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Tax Havens and Offshore Financial Centres

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How do you analyze the present status of tax havens and offshore financial centres?

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 (OFCs). 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 originator of similar amounts of FDIs (Palan, Murphy, Chavagneux, 2010).

In light of such staggering statistics, and the opacity that surrounds tax havens, the question that is asked perhaps not often enough concerns the link between OFCs and the financial crisis.

There is some confusion between the concept of tax havens and offshore financial centres, and it 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 that 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. (1) 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, otherwise known in the past as the Eurodollar market.

The contrasting views of the role of tax havens as OFCs discussed in this paper derive to a degree from the different understandings of nature of the offshore financial markets known otherwise as 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; McClam 1974; Oppenheimer 1985). The tern 'offshore' implied the originally the location of the market outside the territorial boundaries of the U.S. In time the Euromarket came to denote any location trading in non-resident 'hard' currencies such as the British Sterling, the Yen, the Swiss Frank, the Deutsche Mark and the Euro. Offshore Financial Centers, according to this thesis are simply the locations where such financial transactions among non-residents take place. As, however, in this understanding the Euromarket is not distinct from any other markets there are no special characteristics to OFCs, and as majority if not all of world's financial centers tend to handle both resident and non-resident currencies, they can all be described in principles as OFCs. OFC is therefore an arbitrary concept denoting a high proportion of non-resident transactions in proportion to either resident transactions or in terms of assets/per capita ratio. In this hypothesis OFCs are considered to be the financial equivalent of the export processing zone, catering primarily to non-residents (Zoromé 2007).

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. Faced with mounting speculation against the pound after the Suez Canal crisis, the British government imposed restrictions on the use of pound sterling in trade credits between non-residents. British and other international banks sought to use the US dollars in their international dealings in response. Transactions between non-residents and in a foreign currency (i.e. not the British pound) mediated by banks located in London, British or not, were considered by the Bank of England to be taking place abroad or 'offshore', i.e. not under the regulatory laws and supervision of the British state (Altman 1969; Burn 2005; Higonnet 1985; Kane 1983; Robbie, 1975/6). According to this theory, the decision of the Bank of England to treat certain type of financial transactions between non-resident parties undertaken in foreign currency as if they did not take place in London even though contracted there created in effect a new regulatory space outside the jurisdiction of the Bank of England and a new concept – offshore finance. But as the transaction that took place in London was 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 devise because it has no existence outside the accounting books of banks and financial institutions (Hanzawa 1991). 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 as well. 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 ‘60s. 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. These regulations were the product of long standing attitudes, dating back to the late 19th century, towards concentration of financial power, combined with the more recent regulations introduced in the 1930s (the New Deal regulations) of the banking system, to produce a highly restrictive financial regulatory environment in the U.S. A leading example of this regulation was the prohibitions on inter-state banking (McFadden Act, 1927) which meant that U.S. money-centered banks could not buy another bank, or even open a branch, outside of the confines of their state. Another example was the 1933 Glass-Steagall Act that mandated a separation of commercial and investment banking. U.S. banking regulations also dictated lending no more than about 10% of a bank’s capital to one borrower. In addition, Regulation Q, which placed an interest rate ceiling on time deposits on US banks, was a remnant from the 1930s New Deal. (2) Regulation Q kept bank interest rates on time deposits very low, a situation that met with little objection from the banks and which created what were, in effect, anti-usury laws in the U.S.

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). 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

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 that 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 learned soon 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 centers 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. As Marvin Goodfriend of the Federal Reserve Bank of Richmond notes: ‘Eurodollar deposits and loans negotiated in London or elsewhere often are booked in locations such as Nassau and the Cayman Islands to obtain more favorable tax treatment’ (1998: 50).

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’ (Hudson 1998: 541). 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.

Paradoxically, once US and other banks began to operate in London the original arrangements that has created the offshore financial market in London kept British banks and corporations at a disadvantage vis-à-vis their rival foreign financial institutions located in that same city. The reason was that the freedom from the

regulatory and supervisory role of the Bank of England was applied in London only to transactions between non-residents and conducted in a foreign currency. Banks and other financial institutions maintained, therefore, two sets of books, one for 'on-shore' transactions in which at least one of the parties was British residents and/or where the transaction was denominated in British sterling, and the other for 'off-shore' when both parties were non-residents. The UK complex corporate tax system resulted, in addition, in potentially very high corporate tax rates that could reach up to 60 or even 70%! To circumvent its disadvantageous position, British banks and corporations (as well as American banks seeking to avoid London's punitive corporate taxation) established subsidiaries in British Crown territories such as the Channel Islands and Cayman so that they might avoid this anomalous situation. Such subsidiaries allowed them to participate freely in the fledgling offshore market as they could appear now as non-residents. Unfortunately, there has never been any systemic research on the subject and we have to rely on anecdotal sources as evidence of this behaviour.

In time, and 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 in 1981 to set up a more restrictive form of offshore markets in the U.S., 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 IBF, according to Moffett and Stonehill 'represents an attempt by U.S. government regulators to 'internalize" the Euromarkets into the U.S. banking system. The purpose of the IBF was to minimize the size and growth of the offshore shell branches of U.S. banks, while providing U.S.-based banks and their offshore customers with a lower cost of funds.' (1989: 89). 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 modeled 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 indeed, 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': they are aimed primarily to emulate or internalize, as Moffet and Stohehill put it, the Euromarket, into their respective financial system. They are distinct from their 'on-shore' brethrens by the relatively loose regulatory environment, not by the lack of taxation.

The term OFC combined two sets of centres, tax havens turned OFCs and the offshore financial sectors that were established 'spontaneously' in London, the emulated IBFs

in the US and the JOM. In my estimation, London, the IBFs and JOM account for about half of the staggering statistics mentioned in the introduction. Hence, in my estimation only about a half of the volume of financial transactions that are logged by BIS data as OFCs related, are registered or travel through the group of financial centres that we associate with tax havens. Nevertheless, the figures are still very impressive. The evolution of certain tax havens into OFCs, combined in an explosive mix the two rationales: the rationale for tax avoidance and financial regulatory avoidance into one. Put simply, tax havens turned OFCs offered financial operators the twin advantages of avoidance of financial regulations and saving on taxation to boot! Not surprisingly, today, and as far as we can tell from (largely) anecdotal evidence, tax havens turned OFCs are home to the vast majority of the Special Purpose Vehicles, hedge funds and other entities that were engaged in the more esoteric forms of financial engineering that were at the heart of the crisis.

Another 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. (3) The British imperial pole accounted for a combined average of 38.3% of all outstanding international loans and deposits by March 2010 (BIS 2010).

The other 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. (4) This agglomeration accounted for a combined 14.9% of all outstanding international loans and deposits by March 2010, exactly the same as the US. 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.

What explains the emergence of these two agglomerations of international financial centers? It appears that the British agglomeration has tended to concentrate more on trades in incorporeal assets, such as stocks, bonds, bank claims, and other esoteric debt instruments. While the European centres, on the whole, have tended to specialise in intangible assets, such as logos, goodwill, trademarks and brand names. Consequently, under the umbrella term, ‘financial system’, distinctive activities and transactions have evolved relating to a third class of property titles, intangible titles.

The Irish International Financial Services Centres in Dublin is a case in point.

The Irish International Financial Services Centres in Dublin is a case in point. According to Stewart (2005), the total stock of foreign investment in Ireland in December 2003 amounted to €1,041 billon, a sum approximately eight times the size of Ireland's GDP in that year. By 2000, over 400 major companies were using the IFSC, of which 50% were U.S.-owned. Ireland by that year had emerged as the largest single location of declared pre-tax foreign profits of U.S. companies ($26.8 billion, followed by Bermuda with $25.2 billion), although the IFSC directly employing only 4,500 people in 1997 (ECOFIN 1999, 61).

A second peculiarity of the IFSC is that the largest source of foreign direct investment into Ireland was the Netherlands (€10.7 billion), the second largest being the United States (€7.8 billion). Stewart explains this as a consequence of FDI being routed through a complex web of subsidiaries located in different tax havens, each supplying a conduit through which finance moves with the aim of mitigating tax. His research shows that of the 513 companies whose parent was located in the Netherlands, 102 had an ultimate parent in the UK. These included well-known companies such as Marks & Spencer and BOC. Ninety-three of the companies were ultimately owned by U.S. corporations such as Dell, IBM, and Hewlett-Packard, and a smaller number were ultimately owned in France (14), Germany (9), and Japan (9).

The Netherlands, Ireland and the Belgian 'coordination centers' (which is anther variant on the Netherland offshore holding company), the Dutch Antilles 'conduit companies', and to a lesser extent Switzerland and Luxembourg, are all specialists in what Stewart calls 'treasury operations'; they are harvesters of intangible income. They are logged in conventional statistics as financial transactions; hence these centres are ranked among the largest financial centers in the world. Yet although they each have considerable banking, Euromarket or capital market operations, their astonishing success lies elsewhere as harvesters of income from intangible properties. These sorts of treasury operations are highly controversial, no doubt, but they do not pose, I believe, any particular issue of financial regulation and/or stability. The problem of financial regulation lies, therefore, in my view, with the British-centred or British-related OFCs.

In your opinion, how will the situation likely evolve over the next five years?

What are the fundamental problems with tax havens serving as OFCs? Specifically, those that specialise in trading in incorporeal financial assets? Warren Buffett's partner, Charlie Munger said once: 'I think I've been in the top five percent of my age cohort all my life in understanding the power of incentives, and all my life I've underestimated it. And never a year passes but I get some surprise that pushes my limit a little farther" (quoted in Lewis 2010, 43). The fundamental problem, as I see it, has to do with incentives.

Tax havens are specialist ‘secrecy locations’, masters of opacity. Their success hinges on a strings of laws, some very familiar like bank secrecy laws, some more obscure like trust and foundations laws, that ensure that the ultimate identity of asset holders may be hidden even from the tax havens ‘ own governments, let alone others. Normal due diligence procedures are either very shallow or do not take place at all (In Ireland, for instance, it takes less than a day to set up a new hedge fund). Financial operators may present themselves as companies, and companies may chose to appear as financial operators, and so on. While we may have fairly reliable data on the aggregate financial flows that travel through these jurisdictions, we know precious little about what is going on a micro level, by the companies and financial operators themselves. Opacity creates a black hole in any proposed system of international regulation. This was not seen as a problem when the dominant, if mistaken view was that markets are perfectly able to self-regulate themselves, but in the post crisis situation of the next five years the ability, capacity and willingness of OFCs to participate in the international efforts of financial regulation must be questioned.

One often heard argument that can be dismissed from the outset is that the leading OFCs have introduced a system of financial auditing, surveying and regulation on par with the majority of OECD countries. The current peer review process under the auspices of the Global Forum should provide some indications as to the truth in these claims. There is little doubt that the shrewdest tax havens such as Cayman Islands have learned that it was in their interest to appear to cooperate with every new demand for financial regulations, and have been able to extract themselves double-quick from any potential black list.

But within the next years we need to address the question of their incentives for doing so. The financial regulations that were introduced in the past decade were never proactively thought out; they are never introduced in response to home grown problems and/or in light of a domestic constituency demands, but are always aimed at placating the Financial Stability Forum (FSF) and other such organizations. Furthermore, considering the long history of denial and obfuscation in tax matters, and their proven record of innovation of new techniques of avoidance while appearing to comply with externally-imposed demands, I would argue that external auditing of these jurisdictions is absolutely necessary.

Even if an OFC is genuinely interested in improving its domestic system of regulation and surveillance – and the incentives for doing so to the letter are questionable, there is still a yawning gap between intent and content: their declared intention and their capacity to implement their declared policies. Tax havens are small jurisdictions, they lack the resources, especially in terms of skilled personnel to perform appropriate due diligence on what are very sophisticated financial vehicles parked in their territories. For example, the Cayman banking system holds assets of over 500 times its GDP. Jersey holds resources of over 80 times its GDP. It seems an obvious question to ask

Jersey holds resources of over 80 times its GDP. It seems an obvious question to ask whether such small jurisdictions can allocate sufficient resources to monitor and regulate such colossal sums of money. A recent report by the UK's National Audit office has clearly suggested that they do not (NAO 2007). This is an area that cries out for the proverbial more independent research.

Another theory suggests that the bulk of financial transactions that make up the staggering statistics are merely booked in tax havens, and hence, the argument goes, OFCs are not the problem. The Cayman Islands' assets and liabilities are roughly one third of the UK's financial centre's. Yet while the Corporation of the City of London reports that 338,000 were working directly in its financial centre (a figure that can be somewhat misleading, as it refers to everyone, including cleaners and security guards working in the square mile), the UK's National Audit Office reports that only 5,400 people work in Cayman OFC. The disparity between the two figures suggests that either Cayman is an exceedingly efficient centre, or as the number implies, it is still largely a booking centre with relatively little 'real' banking activity.

In the Island of Jersey, a 45 square mile island with a population of 87,000, approximately 12,000 people are employed in the offshore sector. The figure is equivalent more or less to the employment figures of a decent size international investment bank, which tends to have 10,000 to 15,000 employees.

The problem with this argument is that financial operators are clearly prepared to pay the extra costs of using these jurisdictions as conduits (such as legal advice, license fees and other 'transaction costs') for a reason. And the reasons are, unfortunately, have something do with avoidance of one thing or another, avoidance of taxation or regulation or most probably both. If OFCs can be used for 'regulatory arbitrage', which was clearly the case in the past, than any proposed international regulatory regime that does not include these havens is doomed to fail. At this moment in time, it is not at all clear that OFCs are part of any proposals for new international financial regulations. Worse, as I will describe below, prior to the crisis tax havens were used extensively to avoid even some of the very minimal market-led auditing mechanisms, and I have no evidence that things have changed dramatically ever since.

By common consensus the current crisis was caused by an extraordinary level of debt available in the financial system. This happened, seemingly to the surprise of many, despite the progressive development of bank capital adequacy rules under Basle I and Basle II. The Basel Accords sought to ensure that banks maintain adequate capital ratios and are not over exposed to risks. How then did banks build such extraordinary levels of debts?

It became clear amidst the unfolding crisis that banks had been using innovatory credit risk transfer techniques to remove assets from their balance sheets and free up

regulatory capital for further issuance. Known otherwise as the 'shadow banking' system, one of the chief techniques involved the use of 'conduits' structured investment vehicles (SIVs) or Special Purpose Entities (SPE), known otherwise as conduit entities, funded by asset-backed commercial paper (ABCP) and to reduce regulatory capital charges. The term Special Purpose Entity covers a broad range of entities; but more often than not, it is "a ghost corporation with no people or furniture and no assets either until a deal is struck" (Lowenstein 2008). These financial vehicles (or entities) were supposed to transfer assets off bank balance sheets and to other investors in the economy. In reality these vehicles were often used to increase bank's effective leverage and exposure to aggregate risk.

We know that a considerable portion of the SPEs and other forms of structured finance at the heart of this crisis were registered in tax havens/OFCs. To what extent did the use of such offshore centres exacerbate an already dangerous situation? The vast majority of mainstream economists believe that offshore locations played no significant role in exacerbating the crisis. The FSA's Lord Turner Review which states: 'Some SIVs were registered in offshore locations; but regulation of banks could have required these to be brought on-balance sheet and captured within the ambit of group capital adequacy requirements.'(2009, 74). A recent BIS study found 'that it was not generally the case that investors or originators use securitisation vehicles and SPEs as a means of avoiding tax. Rather, decisions as to where to locate an SPE—in onshore or offshore jurisdictions—appear to be based on ensuring that the SPE vehicle itself is fairly tax neutral and thus does not impose marginal increases to a firm's tax burden' (2009, 36).

The little known case of Northern Rock and its offshore subsidiary, Granite, suggest otherwise. (5) Northern Rock was a UK mutual building society that was converted into a public limited company in 1997. Building societies typically raised the money they lent in a rather conventional fashion, by attracting it from depositors. Banks on the other hand, have the option of accessing larger sums from the money markets somewhat easier. After demutualization Northern Rock became a bank, and in early 2007 became the fifth largest mortgage lender in the UK. It was distinct however, from conventional commercial banks in that it had a small deposit base and relied heavily on wholesale money markets to get the funds (75%). This was an aggressive technique: the audit of Northern Rock's accounts in 2006 showed that it raised just 22% of its funds from retail depositors, and at least 46% came from bonds.

Those bonds, interestingly, were not issued by Northern Rock itself, but by what became known as its 'shadow company'. This was Granite Master Issuer plc and its associates, which was an entity formally owned not by Northern Rock but by a charitable trust established by Northern Rock. After the failure of the company it became clear that this charitable trust had never paid anything to charity, and that the

charity meant to benefit from it was not even aware of its existence. The sole purpose of Granite was, in fact, to form a part of Northern Rock's financial engineering that guaranteed that Northern Rock was legally independent of Granite, and that the latter was, therefore, solely responsible for the debt it issued.

This was, of course, a masquerade, and one that was helped by the fact that the trustees of the Granite structure were, at least in part, based in St Helier in Jersey. When journalists tried to locate these Granite employees they found there were no such employees in Jersey, of course. In fact, an investigation of Granite's accounts showed it had no employees at all, despite having nearly £50 billion of debt. The entire structure was acknowledged to be managed by Northern Rock, and therefore (and unusually) was treated as being 'on balance sheet' of Northern Rock and was therefore included in its consolidated accounts. Granite was used, among other things, for the purpose of obtaining the necessary rating for its securitization vehicle.

What are the structural long-term perspectives?

At the current juncture, it is very difficult to discern any long-term trends in the development of tax havens. The expansion of securitization markets has given the credit rating agencies unprecedented power. The reason for this is the tradability of mortgage-backed securities (MBS) fundamentally depended on the ratings they acquired. From the very beginning of the securitization boom, a central concern to ensure the marketability of securitised debt is to enable the rating agencies to analyse and grade the credit risk of the assets in isolation from the credit risk of the entity that originated the assets. The rating analyst was not evaluating the mortgages but, rather, the bonds issued by the SPE. The SPE would purchase, in turn, the mortgages. Thereafter, monthly payments from the homeowners would go to the SPE. The SPE would finance itself by selling bonds. The question for the rating agencies was whether the inflow of mortgage checks would cover the outgoing payments to bondholders. From the investment bank's point of view, the key to the deal was obtaining a triple-A rating — without which the deal wouldn't be profitable.

But in order to get a separate rating for the SPE, credit rating agencies required legal opinions that the securitised assets represented a so-called 'true sale' and are outside the estate of the originator in the event the originator went bankrupt. The primary purpose of such a transfer of ownership is to prevent the seller and its creditors (including an insolvency official of the seller) from obtaining control or asserting a claim over the assets following the seller's insolvency. This is true in the case of an onshore SPE, where the identity of both buyers and sellers is known, but not in the case of offshore SPE, such as Granite. There wsa simply no way of knowing whether Granite was part of Northern Rock or not!

Confusion persists to this day. When Northern Rock was nationalised the House of

Confusion persists to this day. When Northern Rock was nationalised the House of Commons saw late night debates on whether this meant that Granite was also nationalized. Yvette Cooper, chief secretary to the UK Treasury, stated in the House of Commons that ‘Granite is not owned by Northern Rock; nor will it pass into the hands of the public sector’ (Hansard 2008, Column 277). Alistair Darling reiterated this in a letter to Vince Cable, The Liberal Democrat Shadow Chancellor, on 20th of February: “Granite is an independent legal entity owned by its shareholders… Northern Rock owns no shares in Granite’ (Accounting Web, 2008). Yvette Cooper however confirmed in the same parliamentary debate that ‘Granite is part of the funding mechanism for Northern Rock and it is on the bank’s balance sheet’ (Hansard 2008, Column 277).

‘True sale’ is an important cornerstone of the self-regulating financial market. It was assumed, not unreasonably, that the original purchaser of a securitized vehicle would make sure that the transactions were sound, and that the first purchaser of such securitized assets was better placed than the regulator to assess the value of such assets. A gigantic secondary market in such securitized bundles evolved on the assumption that the original transactions were sound. But the case of Northern Rock and Granite suggest that the original and all important transaction was taken place in fact in house, and hence the pretension of true sale was only a masquerade. It is not clear whether the purchaser of Granite bonds were aware they were buying Northern Rock’s debt or whether they were aware that the rating for these bonds were based on a false assumption of ‘true sale’.

The crisis showed, therefore, that the devil is in the proverbial detail. As long as the financial system appeared to perform well, few bothered to ask too many questions; but when the bubble burst, banks and financial institutions remembered out of a sudden that so much trading takes place either offshore or ‘over-the –counter’ (or both) and lost confidence in all published accounts, ratings, solemn declarations and the like. Financial institutions possess hundred if not thousands of such entities, most in these secrecy offshore locations; the majority of the hedge funds and other such institutions are registered in such locations. They all knew full well that just as their competitor had no way of knowing which of these entities were theirs, and whether any published account of any entity (if there were such) had anything to do with any truth, they were not in position to know which of these entities belong to which of their competitors as well.

In such conditions the markets simply ‘froze’; trading virtually stopped and the mountain of securitized assets whose value is the price that the next purchaser is willing to pay was heading towards ‘nil’. The financial system was effectively insolvent, and could be saved only when governments intervened and assumed responsibility wholesale to the entire debt mountain, on and off-shore.

Contrary to the complacent view, it appears to me that the opacity produced by techniques of offshoring and 'OTCs' markets were at the very heart of the processes that fuelled the debt mountain, and exacerbated the crisis many time over when the bubble burst. Opacity is likely, therefore, to remain a key theme in any future debates on international financial regulations. There are clearly efforts made right now to improve the level of transparency and financial reporting among countries, including OFCs. We simply do not know as yet, whether these efforts will be successful. The process is ongoing, and the key the future developments are two:

a. Persistent pressure by the EU and US
b. Equally importantly, the attitude of China. Unfortunately, a great unknown right now.

Notes:

(1) The earliest document we have come across the term was written by Bryant of the Brookings Institutions. The document refers to the 'so-called offshore financial centres' (Bryant, 1983, 19). However, the BIS 1976 annual report had already a section devoted to "banking offshore centres".
(2) Regulation Q Prohibits member banks from paying interest on demand deposits. See: Electronic Code of Federal Regulations (e-CFR), The National Recovery Administration, which was set up under the New Deal, sought to fix prices in industry in order to eliminate ''ruinous'' competition, while Regulation Q attempted to do the same thing in the banking sector.
(3) 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.
(4) 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.
(5) Detailed discussion in Nesvetailova and Palan, Forthcoming.

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