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Labour/Management Programme

MEETING OF TRADE UNION AND OECD EXPERTS ON:
FINANCIALISATION: WHAT REGULATORY RESPONSE?

BACKGROUND PAPER AND QUESTIONS FOR DISCUSSION
prepared by the TUAC Secretariat

To be held on Friday 16th March 2007 at the OECD, Paris, Room Roger Ockrent

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TUAC Labour/Management Seminar on Financialisation – What Regulatory Response?

Organised by
TUAC, ETUC, Global Unions and OECD

16 March 2007
OECD, Room Roger Ockrent

BACKGROUND PAPER AND QUESTIONS FOR DISCUSSION [1]

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Overview

1. In 2002 Ronald Dore, former OECD consultant and Professor at the London School of Economics and Political Science defined financialisation as: "the increasing dominance of the finance industry in the sum total of economic activity, of financial controllers in the management of corporations, of financial assets among total assets, of marketised securities and particularly equities among financial assets, of the stock market as a market for corporate control in determining corporate strategies, and of fluctuations in the stock market as a determinant of business cycles"[2]. One of Keynes' central concerns was the "predominance of speculation over enterprise"[3]. Financialisation, in other words the predominance of financial activities over production of goods and services has made its mark at various stages of economic history. At corporate level, the process of financialisation is often linked with the shareholder value model of governance of firms, which gained momentum in the US and the UK in the 1980s and 1990s. It became the predominant model for reform in many industrialised countries promoted by international organisations such as the OECD and the World Bank. The shareholder value model encourages financialisation of the company since it contends that the maximisation of the value of the share rather than long-term profits is the central purpose of a firm.

[1] This paper has been prepared by the TUAC secretariat on their own responsibility and does not necessarily represent the views of the OECD, TUAC affiliates or global union partners.
[2] "Stock market capitalism and its diffusion" Ronald Dore, New Political Economy 2002 Vol. 7 no 1
[3] "General theory of Employment Interest and Money" J.M. Keynes 1936

2. The term financialisation is also attributed to de-regulatory reforms of the investment chains between ultimate owners of capital (including working families and retirees) and the final destination of their investment (financial assets such as debt and equity, non-financial assts such as real estate). Once regulated and organised around private banks, insurance companies, cooperative and public institutions, the investment chains of financial markets have been de-regulated into a myriad of different types of institutions, transactions, services and products. When coupled with market liberalisation, this process of de-regulation – also known as dis-intermediation – has allowed financial operators to intervene in an almost un-limited investment universe; one in which not only 'real' assets are invested and traded (debt & equity) but also market expectations and risks (such as credit risk and other derivative products).

3. Just five years later Dore's definition of financialisation is found wanting, in view of the growth of "new investors" such as private equity and hedge funds. In a brief period these have become owners and movers of significant parts of economic activity. These alternative funds are largely "leveraged" (i.e. debt financed) and are exempt of much of the regulations that typically apply to collective investment schemes (CIS), to banks and to insurance companies (such as investment prudential rules and reporting requirements).

4. From a trade union perspective the growth of alternative investment funds raises a plethora of concerns. Private equity investments have moved beyond *venture capital* in first generation "start-ups" companies – where risk was justifiably compensated by high returns growth – to *buy-outs* in mature industries, and household brands across the OECD and emerging markets. Their driving force has been to extract from the companies they own high rates of return in the short term to service their high levels of debt and cover high management fees. This has proven increasingly difficult to do in a way that secure the target company's long term interests and that provides decent employment conditions and security for their employees. The conference on private equity organised by three Global Unions – IUF, UNI and IMF – in November 2006 provided a catalogue of the negative (as well as a few positive) experiences of dealing with private equity funds as the anonymous employers for whom increasing numbers of our members ultimately work[4].

Alpha returns, delta-tilt, cross-market & overlay: the new language of financialisation

Investment returns can be disaggregated into two parts: returns that are generated by generic market movements, known as Beta, and residual returns that are attributed to the specific investment added-value, known as alpha. With lower market index Beta returns disposable, investors need to extract more Alphas to meet their funding targets, and for pension funds to match their liabilities. Alpha investment strategies are short horizon strategies using various tactical asset allocation techniques.

5. Systemic risks to financial market stability are created by the opacity in which these highly leveraged and speculative investors are growing. In particular it raises concerns as to the security of workers' pensions. Privatisation reforms have most often been accompanied by deregulation of

[4] International Unions Call for Stricter Regulation of Private Equity Buyout Funds: http://www.union-network.org/uniindep.nsf/9af5cae71a695237c12572910035cb55/3d701a7fa0b3513ec125729100591f74?OpenDocument

pension fund investment policies intended to diversify investment – and hence mitigate – market risks. Once bound by strict quantitative restrictions (for example a 20% limit to the portion of investments in equities), pension funds in most jurisdictions are free to choose the composition of their portfolio by asset classes so long as they respect value-based “prudent person” standards. As demographic pressures squeeze such funds, rates of return on *safe* investments, such as government bonds, are low. Severe losses were incurred by some equity-heavy funds in 2001 when the 1990s asset-price bubble burst. Pension funds are increasingly tempted to seek higher rates of return by diverting part of their assets away from traditional bond and equity placements into riskier hedge funds and private equity funds.

Measuring the phenomenon, and its impact on the economy

6. There are various basic indicators that can be used to measure financialisation: the ratio between stock market capitalisation and GDP, profits of financial firms versus non-financial companies, as well as and the size of directors’ remuneration. World asset prices have been booming for the past ten years. Market capitalisation of domestic shares within the OECD as a ratio of total OECD area GDP rose from 65% in 1995 to over 110% in recent years. The shareholder value model has led to more, not less, concentration of corporate entities to the benefit of OECD countries. In 1990 European and North American stock markets accounted for 63 % of total market capitalisation. In 2002 – that is after the 2001 stock market crash – that share was 79%. There are reasons to believe that the current rise in asset prices is not driven by traditional demand and supply, according to which the current price is actually a healthy market response as growth in asset prices and share value contribute to economic expansion – rather it is a bubble.

7. Intricately linked to financialisation and the shareholder economy have been the growth of CEO remuneration. The ratio of US-based CEO compensation to average production worker compensation has jumped from 30 to 1 in 1970, to 500 to 1 today. From a national accounts point of view, the phenomenon is exemplified by the growing gap between the profitability of financial companies and non-financial companies, in a context of global rises in income inequality within OECD. It is also observed in the increasing share of financial revenues in the overall profit of non-financial companies. The process can also be seen at household level and in particular the diverging trends between stagnant wage earnings and growth in financial and non-financial asset revenues, including investment funds, life insurance and real estate.

CEO remunerations in the United States: the figures

- *The ratio of US-based CEO compensation to average production worker compensation has jumped from 30 to 1 in 1970, to 500 to 1 today.*
- *On an absolute basis, the average CEO of a Standard and Poor’s 500 company saw his total compensation rise from $3.7 million in 1993 to $11.75 million in 2005.*
- *Between 1993 and 2005 US public listed companies’ executive compensation totaled over $350 billion. In percentage terms, the group’s median total compensation rose 16 % between 2004 and 2005, coming on top of a rise of 30 % the year earlier.*
- *The aggregate compensation paid by US firms to their top 5 executives rose to over 10% of these firms aggregate net income for 2001-2003, up from under 5% during 1993-1995.*
- *In 2005 the top 12 most highly paid US CEOs collectively banked almost $2 billion.*

8. Financialisation is also seen in increasing corporate short-termism and its impact on productivity and investment. The successive waves of mergers and acquisitions (M&As) in OECD countries prior to and after the internet market bubble in the early 2000s, have boosted incomes of board members and of (some) shareholders. However they seldom improve long-term value of the firm or of its underlying performance. On the other hand, M&As have given space to a market for corporate control, forcing companies to place a premium on high returns to pay dividends to shareholders and to operate share-buy back programmes in order to secure the firm against predatory take-over. Investment in productive assets and innovation capacities, including workers' human capital has become secondary objectives.

9. The most recent manifestation of financialisation of the economy has been the transformation of risk capital investments funds such as private equity & hedge funds from a rather marginal and minor role in the economy to becoming mainstream if not dominant financial owners. In the past 10 years, the proportion of global M&A transactions financed by private equity has grown exponentially. In the UK alone, the share of private equity buy-out reached 50% of total M&A activity for the first half 2006. Total funds raised by private equity firms in 2005 were $ 160 bn in the US and $ 72 bn in Europe. The trend is toward conducting 'mega cap' (mega capitalisation) buy-out operations. Meanwhile hedge funds accounts for a third to a half of daily transactions on global capital markets.

Worker directors facing management short-termism: the case of Gaz de France

In 2005 the French utility company, Gaz de France, secretly traded on the international daily trading 'spot' market to take advantage of speculative rises in gas prices. In doing so, its strategic reserves fell below the minimum level as required under French regulation. The board level employee representatives, who were informed by their director status, alerted the media. The management of Gaz de France then threatened to sue the employee representatives for breach of director duty of confidentiality. The representatives, whose trade union of affiliation is a member of the TUAC, replied that their duty of confidentiality "ends where the law begins". Ultimately the management did not sue the trade unionists.

Hedge funds

10. No OECD jurisdiction has a comprehensive, legal definition of "hedge fund", and much of the current industry is poorly regulated, if regulated at all. The main distinction between a hedge fund and a CIS is that prudential rules that are typically in CIS regulation, such as borrowing and leverage restrictions, do not apply to hedge funds. Hedge funds are investment funds open to a limited number of investors. They are characterised by the way they charge performance-based fees, by their short-term investment policies seeking absolute 'Alpha' returns (by opposition to generic 'Beta' market index returns) and the mechanisms by which they cover the investment risk. They hedge their risk; hence hedge fund. There is no restriction per se as to the nature of the market in which hedge funds operate. They are free to place capital at risk in equity, bonds, commodity futures, options, and emerging market debt, and the host of derivative instruments associated with the world's burgeoning futures markets. Once the preserve of the super rich with personal fortunes, the composition of their clientele has changed to include a significant number

of pension funds. The size of assets under hedge funds management, now evaluated at over well above $ 1000 bn worldwide has created concerns among financial analysts and regulators, as has their geographical locations: many hedged funds are based in least demanding tax jurisdictions and tax havens.

11. Aside from their inherent threat to financial market stability, hedge funds pose serious concerns with regard to commonly accepted corporate governance practices such as shareholder activism. Promoting shareholder activism has been a priority for many policymakers following the Enron scandal. But shareholder activism is a means to an end, not an end itself; it can be used for 'good' (long-term responsibility) or 'bad' (short-termism). Hedge funds divert the positive objective of shareholder activism to achieve short-term goals that are not necessarily in the wider interests of the company and its core constituencies. They may elude financial and governance controls by exerting undue influence over the board and managers, with such practices as 'empty voting' (borrowing shares for the purpose of voting) which allows them to give an artificial boost to shareholder voting power) or hedging the downside market risks associated with the shares. Each of these practices creates a gap between voting rights and economic interests.

IOSCO definition of hedge funds

In a 2003 report on hedge funds, the Technical Committee of the International Organisation of Securities Commissions (IOSCO) defines hedge funds by looking at the characteristics of and the strategies employed by "entities that would consider themselves to be hedge funds". Hedge funds are described as having at least some of the following characteristics:

- *Borrowing and leverage restrictions, which are typically included in [Collective Investment Schemes] regulation, are not applied, and many (but not all) hedge funds use high levels of leverage;*
- *Significant performance fees (often in the form of a percentage of profits) are paid to the manager in addition to an annual management fee;*
- *Investors are typically permitted to redeem their interests periodically, e.g., quarterly, semi-annually or annually;*
- *Often significant "own" funds are invested by manager;*
- *Derivatives are used, often for speculative purposes, and there is an ability to short sell securities;*
- *More diverse risks or complex underlying products are involved.*

Private equity

12. Private equity firms establish financing vehicles for the purpose of buying out target companies (acquisition of the totality of shares), thus leading to delisting if the company was publicly trade prior to the acquisition. The very specific characteristic of private equity buy-out compared to traditional industrial consolidation is the short term horizon of the transaction: private equity make their purchase with the explicit intention of selling the entity after a 3 to 5 year period of restructuring. The cash input of the fund is often marginal (as little as 20% of total cost of acquisition) and is complemented by debt contracted at mainstream banks. The investment vehicle set up to carry out the acquisition operation – the leverage buy-out (LBO) – is designed around the concept that the vast bulk of the purchase money will come from debt, the servicing and repayment of which is financed by future earnings of the target company. That system allows

the ultra-wealthy to pool their funds and leverage them. A CEO who is paid $10 million a year – which is now considered as a normal compensation for an above average performing executive – can leverage ten times that sum and acquire a company worth $100 million that was patiently built year after year.

13. The rise in private equity led operations in the past five years within OECD countries echoes the past wave of LBO transactions in the US in the late 1980s. That wave was due to favourable macroeconomic conditions (low interest rates) which made debt-financed acquisition particularly attractive. Other factors however are mentioned to explain the current surge in private equity in Europe, such as favourable tax regimes (deductibility of debt service in fixing corporate income tax, tax incentives for sales of corporate assets) and industrial structures that are inadequate or unsuitable to ensure succession and handovers of ownership in family-based small and medium-sized enterprises. For many of them, private equity funds have become the investor by default.

14. The social impact of the private equity regime has yet to be fully assessed. No country or cross-country independent studies have been conducted so far with sufficient quantitative and qualitative evaluation criteria. Some recent research has indicated that the net employment impact is either neutral or positive on the long term. These are looking at the number of jobs created or lost. Such studies do not take into account job quality – wage and benefits, type of employment contracts and outsourcing, nor do they address the broader social effects – impact on community services or supply chain issues. The issue of qualitative assessment is crucial as private equity has expanded in scope so as to be able to target medium-sized and large companies, and more recently companies that have public service obligations or have a strategic country-level importance (such as Telecom Denmark Corporation).

A British member of parliament faced with a private equity firm

"The sale by [a Dutch MNE] of its frozen food service to a private equity firm involved the largest employer in my constituency: 900 jobs. [...] I gave them a couple of weeks before starting a relationship as MPs always do with major local employers, but I heard nothing.[...] I finally got a conference call with two 'representatives'; they did not want to tell what they wanted to do after the purchase; but they confirmed they would sell it off in 3-4 year time. I was quite dissatisfied. [...]. The only titles they use are "advisors" or "partners", the only reference in the letter was the name of the private equity firm, no address, no more information for a EUR 1.25 bn investment. I had never dealt with an investor that does not want to present itself. I can't find a person that is accountable in that firm.[...] We should put spotlight on them and require transparency, who they are. I have been MP for 15 years and I never dealt with a company that had no decency to have some respect for elected peoples and have some notion of being accountable."

Transcript of discussion of a Global Unions Federations meeting on private equity, Switzerland, November 2006

15. One of the concerns about private equity regimes is that they require profit targets that are unsustainable in the long-run, in order to finance the repayment of the debt. That can be achieved over a short period, but comes at the cost of the long-term interests of the firm, and of its workers in particular: sale of strategic assets, 'slash and burn' style of management; cuts in wages and in benefits. Unions at the WEF in Davos this year feared this "buy it, flip it, sell it". Most importantly, private equity regimes are being imposed with less social dialogue than under

traditional restructuring. Unions and workers have no clear view of the company's long term strategy, they have no one to address with their concerns. All too often the management in place states that they are executing orders, and that it is the private equity owner that is in charge.

16. The private equity model is challenging traditional assumptions on corporate governance. One could describe the private equity regime as the worst of all combinations between the two main regimes of corporate governance within the OECD: the Anglo-American and the Continental European regimes. Rather than corporate restructuring for the purpose of shared productivity gains and increased competitiveness, private equity firms now appear to looking at "asset striping" to extract maximum value over a 3-5 year period before reselling the company (or what remains of it) and banking a substantial premium. The lack of transparency of private equity goes against the current trend toward greater corporate transparency and accountability, and is aggravated by the fact that private equity firms themselves are poorly regulated compared to other CIS and to banks and insurance companies. Concerns about stability of financial markets and the exposure of pension funds have also been expressed by regulators and central bankers, notably with regard to the volume of bad loans that is generated by LBO transactions, and the opacity in which private equity firms operate, in terms of the actual performance of their investment and risk management.

Toward a new regulatory agenda

17. Disintermediation and the internationalisation of financial markets – and the resulting diversification of investment portfolios (in search of risk mitigation) – have not been matched by regulatory measures. This has spawned a number of unregulated products (credit risk derivatives, for instance) and transactions (over the counter or 'OTC' trading) and financial institutions, including private equity firms & hedge funds. Financial market operators can bypass national regulations, exploit governance failures, and exploit regulatory competitive advantages by offshoring financial services and transactions in less demanding jurisdictions, notably in terms of tax and accountability requirements. Paradoxically, market liberalisation has favoured more concentration and less competition in some key sectors such as auditing and corporate banking, and has facilitated the emergence of large integrated financial providers with strategic market share, such as Goldman Sachs. Market concentration, information asymmetry and conflicts of interest become important risk factors.

18. Current regulatory frameworks are structured around the clear separation between activities and between products, between banks, insurance companies and securities firms. They are in the vast majority of cases national-based while international financial oversight and regulation has become a major complication for regulators themselves. The progressive financialisation of economies requires reconsideration of the current international regulatory framework and its governance system. Within that broad debate, the systematic character of the growth of private equity investment is of immediate concern for labour because of its direct impact on employment and labour conditions.

Quotes from Davos 2007 panel discussions[5]

- *"The international regulatory architecture has lagged behind market changes, among which is the ease in which risks are transferred within the financial system from one class of institution - for example, banks - to another, such as insurance companies. Yet the regulatory approach remains separated, with different regulatory bodies for different classes of institutions"*
- *"Derivatives have created financial flows that go far beyond that which central bankers and commercial bankers control: M1, M2 and M3"*
- *"Should we worry [ie. about financial market instability]? Yes, as a matter of principle. But should we worry more than before? No"*
- *"[Hedge] Fund managers do not want their competitors to know what their positions are (especially on a daily basis, for which interpretation would be difficult anyway)".*
- *"The notion that capital markets should be biased towards any particular type of ownership [i.e. long-term equity holding] is deeply retarded".*
- *"[Private equity] managers frequently pop into the popular consciousness when something bad transpires, but in fact private equity funds […] serve institutional investors, including public pension funds whose ultimate beneficiaries are blue-collar workers".*
- *"A good private equity firm should average 22-25% higher than returns from the stock market".*
- *"[The private equity] business model is inconsistent with sustainability."*

19. Regulatory reforms of private equity should address several areas. Transparency rules should be established to achieve a clear view over the actual performance of private equity firms, their risk management, their internal organisation, their fee structure and other performance-related incentives. There is a vital necessity to recreate a level playing field with regard to prudential rules, such as restrictions on borrowing levels, that apply to and among all the different categories of investors: hedge funds, private equity firms, CIS, banks and insurance. Tax regimes should be adapted to make sure that taxation is either neutral or biased toward long-term ownership. Tax deductibility of debt service and interests, tax on transaction of assets and on cross-border investments should be reconsidered. Corporate governance reform is another area of priority. There are reasons to believe that under private equity, the board of directors becomes irrelevant. This is problematic since all traditional assumptions about good corporate governance are based specifically on the active and independent role of the board. In particular the division of roles between shareholders and management, between owners of capital and employers is a fiction under a private equity regime. Private equity firms are in position to gain considerable influence over company management, but without having to face the requirements of accountability that are in place under listed public companies, or informal trust-based mechanisms that often prevail under family-controlled businesses. They have become quasi-employers beyond social dialogue and public accountability. Given the particular corporate governance system of private equity regimes, it is also necessary to reconsider and adapt worker representation, information and consultation mechanisms as they exist in a majority of OECD jurisdictions. Worker participation mechanisms – works council and board level employee representation – should be regarded as key

[5] Executive summaries of panels held at Davos 2007 are at the following address: http://www.weforum.org/en/knowledge/Events/2007/AnnualMeeting/index.htm

mechanisms by which the long-term interests of companies that are under private equity regime can indeed be secured and promoted.

Questions for discussion

A. What is financialisation and how does it affect the real economy? What are hedge funds and private equity and what distinguishes them as manifestations of financialisation? What, if anything, distinguishes private equity from the leveraged buyout firms that flourished in the 1980s?

B. What concerns do workers and their unions have about the growth of hedge funds and private equity? What challenges, and opportunities, do these financial institutions pose for workers as:

- *Participants in pension and other benefit funds and worker savings plans?*
  - *Employees of non-financial target companies?*
  - *Job security, wages and health care and retirement security.*
  - *Economic viability of target corporations.*
  - *Corporate governance.*
- *Citizens concerned with systemic financial and economic stability?*

C. Should trade unions seek tax and regulatory reform to minimize the hazards of hedge funds and private equity and help realize the opportunities they provide? What forms of regulatory reform of hedge funds and private equity are most promising?

- *Transparency?*
- *Differential tax and regulatory treatment of corporate debt financing?*
- *Tax incentives for patient capital?*
- *Prudential investment standards for pension and benefit funds and worker savings plans?*
- *Worker representation on corporate boards and via works councils?*

D. At what level should trade unions seek regulatory reform?

- *National?*
- *European?*
- *Global?*

E. What opportunities are there for international trade union cooperation to respond to the challenge of hedge funds and private equity firms?

F. Should trade unions respond to the challenges and opportunities posed by hedge funds and private equity firms through direct collective action? What forms of direct action are most promising?

- *Negotiation with hedge funds and private equity firms?*
- *Collective bargaining with target companies?*
- *Corporate campaigning?*
- *Shareholder activism?*