Proposal for Market Frictions and Financial Risks

Financial Linkages and Stability via Tax Havens

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Tax havens and offshore financial centers pose a specific treat to financial stability and limit the ability of onshore regulators to both understand the risks and effectively regulate them. Our research agenda has focused on mixing large scale empirical work with models and analytical tools to shed light on this opaque word with the aim of improving economic policy. In this proposal we aim to advance our work along several new directions with a unified theme surrounding financial stability concerns in offshore finance.

The challenge posed by offshore financial centers to financial stability takes two forms:

1) Challenge to Measurement and Understanding the Risks:

   Offshore financial centers are notoriously opaque and this presents an important challenge for academics and policymakers trying to measure what exposures exist. On the investor side, these centers obscure who the ultimate investors holding the risk are. The United States, for example, records large liabilities to the rest of the world but only knows who the immediate counterpart is. Often, the counterpart is a passthrough entity located in an offshore center. As a result, the Cayman Islands, Luxembourg, and Ireland all appear to be large holders of US securities. While it is well understood that residents of these countries are not the ultimate holders, it is much less understood who the ultimate owners should be.

   On the firm side, issuance often takes place in offshore financial centers via financing subsidiaries. These subsidiaries are in most cases empty shells that simply transfer the capital to other firms within the same group. Our previous work shows that it is possible to combine a variety of large-scale datasets to trace these flows from the immediate

issuer to the ultimate parent group. For the US for example, many claims on Irish resident entities are actual claims on US firms that have tax-inverted into Ireland.

Our proposal is to connect ultimate investors to ultimate parent companies globally. To do so we use several different commercial datasets as well as regulatory data collected by central banks. We have existing work that attests to our ability to deliver on these difficult topics (Maggiori et al (2020), Coppola et al (2021)). This proposal advances the work in scale, breadth, and quality.

2) Challenges to Regulating the Risks:

Once measurement of the risks is done in an appropriate way, the question still stands on how/why these risks should be regulated? There is often a tendency to dismiss the financial stability risks arising from offshore intermediation. Two prominent recent examples of this fallacy have been the turmoil in US Treasury markets over covid and the UK gilts market over the 2022 budget. In the first case, the selling seemed to be connected to US hedge funds based in the Cayman Islands. In the second case, the selling originated from UK Liability-Driven Investment (LDI) funds largely domiciled in Ireland but owned by UK-based pension funds. Why are the funds domiciled offshore? How is the fund domiciled impacting regulation? These are important questions for a better macroprudential framework.

A different type of risk originates from limited legal recourse of retail investors in these offshore jurisdictions. In recent years, offshore financial instruments have increasingly been sold to retail investors. This has occurred both directly, for example via ADR equities listed on the NYSE but the underlying of which is an offshore equity in the Cayman Islands, or indirectly via passive ETFs and mutual funds. It is apparent that retail investors do not appreciate the differences between onshore and offshore markets. The US congress currently has a bipartisan proposal to force salient disclosure of these risks

to retail investors, the Ticker Act that specifically target Chinese offshore companies listed in the US.

Great Power Challenges in Offshore Markets

The offshore world has recently witnessed the entrance of a major player, China. Traditionally, offshore financial markets were dominated by firms and wealthy individuals resident in advanced western economies like the US. In the last 20 years this picture has changed dramatically with Chinese entities and individuals raising to a prominent role in these jurisdictions.

Chinese entities, both private and governmental, have been using these offshore markets to access western investors. We plan to investigate what drives China's decision to use these offshore markets, whether this is a permanent phenomenon or a temporary one on the transition path to domestic markets liberalization, and how Chinese entities compete with established players (like US firms or governments) in raising capital offshore.

We plan to do so by mixing theory and data. On the theory side we plan to develop a framework to understand progressive liberalization of capital markets by China (both onshore and offshore) and how issuers compete for the same set of investors. On the empirical side, we plan to take this model to the data by using the rich dataset described above linking investors to issuing entities globally. We plan to estimate which investors are attracted to which type of issuers over time and across countries/jurisdictions. The plan is for the model to provide simply sufficient statistics that can be taken to the data at the investor-issuer level.

Government Interventions: Regulation, Taxation, and Sanctions

In ongoing work we are studying how regulation, taxation, and sanctions shape offshore finance. We combine reduced form instrumental variables (IV) and theoretical models to show how firms and investors respond to regulation by shifting their relationship to onshore markets. To do so

we exploit the different timing of regulations applied to different investors around the world. We perform a similar exercise for taxation, especially taxation of interest and dividend payments on securities. Finally, we show who the financial system responds to sanctions by shifting activities offshore as well as which investors benefits from fire sales induced by the sanctions. In both cases, we focus on the recent sanctions imposed on Russian firms.

In this context we plan to investigate how the raise of non-bank finance has facilitates the raise of offshore financing and impacted the flightiness of capital, especially for emerging market firms that rely heavily on offshore finance. Again, we plan to do so by mixing detailed data analysis on capital flows to emerging economies with theoretical work on the inefficiencies of capital flows across border.

References

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