TUAC trade union advisory committee to the
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"Financialisation"

TUAC/ETUC/Global Unions Seminar
OECD Headquarters
16 March 2007, Paris

Summary report prepared by the TUAC Secretariat

The TUAC seminar on Financialisation held on 16 March 2007 under the OECD Secretariat PAC Labour Management Programme focussed on the challenges and the opportunities associated with the current surge in "leveraged buy-out" (LBO) operations by private equity (PE) firms across the OECD. The seminar was chaired by Ron Blackwell (Chief Economist of the AFL-CIO) and brought together over 50 OECD-based and international trade union representatives as well as representatives of the ILO, the European Trade Union Institute and members of the European Economic and Social Committee. The morning session consisted of an exchange of views with several OECD Secretariat experts in corporate finance, corporate governance and taxation, as well with an academic expert and a fund manager. The afternoon session was reserved fpr trade union participants only.

Overview of the trade union discussions

The meeting's discussions underlined the concern among trade unions about the current surge in PE buy-out transactions across the OECD. Unlike venture capital and 'first generation' private equity, 'buy-out' operations involve mature businesses and increasingly large established companies. Acknowledging some of the ambiguities in relation to PE funds, the overall message from the trade union representatives was that the change in scale of the industry – moving from a relatively marginal asset class to an almost dominant form of corporate ownership – constituted a threat to workers, to established forms of social dialogue, to the stability and the health of the 'real' economy, as well as to government revenues collected through corporate taxes. Several of the trade union speakers summarised the issues related to private equity funds as regarding regulation, transparency, taxation, and the question of information and consultation with workers and their unions. In the statement (annex) that was adopted at the end of the meeting and released publicly, these issues stood out as the areas that regulatory reforms should address (i) transparency, prudential rules and risk management, (ii) workers' rights to collective bargaining, information, consultation and representation within the firm, (iii) tax regulation, and (iv) corporate governance.

Summary of the morning session's presentations

The morning session discussions gave divergent but highly informative views on the PE investment model. The session consisted of presentations by Adrian Blundell-Wignall (Deputy Director of the OECD Directorate of Financial and Enterprise Affairs), John Monks (General Secretary of the ETUC), Michel Aglietta (Professor at University Paris-Nanterre) and a Principal with an American PE firm. The session ended with a brief exchange of views with two OECD experts on respectively tax policy and corporate governance: Grace Perez-Navarro (OECD Centre for Tax Policy and Administration) and Grant Kirkpatrick (OECD Corporate Affairs Division).

Adrian Blundell-Wignall (OECD DAF) argued that PE firms have turned inefficient and non-competitive companies into much more streamlined, value-creating actors – among other things by putting much more pressure on managers. He pointed out several factors behind the current surge in PE investments: high level of liquidity on the global financial markets (notably because of Asian surpluses), strong balance sheet of the target companies, low interest rates (making debt financing particularly attractive), institutional investors' search for higher yields in a context of diversification of investment portfolio, as well as recent legislative pressures on publicly listed companies (such as the Sarbanes Oxley Act in the US). Target companies, he said, were usually companies that have a high level of cash-flow, are under-leveraged, have profit margins below their peers and a below average market valuation. He acknowledged that PE firms were increasing buying out less obvious targets, i.e. companies in volatile environments and with too limited cash-flows. The best way to avoid being the target of a PE firm was to ensure a well governed and performing company with low operational costs and flexible labour force, all which being reflected in high stock market valuation. He asserted that PE was actually a response to the increased short-termism of publicly listed companies (PLCs), which were bound to report on financial performance on a quarterly basis. PE managed companies do not have to present quarterly reports and are thus less exposed to short termist pressures and are more prone to adopt long term strategies. Similarly, PE firms can spend more resources and time monitoring the individual performance of the companies they owned, than can investment bankers who are constrained by the large and diverse size of their portfolio.

The representative of the American PE fund had had a long career as a trade union representative, including extensive knowledge of pension fund management and corporate restructurings, and had recently joined a union friendly PE firm. He was, on balance, positive on the value of PE investments for both pension funds and for target companies and their workers. Average annual returns on his PE firm's investment were 36% over a twenty year period. He asserted that PE solutions can create value when the target firm was underperforming, including times when incumbent management "had fallen asleep" in terms of innovation and competitive strategies or in need of an infusion of capital. His firm relies on the cooperation of incumbent unions when they represent a significant part of the firm and as a matter of due diligence always contacted the relevant unions before engaging negotiations with a company. Many of the deals that his firm had obtained had been brought by union leaders themselves who were looking for ways to enhance their members' job security. As advice for the union movement, he called for increased expertise in investment fund and leverage buy-out transactions and increased knowledge of the PE industry itself. Trade unions, he said, should ensure the right kind of relationship with PE firms and should have a seat at the table during negotiations on the buy-out transactions so that the gains are shared with the workers. In this view, financialisation is "neither inherently good or bad, it is what you make it".

A much more critical view of the PE industry was presented by John Monks (ETUC). He expressed concern about the social damages generated by the surge in PE transactions in Europe and particularly in the UK, Germany and France. Corporate innovation and value creation needed time to unfold, he said, and such long term horizon was rather incompatible with the characteristics of most recent PE buy-out investment strategies. Regulatory responses were needed in the areas of taxation and regulation, as well as information and consultation of workers. He noted that some heads of government and central bankers in Europe had expressed similar concerns about the lack of transparency of the industry, but pointed to the limitations in the current debate on regulation. Some governments appeared to value attracting global financial hubs – such as Wall Street and the City of London – higher in importance than the 'real' economy. The current focus on PE, and on hedge funds should not leave PLCs and traditional banking industry out of scrutiny however. Many PLCs and investment banks were also involved in buy-out activities. The issue of financial short-termism should be considered from a broader perspective than the PE industry alone.

Michel Aglietta (Paris-Nanterre University) contradicted the claims of high average returns of PE funds. As PE were exclusively on absolute return performance, he argued that there was no performance projection, no guaranteed return, no market valuation under PE regime. Monitoring PE fund management was virtually impossible for outside partners. There were huge disparities of performance within the industry and even within sectors, which, he concluded, made standard risk assessment tools unfit for the PE model. PE investment significantly departed from normal distribution of probability of risks, as there are much higher probabilities of high level of losses than under standard portfolio analysis. He added that the excess returns claimed by the industry did not take account of the compensation for the illiquidity of the investment. He also contested the prevailing view according to which PE was an asset class on its own, because the industry was in fact highly correlated with the PLC market. A study indicated that if one applies the same leverage to a sample of US mid-cap PLCs and compares the performance backwards over a 10-year period, the PLC sample actually fares better than the PE sample. In his conclusion he warned against the high societal costs generated by the PE model, including the negative impact on employment (except in the financial sector), the inherent pressures on labour costs, the deterioration of social climate within companies – PE firms, he said, had no interest *per se* in negotiating collective agreements – and lack of investment in human capital. He argued that there were conflicts between long-run investments required to provide the services of public infrastructures – a new target of PE firms – and the PE model.

Following these presentations, the OECD Secretariat gave some input on its work in the areas of taxation and corporate governance.

Grace Perez-Navarro (CTPA) said that the OECD's Committee on Fiscal Affairs has not initiated a review of tax issues arising in the context of PE. The CTPA was trying to identify what specific tax issues – if any – are unique to PE financing schemes that OECD member countries might want to evaluate. The CTPA's initial consideration of possible tax issues raised by PE transactions suggests that the types of tax issues that arise are not new and also arise in other contexts where sophisticated tax planning is involved. Some of the issues that may arise are: the tax status of the fund; the effective (or inappropriate) granting of treaty benefits; the tax treatment of the fund's return (income vs. capital gains); the tax characterization of investment instruments (possible arbitrage, use of debt/equity hybrids, terms of debt may lead to re-characterisation as equity); minimisation of dividend taxes (though anti-deferral rules may apply in some countries); maximisation of deductible expenses; and VAT issues. Tax administrators are assessing whether there are increased compliance risks to be addressed and some tax policy makers are reviewing how existing tax rules apply and whether the tax results and effects on the revenue base are desirable. She noted that some countries such as Denmark have proposed legislation to address what are seen as undesirable outcomes from the application of the tax laws currently in place. The CTPA is monitoring developments in its member countries to evaluate whether there are any tax issues of particular relevance to private equity and that would benefit from a CFA review.

Grant Kirkpatrick (OECD DAF) informed on the outcomes of a forthcoming OECD report on the corporate governance implications of alternative investment vehicles. The report would focus on buy-out operations of PLC, so-called ‘Public To Private’ (PTPs) transactions. He noted the positive impact of PE model on the performance of the Board of directors. Boards tended to be smaller, more focused and more skilled under PE regime, he said, adding that directors had usually stronger incentives and clear objectives that were closely linked to the value creation strategy. He did note however, some potential concerns that may arise with respect to the incoming management, which was often a party to the takeover and therefore may be exposed to conflicts of interests.

Annex

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FOR IMMEDIATE RELEASE

UNIONS CALL ON G8 LEADERS TO WORK ON NEW TRANSPARENCY AND TAX RULES FOR PRIVATE EQUITY

16 March 2007, Paris

Unions from 15 countries and a dozen global organisations meeting at the OECD in Paris issued a strong call for the activities of companies to be oriented toward long term sustainable investment strategies that create wealth for all, and good employment opportunities for workers.

Unions note that private equity firms have in a short period become owners and movers of vast pools of capital, significant swathes of the economy and of employment. The share of private equity investments in the total volume of mergers and acquisitions exceeds 20 percent in some OECD economies. These alternative funds are highly "leveraged" (i.e. debt financed) and are exempt from many of the regulations that apply to traditional collective investment schemes, to banks and to insurance companies, notably in the areas of investment prudential rules and reporting requirements.

The very high rates of return required to finance private equity debt-driven buy-outs can jeopardise target companies' long-term interests and provision of decent employment conditions and security for employees. Rather than corporate restructuring for the purpose of shared productivity gains, some private equity firms are seeking to extract maximum value over a short period before reselling the company (or what remains of it) and banking a substantial premium. Trade unions' experiences with employment and working conditions in leverage buy-out firms are alarming. There is a strong concern that the private equity model poses risks to the stability of the international financial system and the sustainability of national economies.

The growth of private equity investment requires a coordinated regulatory response by the international community and by OECD governments in particular. Regulatory reforms should address four areas:

- Transparency, prudential rules and risk management: There needs to be a level playing field between those alternative funds and other collective investment schemes with regard to transparency and reporting on performance, risk management and fee structure. Importantly, the investment policies of private equity within the OECD zone should be regulated according to prudential rules aimed at both financial market stability and long term asset value creation.

- Workers' rights to collective bargaining, information, consultation and representation within the firm should be regarded as key mechanisms by which the long-term interests of companies can be secured and promoted.

- Tax regulation – including tax deductibility of debt service, tax on capital gains and tax havens – needs to be reconfigured to cover private equity regimes so that tax systems remain investment-neutral and are not biased toward short-term investor behaviour. Some countries have already either proposed tax legislation to curb the negative tax effects of the activities of private equity funds (e.g. Denmark) or announced that they would further investigate the effect on their tax systems of such activities. Comprehensive answers should be developed so that the increasing activities of private equity funds does not jeopardise government revenues from corporate taxes.

- Corporate governance: Current national corporate governance frameworks focus on publicly traded companies and generally have far more weaker requirements for un-listed companies. In addition, they do not have sufficient mechanisms to guard against short term value extraction and to promote long term value creation. They are not suitable to address the challenges of private equity's short-term ownership regime. The responsibility and powers of the boards of directors to preserve long-term interests of companies under private equity regime need to be reinforced.

Unions call the OECD Ministers and G8 leaders to create an international regulatory task force on private equity including the OECD, the IMF, the Financial Stability Forum, relevant UN agencies, and the ILO.

TUAC has consultative status with the OECD and represents 66 million workers in 56 affiliated organisations in the 30 OECD countries. It is part of the Council of Global Unions representative of some 180 million workers worldwide.

For more information, contact the TUAC secretariat: tel.: 00 33 (0)1 55 37 37 37 – Email: tuac@tuac.org – website: http://www.tuac.org – 15, rue La Pérouse - F-75016 Paris