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OPAQUE GOVERNANCE,

SPECIAL PURPOSE VEHICLES,

AND THE PREACHER'S WAIVER

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ABSTRACT

This paper argues that special purpose vehicles, SPVs, are two-edged financial constructs whose bad edge consists in conveying opaque governance, whereas its good one amounts to interesting financial engineering. Firstly, the notion of opaque governance is highlighted, to focus next on SPVs and their governance. Afterwards, the paper delves into collateralized debt obligations and their facilitators, the offshore locations. Last, the failing role of some regulators and gatekeepers is emphasized with the purpose of setting up new measures to prevent them from claiming the Preacher's waiver.

JEL codes: G34, G15, G21, G24

Key words: opaque governance; special purpose vehicles; collateralized debt obligations; offshore locations; gatekeepers; regulators.

Institutional disclaimer

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INTRODUCTION

The expansion of the global economy into an interconnected world has given rise to many consequential changes, among which we have to pinpoint periods of financial instability that no longer remain a topic of concern to single countries or governments, but instead turn out to be a matter of international distress.

Deeply rooted with these disrupting happenings, extensively researched by Minsky in his landmark book *Stabilizing an Unstable Economy* (1986), this paper puts forward a deviant behavior that we encounter in some organizations that easily resort to opaque governance in their pursuit of hiding transactions, hence isolating themselves from regulations, transparency and accountability.

Section 1 introduces the notion of opaque governance. Section 2 deals with special purposes vehicles, while next section handles the issue of how slippery and deceitful their governance turn out to be. Section 4 expands on a distinctive vehicle called "collateralized-debt obligation fund". Section 5 outlines the global arrangements through which special purpose vehicles mushroom boundlessly: the offshore locations. Last section winds up the paper by focusing on the sensitive issue of regulation, gatekeepers and connivance with disreputable practices.

1. OPAQUE GOVERNANCE

Let us assume that we are concerned with certain company $\mathbf{c_k}$ belonging to a well-known sample space:

$$\mathbf{C = \{ (c_1, g_1) ; (c_2, g_2) ; (c_3, g_3) ; \dots ; (c_M, g_M) \}}$$

$$\mathbf{C = \{ (c_k, g_k) : k = 1, 2, 3, \dots, M \}}$$

where $\mathbf{g_k}$ stands for the underlying corporate governance of company $\mathbf{c_k}$, whose main structural details are available, either through the founding charter and by-laws, or still better, by their Statute of Governance.

After these preliminaries, we move on to the key concept of this section[1].

Definition 1 Opaque Governance

*By **Opaque Governance** we mean a substitution process whose main features and outcomes are the following:*

a) there is a persistent and purposive design of misconstruing the original governance of the company;
b) such process hinges upon three sustainable procedures:
    - *the accountability structure is shadowed,*
    - *transparency morphs into mere window-dressing,*
    - *there is a systematic flouting of the fiduciary duties of good-faith, diligence, and care;*
c) the original governance of the company is taken over by a new governance shaped to meet the former procedures;
d) the company counterclaims that no change has taken place in the old governance.

Remark:

Definitions, within the scope of this paper, stand for a semantic and methodological vehicle on behalf of any considered reader who may ask himself: which is the meaning the author attaches to such and such expression? Under no circumstance our definitions intend to be regarded the best available, still less the only ones that might be adopted.

Examples of opaque governance frameworks abound; for instance, those that nurture rent-seeking, soft-budget constraints, and tunneling. I have researched these patterns of

[1] Up to our knowledge, this is the first operational definition of the expression "opaque governance" in the current literature.

deviant behavior elsewhere[2]. Instead, my aim in this paper lies on a relatively newcomer in the pursuit of opaque governance: the so-called special purpose vehicle, SPV, which has conspicuously been used and played such a disgraceful role in the financial instability that accrued as from 2007.

A final comment is in order to bring home the gist of the matter: the less enforceable the law becomes and the more lenient governments turn out to be, then the more opaque the governance of organizations will grow eventually[3].

2. SPECIAL PURPOSE VEHICLES

These organizational forms are legal entities that require a sponsoring entity. Among the sponsors or sellers, we find commercial banks, finance companies, investment banks, insurance companies, non-financial corporations, or charitable foundations[4], whereas on the side of SPVs there will be limited liability companies, partnerships, corporations, and trusts. One distinguishing feature of these organizations consists in their being isolated from any likely financial distress of the sponsors; on this ground, it said that they grant "bankruptcy remoteness" to investors.

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[2] See Apreda (2005).

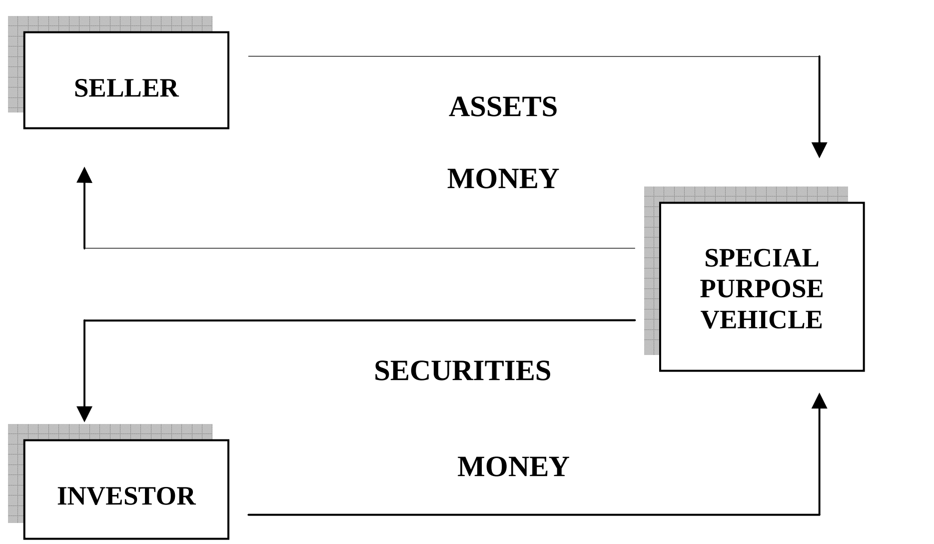
[3] I have elsewhere dealt with governance risks (Apreda, 2011), that is to say, risks that spring from the governance design, structure, and implementation. That's why I chose to leave such issue beyond the scope of this paper.

[4] The use of charitable foundations is standard in the United Kingdom. For example, Northern Rock devised its SPVs by using charitable foundations. In one notorious scheme, the bank was the originator, assigning the mortgage portfolio to Granite Finance Trustee Ltd which was the mortgage trustee (a charitable trust) performing as a conduit towards Funding 2 Ltd that acted as special purpose vehicle, which entered into loans agreement with Granite Master Issuer PLC, which was the actual issuer of the collateral debt obligations (securitized notes in this case). Shin (2009) provides extensive coverage to Northern Rock dealings.

The plain-vanilla mechanism by which the SPVs operate, comprises the following characteristics (see Exhibit 1):

a) The sponsor sells assets to the SPV, receiving money for them.
b) The SPV sells securities to investors and shifts the money to the sponsor.
c) The sponsor contracts out a corporate-server provider to manage the SPV's administrative functions, even recruiting staff and directors.
d) Sometimes, a Trustee may also be appointed to care for the creditors' property rights.

Exhibit 1 ***A Plain-Vanilla SPV***



We can list the most conspicuous examples of SPVs[5]:

- residential and commercial mortgage-backed securities;
- collateralized debt obligations;
- asset-backed commercial paper programs;

[5] Further details can be found in the Report on Special Purpose Entities (Basel Bank, 2009).

- credit-card receivables and automobile loans and leases;
- structured investment vehicles.

Among the variety of innovative products offered to market actors[6], the so-called structured finance secures a place for itself. The general concept and the consequences in the last crisis of getting used to structured finance without transparency and diligence were pungently noticed by Coval, Jurek and Stafford (2009):

> The essence of structured finance activities is the pooling of economic assets like loans, bonds, and mortgages, and the subsequent issuance of a prioritized capital structure of claims, known as tranches, against these collateral pools. […] This ability of structured finance to repackage risks and to create "safe" assets from otherwise risky collateral led to a dramatic expansion in the issuance of structured securities, most of which were viewed by investors to be virtually risk-free and certified as such by the rating agencies. At the core of the recent financial market crisis has been the discovery that these securities are actually far riskier than originally advertised. (p.3)

There has been a broad wave of criticism around the misuse of these organizations throughout the last global financial crisis. For instance, it's worth giving heed to the following allegation by the Basel Bank in its "Report on Special Purposes Entities"[7], published in September 2009:

> It must be emphasized that the usage of SPE structures is not inherently problematic in and on itself. […]The current market crisis that began in mid-2007, however, essentially "stress tested" these vehicles. As a result, serious deficiencies in the understanding and risk management of these SPEs were identified. (p. 1)

[6] An opinionated assessment of financial innovation can be found in a special survey published by The Economist (2012b).

[7] "Special purpose entity" is the customary expression used by the Basel Bank when referring to SPVs.

3. THE OPAQUE GOVERNANCE OF SPECIAL PURPOSE VEHICLES

Let us assume[8] that for certain organization $\mathbf{c_k}$, the planning horizon is

$$\mathbf{H = [\,t; T\,]}$$

and we are interested in following up incremental cash flows pertaining to such organization, that is to say, new cash flows stemming from the planning horizon only. We can assess incremental cash flows at date **t** by figuring out expected values or, at date **T**, checking out the values of realized cash flows. Either way, There is a structural relationship between the cash flows that spring from the company's assets and their subsequent allocation to creditors and stockholders, which is given by the following incremental balance equation:

$$\mathbf{\Delta\, CF(\, assets\,) \;=\; \Delta\, CF(\, creditors\,) \;+\; \Delta\, CF(\, stockholders\,)}$$

This balanced cash-flow system is denoted the "incremental cash-flow model" [9], whereby we can add precision to the intuition lent by Exhibit 1.

a) from the sponsor organization (for instance, a bank)

$$\mathbf{\Delta\, CF(\, assets; bank\,) \;=\; \Delta\, CF(\, creditors; bank\,) \;+\; \Delta\, CF(\, stockholders; bank\,)} \tag{1}$$

But cash flows from assets can be decomposed into two broad items:

$$\mathbf{\Delta\, CF(assets; bank) \;=} \tag{2}$$

$$\mathbf{=\; \Delta\, CF(loans\ to\ be\ securitized; bank) \;+\; \Delta\, CF(remaining\ assets)}$$

[8] See section 1.

[9] For a comprehensive treatment of the incremental cash-flow model see S. Ross (2009), whereas Apreda (2005) applies the construct to deviant governance behaviors.

b) from the SPV

The SPV purchases a portfolio of securitizable loans and pays off with cash. Therefore, the SPV morphs one asset type into another. The logic of securitizaton consists in that the organization can issue its own securities against and with guarantee of those assets.

In carrying out their line of business, the financial institution gets funds not from their depositors, like in the usual partial-reserve system monitored by any central bank, but out in the shadowy non-banking financial system[10], as the shift from (1) towards (2) bear witness. Therefore, incremental cash flows for the SPV and the bank will end up this way:

$$\mathbf{\Delta\ CF(assets;\ SPV)\ =}$$
$$\mathbf{=\ \ \Delta\ CF(investors\ in\ SPV's\ securities)\ +\ \Delta\ CF(SPV's\ stockholders)} \tag{3}$$

with a cash-flow loop on the side of the bank's assets that feeds the creation of credit which I have written between square brackets in the following equation:

$$\mathbf{\Delta\ CF(assets;\ bank)\ =\ [\ \Delta CF(cash\ from\ SPV's)\ +}$$
$$\mathbf{+\ \Delta CF(new\ loans\ sold\ to\ SPV's)\ ]\ +\ \Delta CF(other\ bank\ assets)} \tag{4}$$

Afterwards, we are going to underlie the SPV's governance main characteristics.

Ownership structure

Certain features about the ownership structure depend on the country where the vehicle is created. In the UK, a widely favored organization type is the limited purpose

[10] The so-called shadow banking system is researched in Gorton and Metrick (2010b)

corporation, either domestic or offshore, which entails the use of a charitable trust as owner of the entity. In the USA, predominant ownership structures are the limited-liability corporations following Delaware regulations, while a trust entity is the vehicle.

Purposes of the SPV

In either case, when organizations are incorporated or legally enacted, their purposes are bound to the ownership structure and attested so in their founding charters. On this account, SPVs are single purpose entities. Basically, they hold assets, upon which they issue securities, as it highlighted in relation (3).

Control and Management

The ownership structure and control rights depend on the legal jurisdiction chosen to incorporate the SPV. In the UK, for example, it is frequently favored the enactment of the so-called “orphan vehicles”, whose capital is nominal and held on behalf a charitable trust (Northern Bank is a case in point). The advantage is that the originator does neither own nor control the SPV. Things are different for SPVs in the USA, because the sponsor owns the vehicle when it is a limited liability company, but the latter is legally different from the parental company. When the SPV performs like a securitized entity, its assets are pledged to a trust.

As for management and staff, SPVs have no employees, and the sponsors subcontract all ancillary activities to corporate-service providers, who deal with the logistics, management, and even board building with independent directors, pertaining to the SPV’s needs. As Gorton and Metrick (2010a) sardonically put it, “SPVs are like robots”.

Assets sales

How do owners and the board of the SPV deal with control rights? The sponsor sells assets, usually writing them off from its balance sheet, a fact that is put forward in relation (4). With the money on tap from investors, the SPV brings the purchase of assets into completion, which gives the SPV a comprehensive control right.

Bankruptcy remoteness

This feature is naturally embedded in the Statute of Governance or by-laws. The assets are isolated from the sponsor's creditors reach.

Accountability and transparency

SPVs have become the darlings of the shadow banking system[11] just because they foster lack of diligence processes and transparency practices, showing an utter disregard for any sort of accountability design at the end of the day. In point of fact, (3) paves the way to this lenient behavior.

4. COLLATERALIZED DEBT OBLIGATIONS

Collateralized debt obligations, CDOs, carried out an important role in the last financial crisis. The simple vanilla SPV depicted[12] on Exhibit 1 can be regarded as a stylized and particular environment for CDOs. In contradistinction with vehicles shaped to fill in the needs of residential and commercial mortgage-backed SPVs, the asset-side of any CDO consists of a variegated portfolio of different financial assets:

- residential and commercial mortgage-backed securities;

[11] Gorton and Metrick (2010b) seems a good starting point to do research on this topic.

[12] Section 2.

- investment grade corporate bonds;
- emerging markets bonds;
- securitized bank loans;
- trust preferred securities (in short, trups)
- other CDOs
- commercial paper.

Therefore, a CDO performs as a portfolio manager, a trust fund, that issues their own securities backed by the financial assets that belong to the underlying portfolio. In spite of some financial advantages, these vehicles are two-edged constructs, whose bad edge follows from the fact that they contribute to credit expansion beyond any prudential measure and control of regulators. Let us examine this point in further detail by means of Exhibit 2.

For the sake of illustration, let us consider a financial institution that sponsors three SPVs designed after the CDO's structure. The bank, taking advantage of a portfolio of credits (mortgage-backed or secured otherwise) sells it to his SPV-1, which issues CDOs backed by the securitized portfolio[13]. In point of fact, the money that SPV-1 gets from the CDOs sale is used to repay the bank for the securitized portfolio. After the transaction is brought into completion, the bank substitutes new money for old credits.

At this juncture, the bank has two basic options: either lends money to companies and households, under the guise of plain-vanilla loans; or it buys mortgages, credit cards receivables, cars and trucks loans or leases, and the sort, which are easily securitized. In other words, the bank funds its credit lines without taking deposits, what amounts to credit expansion outside the central bank mechanism of proportional reserves.

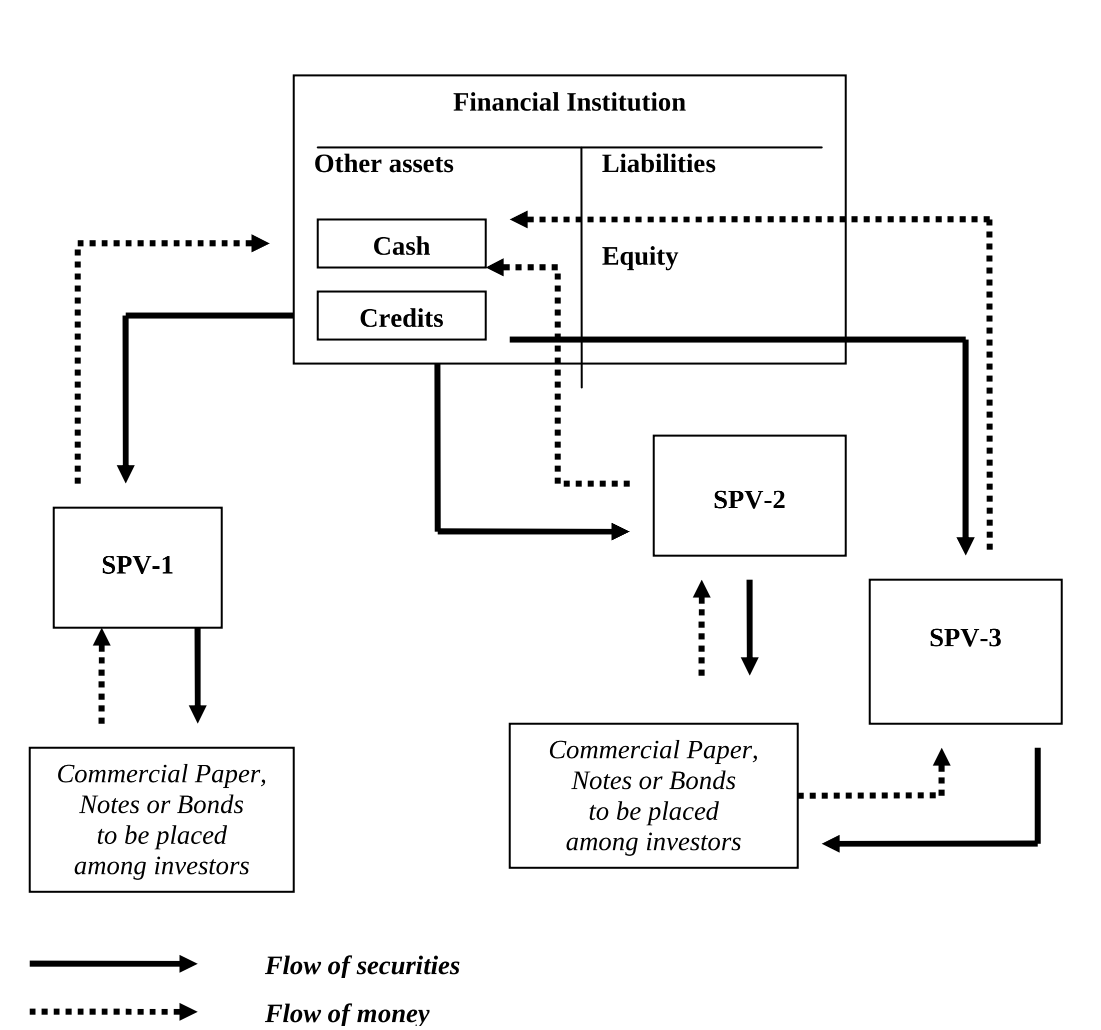
Next step replicates the pattern of the first stage, whereby SPV-2 buys a portfolio of credits in the bank's books, and issues CDOs, but with an innovation: SPV-2 can buy not only the bank securitized portfolio, but other financial assets, among which CDOs

[13] Mostly notes and bonds.

from other SPVs (even from the SPV-1 itself). After the full round-robin transaction is concluded, the bank will be able to set into motion SPV-3. As we guess, this is a process that can go on through several replications.

Five things are worthy of being noticed when looking for the consequences of this kind of financial engineering:

Exhibit 2 **CDOs and Credit Expansion**



a) It goes without saying that as long as SPVs are nurtured by increasing values in mortgage or securitized assets, many investors will buy more securities issued by the vehicles, even resorting to new borrowing from banks.

b) On their own side, banks are responsive to the increasing demand of CDOs and set up new SPVs, so that when investors borrow more money for purchasing SPVs notes and bonds, banks are ready to cater for their demand.

c) Many SPVs that issue short-term commercial paper or notes to pay off standing CDOs take advantage of the increasing demand from their securities and, it goes without saying, go on issuing more CDOs and rolling them over at maturity date.

d) But if the upside trend that stand to back the financial engineering happens to revert to a downward path, then the chain of SPVs is doomed to fail and, worst of all, it sets into motion the well-known[14] and time-dishonored Ponzi's Scheme.

e) At this point, and to fuel the Ponzi's Scheme, Repurchase Agreements (Repo) enter stage. This device allows borrowing by selling spot financial assets, to repurchase them forward, and is a healthy procedure as long as the assets pledged to secure the loan do not worsen their value in the market beyond prudential thresholds. If this took place, SPVs would be unable to pay their securities since loan rates by Repos would wildly run upwards, whereas the value of collaterals go bust. The latest crisis, for some authors like Gorton and Metrick (2010a), was a "run on Repo".

[14] It is a procedure by which companies, investment funds, banks, and governments, engage themselves whenever they resort to new financing not only because they run short of cash to pay interest on their older borrowings, but mainly because they need to pay principals at maturity, borrowing again and again at increasing pace, in a situation that can be featured as a Catch-22 background. For a non-standard approach to financial conduits that sow the seeds of financial instability, Minsky's contribution is a major achievement. See references at the end of this paper.

5. OFFSHORE LOCATIONS

The global economy comprises not only onshore locations, but offshore ones as well. Coming up against so many corporate scandals, financial crises, outrageous misplacing of information, and the channeling of money out of criminal activities towards offshore conduits, academics and practitioners start to realize the great import of these places for the understanding of what is happening down-to-earth, here and now.

Definition 3 Offshore Centers

By offshore centers we mean sovereign places[15] in the world that are able to frame and enforce their own laws with the purpose of providing economic actors from other nations with the following services:

- *decoupling real from legal locations;*
- *incorporating organizations or opening personal accounts on behalf of non-resident individuals and corporate actors with ease of procedures and very low costs;*
- *offering zero or near zero taxation levels;*
- *granting secrecy jurisdictions beyond the reach of other countries or regulators and, by the same token, strong protection from creditors;*
- *making stable and friendly political background available;*
- *giving access to virtual bookkeeping locations with lenient disclosure duties.*

Among the instruments and tailor-made organizations that offshore centers furnish their customers with, we can list the following: offshore banking licenses, captive insurance companies, offshore corporations, special-purpose vehicles, segregated account

[15] From nation-states like Switzerland, to protectorates like Cayman Islands, also including city-states like Singapore, internal states like Nevada, Vermont and Delaware in the USA, or special chartered places like the City of London (Palan,, 2006, 2010; Shakson, 2011; The Economist, 2012a).

companies, use of tax havens for individuals, hedge funds for non-residents, preferential tax regimes, export processing zones, flags of convenience, e-commerce[16].

Although some quarters could remind us about the legal foundations of offshore locations, they likely fail to point out that those places eventually become purchasers and sellers of sovereignty, providing and granting secrecy for the setting up of shell companies and hedge funds in the shadows, catering without distinction not only corporate actors and single investors that seek more flexible frameworks for their transactions, but also big players in drug-dealing, terrorism, political corruption, tax evasion, gambling, and weaponry brokerage.

Sidestepping central banks, security exchange commissions, internal revenue services, gatekeepers and shareholders, they promise hidden harbors and impunity, and they deliver both, with the connivance of law and auditing firms, even investment banks. By essence, offshore centers embrace thousands of companies, financial portfolios, and investment accounts, with contempt for transparency, accountability and due diligence. To put it in other words, they are builders of opaque governance.

Besides this irrefutable indictment, I still contend that offshore locations could become a better place than they are. For instance, supplying export facilities zones to improve the connectivity of countries and markets into the global economy.

To all intents and purposes, the most important measures that offshore centers ought to take involve two courses of action:

[16] By 2002, according to Palan, 80 percent of international financial transactions was conducted through offshore financial markets, whereas the foreign exchange market ($2 trillion daily) is almost entirely offshore. On the other hand, 20% of private wealth, 22 % of banks' external assets, and a large portion of the $44 trillion worth of private banking business, by that date were transacted through offshore financial centers.

a) firstly, by stopping once and for all their involvement with financial crime, either terrorism, gambling, political corruption, tax evasion, or drug-dealing;

b) changing upside down not only the public governance of host countries, but also requiring reliable governance from corporations, hedge funds, accountancy and law firms, investment portfolios, shady players in the banking industry. This must be undertaken by shaping up transparency, accountability, and due diligence procedures between the host and the controlling organizations in the onshore locations.

Skeptics or ironists could assess these measures actually may lead to the death of offshore locations. I advocate instead that far from being the end, it could become the starting point for a new role of offshore locations on behalf of the global economy by supplying sovereign status, and transparent conduits for the carrying out of the manifold transactions that lie at the root of multinational commerce, industry, and financial innovation. Ultimately, solving the offshore problem must not be regarded a matter of forbiddance, but of good governance.

Discussing about upcoming reforms in the offshore economy, The Economist (2011) severely warned that:

> One avenue for reform is to place a greater duty on companies to explain what profits they make where. That would help prevent the worst abuses of transfer pricing scams, in which tax havens play a handy role. […] Overall, however, resistance to change remains strong, not least in big Western financial centers such as Wall Street and in the City of London, which see the flexibility offered by tax havens as an essential part of their business model. (p. 69)

6. REGULATIONS, GATEKEEPERS, AND CONNIVANCE

One thing is to realize that the financial system nurtures internal mechanisms that lead to financial instability. But quite another thing seems to admit that internal players, loopholes in the regulation, as well as pervading connivance among governments, gatekeepers, and even stakeholders, foster such instability, and bring damage to households, enterprises, and taxpayers over whole economies.

Although a good question is whether the regulatory framework ought to have prevented abuses of the shadow financial system from taking place, the actual issues to be discussed here, at least for the main subject of this paper, are the following:

- What is the extent to which regulations can become enforceable?
- How could regulations be shaped up?
- Why do gatekeepers so persistently fail in complying their fiduciary duties?

Let us move on to give an answer to each question, as straightforwardly as possible.

6.1 WHAT IS THE EXTENT TO WHICH REGULATIONS CAN BECOME ENFORCEABLE?

In most countries, the main regulators in charge of interpreting and making regulations enforceable for their formal financial system are two: central banks and securities exchange commissions[17]. In the first case, regulation consists in a legal framework that determines when and how a financial institution is allowed to exist, and a battery of "resolutions or decrees" by which the central banks set operational constraints to lending, borrowing, and foreign exchange transactions, as well capital requirements and risk supervision for banks. In the second case, securities and exchange commissions deal with listed companies that place their debt or equity into the public offer mechanism, as well as with qualified intermediaries, from brokers to dealers, engaged with publicly primary and secondary transactions.

[17] There are countries whose capital markets are not so developed to allow for an independent security exchange commission. In those cases, the central bank has a superintendency to deal with public offers, as it is found in Uruguay, Ecuador, Colombia, at the time this book was published.

A striking feature that stems from reviewing the role of regulators is that they busy themselves with banks and listed companies only, what amounts to brush aside the bulk of corporate actors that meddle themselves in borrowing and lending, namely

- Non-listed companies, by far the majority of organizations all around the world, remain technically closed, most of the time being family-owned companies, under the guise of small, medium and large companies. Whereas in the Anglo-Saxon tradition public offers and capital markets are well developed, nine out of ten countries in the world do not follow this tradition and their companies currently borrow from institutional investors and banks[18].

- Financial intermediaries that run their businesses in the so-called[19] "shadow financial system", which embraces a host of non-regulated corporate actors shielded from the scope of any central bank or security exchange commission. In this variegated group, we must spotlight the following big players:

- Regulated financial intermediaries running their transactions either in the so-called Eurobond Market for deposits and bonds[20], or in offshore locations.
- Institutional investors that engineer conduits for private placements.
- Investment funds that offer both offshore locations and also a variegated spate of SPVs to investors and borrowers alike, in particular Hedge Funds.

- Any company that borrows or lends money through offshore locations or SPVs, by means of private placements that skip over the overlooking of central banks, securities exchange commissions or internal revenue services in their onshore locations.

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[18] We have to bear in mind that a loan from an institutional investor or a bank can be assimilated to debt privately placed. In fact, it behaves like a bond when we regard the loan from the viewpoint of its underlying cash flows.

[19] An expression used in the Basel Bank Report on Special Purpose Vehicles.

[20] On the Euromarket's nature and consequences, see Palan's books about offshore locations (2003, 2010).

Is it any wonder then, after reading this list of makers and users, that the majority of financial transactions are neither regulated nor controlled, or still worse, that financial systems frequently evolve towards instability? Still worse, is it surprising that the above-mentioned conduits make huge profits from opaque governance concoctions?

6.2 HOW COULD REGULATIONS BE SHAPED UP?

There are two mechanisms open to discussion and implementation: improving the current regulations, and creating new regulation. This is of necessity, albeit there are always risks in the enactment of any regulations. Firstly, let us deal with the options, and later with the risks.

a) Improving current regulation

To put it bluntly, central banks and security exchange commissions, must refurbish what they have previously enacted, to prevent regulated banks and listed companies from avoiding regulations by engaging themselves with those conduits listed in section 6.1. For this, three measures should become enforceable:

- Full disclosure and on-sheet recording of all those conduits and transactions must be compulsory.
- Make boards and shareholders directly accountable for this sort of transactions.
- Central banks and security exchange commissions have to upgrade their own governance and adopt a compulsory Statute of Governance.

b) Setting up new regulation

Taking advantage of section 6.1, both the spate of corporate scandals and the last global financial crisis bring forward the need of taking political action and start reshaping financial systems all around the world, pursuing the following constraints:

– SPVs must be regulated by central banks and security exchange commissions, and be only allowed through public placements.

– Regardless of being listed or non-listed, companies committed to offshore dealings must show their transactions and vehicles by means of on-sheet bookkeeping, with full disclosure of operations in the Financial Statements and the Annual Meeting Statement to shareholders.

– Any regulated financial institution engaged in either the borrowing or lending sides of SPVs, both through on shore and offshore locations, must fully disclose such transactions to central banks, as well as in the Annual Meeting Statement to stockholders.

– Ring-fencing retail banking from other activities[21] should become mandatory.

c) The risks of regulation and the missionary's zeal

Regulators redress wrongs, but they also commits wrongs on their own, mainly when they undertake their job with what I call the missionary's zeal *whereby they assume that the more regulation they enact, the better the world becomes*. A clinical approach to such organizations conveys a self-evident diagnostic and treatment: firstly, upgrade their governance and, secondly, make themselves more accountable, transparent and diligent.

d) The lack of incentives

Although the disgraceful failure of gatekeepers and sometimes their apparent connivance at corporate regrettable practices, we can't help avoid the sensible issue of the sheer lack of incentives offered to officers working for regulators, which brings about a perverse mechanism forcefully described by Thomas Sowell (1996):

[21] This measure has forcefully been proposed in the Vickers Report (2011).

> Much criticism of "incompetent bureaucrats" implicitly assumes that those in the bureaucracy are pursuing the assigned goal but failing to achieve it due to lack of ability. In fact, they may be responding very rationally and ably to the set of incentives facing them. For example, government regulatory agencies are often very ineffective in controlling the industry or sector which they have a legal mandate to regulate. But it is a common pattern in such agencies for those in decision-making positions to (1) earn far less money than comparable individuals earn in the regulated sector, and (2) after a few years' experience to move in to jobs in the regulated sector. In short, they are regulating their future employers. Under such a set of incentives, it is hardly surprising that decision makers in regulatory agencies approach those whom they are assigned to regulate with an attitude that is sympathetic, cooperative, and even protective. (p. 15)

6.3 WHY DO GATEKEEPERS SO PERSISTENTLY FAIL COMPLYING THEIR FIDUCIARY DUTIES?

In the mainstream debate about the instability of financial systems, several sources of such instability have utterly been disregarded so far, as if they were not relevant at all. However, such sources are relevant, among which we can notice special purpose vehicles, offshore locations, shadow financial systems beyond any control, regulators trapped by a narrowing scope for their supervisory role and, on the side of gatekeepers a suspicious lack of will for changing their opaque governances [22].

Whereas many actors carry the task of being a gatekeeper, the following ones are the most influential in the financial system, both in the regulated as in the non-regulated fields of experience:

auditing and law firms; investment banks; big market dealers;
credit rating agencies;
market analysts working independently; economic and financial journalism;
non-governmental organizations acting as watchdogs of the system;
research institutes, working independently or as research units within universities;

[22] There are two broad categories of gatekeepers: regulators and non-regulators. It goes without saying that in this section we are going to deal with the latter.

international organizations like the OECD, World Bank, IMF, the Basel Bank.

There is wide and longstanding empirical evidence about the failure of gatekeepers. For the sake of illustration, we can refer the reader to Professor Coffee (2002) indictment of their joint performance when he wrote, in the aftermath of Enron's demise[23] a challenging paper with the provocative title *Understanding Enron: It's About the Gatekeepers, Stupid*.

6.4 THE PREACHER'S WAIVER

In this section, we raise some queries and bring forward a plausible course of action to shape up the rules of the game in the financial system.

a) Many of those gatekeepers do a profitable trade indeed, by apparently watching over banks and companies, rating their performance, advising on governance issues, being opinionated on financial tools of which they barely know their nature or their risk profiles in depth.

However, the most outrageous feature that gatekeepers have been displaying in the last four decades consists in the Preacher's Sympton, a pattern of behavior that could be briefed this way

"*always preach others what to do and how to behave, but be serious enough never to follow what you preach*".

b) If private and public enterprises are urged by gatekeepers to disclose their activities, why could we not request the same from the gatekeepers themselves?

c) If regulations are enforced to upgrade and control the governance of companies, either public or private ones, why should gatekeepers be exempted from keeping up to future regulations?

[23] A comprehensive study of Enron's history and demise can be found in Apreda (2002).

d) If gatekeepers advise, encourage, and claim from corporate actors in the private and public realm to grow more accountable and transparent on behalf of their fiduciary duties, why will they not set an example?

The treatment is crystal clear: improve the governance of gatekeepers by setting up stronger regulatory frameworks, requesting in all cases an enforceable Statute of Governance.

CONCLUSIONS

This paper has set forth the meaning of opaque governance and morphed this notion into special purpose vehicles. Afterwards, we have expanded about collateralized debt obligations and offshore locations.

Next, the paper addressed the subject of regulations, gatekeepers and the regrettable connivance of most actors in the financial system. In closing, it was offered a clinical approach to manage opaque governances, with a down-to-earth and pragmatic frame of mind to fix the problem.

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