



Shadow banking and European offshore financial centres: the blind spot in EU policy debates

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Executive summary

Current debates in the EU on the Capital Market Union (CMU) include activities that are part of the shadow banking system, in particular securitization. The market for securitized assets has made a comeback after the great financial crisis and is currently presented as a complementary funding channel for the EU. Securitization has been re-branded into “high-quality” securitization to stress the distinctive marketplace the commission is aiming at. In at least one aspect the proposals for a market for high-quality securitization and more broadly the EU wide shadow banking system, is not different, namely in its spatial organization in European offshore financial centres (OFCs).

This policy brief contributes to the debate on shadow banking, that includes securitization vehicles by expanding on the role of OFCs, namely, the Netherlands, Luxembourg and Ireland, in facilitating large-scale regulatory arbitrage and tax avoidance. Securitization must be contextualized in the broader shadow banking, or non-bank, dynamics and its spatial configuration. Central to this spatiality are differences in the institutional arrangements in the EU that open the scope for arbitrage.

Current policy initiatives by the Financial Stability Board (FSB) and the EU have a blind spot concerning the role of OFCs in shadow banking. Furthermore, policy debates in the EU and OECD on tax avoidance ignore the role of tax arbitrage in shadow banking. This policy brief argues that an effective policy framework for high-quality securitization must address the European offshore dimension of shadow banking. This means that policies to address shadow banking should bring together both EU/FSB and EU/OECD policy processes to be effective. The discussion on tax avoidance should be broadened to include the effect of tax havens on the spatial concentration of shadow banking activities.

1. Introduction: The concentration of shadow banking in OFC's

In essence, shadow banking is a non-regulated transnational environment where the supply and demand for financial services and products of under-regulated entities is matched, priced, executed and institutionalized. It is the poster child of how a re-scaled financial system operates smoothly across national borders. The spatial configuration of shadow banking entities across the offshore world is critical to understanding how it operates. The offshore connections enable financial flows to move effortlessly in and out of diverse institutional environments in a non-regulated and tax-free environment.

Essential to this geography is the role of OFCs, such as the Netherlands, Luxembourg and Ireland, which act as conduit jurisdictions. These locations do not harbor the higher value added services of shadow banking found in first-tier financial centers such as New York and London, but instead provide a specialized service industry that facilitates pass-through entities processing large capital flows. The size of the OFI sector in the EU is disproportionately concentrated in the UK (29%), Luxembourg (17%), the Netherlands (15%) and Ireland (8%). The largest economies of the Eurozone, Germany (7%), France (7%), and Italy (4%) are small players in the European other financial

institution (OFI)¹ sector. OFCs enable financial institutions to create levels of complexity that create the scope for regulatory arbitrage and allow for tax avoidance. At the heart of complex cross-border corporate structures is the large-scale use of special purpose entities (SPE's), shell companies or brass-plate companies that offer domicile in OFCs. These pass-through entities add to systemic risk in the financial system and are the main vehicles for shifting profits and eroding the tax base. These entities primarily use OFCs to open funding channels by emitting debt, often routing capital through different OFCs in the process.

Next to issues of financial instability and its growing leverage in the regular banking system, shadow banking thrives in OFCs and enables regulatory arbitrage. Shadow banking consists of a variety of actors that often operate across different national jurisdictions. This geography helps different entities to create complex transnational interconnections. While regulation remains predominantly confined to the national scale, the network of shadow bank entities operates across borders on a global scale. This is a critical political economy issue of globalized non-conventional finance. How can we regain control over a transnational network of financial intermediaries that provide credit outside the regulatory reach of nationally organized jurisdictions? The example of Lehman Brothers provides a good illustration of how the geography of modern banking can best be described as an archipelago of entities scattered across OFCs.

2. Policy debate

It was recognized at the G20 meetings in Seoul in 2010 and Cannes in 2011, as well as by the European Commission in 2012, that shadow banking is a breeding ground for financial instability. The G20 therefore asked the FSB to develop an effective framework to constrain these risks, and the FSB published an action plan in 2013. The European Commission set up a parallel process, publishing a green paper in 2012 and its own action plan in 2013. Both policy processes have not recognized the role of OFCs in shadow banking.

At the same time, and on a related but separate topic, there has been an attempt by the OECD and the EU to regain fiscal authority vis-à-vis growing tax avoidance by TNCs. The two bodies issued separate action plans, both of which failed to include shadow banking. An effective policy framework, however, must address the European offshore dimension of shadow banking. This means that policies to address shadow banking should bring together both policy processes to be effective. The discussion on tax evasion should be broadened to include the effect of tax havens on the spatial concentration of shadow banking activities.

3. Conclusion

- Shadow banking is firmly rooted in OFC's. These financial centers act as conduit centers that facilitate immense capital flows generated by shadow banking entities. The underlying mechanism at work is the competition of financial centers in an age of hyper-mobile and fungible capital. We argue that these jurisdictions matter when trying to put in place effective forms of control and regulation for global finance. As long as OFCs offer a safe place

¹ OFI is a proxy for shadow banking



for SPEs, financial institutions and banks can continue to operate in a lightly regulated environment. This is not a firm basis to setup a capital market union.

- The OECD, the FSB, the G20 and the EU should take note of the concentration of OFI flows in a small group of countries. This uneven geography of OFI activities shows that differences in regulation and tax regimes lie at the heart of how shadow banking is spatially organized across jurisdictions. This should have consequences for analysis and policy measures. First, the degree to which the behavior of banks and TNCs is shaped by fiscal considerations should be part and parcel of the approach towards shadow banking. Secondly the discussion on tax evasion should be broadened to include the effect of tax havens on the concentration of shadow banking.
- As long as OFCs are allowed to offer safe haven for financial institutions aiming to circumvent regulation and taxes, we will be confronted with a dual-market environment. On the one hand we have the conventional market, which includes a clear regulatory framework, at which the vast majority of new EU banking regulation initiatives are aimed. On the other hand we have the financial activities that take place in the offshore world. This duality may lead to an ever-larger shadow banking system. Tackling the issue of OFCs is not only important to push back tax avoidance, it is essential if we are to be able to properly regulate and supervise global finance in the post-financial crisis world.
- If the commission wants to setup a new and safer type of securitization it must address the financial geography of shadow banking in the EU. If it fails to do so it will erect a building on top of rotten foundations.