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## Elsewhere, Ideally Nowhere: Shadow Banking and Offshore Finance

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CITYPERC Working Paper Series

Elsewhere, Ideally Nowhere:  
Shadow Banking and Offshore Finance

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# Elsewhere, Ideally Nowhere: Shadow Banking and Offshore Finance<sup>†</sup>\*

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**Abstract** If we were to identify one common thread across the evolutionary stage of the financial system, it is the quest for being located for tax and regulatory purposes elsewhere or, ideally nowhere. Recognising the limits of mainstream economic models in providing a comprehensive explanation of this phenomenon, in this paper we draw on the ideas of Thorstein Veblen and his theory of business civilisation. A Veblenian analysis suggests that dynamics and behaviour in finance that are commonly associated with human failure (greed, exuberance, fraud, incompetence), and which became widespread practice, should best be understood as sabotage in Veblenian terms. Finance is awash with techniques designed to sabotage both clients and the governments who enacted regulations that were supposed to protect the clients. These techniques are legal mechanisms, albeit, as Veblen writes, not in the spirit of the law.

**Keywords** Shadow Banking • Offshore Finance • Sabotage • Veblen • Evolutionary Political Economy

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## 1 Introduction

Major developments in the financial system, including financial crises and major regulatory shifts, are often interpreted as outcomes of tensions between finance and the ‘real’ economy. ‘Finance’ is often believed to dominate the real economy and production, with long-reaching destructive consequences. Such a disjuncture is said to account for major episodes of financial instability, structural crises and economic recessions. The interests of the financial system are also commonly believed to be able to co-opt the agenda of nation-states, with powerful financial lobbies shaping the agenda of governance, nationally and internationally. While suggestive, such explanations tell only part of the story of the configuration of financial power and the developments of the financial system. Part of the limitations of juxtapositions of finance and the real economy and politics, is the underlying assumption that the sphere of finance operates according to very particular logic

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and set of incentives prioritising short-termism and easy gains. Taking issue with such conceptual disjuncture accounts of finance broadly and of the recent financial crisis in particular, in what follows we employ the insights of early institutional tradition in economic thought, to inquire into the apparent autonomy of finance vis-à-vis the rest of the political economic system. In particular we draw of world of Thorsten Veblen, a prominent evolutionary thinker whose work has not received, in the words of Geoff Hodgson, its due attention. Veblen's key insight into the study of modern capitalism focused on the dichotomy between 'the alleged imperatives of workmanlike industry' and of predatory 'business' (Hodgson 2004: 202). In particular, Veblen explained that 'any intrusion of business strategy into the conduct of industry will be sabotage' (Veblen 1923: 278, cited in Hodgson 2004: 203). An evolutionary thinker, Veblen inquired into causal explanation of the developments in industry and business; he understood that once a particular practice becomes successful, others will follow suit. Focusing on two major developments in the financial system that have been brought up by the global crisis of 2007–09, we advance Veblen's notion of business sabotage to the sphere of finance to explain why the rather obscure and opaque systems of tax havens and shadow banking have come to play a central role in contemporary capitalism.

The financial system has gone through a number of phases and transformative moments since World War 2, but if we were to identify one common thread across its stages of evolution, it is the quest for being located for tax and regulatory purposes elsewhere or, ideally nowhere (Palan, 2010) (Urry, Forthcoming). What does this mean? The main structural development in the financial system has been the emergence and persistent growth of new legal or quasi-legal spaces and financial innovations which were either aimed at and/or resulted in the avoidance or minimization of state regulations. The trend began most markedly with the emergence of the Euromarkets in the late 1950s in London, and strengthened with the development of shadow banking industry in the later part of that century.

Since the late 1950s, the financial system has developed an alternative conduit space that transcends national regulations known as the Euromarkets, or the offshore financial market. The Euromarkets host transactions denominated in currencies other than that of jurisdiction in which the market is located. Originally, it traded dollars seeking to escape attempts by the United States to assert control over the use of its currency. In our terms, the Euromarkets was a precursor to the now omnipotent phenomena of offshore finance. Offshore finance refers to very specific wholesale financial markets, known otherwise as the Euromarkets that emerged originally in the late 1950s in London that were largely unregulated (Palan, 2003). In one way or another, about half of the global stock of money passes through offshore jurisdictions. At the same time, approximately one third of all global FDI passes through these jurisdictions (Palan, Murphy and Chavagneux, 2010). Recent estimates place the amount of accumulated wealth registered in offshore havens in excess of \$US 21 trillion, or at nearly 18% of the aggregate global wealth (Henri 2012).

More recently, the global financial crisis of 2007–09 revealed the scale of another set of alternative conduit spaces and entities, collectively known as 'shadow banking' (SB). SB consists of a complex network of financial intermediation that takes place off the balance sheets of the regulated banks, and thus remains largely invisible to regulatory bodies. In the USA on the eve of the crisis, the scale of the shadow banking industry was estimated to be one and a half times larger than the official, 'visible' banking sector. In Europe, recent estimates suggest that SB practices have actually grown in scope after the crisis of 2007–09, while other studies suggest that SB has historically played an important role in the financing of the economy in emerging markets (Ghosh et al. 2012; Bakk-Simon et al. 2012). The two intertwined phenomena of offshore financial centres (OFCs) and SB are now drawing the attention of global and national regulators (BIS 2009). We suggest this attention should be guided by the insight that both are

defined by the search for being not quite anywhere.

What drives the quest of financial actors for relocation to such spaces? Standard economics approaches this question from a rather conventional angle. Economic agents seek spaces that facilitate the efficiency of the market's capacity to allocate resources, and ensure a minimum of state interference with this process. State interference, in turn, tends to distort markets and hinders efficiency. Actors would naturally shift operations to spaces which fulfilled these requirements. The Veblenian approach, known otherwise as the Old Institutional Economics (OIE), tackles the question from a different angle. In what follows, we focus on one key element in Veblen's thought that can serve, we argue, as the basis for an alternative 'macro theory' of finance, but which has not garnered sufficient attention to date. This may be largely because it is rather simple and obvious. Veblen argued that the modern economy, that is, the economy that he witnessed taking shape in the late 19th century U.S., and that has been internationalized since, was dominated by the personality of the businessman, the principal 'habit of thought' of whom in terms of their outlook on profit-making enterprise was, according to Veblen, the technique of sabotage. For Veblen it the figure of the businessman, as opposed to the capitalist in Marxist framework, that provided a better understanding of trends and developments in the modern economy.

The Veblenian approach assumes that finance is a component of business culture that does not seek improvement in efficiency and delivery per se. Instead, the logic of finance is the logic of sabotage. In this perspective, financial actors operate at the very edge of the law, in the twilight zone, in an area that may be still legal, yet not in the spirit of the law. In this article, we employ the Veblenian framework to examine some of the causes behind the emergence of twilight zones in the global financial system and indeed, explain why the institution of finance itself has become a twilight zone.

## 2 The Challenge of 'Elsewhere': Shadow Banking and Offshore Finance

The phenomena of shadow banking and offshore finance have quite distinct trajectories in contemporary financial discourse and academic debates. The problem of tax havens had been known for a long while; it has generated a range of work in International Political Economy and related disciplines (see for example Palan 2004; Burn 1999, Palan et al. 2010; Sharman 2006; 2011) and inspired a network of civil society organisations aiming to redress the socio-economic injustices that spur from the existence of tax havens, such as Tax Justice Network, UK Uncut, Finance Watch, Public Finance International etc. (see Seabrooke and Wigan 2013).

The term 'shadow banking' in contrast, is relatively new. The concept of shadow banking is commonly credited to Paul McCulley, then of PIMCO, who in a 2007 speech to the Federal Reserve Conference in Jackson Hole observed that the (then unfolding) financial crisis could be attributed to the growth of "unregulated shadow banks that (unlike regulated banks), fund themselves with uninsured short-term funding, which may or may not be backstopped by liquidity lines from real banks. Because they fly below the radar of traditional bank regulation, these levered-up intermediaries operate in the shadows without backstopping from the Fed's discount lending window or access to FDIC (Federal Deposit Insurance Corporation) deposit insurance" (McCulley 2009: 257). Indeed, the crisis of 2007–09 was in many accounts a crisis of shadow credit facilities, shadow financial entities and shadow liquidity.

At the same time however, the two phenomena are not only closely connected with each other functionally, but combined, represent a significant part of the global financial space. Finance has evolved in a way that until very recently had not been unaccounted for in any systematic way.

We suggest that underlying the evolution of offshore financial havens and the shadow banking universe has been the factor of ‘elsewhere’: the principle of not being recognised, registered, accounted for, taxed, regulated, detected or understood well, has been the engine being the growth of the offshore political economy (Palan et al. 2010), and has provided the fuel for much of financial innovation that culminated in the emergence of the shadow banking industry.

While the concept of ‘elsewhere’ and even ‘nowhere’ is well-established in the study of the emergence of offshore finance (Murphy 2009), it has not been widely used in the analyses of shadow banking. At the same time, emergent literature on shadow banking has gone a long way in explaining in some detail the core functions that shadow banking entities perform in the credit intermediation process. Underpinning these functions, we argue, is the ability of financial agents to carve out financial and legal spaces that remain unaccounted for by existing regulations, control systems and academic paradigms. Understanding shadow banking and offshore finance, therefore, implies recognising that credit and consequently, ‘money’ today can be created out of the sheer idea of ‘elsewhere,’ or better, ‘nowhere.’ Being and operating ‘elsewhere’ in relation to one’s official balance sheet or using facilities that are registered ‘elsewhere’ for taxation and regulatory purposes and are as a result, accountable to no one, has become an important tool of innovation for financial agents today. In other words, as we argue here, being located ‘elsewhere’ in the global economy, the systems of shadow banking system and offshore finance have come to play a crucial role in the contemporary financial system. This realisation presents both academic and regulatory challenges to finance scholars and policy-makers. In what follows, we address the conceptual dimensions of this problem.

### 3 Finance as Business. Lessons from Veblen

How can the notion and functions of ‘elsewhere’ in the world economy be understood? Mainstream economics offers two contrasting angles on this question. On the one hand, often being linked with illicit financial dealings and activities, the systems of shadow banking and tax havens can be regarded as aberrations and disruptions of normal economic and business activity. Some commentators view the phenomenon of shadow banking as paranormal development in the global economy, often linking it to tax evasion emanating from the underground or unaccounted economy (Buehn and Schneider 2011) and read derogatory connotations into the practices of shadow banking (Knutzen 2012). Elsewhere and nowhere in other words, simply do not exist in many orthodox models of economic and behaviour, they are assumed away.

On the other hand, economic theory has no particular difficulties explaining individual economic unit’s rationale for operating in these alternative spaces. As profit maximizing units, it is entirely predictable, indeed, incumbent, upon those units to employ legal devices that serve their ultimate goal, which profit is. In competitive market conditions, business would innovate new products and even markets in order to gain a competitive position. Offshore finance and shadow banking are expressions, therefore, of financial markets doing what they do best –allocating resources in the most efficient way available. In particular, most commentators note the very central role that key functions that shadow banking –risk, maturity and liquidity transformation –performs in today’s financial system. Whereas the existence of offshore financial centres has typically been interpreted as a healthy element in tax optimisation by competitive economic agents.

In contrast to the deductive approach and principles of abstraction of orthodox economics, an alternative approach that is associated with a group of economists led by Thorstein Veblen, John R. Commons and Joseph Schumpeter (known as Old Institutional Economics, OIE), has tended to approach questions in economics in an observational and empirical manner.

Thorstein Veblen, who may be considered the leading light in this approach, drew his primary data from Congressional Committees reports of late 19th and early 20th century that focused on the predatory practices of American businesses. Veblen concluded on the basis of these reports that the central figure in modern capitalism was neither the rational consumer of standard economics, nor the capitalist as owner of the means of production of Marxist theory, but rather, the figure of the businessman. Businessmen were individuals, he argued, with no specialized expertise in production, manufacturing, services or management. They were experts in ‘the art of buying and selling’. Veblen’s theory amounted in essence, to generalizations of the likely behavioural patterns of the businessmen, as purveyors and traders in property rights under diverse environmental conditions. Following Veblen, in our analysis of finance we propose to start from a simple and straightforward premise. Namely, that banks, as well as the various departments and desks that banks are made of, tend to think and behave like businesses, and they see their interest and function exclusively in pecuniary terms.

What does the concept of bank as a business enterprise entail? First and foremost, businesses are concerned with pecuniary gains. This idea appears self-evident, but its implications run deep. Veblen believed that far from embracing competitive markets, businesses were concerned by the state of equilibrium conditions described in standard economics, since open and ‘fair’ competition inevitably would result in wafer-thin profits, if any. Businessmen in fact complained about ‘ruinous competition,’ and devised an impressive array of techniques, documented in the various Congressional Reports of late 19th century, that were intended to ensure that the free market of standard economics did not apply to their businesses. Best known of these devices were monopolies and cartels, but according to Veblen, these were only the tip of a very large iceberg.

Veblen used a generic term to describe the businessman’s techniques for profit generation as ‘sabotage’. Sabotage was, in his words, ‘the deliberate, although entirely legal, practice of peaceful restriction, delay, withdrawal, or obstruction used to secure some special advantage or preference’ (Veblen 2001 [1921]: 4). Sabotage, he argued, “commonly works within the law, although it may often be within the letter rather than the spirit of the law. It is used to secure some special advantage or preference, usually of a business-like sort. It commonly has to do with something in the nature of a vested right, which one or another of the parties in the case aims to secure or defend, or to defeat or diminish” (Veblen 2001 [1921]: 6). Businessmen, Veblen argued, would deliberately seek to disorient their competitors by restructuring and re-organizing the world around them in ways that would sabotage their clients, competitors and/or the governments.

Mainstream economics does accommodate the pecuniary principle and techniques of sabotage: economists habitually argue that capitalists are in the business of maximizing profits. But they tend to argue that it is the governments that, due to their very nature, sabotage business, or function as rent-seeking enterprises that damage the market. In arguing that however, economists tend to neglect two related factors. First, that there are many good reasons for business to and try and sabotage their own governments as well (let alone other governments, often with the aid of their own). Not least among these reasons is the fact that the government is both an absolute and necessary requirement for the economy to operate. But government is expensive. Hence, businessmen use sabotaging techniques as a redistribution tool – in order to ensure that while benefits of government accrue to business, costs fall elsewhere. To use conventional language therefore, we need to recognize that it is not only governments that are rent-seeking, but businesses themselves are rent-seeking enterprises. Veblen’s theory predicts that whenever rent-seeking opportunities arise, business will tend to grab those. The most likely source of rent-seeking opportunities, in turn, is the state and the law.

Second, modelled on abstraction, economic theory neglects to ask whether businesses seek to

maximize pre-tax or post-tax profits. Considering that corporate taxation in many OECD countries may reach 30 or even 40 per cent of declared pre-tax profits, this is not a trivial question. Maximization of pre-tax profits tells us next to nothing about what businesses, and in particular, their owners and share-holders, truly care about, which is post-tax profits. Theoretically, the difference may appear marginal. It is not. The quest for post-tax profits has led to the development of a service economy with lucrative lines in tax and regulatory avoidance. This service sector, run by highly skilled professionals such as lawyers and accountants, is now so large and sophisticated that it functions as an economy in and by itself. Politically, it has also emerged as a powerful international lobby group. It is a service economy that is founded on the desire of economic agents to avoid or evade taxation or regulations. The main source of income to this service economy is the business of avoidance and evasion. At the same time, the development of offshore financial markets since the late 1950s demonstrates that the business of avoidance has reached industrial proportions, and has become one of the key technique for sabotaging the state as well, a process that Veblen did not address in his original writings. This industry of regulatory avoidance, facilitated and dependent on locations and services ‘elsewhere’ and otherwise known as financial innovation, is now considered one of the main functions of international finance. Regulatory bodies are only beginning to take account on these trends.

To over-simplify somewhat, the rise of the offshore world and shadow banking industry can be seen as a history of the discovery, often by accident, of opportunities for sabotage, including sabotaging the state.

## 4 Shadow Banking and Offshore Finance

The complex and still little understood system of shadow banks, financial-legal entities and their connections are one of the most challenging outcomes of the post-war financial evolution and more specifically, of the endogenous process of financial evolution. Narrow definitions of this phenomenon describe shadow banking as market-based (as opposed to bank-based) ways of funding financial transactions, or in other words, ‘money market funding of capital market lending’ (Mehrling et al. 2012). More inclusive definitions suggest that shadow banking is simply, ‘credit extension outside of the banking system’ (FSB 2012). The figures for the shadow banking industry are staggering. According to the data from the Federal Reserve, in 2007, on the eve of the global financial meltdown, the size of shadow banking in the USA was \$18 trillion, or \$6 trillion above the volume of the regulated banking system. In the aftermath of the crisis, the size of shadow banking system has decreased to an estimated \$15.8 trillion (Pozsar et al. 2010). Recent data from the Financial Stability Board (FSB) puts the size of the global shadow banking system at around \$67 trillion at the end of 2011, or roughly a third of the world financial system.

Modern tax havens have existed since the early twentieth century. They were used, and are still being used, primarily but not exclusively, for tax evasion and avoidance purposes. Tax havens are also used however, for other purposes. Since the early 1960s, all the premier tax havens of the world have developed financial centres known otherwise as Offshore Financial Centres. It is estimated that about half of all international lending and deposits originated in OFCs, of which approximately half again are located in OFCs that double as tax havens. The Bank of International Settlements (BIS) statistics of international assets and liabilities ranks the Cayman Islands as fourth largest international financial centre in the world, while other well-known tax havens/OFCs, such as Switzerland (7th) the Netherlands (8th), Ireland (9th), Singapore 10th, Luxembourg (11th), Bahamas (15th) and Jersey 19th are lower in the ranking. In addition these centres are recipients of approximately 30% of world’s share of FDI, and in turn, are the originators of similar amounts of FDIs (Palan, Murphy, Chavagneux, 2010).



There is some confusion between the concept of tax havens and OFCs, and is not only a matter of semantics. The contrasting views of the role of tax havens as OFCs derive to a degree from the different understandings of nature of the offshore financial markets, the Euromarkets. Some economists believe that the Euromarkets is simply a wholesale financial market for U.S. dollar that emerged in Europe in the 1950s (Schenk 1998). A very different theory claims that the Euromarkets is a very specific type of market that emerged in late 1957 in London (Burn, 2005). According to this theory, the Bank of England came to an informal agreement with the City's merchant banks to treat certain types of financial transactions between non-resident parties and denominated in foreign currency as if they did not take place in London, even though they were in London. Paradoxically, the bank created, in effect, a new regulatory space outside its jurisdiction, and a new concept – offshore finance. But as the transactions that took place in London were deemed by the Bank of England to be taking place elsewhere, they ended up under no regulation at all, or offshore. These transactions, according to this theory, take place in a new unregulated space called the Euromarkets, or the offshore financial market (Burn 2005).

As far as we can tell, the original rationale for the development of the Euromarkets 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 that prevented British banks temporarily from lending in the non-Sterling area, apparently with the compliance of the Bank of England. As long as the Euromarkets served that very specific purpose, it remained small and practically unknown for three or four years. Soon, however, U.S. banks discovered the market as well, and they discovered, moreover, that the market can be used to sabotage their own government's regulations. This was the reason for its spectacular development.

Having learned of the new facility offered by London, some of the leading US banks rapidly developed a branch network in London beginning in the early 1960s. They were not motivated by tax – taxation in the UK was particularly high at that time. They were interested in Euromarkets facilities in order to circumvent stringent U.S. banking and financial regulations. In Veblenian language, they set up branches in London, to sabotage their own government's regulatory efforts.

In parallel, in the 1950s, US multinationals began to expand their international operations. Once they discovered the facility of the Euromarkets, corporate clients began to bypass the banks and tap directly into the Euromarkets to earn higher rates of interest while also looking to the same Euromarkets to fund their operations (Burn 2005; Sylla 2002). To stem the flow, in 1963 the Kennedy administration proposed an Interest Equalization Tax to ensure that U.S. citizens did not get preferential interest in the European markets. The results, predictably, were the opposite of what was intended. Instead of stemming the flow of capital out of the U.S., American corporations kept capital abroad to avoid paying the interest equalization tax, fuelling in the process the growth of the Euromarkets. U.S. banks soon learned that the unregulated environment in London allowed them (or their London branches) to circumvent all the New Deal regulations. They were able, therefore, to establish large diverse banks in London, capable of competing in every aspect of finance. German and Japanese banks then followed suit.

We also know from various reports that some of the smaller U.S. and Canadian banks faced with the high infrastructural costs of a London base, realized that the Caribbean OFCs offered a cheaper and equally attractive regulatory environment – free of exchange controls, reserve requirements and interest rate ceilings, and in the same time zone as New York. According to various reports (Sylla 2002), the early spill over of OFCs activities into the Bahamas and Cayman was, like the London Euromarkets, 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. The offshore financial system emerged

and flourished largely, therefore, as mechanism of regulatory avoidance on a massive scale. The notion of being ‘elsewhere’ for regulatory and tax purposes has been a necessary condition for this development, often leading to financial transactions being in fact regulated nowhere.

These observations bring us to the more well-rehearsed arguments about lack of transparency in modern finance (Best 2004). Secrecy, lack of transparency, complexity and opaqueness has become essential ingredients of today’s financial innovation, yet for different reasons than traditionally assumed. While offshore finance has often being linked to illicit financial flows and money laundering (Sharman 2011), and while the notion of shadow banking often relates this phenomena to the underground or grey areas of economic activity, the real significance of shadow banking and offshore finance is that they function as important ‘black holes’ in the global economy. As Murphy explains, a misconception about financial complexity and secrecy today is the assumption that the secrecy world is geographically located. It is not. As he writes, “it is instead a space that has no specific location. This space is created by tax haven legislation which assumes that the entities registered in such places are ‘elsewhere’ for operational purposes, i.e. they do not trade within the domain of the tax haven, and no information is sought about where trade actually occurs.” As he continues, “to locate these transactions in a place is not only impossible in many cases, it is also futile: they are not intended to be and cannot be located in that way. They float over and around the locations which are used to facilitate their existence as if in an unregulated ether” (Murphy 2009: 2).

Recent financial history suggests therefore, that while ‘elsewhere’ has been paramount to the emergence of the global financial system and its key nodes, the shadow banking system firmly linked together the idea of ‘elsewhere’ and ‘nowhere’ not simply for the conduct of financial transactions, but for the very process of credit creation as well. The two black holes of offshore finance and shadow banking have become functionally central to the daily operation of the global financial system.

## 5 ‘Elsewhere’ and Sabotaging the State

The brief history of offshore finance sketched out earlier in this article illustrates the importance of spatial, geographical and political differentiation in modern finance. Trading essentially in incorporeal property titles, debt and risk instruments and the like, the financial system can operate in one location, say London, but then register the transaction in another location. This practice skews official locational statistics of financial activities. In the mid to late 1990s, a wave of securitization became the major catalyst to the growth of the shadow banking system. Under the existing rules, if banks wanted to engage in a new segment of activities such as for instance, the subprime mortgage market, and thus take on more risk, they needed more regulatory capital to account for these risks. The Holy Grail of financial innovation came in 1994–95, when a technique that would later become known as collateralized debt obligation (CDO) was invented (Tett, 2009). The instrument allowed banks (JP Morgan initially) to insure the risk of default of a corporate client and move it elsewhere (sell to a third party, in this case AIG). Soon enough the technique was extended to mortgage products and specifically, to subprime mortgages and eventually, other types of unsecured debt. The practice, now cantered on several types of risk trade, reliance on wholesale market funding (or shadow banks) for loans, and offshore financial jurisdictions for the legal architecture of the complex chain of securitization, allowed more risk-prone financial institutions to sabotage their more conservative competitors. On the surface, the mechanism appeared as the perfect example of innovation in the financial market producing efficiencies in intermediation between savers and borrowers. The reality was quite different: the expanding bubble economy and the shadow banking system were bound to implode.

Was the recent wave of financial innovation and securitization an act of financial sabotage? Was it a deliberate action aimed at profit making through subversion, obstruction, disruption or destruction? It is possible to argue, as many economists do, that the concept of a mortgage-backed security (MBS) or asset-backed security (ABS) is a good one, as it ensures continuing liquidity in the housing market. A CDO too, is a brilliant invention as it allows banks to free up capital to employ it more productively. But at the same time, the good rational actor of standard financial economics should have been very careful in dabbling in securitization and re-securitization during ‘good times’. The key function of banking institutions, after all, is to ensure the smooth and efficient intermediation between savers and borrowers. They were playing with other people’s money and should have been prudent in doing so. In the boom decades of financial innovation, rational actors were swamped by the bullish ones, and subsequently suffered losses.

It is interesting to note that the language of sabotaging the state is also associated with another development of innovation driven finance. Nigel Lawson, former UK Chancellor of the Exchequer under Thatcher and member of the House of Lords selected to sit on a parliamentary investigation into the Libor-rigging scandal said on the leading BBC program, *Newsnight*, in 30/01/13 that “structured financial vehicles in a euphemism for tax avoidance.” Lawson has a point. A good number of SPVs were registered offshore, presumably to obtain what a BIS study described as ‘tax neutrality’ – or facilitate tax avoidance in layman’s terms (BIS, 2009). Everyone loves the idea: those who gained from the facility of tax neutrality (i.e. avoidance, or sabotaging your own government) clearly did. Those who bought the products assumed they were getting better deals as the sellers were not burdened by taxation. Those who provided the facility happily charged for the service.

Let us consider the nature of a not atypical Cayman registered set of Special Purpose Vehicles (or SPVs) that were run by Bear Stearns. SPVs are highly obscure financial entities, and not much is known about them. The reason we know some of the details of these SPVs is due to the bankruptcy preceding that Bear Stearns entered into. Bear Stearns maintained two High-Grade open ended investment companies that invested in ABS), mortgage-backed securities, derivatives, options, swaps, futures, equities, and currencies. Funds that were registered as Cayman Islands exempted limited liability companies. The funds were administered by PFPC Inc., a Massachusetts corporation, which administered the funds and performed all back office functions, including accounting and clerical operations. The books and records of these funds were maintained and stored in Delaware, a state known as internal tax haven in the U.S. (Sharman, 2011). Deloitte & Touché, Cayman Islands, performed the most recent audit of these funds. The investment manager of this fund was Bear Stearns Asset Management Inc., a New York corporation (“BSAM”). The investor registers were held in Dublin, Ireland (another well-known tax haven) by an affiliate of PFPC Inc... Two of the three investors in one of the Funds were registered in the Cayman Islands as well, but they were both Bear Stearns entities, which appear to have the same minimal Cayman Islands profile as did the two Funds. Accounts receivable were located across Europe and the U.S.; counterparties to master repurchase and swap agreements were based both inside and outside the U.S., but none was in the Cayman Islands.

The courts concluded that the link between Cayman Islands and the two SPVs was tenuous. The funds were registered in the Cayman, and had two (‘dummy’) directors that were residents of Cayman – but that was about it. Bear Stearns went into the trouble of setting up very complex structures, spanning many jurisdictions, paying hefty fees for licenses, professionals (lawyers, accountant, clerks), and the Cayman Islands dummy directors whose job was to do absolutely nothing.

What exactly was the purpose of complex structures like the one maintained by Bear Stearns in the Caymans? The concept of ‘dummy director’ is very popular (McCabe, 2012). McCabe’s

analysis of 3,232 companies with an address at the Irish Financial Services Sector (IFSC) named individuals, each sitting on the boards of hundreds of companies, a lucrative business for these individuals. The Irish stockbroker firm A&L Goodbody is company secretary for 1,088 companies, including aircraft leasing firm, banks, investment funds, asset management, real estate and energy. Matsack Trust limited is a company secretary for 1,295 companies, and so on. Clearly Goodbody and Matsack cannot possibly execute their task as company secretary in any meaningful way for any of those companies. Similar findings for large scale brass plate companies are found in the Netherlands and in Cayman.

Why then, set up these complex and expensive structures that on surface, do not appear to be the most efficient way of allocating scarce resources? There were a number of reasons for doing so. First and foremost, offshore SPVs facilitate tax neutrality, or tax optimization. In Veblenian language, that amounts to sabotaging your government. The idea of tax minimization is so widespread and built in into our psyche that it is not even seen as problem. The problem arises, however, when the financial system implodes, as it did in 2008, requiring the state to bail it out. But it is the same financial system that already weakened the state to the point at which bailing out the financial system led to very large sovereign debt crisis which ultimately damages the ability of the state to sustain the economy which finance feeds upon.

Our own research into the uses of offshore SPVs revealed a further purpose of sabotage. In the now well-known bankruptcy case involving a British bank, Northern Rock, a Jersey-based SPV called Granite Master Trust was used by the bank to effect a sham process called ‘true sale.’ True sale tends to mean different things in different jurisdictions, but essentially it refers to exchange between two entities that do not share common ownership. The idea is that when two separate entities trade assets they will do so for good economic reasons, hence, the trade may be considered as ‘true sale’ as opposed to the very common intra-company trade that take place world-wide. Rating agencies were prepared to rate only the products that were sold in the markets under ‘true sale’ arrangements. The beauty of offshore SPVs was that that no one was able to know for sure who were the ultimate owners and beneficiaries of assets or the SPV, as was the case of Northern Rock (and we have learned subsequently, many other banks). Hence, financial houses could ‘sell’ a product effectively to themselves or to the entities they controlled offshore at any price they wish to cite, and the apparent ‘true sale’ would serve as pointer for other trades that would then follow the original true sale (Nesvetailova and Palan 2012). Was it an act of rogue behaviour by some marginal financial actors, or was it an act of Veblenian sabotage typical of the industry as a whole? Complexity was introduced, as in many other instances in finance, in order to fool gullible investors. Incredibly though, as Veblen noted, it is not illegal, even if not in the spirit of the law.

Andy Haldane of the Bank of England calculates that the ‘natural’ size of large bank, that is the natural size of the efficient standard economics banking entity, is about \$US 100 billion of assets (Haldane, 2012). Yet, many banks evolved somehow into much larger entities, some of them had over \$US 1 trillion of assets. Why is that? Veblenians point out that size had become a prime technique of sabotaging both the state and competitors. In the leverage game, banks learned that size does matter, for three related reasons. First, the market factored in their ‘too big to fail’, which meant that companies could now garner lower rates of interest in the ‘open markets’ because the markets factored in sovereign support to them. Haldane calculates that the combined advantage of being too big to fail gave these institutions discounted interest rates that would account collectively to about \$US 70 billion annually before the crisis.

Second, and more directly, size combined with leverage has increased their economic leverage and apparent profit (Mester, 2005; Mishkin, 2006). The profits were sustainable however, only for as long as the boom continued. When the music stopped playing, the complex interconnections and the size of leverage created during the boom years, brought down large banking houses and

the banking system as a whole. The link between apparent performance during good times and the impact of potential losses during a crisis is the third technique of sabotaging by size. Size, or systemic significance widely understood, appears to give immunity, in a very broad sense, to financial institutions. Our banks have become not only too big to fail, but also too big to jail (Alessandri and Haldane, 2009; Mishkin, 2006; Pennacchi, 2000). Eric H. Holder, Jr., U.S. attorney general, has noted the failure to prosecute multinational banks for various transgressions during the recent boom: “I am concerned that the size of some of these institutions becomes so large that it does become difficult for us to prosecute them when we are hit with indications that if we do prosecute – if we do bring a criminal charge – it will have a negative impact on the national economy, perhaps even the world economy” (Henning, 2013). Analysing the possible lessons of such a crisis, Veblen warned that

“the abruptness of the recapitalization and of the redistribution of ownership involved in a period of liquidation may be greatly mitigated, and the incidence of the shrinkage of values may be more equally distributed, by a judicious leniency on the part of the creditors or by a well-advised and discreetly weighted extension of credit by the movement to certain sections of the business community.” (Veblen, 1904, p. 205)

It appears that the age of financial innovation has stretched Veblen’s notion of such mitigation to extreme. A study conducted by the New York State Attorney office in the midst of the crisis presents an analysis of the ‘Heads I Win, tails Your Lose’ bank bonus culture, specifying in detail the size of bonus packages paid out by the banks who were the recipients of Troubled Asset Relief Program (TARP) scheme in 2008. The summary of the investigation is simple enough: “When banks did well, their employees were paid well. When banks did poorly, their employees were paid well. And when banks did very poorly, they were bailed out by taxpayers and their employees were still paid well. Bonuses and overall compensation did not vary significantly as profits diminished” (Cuomo, 2009: 1).

## 6 Conclusion

The article has addressed a puzzle: what are the causes of the quest for spatial differentiation and being in regulatory spaces elsewhere. Recognizing the limits of mainstream economic models in answering this question, we have drawn on the ideas of Thorstein Veblen and his theory of business civilisation. A Veblenian analysis of this development suggests that the behaviour in finance that is commonly associated with human failure (greed, exuberance, fraud), became widespread practice, and can be best understood as sabotage in Veblenian terms. It amounted to techniques of sabotaging clients and the governments who enacted regulations that were supposed to protect the clients. These were legal mechanisms, albeit as Veblen writes, not in the spirit of the law.

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