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Shadow Banking and the Offshore Nexus – Some Considerations on the Systemic Linkages of Two Important Economic Phenomena

Karl M. Beyer and Lars Bräutigam, ICAE, JKU Linz

Institute for Comprehensive Analysis of Economy

Institut für die Gesamtanalyse der Wirtschaft

Johannes Kepler Universität Linz

Altenbergerstraße 69
4040 Linz
Austria

Tel.: +49 732 2468 3402

cscc@jku.at
www.icae.at

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1 Abstract

Shadow banking and offshore financial centers have been called the two “black holes” of the global economy. Current investigations on shadow banking and the global financial crisis normally do not consider the role of financial havens. That is not surprising as the linkages between them are rather implicit. We want to specify some of the various interconnections between both economic phenomena and discuss their systemic relations. Therefore, the institutional and structural linkages of shadow banking and offshore financial centers will be investigated. We want to provide answers why those financial institutions which had close ties to the shadow banking system, made use of offshore jurisdictions. As a matter of fact, offshore jurisdictions have been very important for regulatory and tax arbitrage operations of shadow bank entities. We will also reflect on the question if shadow banking in turn influenced the offshore nexus itself. For these purposes it will be necessary to overcome some difficulties in the traditional understanding of offshore. Offshore-like conditions can emerge through political decision-making in any place of the world. We claim that the offshore nexus was elementary to the growth and spread of the shadow banking system while the financial industry itself gave reason to the development of offshore-like conditions in onshore regions. An additional hypothesis that will be discussed is whether the shadow banking system can be regarded as the connecting point of the offshore nexus and the last financial crisis.

2 Introduction

The shadow banking system and offshore jurisdictions represent two essential constituents of the global economy. The notion of Palan and Nesvetailova (2014, 31), who regard them as two „important ‚black holes' in the global economy“, is complex. It is hard to deduce reliable quantitative data and information on the cores of shadow banking and offshore financial activities although the economy seems to be gravitated towards them. Like a black hole, they remain widely out of scope; and it is rather difficult to measure their size. Unlike a black hole, however, they do not hide in the middle of nowhere but appear to exist in the brightest places of finance.

Researchers mostly investigate both fields separately. Recent years have seen a growing number of articles and profound research on shadow banking and on offshore financial spaces. However, a few authors have already contributed articles to the research on the connections between shadow banking and offshore (see Schmidt 2012; Fernandez and Engelen 2013; Stewart 2013; Beyer and Bräutigam, 2014, Palan and Nesvetailova 2014). In this article, we try to contribute to a better understanding of the relations and connections between shadow banking and offshore.

In this paper, we therefore will discuss the connections between the shadow banking system and offshore financial spaces by focussing on the following questions:

- Which connections and linkages exist between shadow banking and offshore phenomena?
- How narrow, far-reaching and substantial are these connections?
- How did these connections emerge and why; what are the reasons for their existence?
- Did both sides mutually reinforce each other?

In trying to find answers to these questions, we will consider the connections on three different approaches. The first approach bases on a historical analysis, the second focusses on the institutional and spatial connections. Finally, we will try to find functional or systemic dependencies or congruencies. Some introductory remarks to shadow banking (entities) and offshore precede the three main parts of the paper.

3 What are Shadow Banks and what is Shadow Banking?

McCully was the first author to use the term “shadow bank”, or “shadow banking system” to illustrate a system of “levered up non-bank investment conduits, vehicles, and structures” (McCully 2007, 2). In the literature on shadow banking also other terms are used to denote these new developments such as “parallel banking system” (Poschmann 2012, 3), “securitized banking” (Gorton and Metrick 2012) or “non-bank banking” (Dombret 2013). However, no widely accepted definition exists on the nature of shadow banking. In most cases, the shadow banking system is interpreted functionally as a market-based (or securitization-based) credit intermediation system, in which different financial entities conduct a series of operations:

> “Shadow banking comprises a chain of intermediaries that are engaged in the transfer of funds channeled upstream in exchange for securities and loan documents that are moving downstream. Therefore, what was once accomplished under a single roof in the traditional banking system is now done over a sequence of steps in the shadow banking system, each performed by specialized entities that are not vertically integrated.” (Noeth and Sengupta 2011, 9)

The entities that conduct shadow banking are linked through instruments and different funding techniques and can be distinguished as follows:

In a narrow sense, shadow banks are specific types of special purpose entities (SPEs) or vehicles (SPVs). Both commercial and investment banks use these entities for off-balance warehousing, securitization and investment purposes. The legal design of SPVs is very special and allows for both their bankruptcy remoteness (a true sale of the financial assets exempts from any claims of the former proprietor) and their tax privileges (for details see BIS 2009; Gorton and Metrick 2012b). Warehousing and investment vehicles (like ABCP conduits, structured investment vehicles (SIVs) and securities arbitrage conduits) use short-term funding to invest in long-term instruments. This securitization-based definition of shadow banking refers to the process of transforming claims of payments into different investment products.

In a broader sense, these shadow banking entities depend on other financial institutions as funding sources for their financial operations. Investment banks or broker dealers are administering SPVs for warehousing and securitization. Money market funds (MMFs) predominantly purchase short-term asset-backed commercial papers (ABCPs) issued by conduits and SIVs for funding. Hedge funds frequently invested in high-risk tranches of collateral debt obligations (CDOs) before the crisis. Pension funds, on the other side, were searching for risk-free but best profit-yielding financial products. These institutional investors were limited to invest in top-rated securities, thus credit rating agencies were important to rate structured finance products. Monoline insurers and several traditional insurance companies offered credit default swaps (CDS), which allowed other agents to hedge risks and engage in further investments. Poszar et al. (2012) provide a complex graphical illustration of the interconnections between most of the financial entities that have been mentioned here and explain in detail how all these entities and instrument form a full-fledged shadow banking system.

4 The Offshore Links of Shadow Banking

As it was stated above, shadow banking and offshore economies are two important fields of research, which need to be investigated further in their own respect. However, there are also close ties between both subjects. Two important characteristics of the global shadow banking system are its spatial fragmentation and its transnational connections:

> “Shadow banking consists of a variety of actors […] that often operate across different national jurisdictions. This geography matters for ability of different entities to create complex transnational interconnections.” (Fernandez and Engelen 2013, 7)

The shadow banking system is not only institutionally fragmented and complex. In addition, its constituents normally operate in a range of different jurisdictions. A substantial part of shadow bank entities is located in different offshore jurisdictions and financial interconnections also exist between them. To demonstrate this, the relations between onshore and offshore jurisdictions have to be regarded in more detail.

The notion “geography matters” (ibid.) can be rather misleading. The reason is that the term ‘geography’ in this context denotes a landscape of regions (i.e. countries, islands (independent or under administrative control by a country)) with regulatory frameworks that can vastly differ. The differences are to be found in terms of which rules exist and how they are applied to certain business activities; such as permissions and restraints to set up (financial) entities or the duties (reporting) and the level of taxation they are subjected to.

In our understanding, the geographic aspect exerts a controversial influence on terms like “offshore jurisdictions” or “offshore financial places” in the literature on shadow banking. Financial places like Delaware or the City of London are often considered as onshore, even though they provide offshore characteristics such as low taxes, favourable regulation or lax supervision. From such a perspective, it is rather difficult to properly determine the relations between shadow banking and offshore jurisdictions. Apparently, onshore and offshore spaces can also coexist within a country. Furthermore, some offshore jurisdictions such as Ireland or Luxembourg exist close to or within a group of onshore economies. Wainwright (2013) denotes these jurisdictions as “midshore spaces”. The only difference between them and other offshore economies is their “geographic” location either within a country with high regulatory standards or at its border.

Therefore, three types of offshore jurisdictions can be distinguished. Some offshore spaces can even coexist with onshore spaces within a country (type one). We prefer to call them subnational offshore spaces. The immediate vicinity to continental onshore spaces characterizes the second type of offshore jurisdictions such as Luxembourg. The third type represents “typical” offshore spaces such as the Bahamas or the British Virgin Islands, which are situated “offshore” in the original meaning of the word. However, the differences in the legal frameworks alone determine the offshore or onshore character of a jurisdiction and thus the spatial or geographical distribution of onshore and offshore economies.

All these aspects are essential to understand how the shadow banking system is embedded in and linked to (a system of) offshore jurisdictions. Finally, we want to emphasize that we use all of the terms that relate to offshore – jurisdictions, financial spaces or places – mostly in the same meaning. Thereby ‘spaces’ includes phenomena like offshore markets, which may consist of transnational contracts or transnational banking activities.

4.1 Historical Roots of Shadow Banking and Offshore

In investigating the connections between shadow banking and the offshore system, it is useful to focus first on the historical influence of offshore spaces on shadow banking. With regard to the historical evolution of shadow banking, some clues can be found that from the very beginning of existence of offshore markets, the interplay between them and regulated markets added to the development of shadow banking institutions. Thus, a unilateral though indirect relation from offshore to shadow banking exists. Some offshore institutions enforced developments within financial markets by exerting systemic pressure on its regulated parts.

This mode of influence already started with the existence of the Eurodollar market, the first significant offshore market. Some years after its establishment in the late 1950ies, U.S. banks started to operate on this market. The Eurodollar market was a free market from its very beginning; no regulatory setting or supervision existed. These reasons added to its attraction for financial institutions. U.S. banks soon discovered ways to evade some of the existing regulatory rules in the U.S., such as the Regulation Q, which had been established in the aftermath of the Great Depression and prohibited interests on demand deposits and defined ceilings for interest rates on saving

deposits. However, the coexistence of regulated and unregulated markets allowed for practicing regulatory arbitrage. Whenever the short-term interest rate rose to profitable levels in the Eurodollar market, funds were transferred from financial markets in the U.S. These transactions caused effects, for example on the mortgage market. Funding for the entities which were engaged in this market got scarce, as deposits from banks and thrifts were removed and transferred to the Eurodollar market, or, some years later, invested in money market funds. As a consequence, the U.S. mortgage market got under pressure to sustain funding for its investments and could not always meet the demand for mortgages. The lasting pressure in these markets culminated in financial innovations in the 1970ies and 1980ies. One of these innovations, securitization, which should become essential to the development and rise of the shadow banking system, was believed to solve the problem of financing long-term mortgages.

On a more general level, the high growth and the resulting importance of the Eurodollar market was one of the reasons why existing regulations in the U.S. were finally reduced or abolished. This incident is a perfect example that the sheer coexistence of an offshore and a regulated market can result in feedback mechanisms. Those financial entities which could escape the U.S. market were able to reduce their effective regulatory exposure. Those entities, which did not make use of the Eurodollar market for certain reasons, had to face disadvantages. Those which could not operate on the Eurodollar market faced problems to acquire funding for their operations. The systemic risk within the regulated sphere was growing in relation to the amount of reserves that were available, because U.S. banks could use Eurodollar funds to support their operations in the U.S., avoiding reserve requirements while expanding business activities.

Consequently, offshore cannot be assumed to exist entirely separated. Financial operations in offshore markets had effects on markets with stronger regulatory frameworks. The coexistence of markets and the drain to the Eurodollar market caused institutional developments in the regulated market. As a matter of fact, these developments in regulated financial markets were one among various reasons responsible for the evolution of the shadow banking system. In a later stage of this evolution, the offshore system accelerated the growth and the global expansion of shadow banking (see below). Its evolution became very dynamic because an increasing number of financial institutions and entities, which constitute the shadow banking system, made use of the lower regulatory level in offshore jurisdictions.

4.2 Institutional and Spatial Analysis

Exactly this strategy – to set up entities in jurisdictions with lower regulatory standards – is subject to the institutional and spatial approach, which elaborates on the distribution of shadow bank entities in onshore and offshore jurisdictions. This approach to theorize the relations between offshore and shadow banking intends to reveal which kind of shadow bank entities are settled in offshore jurisdictions and to which extent. In addition, it tries to discover the institutional basis shadow bank entities and offshore share or in which they overlap.

At this point it is important to recall our understanding of offshore that has been outlined above. We define jurisdictions or certain parts of it as offshore primarily with regard to the legal framework provided to financial entities or business entities in general. This provision brings up a rather arbitrary geographical distribution of offshore, in which traditional offshore spaces, small islands etc. represent only a part.

According to the Bank for International Settlements (BIS 2009, 63), SPVs for warehousing, securitisation and investment purposes are often settled in traditional offshore jurisdictions. Although these entities are settled offshore, there is only minor or no physical presence of staff. Instead these SPVs are operated from other countries (IMF 2004). The BIS emphasizes that

> "while offshore incorporation of SPEs [special purpose entities; L.B.] is common, it is not as common as incorporation in the same country as that in which the assets are originated and from which the notes

> are sold […]. This is often for reasons of legal and regulatory certainty, and it may be a preference not only of the originator but also of investors." (BIS 2009, 75)

This statement is misleading because those SPVs which are registered in the country of the sponsor often settle in subnational financial spaces such as Delaware in the United States or the City of London in Great Britain. These subnational locations provide offshore-like advantages to entities that are pivotal to shadow banking. Because of these advantages setting up SPVs in traditional offshore jurisdictions seems unnecessary. This could be an explanation why U.S. ABS SPVs are located preferably in Delaware. However, U.S.-CDO SPVs frequently use a dual structure, and this is undermining the previous hypothesis. One SPV is settled in a typical offshore jurisdiction, while the second is founded in the U.S., typically in Delaware, to perform the function of a co-issuer (Moser and Williams 2010, 161). Europe, however, does not fit in the pattern of subnational offshore spaces. In Europe, the most preferred jurisdictions for securitization are Ireland, Luxembourg, Jersey and Great Britain (BIS 2009, 75).[1] As some of the national member states offer a lower level of regulation, these inner European offshore jurisdictions get preferred. The ECBs statistics on FVCs, which surveys the settlement of financial vehicles for securitization in Europe and the size of their balance sheets, illustrates that half of all financial assets of securitization vehicles are settled in Ireland (23%), The Netherlands (18%) and Luxembourg (8%).

In the majority of cases, hedge funds can be located in traditional offshore jurisdictions, although some exceptions exist. The report of the International Organization of Securities Commissions (IOSCO 2013) illustrates the geographical distribution of hedge funds. In April 2014, most hedge funds which administered more than 500 million U.S. $ were registered at Cayman Islands (471 out of 1044 or roughly 45%). With a huge gap other offshore jurisdictions follow: Luxembourg (59), British Virgin Island (26), Ireland (22), Bermudas (21) and The Bahamas (3). Although 602 out of 1044 hedge funds are registered in offshore-jurisdictions, almost all hedge funds are managed in the U.S. (858) and Great Britain (97).

In addition, also money market funds show remarkable connections to offshore financial places. In 2013, three countries of the Eurozone accommodated 96% of 835 billion Euros of financial assets administered by money market funds: France (39%), Ireland (33%) and Luxembourg (24%) (ECB 2014, 33; Deutsche Bundesbank 2014, 23). Thus roughly 57% of all the financial assets of Eurozone money market funds were held in offshore jurisdictions.

With regard to the amount of financial assets of other Eurozone investment funds such as hedge funds (money market funds excluded) totalling 8.4 billion Euro in the beginning of 2014, the share of Luxembourg is 34%, followed by Germany (18%), Ireland (16%), France (14%), The Netherlands (8%) and other countries of the Eurozone (10%) (ECB 2014). Even these funds prefer countries with offshore features (such as Luxembourg, Ireland or the Netherlands).

The institutional and spatial perspective illustrates that a variety of financial agents that constitute the shadow banking system or participate in it choose offshore jurisdictions as domicile. However, the reasons and motives why they favour offshore jurisdictions for their operations remain unanswered. The following section will shed light on this.

4.3 Functional Approach/Perspective

In the historical section we discussed early offshore phenomena such as the Eurodollar market and their influence on the evolution or upcoming of shadow banking. Apart from this impact which established the institutional preconditions for shadow banks, the existence of offshore spaces has also been essential to the development of the shadow banking system in more recent times. In fact,

[1] With regard to securitization of credits originated by US financial entities, Delaware and Cayman Islands are important jurisdictions (BIS 2009, 75).

the offshore space functions as a host for certain shadow banking entities and instruments. Stewart for example argues that

> "many of the instruments created by recent financial innovation were administered in low tax financial centres/tax havens, resulting in an unregulated financial system" (Stewart 2010, 6)

By hosting some of the emerging shadow banking entities, offshore jurisdictions were somehow adding new functional mechanisms to the financial system that remained rather unnoticed, unregulated and unsupervised until the last financial crisis. In a more recent publication, Stewart's claims "that the 'shadow banking' sector developed in tax havens and low tax centres to facilitate regulatory and tax arbitrage" (2013, 2). Nesvetailova and Palan (2013, 358) similarly explain that

> "offshore financial centers, providing a variety of regulatory and tax niches for financial innovation, play a crucial role in facilitating the spread of complex securitization structures, and thus contribute to the phenomenon of shadow banking."

Therefore, offshore jurisdictions clearly form "a major part of the shadow banking sector" (ibid.). But why exactly does the "spread of complex securitization structures" take place in offshore regions? Obviously innovations or financial practices can spread from any point in the world. An essential reason is the role of tax and regulatory arbitrage for shadow banking, on which we elaborate in the following three subsections.

4.3.1 Tax Arbitrage

The Bank for International Settlements (BIS 2009, 74f) emphasizes that tax considerations are highly relevant for the decision in which jurisdictions SPVs should be settled. These considerations do not focus on simply saving taxes but on avoiding additional taxation (*tax neutrality*) that result from the sheer use of SPVs by its sponsor, which would result in a double taxation of inflows. Wainwright (2013) argues that this aspect was highly important for the evolution of the European ABS-market. Onshore jurisdictions did not provide tax neutrality for SPVs, and only later, when it had already become a common practice to settle these entities offshore, some European countries tried to attract SPVs and took efforts to adjust their laws respectively. For Wainwright (2013, 27)

> "the emergence of ABS markets in Europe illustrates how European governments have also adopted the strategies of small island economies, and in doing so facilitated the emergence of onshore-offshore spaces."

Thus, the spread of shadow banking practices has been preceded by a spread or establishment of offshore-like conditions in some of the European countries. These developments indicate that also the existence and the practices of shadow banking contributed to the expansion of offshore spaces or their adjustment.

4.3.2 Regulatory Arbitrage

As a matter of fact, tax arbitrage in the context of shadow banking is always connected to regulatory arbitrage. Avoiding taxes on a legal basis can only be achieved by choosing another regulatory framework, which in the case of shadow banking operations had less rigid effects on new financial techniques. According to Stewart (2010, 8), regulatory arbitrage seems to be the more dominant reason of financial agents using offshore spaces in general. Quite often, financial agents have to choose offshore jurisdictions because some of their operations are prohibited by national laws and regulation or because it would generate high administrative costs (for the case securitization in Europe see ECB (2008, 87)). Thus regulatory arbitrage processes are not only undertaken for gaining relative advantages in terms of saving costs. It has also been a vital interest of financial agents to find regulatory niches which did not prohibit certain investments or shadow banking operations.

In addition, financial agents made use of certain other conditions. Regulatory supervisors in offshore jurisdictions did not always know about their responsibilities for operations of foreign financial entities and branches, although the regulatory framework would permit their regulation. This has been the case in Ireland, which has been documented by Stewart (2008). The European regulatory framework designates that the hosting country is responsible for regulation of foreign entities and branches. Irish regulators, however, did not feel responsible for entities of foreign banks. As a result, these entities were out of the regulatory scope before the crisis. Nesvetailova and Palan (2013, 360) argue in this context that it is easy to set up financial entities offshore but hard "to perform appropriate due diligence on operations that in reality are highly complex financial vehicles." In some cases administrative resources in offshore jurisdictions are rather scarce.

4.3.3 Impact of Tax and Regulatory Arbitrage on Shadow Banking Operations

Both tax and regulatory arbitrage can be regarded as essential for setting up shadow banking entities in offshore jurisdictions. With regard to the necessity of tax neutrality for SPVs, it can be stated that the growth and spread of shadow banking practices would not have reached its current dimensions and its geographic distribution without the existence of offshore jurisdictions. In general, the development of the shadow banking system strongly depended or at least benefitted from the liberties and advantages in offshore jurisdictions (low taxation, light regulation, lax supervision). Among other factors, offshore jurisdictions added to the development of shadow banks; although this does not imply that shadow banking could not have evolved at all without them. Nevertheless, its expansion and formation would probably differ enormously.

5 Conclusions

The historical origins and the dynamic development of shadow banking that followed were substantially influenced by the existence of offshore jurisdictions. The shadow banking system is using offshore financial places to exploit the financial and regulatory advantages they are offering. Therefore, as we have shown, shadow banking and offshore are closely related. Both are overlapping spatially. The importance of this observation however has to be reflected in further research, because even though the shadow banking system has significant offshore dimensions, financial entities such as SPVs and hedge funds may also be managed remotely from onshore financial centres. Consequently, offshore jurisdictions would only be the place for settling financial entities and therefore just function as the legal domain of certain parts of the shadow banking system. In this context, it is also important to remind that financial innovations are expected to have spread from offshore regions that lacked effective supervision, although the very process of innovation could have been moderated onshore. Thus, offshore jurisdictions would only have provided specific legal and regulatory frameworks that fostered the evolution of the shadow banking system. Nevertheless, the spatial fragmentation of the shadow banking and the offshore system contributed to the opacity and complexity of the global financial system. The deficits in adequate supervision and regulatory standards in some countries, especially in offshore jurisdictions, obstruct risk analysis and efficient legal and regulatory actions against the accumulation of systemic risks.

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