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of the Irish Financial Services Centre

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# Low tax Financial Centres and the Financial Crisis: The Case of the Irish Financial Services Centre \*

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## Summary

This paper argues that low tax centres played a key role in the development of a shadow banking system and in the global financial crisis. The paper focuses on the Irish Financial Services Centre (IFSC). The paper examines the impact and operation of firms issuing asset backed securities and other funds. The paper shows that the presence of these entities in the IFSC creates relatively few jobs and may pose a considerable regulatory risk to financial firms in other countries. The paper also examines a number of case studies of banks with IFSC based subsidiaries that failed, focusing in particular on four German owned banks. The paper argues that existing and proposed regulation within the EU will fail to reduce excessive risk taking because regulation is largely host country based. Finally the paper concludes that low tax centres based on regulatory and tax arbitrage are unlikely to provide long term sustainable economic success.

## Key Words

Shadow banking; Irish Financial Services Centre; hedge funds and special purpose vehicles; German Banks, regulation and reform

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## 1. Introduction

Aggregate data for 11 major countries shows ‘shadow banking’ sector assets to be around half the size of banking assets (Financial Stability Board, 2011, p. 8). In the US in 2007 ‘shadow banking’ was larger than traditional banking (Financial Crisis Inquiry Commission, Figure 2.1). Shadow banking is largely engaged in liquidity and maturity transformation and in risk transference in what has been described as “covert liquidity transformation (Knight 2008). The main reason for the growth in off balance sheet financing is regulatory arbitrage for example to avoid or reduce restrictions on capital adequacy ratios. ‘Shadow banking’ activities although off balance sheet and organised through limited liability special purpose vehicles, are often controlled or have liabilities guaranteed by traditional banks (ECB, 2009, p. 10). Not surprisingly for many years shadow banking escaped the attention of many in the “official community” (Borio, 2008, p. 12) and played a key role in the global financial crisis.

This paper argues that the ‘shadow banking’ sector developed in tax havens and low tax centres to facilitate regulatory and tax arbitrage. Consequently reform within the EU requires centralised supervision, in order for example to minimise harmful regulatory arbitrage, and to ensure full disclosure of ‘off balance sheet financing’. Reducing harmful regulatory arbitrage opportunities on a global basis is more difficult and requires careful monitoring of the role of tax havens/low tax centres by financial firms, and consequent rule revision. The paper is based on data on debt and investment fund securities quoted on the Irish Stock Exchange (<http://www.ise.ie>) and associated documentation and on company accounts and other documents filed with Companies Registration Office (<http://www.cro.ie/>) in relation to Financial Vehicle Corporations. A list of these companies operating in Ireland is published by the ECB.

A tax haven/low tax financial centre is sometimes cited as the location of assets in reports of losses by hedge funds and investment vehicles. In other cases tax havens feature as part of a complex organisational structure in which financial flows and risk are managed<sup>1</sup>. While analysis of the financial crisis may often comment extensively on regulatory change it omits any discussion of the role of tax havens (Bailey, Elmdorf and Litan, pp. 149-158). The UK based Turner Review (pp 21,29,43), the US Financial Inquiry Commission, and the Financial Stability Board (2011) deal extensively with ‘shadow banking’ and necessary regulatory reform but do not discuss a tax haven/low tax centre connection. Similarly, regulatory reform in the EU (De Lasoriere and Liikanen Reports) and proposals to develop a policy response to the growth of ‘shadow banking’ (European Commission, 2012a), fail to acknowledge the key role low tax centres play in the ‘shadow banking sector’<sup>2</sup>.

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<sup>1</sup> There has been extensive discussion of the role of Antigua in a fraud in excess of \$8 billion by Stanford (Financial Times, 19/2/09). The Guardian (13/3/09) describes how RBS (Royal Bank of Scotland) was extensively involved in complex tax avoidance schemes using the Cayman Islands. There has also been increased interest in the US see for example Government Accountability Office, 2008. See also Guardian Newspaper 3, 4, 5 February, 2009;

<sup>2</sup> The Liikanen report in stating that ‘shadow banking’ performs important functions in the financial system’ (p. 76), fails to recognise that key competitive advantages of shadow banking are regulatory and tax arbitrage across different jurisdictions.

The Financial Stability Board, established by the Group of 20 major industrialised countries) defined the ‘shadow banking system’ as “the system of credit intermediaries that involves entities and activities outside the regular banking system” (Financial Stability Board, 2011, p. 3). This definition fails to recognise that many of these entities are an integral (but unrecognised) part of the regular banking system, but are subject to greater risk and uncertainty. One source of risk arises from varying liquidity requirements, but in contrast to banks, non-bank financial firms do not have access to central bank lending facilities, but rather rely on market based funding. This risk is magnified by very high gearing ratios. At the start of the global financial crisis (2008) firms dependent directly on the inter-bank market, either found that the cost of funds increased dramatically or were unable to obtain funds at any price (Turner Report, p. 27; Financial Crisis Inquiry Report, Fig. 20.1). The case of Long Term Capital Management is an early example of the risk faced by highly leveraged financial firms in the absence of a lender of last resort (Dunbar, 2001).

Risk was compounded by poor or non-existent regulation. This is because of the location of ‘shadow banking’ type activities in off shore financial centres one of whose main advantages was ‘light touch regulation’ and in recognised tax havens such as the Cayman Islands (Bender, 2010). This source of risk typically only becomes apparent in a crisis. As a consequence when markets became aware of the risk associated with these firms, liquidity is reduced, increasing risk further.

The paper is organised as follows. The next section considers the role of regulation and low tax centres. This is followed by an examination of the growth of the Irish Financial Services Centre (IFSC) and of firms issuing financial instruments such as asset backed securities. The paper then examines some cases studies of subsidiaries of failed banks in the IFSC, focussing in particular on four German banks. Finally some conclusions are made.

## **2. Regulation**

Competition between financial centres is considerable and has contributed to reduced regulation. Historically hedge and other funds were often domiciled in the Cayman Islands, Bermuda or the British Virgin Islands, but more recently European jurisdictions such as the Channel Islands, Ireland and Luxembourg have ‘streamlined regulation’ amongst other factors to attract funds. One effect of this competition, prior to the financial crisis, was to shorten the period between application for a quotation and commencement of trading. In Ireland if the relevant documents were provided to the regulator by 3 p.m. a fund (with some exceptions) was authorised the next day (Steward, 2008)<sup>3</sup>. In 2008, Luxembourg 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. Steward comments that unlike the Irish regulator, the regulator in Luxembourg does not ‘scrutinise promoters’.

There are over 4,000 investment funds and many more sub-funds, quoted on the Irish Stock Exchange. Many of these funds’ assets consisted of subprime loans. In order to be quoted on the Dublin Stock Exchange they must be sponsored by a local stock broking firm;<sup>4</sup> documents must be lodged with the regulator, and if an incorporated entity, the registrar of

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<sup>3</sup> “In 2007 “Qualifying Investor Funds” may be authorised by the regulator on a filing only basis, so that there is no prior review of documentation. Qualifying investor Funds are most frequently used by hedge funds, fund of hedge funds, equity funds, and others Source:- Dillon Eustace (2007).

<sup>4</sup> In most cases Davy and Goodbody Stockbrokers located in Dublin.

companies<sup>5</sup>. In return fees are paid to the Irish Stock Exchange and to the sponsoring broker. These investment funds may in turn be owned by a special purpose vehicle, with some corporate secretarial functions performed by a firm based in the IFSC.

In relation to debt instruments the Irish Stock Exchange states that “The Exchange have committed to very aggressive and specific turn-around times on all documents submitted i.e. a three day turn-around on the first draft of the document and two days on subsequent drafts” and that “the procedures for listing have been simplified particularly for debt issuance programmes. “Housekeeping’ requirements and other administrative procedures have been minimised”<sup>6</sup>. In 2007 “Qualifying Investor Funds” may be authorised by the regulator on a filing only basis, so that there is no prior review of documentation. Qualifying investor Funds are most frequently used by hedge funds, fund of hedge funds, equity funds, and others (Dillon Eustace 2007).

In spite of stated high regulation standards<sup>7</sup>, many of the sub-prime and other funds that collapsed in value in the recent financial crisis, were listed on the Irish Stock Exchange. The collapse of these funds led in turn to large losses at banks and especially four German banks with subsidiaries at the IFSC (Sachsen Bank, WestLB, IKB and Depfa/Hypo Vereinsbank).

An important issue is where responsibility for regulation rests. If the principle that regulation follows domicile is followed, then locations such as low tax centres and tax havens are also the location of the responsible regulator. However a former Irish financial regulator stated that he had no responsibility for entities whose main business is raising and investing in funds based on subprime lending.<sup>8</sup>

Part of the difficulty arises from a conflict between financial firms who wish to locate activities which incur lowest cost (least regulated and lowest tax), and the requirements of investors in financial products provided by these firms who are concerned with minimising risk and greater protection for investors. The requirements of regulators overlap with those of investors, and sometimes financial firms but will also have additional concerns for example to prevent systemic risk to the financial systems where ultimate liability lies. There may also be conflict between regulators. The Alternative Investment Fund Managers Directive (European Commission, 2011) which requires common standards across EU based hedge funds will reduce ‘regulatory arbitrage’ opportunities, but not those resulting from differing tax rates. Regulatory arbitrage opportunities may not be entirely removed, however, as the body responsible for overseeing regulations and their implementation (European

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<sup>5</sup> See <http://www.cro.ie/>

<sup>6</sup> Available at :- <http://www.ise.ie/>.

<sup>7</sup> The Irish Stock Exchange also states that the Exchange has “standards of regulation to stockbrokers and listed companies which are acknowledged to be among the highest in Europe”, Irish Stock Exchange ‘Why List’, available at <http://www.ise.ie>

<sup>8</sup> The Irish Financial Regulator stated that “it is not required to police the activities of vehicles such as Ormond Quay” (an IFSC based SIV which led to large losses at Sachsen LB) (Clerkin, 2007). In 2007 the regulator stated in relation to difficulties with subprime funds located at the IFSC:-

“.. .. it is important to point out that some of the particular investment vehicles that have recently encountered difficulties and the small number of those that happen to be based in Ireland are special purpose companies, invested in by professional investors, including financial services firms, who are generally regarded as having adequate professional expertise available to them when undertaking such investments. Internationally the approach therefore has been that these vehicles do not require close regulatory oversight. Our regulatory system here is no different in this regard to that in other jurisdictions, including the rest of the EU. Indeed our regulatory regime is recognised as conforming to international best-practice standards”. (See speech to the Irish Bankers Federation National Conference (11/9/2007).

Securities and Markets Authority) will rely for compliance on “group pressure through peer reviews which are carried out by fellow national authorities”<sup>9</sup>. In addition there may be conflicts with non-EU based regulators.

The Madoff and Stanford ‘ponzi’ cases illustrated some of the regulatory and other issues resulting from the location of hedge and other investment vehicles in low tax centres and tax havens<sup>10</sup>. While the directive imposes ‘equivalent regulatory requirements on non-EU based hedge fund activities’ (Reynolds, 2012), and prohibits alternative investment funds that are on the Financial Action Task Force ‘black list’, no ‘tax haven is currently on this list’<sup>11</sup>. For this and other reasons tax havens are likely to retain their dominant position in the global hedge fund sector.<sup>12</sup>

The main policy recommendation in relation to the global financial crisis is reform of financial regulation (Borio, p. 17-18; Baily et al p. 9; Knight, 2008). The de Larosiere Report (2009) concluded (p. 27) “The present regulatory framework in Europe lacks cohesiveness”, and the main recommendation for reform is the establishment of a European System of Financial Supervision (ESFS) (de Larosiere Report, p. 47). In particular as far as cross border institutions are involved the report recommends reliance on “colleges of supervisors”, especially for those credit institutions presenting a systemic risk to the host country<sup>13</sup>.

Subsequent proposals for EU wide rules for bank resolution also relied on national resolution authorities within each member state which will apply “resolution tools and powers in a more harmonised way by establishing resolution colleges (European Commission, 2012b, p. 53) with the assistance of the European Banking Authority (EU, 2012, p. 55). The European Commission Impact Assessment on bank resolution proposals acknowledges that it “does not address the fundamental underlying conflict of interest that arises in the EU from a disconnect between the pan-European nature of cross border group and national financial stability and fiscal responsibilities” (European Commission, 2012b, p. 66)<sup>14</sup>. EU proposals (supported by the ECB) for a single banking regulator led by the ECB, with pre-emptive intervention powers recognises some of the flaws in the de Larosiere proposals such as ‘regulatory arbitrage, (European Commission September 2012c, p. 5). These proposals formed the basis for a proposed ‘single supervisory mechanism’ consisting of the ECB and

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<sup>9</sup> See <http://www.esma.europa.eu/page/Review-Panel>

<sup>10</sup> The Madoff case illustrated problems arising from off shore financial centres and ‘light touch regulation’. The Stanford case illustrated problems with financial regulation in Antigua. French investors channelled up to €500 million to Madoff via UCIT funds quoted in Luxembourg and Dublin (Financial Times 26/1/09) Regulation in Luxembourg has been subject to extensive criticism (Financial Times 30/1/09) but despite two Irish funds also investing with Madoff (Irish Independent, 15/1/09) and suing HSBC Trust Services (Ireland) and PWC (Irish Independent 30/1/09) there has been no public criticism of Irish regulation in this case. The Stanford fraud case also involved another low tax jurisdictions Bermuda.

<sup>11</sup> See Financial Action Task Force (2012).

<sup>12</sup> See Pierce and Clipstone, (2011) Cayman Retains Dominance Amid AIFM Directive Focus, IFC Caribbean Review, Walkers, Cayman Islands, available at <http://www.walkersglobal.com/files/Publication>

<sup>13</sup> A proposed revision to existing directives regulating banks (2006/48 EC and 2006/49/EC) had already included enhanced role for the consolidating supervisor, so that a member state can request the consolidating supervisor “for a branch of a credit institution to be considered as systematically relevant ((See proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC article 42a, Brussels 11/10/2008). If an entity is considered to be systematically relevant then it will require the formation of a ‘college of supervisors’ (article 6.3.2 Proposal for a Directive of the European Parliament and of the Council, Commission 2008/0191 (COD).

<sup>14</sup> The German Chancellor has criticised the European Banking Authority because of its inadequate supervision of stress tests on Spanish banks, due to conflicts with national supervisors (Reuters, Merkel lauds Spanish aid request but chides EBA, June 12, 2012).

‘national competent authorities’ (Council of the European Union, press release 13 December 2012), although details and functions are undecided.

### 3. The Irish Financial Services Centre (IFSC)

Maintaining and expanding financial services is a major part of current Irish Government Policy (Department of the Taoiseach, 2011, p. 4). The annual Finance Act often amends or introduces new legislation to enhance the attractiveness of Ireland as a location for financial firms. Government strategy for the financial services sector (Department of An Taoiseach, p. 2) requires the Department of Finance and the Revenue Commissioners to “fully engage and consult with the [Financial Services] industry to enhance the tax framework, including through the annual Finance Bill process”. There are several examples of such ‘cooperation’<sup>15</sup>. The Finance Act (2012) contained 21 separate measures to support the financial services industry. It was also stated that “none of the measures would have a significant cost element” (Department of Finance Press Release Finance Bill, February, 2012). The Finance Act (2011) required State agencies including the Industrial Development Authority (IDA, <http://www.idaireland.com/home/>) to support the IFSC. For the period 2003-2010 the Central Bank (the regulator of the financial sector) was specifically required to “promote the development within the State of the financial services industry”<sup>16</sup>. The Finance Act (2010) made it easier for funds to move from locations such as the Cayman Islands to Dublin (Greene, 2009).

The IFSC dominates foreign investment in the Irish economy. Table (1) shows total foreign investment in Ireland for the period 2001-2011. The table shows that foreign direct investment reached a peak in 2003, fell until 2006, and in 2011 was above the 2003 peak. Total foreign investment in the IFSC rose from 2001 to 2007 fell slightly in 2008, reflecting the financial crisis, and has continued to rise since then. In 2011 IFSC investment was over 20 times the size of non-IFSC foreign direct investment and over 17 times the size of GNP. In 2001 IFSC investment was about 7 times direct investment and just over 6 times GNP.

Table (1)  
The Growth of the IFSC in Dublin: Total foreign Investment in Ireland (€billion)<sup>1</sup>

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Direct	152.1	174.4	176.4	152.4	138.6	118.8	138.4	135.3	173.6	213.7	194.5
Direct non-IFSC <sup>2</sup>	83.2	98.4	97.6	90.7	98.0	66.2	82.2	101.7	120.9	112.8	103.7
Portfolio	412.1	447.1	542.2	721.0	1025.9	1223.7	1329.9	1280.7	1464.6	1668.2	1725.5
Other	303.8	329.0	389.8	443.8	556.9	678.3	838.7	992.7	937.3	921.5	913.4
Total	868.0	950.4	1108.4	1317.2	1721.4	2020.8	2307.0	2419.7	2573.4	2794.9	2835.1
IFSC <sup>2</sup>	616.3	676.6	813.3	975.4	1300.2	1566.7	1727.0	1684.6	1786.5	2076.4	2170.4

Notes

(1) Current market prices.

(2) This number may understate IFSC type activities, as international financial firms are no longer required to locate at the IFSC see Stewart (2008) for a further discussion.

Source: CSO (2010) and (2008), International Investment Position, Table 1 and 3.

<sup>15</sup> See for example Ernst and Young (2003).

<sup>16</sup> Central Bank and Financial Services Authority of Ireland Act 2003, section 5 (b). This clause has been omitted from legislation reforming financial regulation in Ireland. See Central Bank Reform Act, 2010.

Hedge funds quoted in Dublin, where some administrative functions may be undertaken, are often managed in London, but domiciled in a tax haven/low tax regime. As a result of the financial crisis there was an estimated outflow from hedge funds of \$400 billion in 2008 (Financial Times, 21 January, 2009) and a subsequent restructuring and closure of many. All three funds reported as closing on one day (Mackintosh 2009), were managed in London, quoted in Dublin but domiciled in a tax haven. One of these funds (Lansdowne Partners) had seven funds consisting of 148 sub-funds quoted in Dublin and all but one, were domiciled in the Cayman Islands. A second firm (Rab Capital) had seven funds and 23 sub-funds quoted in Dublin, 19 were domiciled in the Cayman Islands, three in the Isle of Man, and one in the British Virgin Islands, and the third firm (New Star) had three main funds and eight sub-funds quoted in Dublin, and all were domiciled in Bermuda<sup>17</sup>.

Hedge and other funds operating in Ireland make extensive use of ‘special purpose vehicles’. One group of special purpose vehicles (referred to as Financial Vehicle Corporations) benefit from especially favourable tax treatment. ECB data shows 742 of these firms are located in Ireland, 26% of the eurozone total.

The nominal corporate tax rate is 12.5% on trading companies in Ireland, but the tax rate on passive income, such as interest received is 25%. The 1997 Finance Act (section 110), allowed companies meeting certain requirements to compute tax as if they were a trading company (referred to as ‘section 110 companies’). This means that all expenses, for example expenses of issuing securities may be offset against tax, and as a result of tax changes introduced in 2003, interest on debt or loans notes issued are also allowed as deduction against tax (Ernst and Young, 2003). Hence for example, investors may own debt for Irish tax purposes, but equity for US tax purposes. This has very favourable tax consequences, for example, the higher interest charges, the lower taxable profits and Irish corporate tax payments (Dillon Eustace, 2010, p. 6), while at the same time US debt owners are able to report rising dividend income, although this income is unlikely to be remitted directly to the US. VAT payments may also be minimal if activities are “structured properly” (Dillon Eustace, 2010, p. 7)<sup>18</sup>. There are also no withholding taxes on interest payments.

Certification of tax status appears to be minimal. One large accounting firm states “no ruling or authorisation is required from the Revenue Commissioners whether the company is in fact a section 110 company” (Grant Thornton 2010, p. 2). As in the case of other fiscal incentives, their scope has been considerably enhanced since introduction. For example the range of assets which ‘section 110 companies’ may invest in has been extended from financial assets such as debt, derivatives and shares to include commodities, plant and machinery, and carbon offsets (Dillon Eustace, 2011).

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<sup>17</sup> Reports relating to the financial crisis rarely refer to the fact that many funds that were forced into liquidation or closure were quoted on the Irish Stock Exchange. For example, a front page article in the Financial Times citing a plan to restructure an SIV called Cheyne Capital after 10 months of negotiations, and further restructuring at four other SIVS (Golden Key, Mainsail, Whistlejacket and Rhinebridge), neglects to note that in all cases the funds were quoted on the Irish Stock Exchange. There is also no reference to any management functions being undertaken in Dublin (Sakoui, 2008). The Financial Crisis Inquiry Report (2011), has extensive discussion of the failure of IKB and to an off balance sheet financial vehicle (Rhineland), but does not refer to a key Dublin based vehicle (Rhinebridge). The Liikanen Report also has extensive discussion of failed banks such as Depfa Bank and the German Landesbanken, but does not refer to the location in Dublin of subsidiaries where most losses were incurred.

<sup>18</sup> For example, Adagio II CLO an SPV (section ‘110’ company) reported gross assets of €326 million at the end of July 2010, and gross income of €2 million. Pre-tax profits and tax paid were zero. Operating expenses amounted to €2.7 million, of which portfolio management fees paid to Axa Investment Partners, Paris amounted to €1.16 million.

#### 4. The IFSC and Special Purpose Vehicles

Financial instrument such as subprime funds, derivatives and other financial instruments, may be issued and controlled through a special purpose vehicle (SPV), whose legal form is a public limited liability company incorporated in Ireland. It is a special purpose vehicle because a trust deed may specifically prohibit the firm from owning fixed assets or having employees, or establishing subsidiaries<sup>19</sup>. These companies are administered and legally resident in Ireland, although most key functions take place in financial centres, especially London, but also other centres such as New York and Paris. The identified owner is a trust, in most cases in the study group this is specified as a charitable trust. This structure is designed to ensure tax residence in Ireland. Ownership in the form of a charitable trust, means that the entity cannot be part of a larger group, and the accounts are not consolidated. Notes to company accounts may state that the directors regard the trustees as the “ultimate controlling party” or that in the opinion of the directors “there is no identifiable single controlling party” or that the board ‘has considered the issue as to who is the controlling party of the company’, and conclude that it is the directors<sup>20</sup>. Another criterion in ensuring tax residence is satisfied, is to have local administrative services, although as shown later this may be minimal.

The financial crisis revealed large gaps in information and regulation of special purpose vehicles and of the ‘shadow banking sector’. As a result, data on Special Purpose Vehicles (SPV’s) operating in the EU is now collected and published by the ECB and referred to as Financial Vehicle Corporations (FVC’s). This data shows that almost all FVC’s are located in the eurozone area, and that 10 out of 17 eurozone members have resident FVCs. According to ECB data there were 776 ‘Financial Vehicle Corporations’ (commonly referred to in Ireland as section 110 companies) operating in Ireland in 2012 (Q1), approximately 27% of the EU total, and the highest in the EU, followed by Spain, the Netherlands and Luxembourg ([http://www.ecb.int/stats/pdf/money/FVC\\_Q32011.pdf](http://www.ecb.int/stats/pdf/money/FVC_Q32011.pdf)).

The number of new FVCs in Ireland grew from zero in 2001 to approximately 300 in 2007 and fell to under 100 in 2010 (Godfrey and Jackson, 2011, chart 1). All of these entities file accounts under the companies acts and most of them have debt securities quoted on the Irish Stock Exchange and have filed associated documentation with the stock exchange and Registrar of Companies.

A sample of FVCs was selected for more detailed examination from a list produced by the ECB of all securities issued by FVC’s in the EU by country. Irish resident FVCs accounted for 4227 securities (40% of the EU total) for the third quarter of 2011. Those firms with multiple issues of securities were treated as one observation, resulting in a total of 725 firms. All companies in Ireland must file an annual return which in the case of FVC’s includes

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<sup>19</sup> For example the prospectus of one SPV examined (Angel Court CDO PLC) includes amongst other restrictions that the issuer “may not have any employees or premises”.

<sup>20</sup> For example in the case of an SPV with close links to HSBC, Orpington Structured Finance 1, footnote 16, Annual Report and Accounts 2010, states that the share capital is held “in trust for charity”, and the directors control the day to day activities of the company. In this case all administrative and other expenses such as the company audit and tax fees are paid by HSBC (Annual Report and Accounts 2010, Footnote 8).

annual accounts. Accounts for the first 10 firms were examined and every 10<sup>th</sup> firm thereafter, resulting in a total of 82 firms<sup>21</sup>.

The following are the key features of the sample examined. They have zero employees. All firms have administrative services performed in Ireland by a management company for a fee, although most administrative functions (portfolio management, arranger, transfer agent, collateral administrator, paying agent, swap counter party, trustee services, and legal services) are performed outside Ireland. In almost all cases the directors were employees of the management company. Many firms also have connections with advisory firms in other low tax centres such as Luxembourg and Jersey, and some advisory firms are located in tax havens such as the Cayman Islands and Bermuda.

Table (2) shows some financial features of those firms for which data was available for 2009 - 2011. The table shows that the study group, assets and gross income are large but pre-tax profits are negative and median amounts are zero. Table (2) also shows that for the group as a whole, equity (retained profits plus issued capital) as a % of gross assets was -5.4% for 2010 and -2.8% for 2009 due to retained losses. Gearing ratios are high. For the period 2009-2011 the median value of gross assets varied between €328 and €348 million, but the median value of equity for all years was just over €40,000<sup>22</sup> giving an equity/assets ratio of around 0.012% for each year. This compares with an aggregate mean equity/assets ratio for Q4 2010 for all EU based FVC's of 0.182% and for FVC's based in Ireland (799 firms) of 0.234%. It is also interesting to note that 78 of 82 firms examined were owned by a trust of which 69 were owned by a 'charitable trust' and also claimed to be independent of any other company<sup>23</sup>. In three cases ownership was described as being 'held in trust', yet three of five directors were employees of KBC and services such as portfolio management, banking and custodial services were provided by KBC Bank. Gross assets for these three cases varied between €440 million and €25 million<sup>24</sup>. In eight cases in the study group although owned by a charitable trust, the company accounts were consolidated with a larger group<sup>25</sup>.

If these firms are genuinely stand alone very high gearing ratios and negative equity in some cases, pose considerable risks to individual banks and the financial system where those banks are located. These may arise not just from trading contracts arising from the subprime crisis, but from new trading contracts entered into by financial firms as in the losses incurred by JP Morgan in 2012 (Swartz and Silver-Greenberg 2012).

Table (2) also shows that due to reported losses that for the group as a whole there was a repayment of corporation tax in 2009. Total corporate tax paid in 2010 amounted to €0.4

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<sup>21</sup> Most of the firms in the sample also had one or more securities quoted on the Irish Stock Exchange and has a result issued a prospectus and arrangement document. These are available at <http://www.ise.ie/Debt-Securities/>. Some securities issued by resident NFCs were listed on another Stock Exchange such as Jersey.

<sup>22</sup> For example Orpington Structured Finance I had total equity of €14, including one issued share of one euro and gross assets of €1.674 billion.

<sup>23</sup> In 19 cases the shareholders consisted of three charitable trusts Badb, Medb and Eurydice charitable trusts, all with the same address (shared with a firm of solicitors) and directors. Accounts available for seventeen of these firms for 2010, showed aggregate gross assets of €6.1 billion. Accounts of the three charitable trusts show income from trustee fees, donations received and donations paid. For the most recent two year period donations received exceed donations paid (€1.03 million compared with €0.87 million). A footnote to the accounts states that "donations are treated as received and paid once a relevant declaration of trust has been put in place".

<sup>24</sup> The annual report of KBC (2011, p. 195) states companies are not consolidated unless profits are greater than €1 million or share capital is greater than €2.5 million.

<sup>25</sup> Two of the eight (Fasnet Securities 6 and Fasnet Securites 2), reported losses of \$596 million and \$377 million respectively for 2010 and were consolidated in the accounts of Irish Life and Permanent.

million. Corporation tax payments are low or negative because reported profits are low. Median pre-tax profits varied from €6 to €1 for the years 2009-2011. Median corporate tax payments were zero for all years.

Table (2)  
Financial Features of Financial Vehicle Corporations in Ireland

Number of firms	Gross Assets	Gross Income	Equity Capital <sup>3</sup>	Pretax Profits	Tax
	€billion	€billion	€billion	€billion	€million
Total in EU 3074 <sup>1</sup>	2353.0		42.816		
In Ireland 827 <sup>1</sup>	574.8		1.6		
Study Group <sup>2</sup>					
2011 35	20.528	0.205	-3.2401	0.6329	0.538
2010 78	39.228	0.793	-1.9892	-0.726	0.399
2009 75	41.403	2.221	-1.186	-0.117	-0.403

- (1) Q4 2010. See [http://www.ecb.int/stats/pdf/money/fvc/FVC\\_overview](http://www.ecb.int/stats/pdf/money/fvc/FVC_overview). Although ECB data refers to 827 FVC's operating in Ireland in Q4 2010, it was only possible to identify 725 separate firms from published details of all securities issued (see <http://www.ecb.int/stats/money/mfi/html/index.en.html>).
- (2) The first 10 companies and every subsequent 10<sup>th</sup> firm were selected from the ECB list. This resulted in 82 companies. No accounts were available for two companies. For most accounts the year end date was December 31<sup>st</sup>. In cases of a different year end date the following rule was applied because of differing year end dates; Accounts for a year ending 30<sup>th</sup> June were ascribed to the previous year. Accounts ending 1st July or after were ascribed to the current year. For most firms the year end was December 31<sup>st</sup>. Non-euro accounts were converted using exchange rates at the balance sheet date.
- (3) Defined as issued equity plus retained profits.

Table (3) shows some features of firms in the study group in terms of administrative and other payments. A minority of firms disclosed payments for administrative and other expenses examined. Table (3) shows that the largest proportion of administrative fees consist of portfolio expenses, collateral managers and arrangers. All firms providing these services were located outside Ireland, in many cases London. Identifiable expenses in Ireland consisted of expenses for local corporate administrative services, audit fees and tax services and accounted for 1.2% to 3% of total expenses for the year 2009-2011<sup>26</sup>. Median tax payments are zero for all years but median expenditure on tax advice varied from €4,800 to €5,000. Audit charges and tax fees accounted for around half of disclosed local expenditures. All FVC's are likely to incur other expenses in Ireland such as legal fees. However for the study group it is unlikely that local expenses in total would amount to much more than 3% of total administrative expenses.

Because the main benefits and linkages of these firms operations are outside Ireland, it is unlikely that further growth in this sector will lead to more than minimal job creation. This is in contrast to that envisaged by the current Irish Government<sup>27</sup> (Department of Jobs, Enterprise and Innovation, 2012).

<sup>26</sup> Over 95% of revenues accrue to the 'big four'.

<sup>27</sup> See Department of An Taoiseach (2011), p. 2 which proposes an expansion in activities at the IFSC to include Islamic Finance, green finance, carbon management, IP commercialization, private equity investment, and 'Green Tech' fund management. The estimated number of new jobs created from these initiatives is 10,000. See also Department of Jobs, Enterprise and Innovation, (2012).

Table (3)  
Local Expenditures by Financial Vehicle Corporations in the Study Group

€million

Year	Number of firms <sup>1</sup>	Total Admin. Expenses	Portfolio/ largest expenditure	Local Admin	Auditor Fees	Tax services
2011	12	55.838		0.355	0.250	0.061
2010 <sup>1</sup>	38	131.402	97.071 <sup>2</sup>	0.999	0.696	0.193
2009	32	51.793	26.043	0.893	0.540	0.157

1. This shows data for only those firms disclosing total expenditures and local expenditures
2. Fifteen firms disclosed this information for 2010 and 13 for 2009.

## 5. Case Studies: Failed Banks with IFSC Operations

Almost all large international financial institutions have either securities quoted on the Irish Stock Exchange or a presence in the IFSC, for example Bear Stearns.

### Bear Stearns

The collapse of Bear Stearns and its subsequent takeover by JP Morgan in March 2008, was one of the early indicators of the severity of the current crisis. The first public indication of problems at Bear Stearns emerged when a Bear Stearns hedge fund announced considerable losses (Goldstein, 2007), and a second fund announced a smaller loss (Bear Stearns High-Grade Structured Credit Strategies). Lenders attempted to reclaim loans (Bajaj and Cresswell, 2007). On June 22<sup>nd</sup> Bear Stearns pledged \$3.2 billion in loans (Cresswell and Bajaj, 2007), but this was insufficient to prevent further withdrawals. 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). While key executives at both funds faced prosecution in the US (Thomas, New York Times, 2008), they were acquitted in November 2009 (Kouwe and Slater, 2009). The reported reason why Bear Stearns attempted to rescue these funds was because of “reputational risk” rather than a contractual obligation (Baily, et al. p. 52). This failed intervention is likely to have been a key component of the collapse of Bear Stearns.

Bear Stearns had several investment vehicles listed on the Irish Stock Exchange. These consisted of two investment funds (Bear Stearns Offshore Fund of Hedge Fund Series and Bear Stearns Offshore Leveraged Fund of Hedge Fund Series), and seven debt securities divided into 69 sub funds with a total issued value of \$7.069 billion. Bear Stearns also operated three subsidiaries in the IFSC, Dublin through a holding company (Bear Stearns Ireland Ltd.). Table (4) shows the main features of the holding company of Bear Stearns in Ireland.

1. Capital ratios are low and fell over the period 2002-2007. In 2007 \$1 of equity financed \$119 of gross assets. In contrast the current Tier 1 ratio for commercial deposit taking banks in Ireland (equity/risk weighted assets) is 10.5% although all deposit taking banks have ratios substantially in excess of this..
2. Most assets and liabilities are short term.

3. Although profitable no dividends were paid. Most capital consists of contributed capital reserves.
4. There are large intra-group assets and liabilities most likely representing extensive intra-group transactions.

Table (4)  
Assets and Liabilities of Bear Stearns Ireland Ltd.  
\$ billion

Year	Gross Assets	Ratio of equity/ total assets <sup>2</sup> %	Financial Assets held for Trading	Securities purchased with agreement to sell to group companies <sup>1</sup>	Reserves -capital contributed	Retained Profits	Number Employed
2007	61.218	0.85	48.4	3.01	0.378	0.14	141
2006	36.033	1.25	27.5	5.34	0.271	0.11	114
2005	14.231	2.05	7.4	3.49	0.201	0.90	85
2004	9.228	2.27	3.5	3.23	0.154	0.55	69
2003	7.315	1.77	3.0	3.22	0.105	0.25	67
2002	6.889	1.53	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;. Intra-group liabilities are described as market and client payables, swap agreements and forward contracts and short term borrowings.
- (2) This is similar to Tier 1 capital ratio. The main difference is that assets are not risk weighted.

The accounts also state that the group and subsidiaries are regulated by the Irish Financial Services Regulatory Authority. One of the subsidiaries is an authorised bank requiring considerable disclosure and compliance activity. In an interview, the then Irish regulator appears to consider the remit of the regulator is to ‘Irish banks’ that is banks which have their headquarters located in Ireland (Clerkin, 2008).

Bear Stearns is not an isolated example in relation to the use made by US financial institutions of the IFSC . Lehman Brothers had four debt securities with approx. \$27 billion issued and five funds administered from the IFSC and quoted on the Irish Stock Exchange in September 2009. The minimum subscription to these funds varied between \$0.25 million and \$5 million, although one of the funds had a minimum subscription of \$2500.

In addition there are 10 Lehman subsidiaries incorporated in Ireland under the companies Acts. The prospectus of one of these states:-

“The company may employ investment techniques and instruments for efficient portfolio management.. .. Under the conditions and within the limits stipulated by the Central Bank under the UCITS regulations” Prospectus of Lehman Bros Alpha Fund PLC 2003, p. 11)

Another prospectus states the company is a collective investment scheme organised as a company and “authorised by the Financial Services Regulatory Authority” (p. 19). All the capital of the company is invested via another Lehman subsidiary located in the Cayman Islands. Both prospectuses state that the company is tax resident in Ireland

## Other Firms

Apart from Bear Stearns and Lehman Brothers, most if not all large banking and insurance companies have securities quoted on the Irish Stock Exchange. For example, AIG had three funds listed in Dublin with a value of \$1298 billion) and one debt security; Merrill Lynch had one investment fund and 2 debt funds; Goldman Sachs had 31 investment funds and 2 debt funds; UBS has numerous quoted debt instruments on the Irish Stock Exchange.

German banks in particular had considerable connections with the IFSC. Deutsche Bank had quoted notes and trust certificates to the value of €160 million, the trustees of which are registered in the Cayman Islands; Deutsche Bank (Luxembourg) also had €433 million in debt instruments quoted on the Irish Stock Exchange, and Deutsche Investment Managers had three funds quoted on the Irish Stock Exchange (February 2009). Commerzbank has three debt securities quoted on the Irish Stock Exchange with a value of €1.30 billion, and £800 million. All three are domiciled in Delaware.

Of particular interest are German banks with subsidiaries in the IFSC, that required State aid (Sachsen Bank, IKB, West LB and Hypo Real Estate). Sachsen bank had securities quoted on the Irish Stock Exchange with a value of \$92 billion. Sachsen bank was taken over by LBBW in 2007. LBBW had two funds quoted on the Irish Stock Exchange. The offices of LBBW were searched by German state prosecutors in Stuttgart in December 2009, because of suspected breaches of trust involving investing in subprime loans since 2006 and which were reported as likely to result in large losses (Sackmann, 2009). At the start of the subprime crisis IKB had exposures of €16 billion to the sub-prime market (Bacchus 2008-2 plc, prospectus) and total exposure to risky investments of €24 billion (BBC News 21/8/08). An investment vehicle owned and run by IKB, Rhinebridge with securities quoted on the Irish Stock Exchange of at least €370 million was forced into liquidation in 2007 and in 2008 IKB was taken over by Lonestar. West LB had one investment fund and quoted securities with a value of €1.587 billion. Depfa Bank had numerous quoted debt securities with the nominal value of debt instruments of €12.6 billion and \$5.2 billion as well as other currencies.

The operation of German owned banks at the IFSC in Dublin, provides a useful example of issues arising from ineffective cross border supervision. The de Larosiere Report notes (p. 40) that failures in home country supervision if inadequate, as in the case of the Icelandic banks, can create significant difficulties for other countries. Fonteyne et al (2010, p. 9) identify three cases on which a European crisis management framework should focus:- (i) systemic importance in an EU country outside the home country; (ii) systemic importance because of size to the EU; (iii) systemic importance in an EU home country with substantial cross border activities. None of these categories cover the case of the four German owned banks operating at the IFSC (Depfa, IKB, Sachsen Bank and WestDeutsche LB). These banks posed large risks to the source country Germany, and in one case (Depfa Bank) systemic risks to the source country but most of their operations in terms of liabilities, assets and profits were outside Germany in another EU country. Hence a fourth category needs to be added to the above categories (iv) systemic importance to an EU country but with operations largely in another EU country.

There were failings in source country regulation (Germany), in the case of these four German owned banks but these failings were compounded by failures in host country regulation (Ireland), and failure of coordination between both regulators. The case of Depfa Bank is an illustration of problems with source country regulation.

Depfa bank was established in 1922 in Germany. In 2002, following a reorganisation<sup>28</sup>, Depfa bank switched from being a German registered company to an Irish registered company, with headquarters in the IFSC.<sup>29</sup> While Depfa was an Irish incorporated entity, with its seat of government in Ireland, most operations were outside Ireland, the largest part of which were in Germany and Depfa shares were listed and traded in Frankfurt. Depfa was taken over by Hypo Real Estate (HRE) in 2007. Hence from the period 2002 to 2007 the main regulator of Depfa was the Irish regulator during a period when financial strategy and policies were developed which eventually led to a crisis for Hypo Real Estate<sup>30</sup>. It is doubtful that if Depfa had remained an independent entity that the Irish Regulator/Central Bank would have been in a position to provide liquidity, even if the sums were a fraction of those eventually required.

In addition Hypo bank had a subsidiary (Hypo Real Estate Bank International) whose headquarters were located at the IFSC since 2003 (IDA, Dublin Report, Autumn 2003). One of the key problems with the regulation of German banks in the IFSC was the difficulties with cross border supervision as described in the de Lasorriere Report, (pp. 73-74). Three of the four banks had incorporated entities in Ireland and hence were subject to Irish corporate law. All of the banks were audited by one of the big four (Sachsen Bank, and Depfa Bank were audited by PWC, IKB and WestLB by KPMG). Firms undertaking public audits in Ireland are in turn regulated by the Irish Accounting and Auditing Supervisor (IASSA).

As part of their operations in Ireland a number of German Landesbanks issued securities based on subprime lending which were quoted on the Dublin Stock Exchange, for example West LB (Financial Times 12/2/08).

Table (5) shows State aid to four IFSC based German Banks as a result of losses on subprime and other securities.

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<sup>28</sup> Depfa Bank Annual Report, 2002, p. 12

<sup>29</sup> This reorganisation and relocation of the headquarters to Dublin was described by the Financial Times as being for tax reasons (Financial Times, October, 5, 2003). The location of hedge funds is also influenced by host country taxation, but also by the extent of regulation. See also Bender (2010) who quotes a partner in a law firm (A. and L. Goodbody) as stating the current thinking is for managers to keep their hardcore hedge strategy in a Caribbean-based fund, and then establish a Dublin "lite" version for European consumption".

<sup>30</sup> Hypo Bank reported a loss for the quarter ending 30 September 2008 of €3.1 billion, of which €2.5 billion related to Depfa Bank Source Irish Times 13 November 2008. In August Hypo stated that it expects to make losses until 2012 (Financial Times, 7, August, 2009). In October 2009 the final 10% of shares not owned by the State were purchased by Germany's financial markets stabilisation fund SoFFin (Financial Times September 29, 2009). Hypo recently announced the establishment of a 'bad bank' to which €10 billion of asset would be transferred (Financial Times 22/1/2010). Most of these assets relate to its Irish subsidiary Depfa Bank.

Table (5)

State Aid to German Banks with Quoted Securities in Dublin  
€billion

Name of Bank	Amount of State Aid
IKB <sup>1</sup>	12.0
Sachsen Bank <sup>2</sup>	2.8
West LB <sup>3</sup>	€6.4 in guarantees and 3 billion equity injection under consideration.
Hypo Real Estate (Depfa Bank) <sup>4</sup>	€145 billion of State aid, €10 billion of equity, asset relief measures with a value of €20 billion and liquidity guarantees of €145 billion <sup>5</sup> .

(1) <http://www.german-info.com/press> July 7 2009

(2) Europa Press release:- State aid: Commission approves restructuring of Sachsen LB, 4 June 2008.

(3) Reuters 16/11/09 and Worldnews.com 7/11/09

(4) Problems at Depfa bank was the main reason for difficulties faced by Hypo Bank and its eventual rescue.

(5) Source:- EU Press release 18<sup>th</sup> July, 2011.

### Depfa Bank and Leverage

Depfa bank had the largest losses of any German bank as a result of the financial crisis and required the largest State aid from the German government. One of the features of Depfa bank was the high ratio of equity to assets. In 2006 equity amounted to €2.77 billion and assets €223 billion (Table 6). The regulator allowed such a high level of leverage because risk weighted assets according to Depfa amounted to just €33 billion. The problem was that the assets Depfa Bank held were in fact highly risky. Depfa bank was the worlds largest guarantor to act as buyer of last resort to variable rate bonds (Duhigg and Dougherty, 2008). These bonds had in the initial stages low rates of interest which in later years increased. Thus their risk was a function of the time date of the bond. Duhigg and Dougherty state:- “By 2006 Depfa was the largest buyer of last resort in the world, standing behind \$2.9 billion of bonds issued that year alone”. In effect Depfa bank was acting as an insurance company without hedging any of the risks involved. The other main form of risk was in the form of financing. In 2006 (prior to the crash) €222.9 billion in assets were financed by short term deposits from banks (€63 billion, other deposits (€31 billion) and debt securities in issue (€103 billion).

Table (6)  
Assets and Liabilities of Depfa Bank 2005-2011

	€billion						
	2011	2010	2009	2008	2007	2006	2005
Gross Assets	129.9	144.0	212.6	249.0	217.9	222.9	228.6
Risk weighted assets	5.746	7.235	52.053	56.477	44.9	33.3	24.08
Equity <sup>1</sup>	1.603	2.433	0.412	-0.276	2.95	2.77	2.30
Financed by							
Debt Securities in Issue	39.5	44.3	47.6	59.3	62.8	102.8	101.6
Deposits and Liabilities from other Banks	38.06	39.8	134.4	149.6	89.8	63.2	67.0
Deposits and Liabilities to customers	21.4	25.9	0.9	2.1	30.2	31.1	28.8

(1) Excluding preferred securities

Source: Annual Report and Accounts of Depfa Bank for various years.

With such high leverage the gap between interest income and interest expense was narrow. For 2007 Depfa reported interest and other income of €6.8 billion and interest and other charges of 6.5 billion. As interest rates rose following the collapse of Lehman Brothers, the cost of funding also rose. The margin between interest revenue and costs of funding became negative. Depfa Bank became regarded as being highly risk and sources of funding were withdrawn, precipitating a liquidity crisis for Depfa (and its parent Hypo Vereinsbank) and the eventual rescue. Restructuring at Depfa has involved reducing gross assets by 40% but more especially risk weighted assets.

#### Sachsen LB

Sachsen Bank was one of the most widely reported examples of a German bank which made losses on subprime funds. Sachsen LB Europe received a full banking Licence from the Central Bank of Ireland in February 2000. The main losses occurred through a conduit called Ormond Quay, incorporated in Ireland (although not as a 'section 110 company') and based in the IFSC, Dublin<sup>31</sup>. In addition Sachsen Bank also had €200 million invested in Synapse Investment Management which became insolvent. This fund had securities quoted on the Irish Stock Exchange, but was incorporated and managed in the UK. Sachsen Bank operating in Ireland (Sachsen Bank Europe PLC) had 56 employees in 2007, (15% of the group total. Table (7) shows that from 2003 Sachsen Bank in Ireland accounted for most of the group profits. For the year 2005 the Group as a whole reported €18 million in gross profits but for the same period the IFSC based firm reported a profit of €50 m. This means that the group outside Ireland reported a loss of €32 million. Thus the Irish subsidiary accounted for all of the group profits even though employing a minority of group employees.

Table (7)  
Sachsen LB Europe Plc, Gross assets, Profits and Employees  
€million

Year	Gross Assets Sachsen LB <sup>1</sup>	Sachsen LB Value of securities on Balance Sheet	Ratio of equity in balance sheet to total assets	Gross Assets of Sachsen Group	Pre tax Profits of Sachsen Bank LB <sup>1</sup>	Profits of Sachsen Group	Dividends of Sachsen LB	Employees of Sachsen LB <sup>1</sup>
2001	1563.085	1411.032	8.1		11.75		0.0	37
2002	2317.932	2317.932	6.1		17.01		0.0	26
2003	3816.993 (6.5%)	3816.993	3.82	58549.0	33.02 (58.9)	56.208	25.0	33 (5%)
2004	4899.46 (8%)	3182,235	3.0	60559.0	41.15 (64.3%)	63.941	35.0	38 (5.9%)
2005	4890.453 (7%)	3058.571	2.9	68420.0	50.58 (280%)	18.098	57.5	46 (7.7%)
2006	4496.6	2325.0	4.58	62260.0	54.89 (66.1%)	82.953	22.2	50 (14.4%)
2007	4713.3	2228.5	1.99	62094.6	-144.514 (22%)	-641.6	47.0	56 (15%)

(1) The number in parentheses shows the Irish subsidiary as a proportion of the group total

Source:- Annual Reports of Landesbank Sachsen Girozentrale available at <http://www.sachsenlb.de>. And Annual Reports of Sachsen LB Europe.

<sup>31</sup> This SPV had liabilities in 2007 of €15,160 million, and shareholder funds of €42,250.

The 2005 accounts of Sachsen LB Europe footnote (3) state:- “the quality of the portfolio is of the highest level and continues to reflect the reverse nature of the bank” and “the majority of credit portfolio exposure is to Euroland”. As regards interest rate exposure footnote (3) b(i) and footnote (27) a sensitivity analysis was used assuming an increasing in interest rates of 0.08%. This was a fraction of the actual rise in interest in succeeding years<sup>32</sup>. Sachsen Bank was merged with another Landesbank (LBBW) in 2008).

#### **IKB**

IKB bank made large losses and faced considerable difficulty in raising finance largely as a result of two off balance sheet conduits (Rhinebridge and Rhineland, Financial Times, March 28, 2008). Rhinebridge was quoted in Dublin. The investment strategy was to borrow short term commercial paper to purchase higher yielding higher assets. Although quoted on the stock market the largest shareholder is the state owned KfW development bank. This bank has now been sold to US based private equity Group Lone Star.

#### **West LB**

WestLB had several subsidiaries operating in the IFSC in Dublin. In April 2008 the Bank reported losses of €1.6 billion after writedowns on subprime loans of over €2 billion. One of these funds (Kestrel) was responsible for losses of \$402 million in 2007, and \$845 million in 2008.

There are several reasons for the collapse of German banks in the financial crisis. One reason is regulatory failure. Another contributing reason was fraud. Goldman Sachs paid \$550 million to settle SEC charges in relation to the sale of a CDO fund based on US residential mortgages (Abacus 2007-AC1) to various investors. IKB received \$150 million as compensation (Chan and Story, 2010). This issue has also arisen in relation to other large banks such as Merrill Lynch, Citi, UBS and Deutsche Bank (Jenkins, 2010) and may involve other German banks as ‘victims’ such as WestLB and Sachsen Bank (Wilson and Jenkins, 2010).

## **6. Conclusion: Financial Regulation and Low Tax Centres**

There has been considerable reform of EU banking and financial regulation, for example the establishment of the European Banking Authority and the European Securities and Markets Authority, and further reform is proposed such as a ‘single supervisory mechanism’ but existing policies continue to place considerable responsibility on host countries. Existing EU directives, require the source country to be the main regulator but the country where an entity is legally registered also has some responsibility for regulation<sup>33</sup>. For example all incorporated entities are subject to Irish corporate Law and the Office of the Director of

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<sup>32</sup> Eurobar one week interest rates rose from 2.112% in January 2005 to a peak of 4.846% at the end of September 2008. Source:- <http://www.euribor-rates.eu/euribor-2009.asp>

<sup>33</sup> See EU Directive, 14, June 2006, Directive 2006/48/EC which states (Art 21) “The hosts member state should be responsible for the supervision of the liquidity of the branches and monetary policies”. Art 22 14 states host country authorities should in an emergency be able “to verify that the activities of a credit institution comply with the relevant laws, etc”. Article 10 states that “A credit institution which is a legal person should be authorised in the Member State in which it has its registered office”

Corporate Law Enforcement. Where there are Irish registered subsidiaries incorporated under Irish company law, the accounts must be audited. The auditors of 'failed' banks such as Depfa Bank and Sachsen Bank in Ireland (PriceWaterhouseCoopers) are subject to regulation by the Irish Accounting and Auditing Supervisory Authority (IASSA).

In addition incorporated entities located at the IFSC require a licence from the Department of Finance, and involves a certification procedure. Similarly securities listed on the Irish Stock Exchange require a prospectus which again were subject to scrutiny by the Irish Stock Exchange and since December 2011 the Central Bank. The Irish Stock Exchange is in turn regulated by the Financial Regulator. However in many cases local regulation of subsidiaries of international entities has been minimal.

The subprime crisis illustrates a problem of regulating complex financial products, operating across a number of different jurisdictions one or more of which may be a tax haven. The GoldmanSachs and IKB case illustrates the issue of information asymmetries between purchasers of complex instrument and those who create and market them. It also illustrates conflicts of interest that allows one party to the contract to exploit information asymmetries.

The enforced liquidation of the Carlyle Capital Corporation which in February 2008 was reported as managing \$21.7 billion in funds is a good example of the difficulties in regulation following from different country locations of discrete parts of the group. Werdigier (2008) comments that "Carlyle Capital's problems also provide a glimpse into the challenges faced by the usually secretive hedge fund industry because, unlike most such funds, Carlyle Capital is publicly listed." However while Carlyle Capital was publicly listed in Amsterdam it was registered in Guernsey to benefit from a low tax regime (Guardian Newspaper 14/8/08). Seven of its funds were listed on the Dublin Stock Exchange, three of these funds were registered in the Cayman Islands, and a further three were registered in the Cayman Islands and Delaware.

These and other examples cited in this paper confirm the need for further regulatory reform, and especially the need to take into consideration the use by financial firms of special purpose vehicles which may be off balance sheet and located in low tax regimes/tax havens. The proposal for a eurozone wide banking regulator is a vital reform. At the same time increased regulation imposes costs on firms which industry lobby groups describe as 'disproportionate or inappropriate regulation'.

The Irish Financial Services Centre, regarded by Government and policy makers as a key part of the Irish economy, is forecast to play an even greater role in future years. This paper however shows the relatively low economic benefit of one aspect of IFSC operations organised through Financial Vehicle Corporations. Even though assets are large, employees are zero and domestic expenditures are also low. Furthermore future jobs growth is unlikely. However Financial Vehicle Corporations and special purpose vehicles have played a key part in the development of the unregulated 'shadow banking system'. Increased regulation (in Ireland and elsewhere) due to their contribution to the economic crisis and potential to contribute to future crises, may cause such firms to either reduce or relocate their activities so that they become an integral part of a group structure. This is a development that both Ireland and other countries should welcome.

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