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Low tax Financial Centres and the Subprime Crisis: The IFSC in Ireland

Jim Stewart
School of Business,
Trinity College,
Dublin

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- This paper is about the subprime crisis and the role played by financial centres/low tax regimes.
- The focus is on the IFSC in Dublin, where many of the funds that have been reported as having collapsed or facing liquidity difficulties are 'located'

Low tax Financial Centres and the Subprime Crisis: The IFSC in Ireland

Table (1) shows that foreign direct investment reached a peak in 2003 and has since fallen.

Total foreign investment in the IFSC continues to rise and in 2006 is approx 14 times the size of foreign direct investment.

Table (1)
The growth of the IFSC in Dublin: Total foreign Investment in Ireland
€ billion

	2003	2004	2005	2006
Direct	176.435	152.446	138.626	118.900
Portfolio	542.200	720.952	1025.902	1224.126
Other	389.807	443.796	556.906	670.968
Total	950.469	1108.442	1721.428	2013.994
Represented by IFSC[1]	813.336	975.357	1300.223	1562.750

Low tax Financial Centres and the Subprime Crisis: The IFSC in Ireland

- The current crisis, the subprime crisis and associated collapse in value of various forms of financial instruments (ABS, CDO, SIV) banks and hedge funds has been described as "the worst financial crisis since the Great Depression" (Baily, Elmendorf and Litan, p. 61)
- It has attracted considerable interest and policy analysis.
- Various proposed reforms: Credit rating agencies, mark to market rules, greater transparency, but the main reform proposed is reform of financial regulation
- But to date little has been written on the role of tax havens/offshore financial centres in the credit crisis in terms of policy analysis.

Low tax Financial Centres and the Subprime Crisis: The IFSC in Ireland

- One analysis considers that a key element of the crisis is the:-
- "sheer size of the special purpose vehicles that had grown exponentially in recent years a- a thinly capitalised "shadow banking system", involved in large-scale liquidity and maturity transformation, that had escaped the attention of many, including in the official community" (Borio, p. 12).
- Another analysis refers to the growth of the shadow banking system consisting of conduits and SIVs which carried out "covert liquidity transformation on a large scale" (Knight, 2008).
- One reason for the lack of official attention to the growth of the shadow banking system was the extensive use offshore financial centres/ tax havens.

Low tax Financial Centres and the Subprime Crisis: The IFSC in Ireland

- The Causes of the crisis:-
- **Financial Innovation**: Some argue that financial innovation associated with risk management has been a major source of growth in particular for the US.
- But financial innovators and regulators may be in a race, and the regulators will always lose that race
- **Risk management**: Bernstein "The revolutionary idea that defines the boundary between modern times and the past is the mastery of risk" and that "the normal distribution forms the core of most systems of risk management".
- In contrast Taleb describes the normal curve as an "intellectual fraud" (Taleb, p. 229) and argues that many characteristics of financial markets cannot be described by a normal distribution.
- **Liquidity** : The financial crisis originated in what has been described as the "shadow financial system" outside the conventional ways that liquidity was provided.
- **Regulation**: As a result of the emergence of a 'shadow banking system' the greatest regulatory concern is:-
- ".. .. ..the supervision of so-called "conduits", off-balance sheet vehicles which borrow money, finance loans, and generally behave just like banks. Most of this activity is regulatory arbitrage – it exits to avoid the restrictions placed on banks – and supervisors appear to have ignored it. (Financial Times, Leader, The Right Response to Northern Rock, October 1, 2007).

Low tax Financial Centres and the Subprime Crisis: The IFSC in Ireland

- The role of tax havens and locations with 'light touch regulation' however has not however been subject to any criticism or suggestions for reform.
- For example the Financial Times lays the blame on the difficulties faced by German banks exclusively with the structure of the German banking industry and State owned banks (F.T. 3/9/07).
- Within Ireland the Financial Regulator has been quoted as saying that they have no responsibility for entities whose main business is raising and investing in funds based on subprime lending. A stance that has been repeated by commentators in the media.

7

Low tax Financial Centres and the Subprime Crisis: The IFSC in Ireland

- **Competition between financial centres is considerable**.
- Historically hedge funds were often domiciled in the Cayman Islands, Bermuda of the British Virgin Islands.
- More recently European jurisdictions such as Channel Islands, Ireland and Luxembourg have been "streamlining regulation" amongst other factors to attract funds.
- In Ireland if the relevant documents are provided to the regulator by 3 p.m. the fund will be authorised the next day (Financial Times, Special Report Fund Markets, April 7 2008). Luxembourg has introduced a new law, so that as long as the fund manager "notifies" the regulator within a month of launch, the fund can enjoy pre-authorisation approval.
- A report by the Financial Times comments that unlike the Irish regulator, the regulator in Luxembourg does not "scrutinise promoters".

8

Low tax Financial Centres and the Subprime Crisis: The IFSC in Ireland

- **A Case study:- Bear Stearns**
- The first public indication of problems at Bear Stearns emerged when a Bear Stearns hedge fund announced considerable losses (Business Week June 12, 2007), and a second fund announced a smaller loss (Bear Stearns High-Grade Structured Credit Strategies).
- On June 22nd Bear Stearns provided one fund with $1.6 billion in liquidity but this was insufficient to prevent further withdrawals. Lenders attempted to reclaim loans (New York Times 21/6/07) redemptions were suspended and both funds filed for bankruptcy approximately six weeks after the first announcement of losses.
- Both funds were incorporated in the Cayman Islands where they were liquidated (Bloomberg August 7 2007).

9

Low tax Financial Centres and the Subprime Crisis:
The IFSC in Ireland

- **The IFSC connection**
- Bear Stearns has two investment funds and six debt securities listed on the Irish Stock Exchange.
- Bear Stearns also operates three subsidiaries in the IFSC, Dublin through a holding company (Bear Sterns Ireland Ltd.).
- Table (1) shows the main features:
- Gearing is high (84 US cents of equity financed $100 of gross assets) and increased through time.
- 2. Most assets and liabilities are short term.
- 3. Although profitable no dividends were paid. Most capital consists of capital reserves.
- 4. There are numerous intra-group assets and liabilities most likely representing extensive intra-group transactions.

10

Low tax Financial Centres and the Subprime Crisis:

The IFSC in Ireland

Table (1)
Assets and Liabilities of Bear Stearns Ireland Ltd.
$ billion

Year	Gross Assets	Financial Assets held for Trading	Securities Purchased Under agreements to sell to group companies[1]	Reserves -capital contributed	Retained Profits	Employees
2007	61.218	48.4	3.01	0.378	0.14	141
2006	36.033	27.5	5.34	0.271	0.11	114
2005	14.231	7 .4	3.49	0.201	0.90	85
2004	9.228	3.5	3.23	0.154	0.55	69
2003	7.315	3.0	3.22	0.105	0.25	67
2002	6.889	4.0	2.22	0.105	0.00	61

Notes
(1). Other intra-group transactions are described as loans receivable from an affiliate and market and client receivables;. While intra-group liabilities are described as market and client payables, swap agreements and forward contracts and short term borrowings.

11

- The accounts state that the group and subsidiaries are regulated by Irish Financial Services Regulatory Authority. One of the subsidiaries is an authorised bank with considerable disclosure and compliance requirements.
- Despite the location of managed funds in Ireland and substantial operations including an authorised bank the Irish regulator does not feature in any media analysis or discussions relating to the insolvency and subsequent take-over of Bear Stearns.
- In an interview the Irish regulator considers his remit is to ‘Irish banks’ that is banks which have their headquarters located in Ireland. The regulator is reported as stating that he meets the chief executive of the Irish Banks ‘at least once a week’ (Sunday Business Post, May 11, 2008).

12

Low tax Financial Centres and the Subprime Crisis: The IFSC in Ireland

- Nineteen funds reported as facing difficulties in the sub-prime crisis, have been identified as located at the IFSC. Almost without exception the IFSC link is not discussed.
- There is one exception: German banks
- Table (3) shows State aid to Four German Banks as a result of losses on subprime securities with quoted funds in Dublin. All four banks have securities quoted on the Dublin stock Exchange on which most of the losses were incurred.. Two of the four also have incorporated entities in Ireland (Sachsen LB and West LB).
- The largest losses were sustained by IKB Bank due to an off balance sheet conduit known as Rheineland quoted in Dublin (Financial Times, March 28, 2008).

13

Low tax Financial Centres and the Subprime Crisis: The IFSC in Ireland

Table 3
State Aid to German Banks with Quoted Funds in Dublin

Name of Bank	Amount of State Aid € billion
Bayern LB	2.4
IKB	7.8
Sachsen LB	2.8
West LB	3.8

Source:- Der Spiegel April 10, 2008.

14

Low tax Financial Centres and the Subprime Crisis: The IFSC in Ireland

- One bank that has attracted a lot of attention including its connection with the IFSC is Sachsen Bank
- Although it has been stated that Sachsen bank had no employees in Dublin, accounts filed in Company House show that the Dublin based firm employed 45 people, or approximately 12% of the total employees of the bank (Table 4).
- The Irish subsidiary accounts for under 10% of gross assets but makes in excess of 50% of group profits.
- For 2005 the Irish subsidiary reported profist of €50 million, the group as a whole €18 million.
- .
- None of the accounts for any of the years examined or prospectus mention regulation or the Irish regulator.

15

Low tax Financial Centres and the Subprime Crisis: The IFSC in Ireland

Year	Gross Assets Sachsen LB	Sachsen LB Value of securities on Balance Sheet	Gross Assets of Sachsen Group	Profits of Sachsen Bank LB	Profits of Sachsen Group	Dividends of Sachsen LB	Employees of Sachsen LB
2001	1563.085	1411.032		11.751		0.0	37
2002	2317.932	2317.932		17.014		0.0	26
2003	3816.993 (6.5%)	3816.993	58549.0	33.016 (58.9)	56.208	25.0	33 (5%)
2004	4899.46 (8%)	3182,235	60559.0	41.147 (64.3%)	63.941	35.0	38 (5.9%)
2005	4890.453 (7%)	3058.571	68420.0	50.579 (280%)	18.098	57.5	46 (7.7%)
2006			67760.0		82.953		

Source:- Annual Reports of Landesbank Sachsen Girozentralle available at http://www.sachsenlb.de. Annual Reports of Sachsen LB Europe.

16

Low tax Financial Centres and the Subprime Crisis: The IFSC in Ireland

- **Who is the responsible regulator?**
- EU directives seem clear the host country has responsibility for regulation
- EU Directive on Financial Regulation Directive:- (14, June 2006, Directive 2006/48/EC), states
- Art 21
- Responsibility for supervising financial soundness. The hosts member state should be responsible for the supervision of the liquidity of the branches and monetary policies. The supervision of market risk should be the subject of close cooperation between the competent authorities of the home and host member states.
- Art. 22
- Without prejudice to their own powers of control, the competent authorities of the host member state, should be able, I an emergency to verify that the activities of a credit institution comply with the relevant laws, etc.
- Art. 10
- "A credit institution which is a legal person should be authorised in the Member State in which it has its registered office"

17

Low tax Financial Centres and the Subprime Crisis: The IFSC in Ireland

- There is a conflict of interest between financial firms who wish to locate activities which are least regulated and lowest tax and the requirements of the location of investors/liabilities of these firms who are concerned with conduct of business type regulation.

- There are conflicts between low tax regeimes and regulators in other countries. For example it is reported the industry would like to locate outsourced activities in any jurisdiction. This position is supported by regulators in Germany, France and the UK (F.T. January 14 2008).

- In contrast Luxembourg and Ireland are opposed to this position and wish to maintain the current system where there are restrictions on outsourcing. Luxembourg and Ireland are centres of the fund management industry with considerable number of employees involved in administration of funds.
- However a key issue in relation to the current arrangement is whether these funds even though they may have an administrative presence are adequately supervised, and if in fact they have key decision making functions.

18