as a history of the discovery, often by accident, of opportunities or 'free lunches' that have existed because the world economy operates in a striated space of the state system. Regulation of such 'free lunches' is an exceedingly difficult problem. Regulatory paradigms have had difficulties incorporating notions of such free-lunches; predictably, the impact of regulations in the financial and tax sphere had tended to produce a spate of unintended consequences. One positive aspect of current discussion is that the current debate on regulation of the two spheres aims to consider seriously such possible unintended consequences.

Tax Havens and Offshore Finance

Modern tax havens have existed since the early twentieth century. They were used, and are still used, primarily but not exclusively, for tax evasion and avoidance purposes. Tax havens are used, however, for other purposes as well. Since the early

1960s, all the premier tax havens of the world have developed financial centres known otherwise as Offshore Financial Centres. It is estimated that about half of all international lending and deposits originated in OFCs, of which approximately half again are located in OFCs that double as tax havens. The Bank of International Settlements (BIS) statistics of international assets and liabilities ranks the Cayman Islands as fourth largest international financial centre in the world, while other well known tax havens/OFC such as Switzerland (7th) the Netherlands (8th), Ireland (9th), Singapore 10th, Luxembourg (11th), Bahamas (15th) and Jersey 19th. In addition these centres are recipients of approximately 30% of world's share of FDI, and in turn, are the originators of similar amounts of FDIs (Palan, Murphy, Chavagneux, 2010).

There is some confusion between the concept of tax havens and OFCs, and is not only a matter of semantics. The different conceptions of the two terms go to the very heart of what is considered to be the problem (or not) with OFCs. Some experts see no difference between tax havens and OFCs, and employ the terms interchangeably. The term OFC or even IFC (International Financial Centre) is employed simply because it is less offensive than tax havens. Yet, historically, the two terms were distinct. Modern 'tax havens' are known to have existed at least since the beginning of the twentieth century. Offshore financial centres, in contrast, are a more recent phenomenon that became current only around the mid 1970s (Bryant, 1983). They are broadly defined as markets in which financial operators are permitted to raise funds from non-residents and invest or lend the money to other non-residents free from most regulations and taxes. Most commonly, the designation 'offshore' financial market is used to describe the wholesale international financial market, previously known as the Eurodollar market.

The contrasting views of the role of tax havens as OFCs derive to a degree from the different understandings of nature of the offshore financial markets, the Euromarket. Some very distinguished economists believe that the Euromarket is simply a wholesale financial market for U.S. dollar that emerged in Europe in the 1950s (Schenk 1998). The term 'offshore' implied the original the location of the market outside the territorial boundaries of the U.S. Over time, the Euromarket came to denote any location of trades in non-resident 'hard' currencies such as the British Sterling, the Yen, the Swiss Franc, the Deutsche Mark and the Euro. OFCs,

according to this thesis, are financial centres specialising in non-resident finance. As however, in this understanding the Euromarket is not distinct from any other market, there are no special characteristics to OFCs; as the majority, if not all, of world's financial centres tend to handle both resident and non-resident currencies, they all in fact, can be described as OFCs.

There is a very different theory which claims that the Euromarket is a very specific type of market that emerged in late 1957 in London (Burn 2005). According to this theory, the Bank of England came to an informal agreement with the City's merchant banks to treat certain type of financial transactions between non-resident parties and denominated in foreign currency as if they did not take place in London, even though they were in London. Paradoxically, the bank created, in effect, a new regulatory space outside its jurisdiction, and a new concept – offshore finance. But as the transactions that took place in London were deemed by the Bank of England to be taking place elsewhere, they ended up under no regulation at all, or offshore. These transactions, according to this theory takes place in a new unregulated space called the Euromarket, or the offshore financial market (Burn 2005).

Experts who subscribe to this thesis sometimes call the Euromarket a booking device because it has no existence outside the accounting books of banks and financial institutions. Such 'offshore' spaces are created when the books of foreign-to-foreign accounts are kept separate from the books for domestic financial and capital transactions (or 'on-shore'). The essential point is that offshore financial markets are unique, not because of the non-resident currencies that are traded on their platforms, but because those exchanges escape nearly all forms of supervision, regulation and, often, taxation. This theory suggests that OFCs punched a hole at the very core of the international regulatory map, a hole that must be addressed by current plans for revisions of the international regulatory architecture.

As far as we can tell, the original rationale for the development of the Euromarket had little to do with taxation. British banks developed the market as a way of coping with the new regulation imposed by the British Treasury. The Euromarket remained small and practically unknown for three or four years until U.S. banks discovered it in the early 1960s. By late 1950s, some of the US banks were among America's and the world's largest banks, but due to these regulations 'even

the largest of them individually possessed no more than about 3 per cent of US bank assets' (Sylla 2002, 54). Some of the leading US banks rapidly developed a branch network in London since the early 1960s with the intention of circumventing stringent U.S. banking and financial regulations. In consequence as US multinationals began to expand international operations in the 1950s, US banks had difficulties servicing their large corporate clients. U.S. Banks were caught, therefore, in a funding squeeze. Once they discovered the facility of the Euromarket, corporate clients began to bypass the banks and tap directly into the Euromarket to earn higher rates of interest while the clients were also looking to the same Euromarket to fund their operations (Burn 2005; Sylla, 2002). To stem the flow, the Kennedy administration proposed in 1963 an Interest Equalization Tax to ensure that U.S. citizens did not get preferential interest in the European markets. The results, predictably, were the opposite of what was intended. Instead of stemming the flow of capital out of the U.S., American corporations kept capital abroad to avoid paying the interest equalization tax, fuelling in the process the growth of the Euromarkets. U.S. banks soon learned that the unregulated environment in London allowed them (or their London branches) to circumvent all the New Deal regulations. They were able, therefore, to establish large diverse banks in London, capable of competing in every aspect of finance. German and Japanese banks then followed suit.

London emerged, therefore, as a 'spontaneous' offshore financial market as a result of what might almost be seen to have been an administrative accident. All other areas under the jurisdiction of the UK at the time, including Honk Kong, the Channel Islands, the Cayman Islands and other British Caribbean Islands enjoyed the same legal provisions and developed as spontaneous offshore centres as a result. It did not take long, of course, for banks and other financial institutions to appreciate some useful synergies between tax havens and OFCs, particularly if located in the same place. In dual status tax havens/OFCs banks and other financial institutions, they could not only to circumvent stringent financial regulations, but also find 'tax efficient' ways of conducting their business. This is why some tax havens developed as OFCs.

We also know from various reports that some of the smaller North American banks, U.S. and Canadian, faced with the high infrastructural costs of a London base, 'realized that the Caribbean OFCs offered a cheaper and equally attractive

regulatory environment – free of exchange controls, reserve requirements and interest rate ceilings, and in the same time zone as New York. According to various reports (Sylla 2002), the early spillover of OFCs activities into the Bahamas and Cayman was, like the London Euromarket, not motivated by tax advantages, but because it was cheaper to set up branches in these locations. They had an additional advantage of sharing New York's time zone. This explains why smaller U.S. and Canadian banks were at the forefront of establishing Cayman's OFC and why some experts use the short hand description that the U.S. and Canadian banks 'established' the Caribbean havens.

In 1981, due to the success of London's offshore centre, the U.S. Treasury - which for years had tried to fight off unsuccessfully the fledgling offshore financial market - reluctantly agreed to set up a more restrictive form of US offshore markets, the International Banking Facilities (IBFs). These type of facilities enabled depository institutions in the United States to offer deposit and loan services to foreign residents and institutions free of Federal Reserve System reserve requirements, as well as some state and local taxes on income. The Japanese government created a similar structure in 1986 modeled on the U.S IBFs': this was the Japanese Offshore Market (JOM). Both, incidentally, are modelled on Singapore Asian Currency Market (ACU) which was set up in 1968. Bangkok also followed suit by setting up the Bangkok International Banking Facility (BIBF), Malaysia has somewhat similar arrangement in Labuan, as does Bahrain. According to some estimates, about one third of international banking in the U.S. is undertaken in IBFs and nearly a half of Japanese are in JOM. While the U.S. and the Japanese IBFs are exempt from some state and local taxes on income, they are not tax havens as such, but are, if anything, 'regulatory havens.'

An important distinction to be made is among tax havens/OFCs themselves. There are, in fact, two important agglomerations of tax havens/OFCs. One of these agglomerations has a distinct British Imperial flavor. It consists, first and foremost, of the City of London, and includes, in addition, the British Crown dependencies of Jersey, Guernsey and the Isle of Man, and British Overseas Territories including the Cayman Islands, Bermuda, British Virgin Islands, Turks and Caicos and Gibraltar, and recently independent British colonies such as Hong Kong, Singapore, the

Bahamas, Cyprus, Bahrain and Dubai.² The British imperial pole accounted for a combined average of 38.3% of all outstanding international loans and deposits by March 2010 (BIS 2010).

Another important agglomeration consists of a string of mid-size European states known for their welfare provisions as well as for serving as tax havens. This agglomeration includes the Benelux countries, Belgium, Netherlands and Luxembourg, as well as Ireland, Switzerland.³ This agglomeration accounted for a combined 14.9% of all outstanding international loans and deposits by March 2010, exactly the same as the US.⁴ Combined, the two agglomerations accounted for approximately 53.3% of all international banking assets and liabilities by March 2010, down from 58.3% only a year ago.

Shadow Banking

The term ‘shadow banking’ is a relatively new addition to modern financial vocabulary. It is commonly attributed to Paul McCulley of PIMCO, who in his 2007 speech to the Federal Reserve Conference in Jackson Hole observed that the (then unfolding) financial crisis can be attributed to the growth of “unregulated shadow banks that [unlike regulated banks], fund themselves with uninsured short-term funding, which may or may not be backstopped by liquidity lines from real banks. Because they fly below the radar of traditional bank regulation, these levered-up

² Bermuda, which is the largest captive insurance centre in the world, but has a relatively small banking center, can be included as well, as indeed, Cyprus and the more numerous but less significant former British colonies in the Pacific. For discussion of Bermuda’s financial center see Crombie 2008. For discussion of the Pacific offshore centers and their relationship to the UK see: Sharman and Mistry 2008.

³ A Survey of surveys of the eleven best known and most authoritative lists of tax havens of the world found that Switzerland is considered as a tax haven by nine of them, Luxembourg and Ireland by eight, the Netherlands by two and Belgium by one. Palan et. Al. 2010.. Switzerland and Liechtenstein share a custom union as well as strong political links. Observers tend to treat the two countries as a linked financial center. See Kuentzler 2007 for discussion.

⁴ The U.S., in contrast, accounted for 12.4% and 12.9% of all outstanding international loans and deposits and Japan for 4.5% and 3.8% respectively in March 2009, while the European havens were about 2% higher only a year before. The US appears to be the only large net gainer during the crisis of 2007 up to this day.

intermediaries operate in the shadows without backstopping from the Fed's discount lending window or access to FDIC (Federal Deposit Insurance Corporation) deposit insurance" (McCulley 2009: 257).

The first comprehensive study of the US shadow banking system was published in late 2010 and quickly became a classic (Pozsar et al. 2010). The study mapped the structure of shadow banking in the US context, distinguishing between government-sponsored, internal and external shadow banking sub-systems (Pozsar 2010: 30-36).⁵ The study estimated that, the size of SB activities in the USA was about \$6trillion larger than the official banking system of the country. By 2010, these figures decreased, yet the significance of the shadow banking system for the US economy was still notable: it accommodated \$16 trillion of assets. The Fed analysis prompted further efforts to identify, understand and map out the chains of shadow banking system at the global level. In 2011, the FSB estimated that globally, the shadow banking system's assets totalled some 46 trillion euro in 2010, compared to 21 trillion euro in 2002. This means shadow banking makes up an average of 25% to 30% of the total financial system and its size is equal to half of all bank assets (FSB 2011a). Recent calculations by the FSB put the size of the global shadow banking industry at \$67 trillion. The so-called Anglo-Saxon financial system dominates SB practices, with US and UK accounting for 46% and 13% of the global shadow banking system, respectively; while the share of Japan and the Netherlands⁶ follows closely (8% each) (FSB 2011b). At the same time, analysts at all levels admit that because so many of the practices of shadow banking remain obscure and take place under the regulators' radar, current data on shadow banking activities may be under-estimations.

⁵ Similar to the "internal" shadow banking sub-system (which evolved historically in parallel to the moves away from deposit-based banking to original and distribute model of banking), as banks sought to the "external" shadow banking sub-system was a global network of balance sheets, with the origination, warehousing and securitization of loans conducted mainly from the U.S., and the funding and maturity transformation of structured credit assets conducted mainly from the U.K., Europe and various offshore financial centers. However, unlike the "internal" sub-system, the "external" sub-system was less of a product of regulatory arbitrage, and more a product of vertical integration and gains from specialization (Pozsar et al 2010: p. 36).

⁶ The Netherlands has a large and sprawling OFC.

Some commentators view the phenomenon of shadow banking as paranormal development in the global economy, often linking it to tax evasion emanating from the underground, or unaccounted economy (Schneider et al. 2012; Buehn and Schneider 2011) and ultimately read derogatory connotations into the practices of shadow banking (Knutzen 2012). Others however, highlight the very central role that key functions that shadow banking – risk, maturity and liquidity transformation – performs in today’s financial system.⁷ One key point of contention is the question of whether hedge funds - a largely unregulated part of global finance - should be identified as part of SB system in the first place.

The emergent literature on mapping shadow banking structures also reflects the importance of historical and political economic institutions in its evolution. SB practices have historically been prominent in the US, where funding of the economy is geared towards capital markets. Indeed in the USA, a parallel financial system developed as early as the 1930s, despite the formal bifurcation between commercial and investment banking activities formalised by the Glass-Steagall Act (Kregel 2010). The City of London too, has been accommodating specific financial innovations: securitisation and re-securitisation, over-the-counter (OTC) derivatives trade, collateral rehypothecation and repo market operations have thrived in the financial and legal space provided by the City of London. In the EU context, SB activities are associated primarily universal banks. Reflecting the diversity, the FSB defines SB as ‘credit intermediation occurring outside or partially outside the banking system, but involving maturity transformation and leverage, the defining characteristics of banking’ (Turner 2012).

Evaluations of the impact of the shadow banking system on the global economy vary. Most current studies view SB as an integral part of the global credit

⁷ Credit transformation refers to the enhancement of the credit quality of debt issued by the intermediary through the use of priority of claims. For example, the credit quality of senior deposits is better than the credit quality of the underlying loan portfolio due to the presence of junior equity. Maturity transformation refers to the use of short-term deposits to fund long-term loans, which creates liquidity for the saver but exposes the intermediary to rollover and duration risks. Liquidity transformation refers to the use of liquid instruments to fund illiquid assets. For example, a pool of illiquid whole loans might trade at a lower price than a liquid rated security secured by the same loan pool, as certification by a credible rating agency would reduce information asymmetries between borrowers and savers (Pozsar et al 2010: 8).

chain. Techniques and instruments of disintermediation and securitisation, it is argued, help banking groups minimise costs, achieve efficiency gains and diversify their portfolios (Pozsar et al. 2010). Others argue that the obscurity of SB entities and practices add to uncertainty and lack of knowledge about the true financial state of many companies, contributing to the growth of offshore financial havens and 'secrecy spaces.'

Why has the phenomenon of SB emerged in recent times? Many current perspectives offer a functional perspective on these questions, diagnosing the phenomenon as an outcome of regulatory arbitrage in the financial system. Here, the Fed study notes that while the interconnectedness of official and shadow banking structures is not problematic in itself, some elements of this linkage became sources of fragility because they reflected three specific types of arbitrage: (1) cross-border regulatory systems arbitrage, (2) regulatory, tax and economic capital arbitrage, and (3) ratings arbitrage (Pozsar et al 2010: 29). These arbitrage opportunities in turn, arose out of the fractured nature of global financial regulation; the dependence of capital adequacy rules (Basel II) on credit ratings; and a series of uncoordinated decisions by accounting and regulatory bodies regarding the accounting and regulatory capital treatment of certain exposures and lending and asset management activities (Pozsar et al 2010: 29-30).

Historical approaches to financial innovation suggest that shadow banking is more than a functional facet of modern finance. The search for new financial and legal space, and therefore financial innovation through off-balance sheet vehicles and operations, fulfils growing demand for funding otherwise unavailable within the constraints of the official (regulated) banking system. Here, several studies have analysed the increased role of repo markets in providing financing for companies (Adrian et al. 2011; Krishnamurthy et al. 2012), while other scholars and regulators have noted the acute problem of scarcity of high-quality collateral that is sought after by a multitude of institutional investors (Pozsar and Singh 2011; Moe 2012). While the debate about the legal and economic foundations of shadow banking is set to continue for quite some time, it is clear that the deep-seated origins of this phenomenon go beyond the regulatory domain of banking, and pertain to the core questions about the balance between financial and 'real' economies, and to the way

credit intermediation works in a capitalist system geared towards futurity (Palan 2013 C&C) .

Regulatory Efforts

Tax havens

The years 1998-2000 saw the beginning of a new phase in international efforts to combat tax havens. A coordinated three-pronged attack was pursued by separate international organizations at a multilayer level. The more significant developments in the battle against secrecy and tax havens were pursued, however, separately, by the EU and the US. The OECD developed its campaign against harmful tax competition at the request of the G7, the FSF tackled financial stability, and the FATF money laundering. There were already close links between the FATF and the OECD, not least because the FATF secretariat is located at OECD headquarters in Paris. An OECD report published in 2000 charted linkages between bank secrecy, money laundering, and tax evasion.

Initially, the most significant development in the battle against tax havens came in 1998 with the publication of a landmark OECD report entitled 'Harmful Tax Competition: An Emerging Global Issue' (OECD 1998). We will focus our attention on the OECD's efforts which are still at the forefront of the multilateral efforts to tackle tax havens. Tax havens were described by the OECD rather forcefully as 'free riders of general public goods created by the non-haven country' (1998, 15) and 'poachers' (1998, 16). The OECD went so far as to invent a new 'industrial sector' to describe them, noting that 'many havens have chosen to be heavily dependent on their tax industries' (1998, 10)—“tax industries” being a creative term for 'rent'.

The OECD is a think tank. It could do little more than build up peer pressure by 'naming and shaming', as it was called, states that practice harmful tax competition. The key to the OECD process was a promised list of non-cooperative jurisdictions, to be released by the end of 2001. Ominously, the 1998 report recommends that its members adopt serious defensive measures against non-cooperative countries. The OECD recognizes that Switzerland and Luxembourg are

tax havens but seems to be unwilling or unable to force them to change their policies.

The first OECD campaign proved a failure for a number of reasons. Primarily, due to conceptual difficulties in defining clearly harmful tax practices as opposed to the typical program of complex tax rules, tax holidays and targeted subsidies practices by most advanced industrialized countries. Furthermore, some members of the OECD, such as Switzerland, Luxembourg, the Netherlands, the US and the UK, are also considered tax havens. The OECD had no recommendations how to deal with those. For all those reasons the OECD campaign against harmful tax competition was whittled down by 2004 (Sharman 2006). The OECD announces the campaign a complete success, declaring that all states were removed from its black list, and moved on quietly to the next set of programs.

The failure of the concept of harmful tax competition has convinced the OECD that a different angle was needed. There was a simple and obvious argument to be made. If tax havens were not different from any other countries, and if they were regulated and responsible members of the international community as they have argued, why then is there a need for secrecy? Legitimate business should be able to stand to scrutiny. The OECD shifted its attention, therefore, to what Richard Murphy described as 'secrecy locations', seeking to break down the wall of secrecy and opacity that were constructed by tax havens.

There is a debate as to how to go about it. Many have argued that only a system of automatic exchange of information among countries can resolve the abuse perpetrated by tax havens. In such systems countries will routinely pass on information on foreign holders of banking accounts, companies, trusts, etc. to their respective countries of origins. As to be expected, automatic exchange agreements are resisted by the finance industry. Instead, a compromise position was reached with agreement that for bilateral tax informational exchange agreements (TIEA) among countries. TIEA are rather cumbersome agreements signed between countries for exchange of information in case of reasoned suspicion of possible financial abuse. In support of the TIEA system, the OECD has launched, in conjunction with the Global Forum, an ambitious project of peer review process, by which all countries in the world are subject to peer review by delegates from other

countries with the aim of strengthening the principles of know your client and techniques of information exchange.

Another system of limited automatic exchange was instituted by the EU. Since July 2005, all EU member states, as well as Switzerland and EU dependencies, are required to exchange information with the relevant national authorities. Austria, Belgium, and Luxembourg retained their bank secrecy rules but are required to impose a withholding tax on earnings from deposits starting at a rate of 15% from 2005 to 2007, rising to 20% from 2008 to 2010, and to 35% thereafter. The two systems combined, argues Itai Grinberg, 'share one thing in common: they require financial institutions to be cross-border tax intermediaries... these two forms of cross-border administrative assistance represent an important shift for the international tax system. For years, financial institutions have acted as domestic tax intermediaries by providing information reporting on their domestic payees to the tax administration of their country of residence or withholding from such payees' (Grinberg 2012)(4). The new system put the burden on financial institutions as cross-border intermediaries between respective tax authorities.

At time of writing three models of tax information agreement are emerging: the OECD's authorized intermediary project, the EU's Directive on Administrative Cooperation in the Field of Taxation and proposed revision of the EUSD, and the United States' FATCA legislation. There are differences among them, but Grinberg again is correct when he writes about the communality among the three. They each require 'domestic financial institutions to routinely provide cross-border administrative assistance to a sovereign outside the country in which the financial institution is located, and thereby serve as cross-border tax intermediaries.'(16). We are moving, in other words, in the direction of automatic exchange agreements where the onus of collecting, storing, retrieving information is placed on the financial actors themselves.

Regulating Shadow Banking

As the previous sections suggest, our understanding of the phenomenon of shadow banking is in its infancy. And although the very functioning of the many types of

shadow banking entities is inevitably linked to the existence of tax havens and financial secrecy spaces, comparatively little effort has been dedicated to the question of how the shadow financial system can be regulated, as opposed to the much longer running debate on the regulation of tax havens. The lack of available expertise partly reflects the relative novelty of the problem: although non-bank financial intermediation has always existed in most economic systems, the destabilising impact of financial innovation through SB has been recognised only a few years ago, in light of the 2007-09 crisis.

In the emergent regulatory literature on shadow banking it is possible to delineate two levels of regulatory focus. On the one hand, the broad umbrella of post-crisis transatlantic financial reforms includes ongoing efforts to identify, isolate, monitor and control the risks associated with entities that inhabit the complex world of shadow banking. For example, Deloitte (2012) has identified several segments of financial activities, typically linked to shadow banking, that will be affected by post-crisis regulatory reforms. These include money market mutual funds; asset-backed commercial paper conduits, private-label securitization and repos and securities lending. Many reform initiatives emanating from the post-crisis regulatory moves (such as Basle II/III, the Dodd-Frank Act or the Volcker or Vickers rules) are aimed to enhance market discipline associated with the use of these entities, increase transparency and prudential regulation of activities linked to these entities and processes.

While some isolated destabilising practices that led to the crisis of 2007-09 would be tamed under such an approach, the ultimate effect of these moves remains unknown. Singh (2012) for instance, has argued that the effort to shift OTC derivatives trade from the banks' books onto organised clearing houses will simply create a new 'too big to fail' problem in global finance. In a new, 'cleared' world of derivatives trade, risk will simply be shifted from individual banks to new institutions similar to concentrated "risk nodes" in the financial system, while existing regulatory apparatus is not adept at dealing with resolution of such systemic risk nodes in times of stress or crisis. Generally, it is fair to say that this line of regulatory focus on the problem of shadow banking is underpinned by the ultimately benign view of financial innovation generally. Indeed, the problem that needs to be targeted, according to these proposals, is not financial instability or financial innovation per se, but the

workings of the individual parts of the financial system that have malfunctioned in the preceding economic cycle.

At another level, a more serious academic and policy debate about the linkages between SB units and structures and the channels of the official banking system, has only just begun (Amato and Fantacci 2011; Merhling 2010; Lysandrou 2012; Bakk-Simon et al. 2012). In contrast to the targeted approach of post-crisis regulatory reform outlined above, this level of discussion is founded on the concerns about the ultimate function of financial innovation by private market participants in context of a business cycle (Borio 2012), and thus is ultimately linked the question of the imbalance of gains and losses between the private and public sector in financial capitalism. Adair Turner (2012 Cass) has summarised this discussion as being framed around three key questions: (1) how much financial innovation is actually useful; (2) whether to regulate or isolate shadow banking from the rest of the financial system; and (3) how to manage pro-cyclicality of secured finance.

According to Turner, major post-2009 regulatory moves, such as Basle III accord or national banking laws and securities legislations, will help enhance regulation of these areas while the ongoing work at the global financial bodies such as FSB should help to ascertain whether specific regulatory focus on shadow banking is needed in the effort to reduce instability associated or driven by with financial innovation. However addressing this set of questions is hurdled by three major factors. First, the answers are inevitably inter-linked and require a formidable concentration of technical expertise, up-to-date knowledge of financial practice, legal rules and political realities. It is unclear whether such concentration of knowledge exists at the level of international regulatory bodies; indeed even in the framework of the BIS - probably the best-equipped organisation of global financial governance – post-crisis regulatory initiatives have been progressing slower than originally planned.

Second, the core challenge in any comprehensive governance plan is to understand financial innovation and its connectivity with the elements of the economic system, a task which is not helped by the current state of mainstream economics and the continuing crisis in the Eurozone. Third, any type of a radical financial reform tends to be seen by the financial community as constraining the field

of profit-making, thus firing up political sensitivities of any regulatory agenda. At the same time, in 2012 Adair Turner noted that “[g]iven the enormous cost which instability can produce, and given the uncertain benefits which this complexity has delivered, our regulatory response should therefore entail a bias to prudence – a bias against complex interconnectivity, against procyclical market contracts, and against allowing maturity transformation or high leverage to develop in unregulated institutions or markets” (Turner 2012 Cass: p 36).

The viability of such a prudent, and radical, approach to financial governance ultimately related to a more general issue about the underlying paradigm of economic regulation and governance. The priorities set out by ambitious regulatory proposals can only be addressed if the elements of the economic and financial cycle, as well as their interconnectivity in the contemporary economic context, are understood well. Most current approaches to macroeconomic and financial modelling have been built without the notions of a financial cycle: the issue of connectivity has fallen out of fashion in mainstream economics, and was the subject of research only of a few economists outside the mainstream. Yet as Borio argues, in reality, and in contrast to most existing models of economic equilibrium, the financial cycle is much longer than the traditional business cycle. The financial system today does not just allocate, but also generates, purchasing power. And in the global context, the dynamics of different financial cycles are highly integrated (Borio 2012: 2-3). In this framework, any policy towards regulation of shadow banking needs to centre on the question of the relationship between private and public debt and debt management. As Borio continues, this recognition in turn, suggests that an effective management of post-crisis stagnation or depression, an active strategy should centre on the idea of substituting public sector debt for private sector debt. This is based on the public sector’s superior ability to bring forward (real) resources from the future, underpinned by its power to tax (e.g. Holmström and Tirole (2011)).

However the greatest hurdle towards a world of more accountable financial innovation is that despite the change in tone, the regulatory efforts of financial architects are constrained by the political environment of the yesteryear. Represented most vividly by the political regimes in the UK and Germany, but also by national economic policies that continue to be built on the benign view of financial innovation (and by association, private financial leverage that had been magnified

through shadow banking), and an *a priori* negative understanding of the role of public debt in the economy. Unless this dogmatic view is reversed, the practices of shadow banking, and financial fragility driven by them, will continue to thrive in the economy otherwise stricken by a protracted recession.

Conclusion

The crisis of 2007-09 and its aftershocks have revealed a series of structural, institutional and functional problems caused by financial innovation. Many of the problems pertain to the notion of systemic risk in finance today, and the way the costs of financial crises are externalised from the private sphere of the financial markets to the public realm of the economy and society. The crisis in particular has cast light on two important, yet until recently hidden, dimensions of the contemporary financial system: the global economy of tax havens and offshore finance, and the complex web of entities and practices that has been dubbed, the shadow banking system.

The governance of these black holes of the global economy constitutes one of the most difficult challenges confronting regulators and policymakers. In this work, we have reviewed some of the key initiatives currently being discussed at national and global levels of financial policy-making. The ‘black holes’ of the contemporary financial system do not only pose intellectual and practical challenges to policy-makers and regulators, but also to academics analysing the nature of the global economy. In an environment where many scholars are habituated to think in a particular way about the world we inhabit, we find the evolution of such alternative, often virtual spaces, disconcerting.

Our analysis suggests that any regulatory move aiming towards a more effective regulation of offshore finance and shadow banking requires a formidable degree of expertise about the operation and functions of these financial realms. In our opinion, a number of research departments at the Federal Reserve, the Bank of England, the BIS and the ECB, but interestingly, less so the IMF and the World Bank, emerged as leaders in both gathering information and producing innovative, out of the box thinking about the current dilemmas. Still, perhaps due to institutional

biases, in most popular accounts, the two phenomena are treated as somewhat marginal to the core processes of economic globalisation, crisis management and economic regulation. Despite the staggering data associated with the amount of capital accommodated in offshore finance and shadow banking structures, current debates in economics and political science reflect this vision.

One of the most crucial steps towards a better regulation of these financial black holes lies in finding an alternative analytical framework that would allow us to understand the real linkages between, and within, the economy, financial system and its shadow components. Economic orthodoxy, as this work has suggested, is unable to offer such vision. There are very few signs of any comprehensive attempt at dealing with the complexities of financial regulation in the age of financial innovation. At the time of writing (winter 2012/2013), it is also not entirely clear whether OFCs and shadow banking will be part of the new regulatory architecture. If they are not, then the emerging system of global financial regulation is doomed to fail.

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