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Perspectives on Regulation of Systemic Risk in the Financial Services Industry

House Financial Services Committee

March 17, 2009

Good morning Chairman Frank and Ranking Member Bachus. My name is Damon Silvers and I am Associate General Counsel of the AFL-CIO and Deputy Chair of the Congressional Oversight Panel. My testimony today is on behalf of the AFL-CIO. Though I will refer to the Congressional Oversight Panel's report on regulatory reform mandated by the Emergency Economic Stabilization Act of 2008, my testimony reflects my views and those of the AFL-CIO, and does not necessarily reflect the views of the Congressional Oversight Panel, its chair or its staff. I have attached as appendices recent statements of the AFL-CIO Executive Council addressing financial regulation.

Systemic crises in financial markets harm working people. Damaged credit systems destroy jobs rather than create them. Pension funds with investments in panicked markets see their assets deteriorate. And the resulting instability undermines business' ability to plan and obtain financing for new investments—undermining the long term growth and competitiveness of employers and setting the stage for future job losses. The AFL-CIO has urged Congress since 2006 to act to reregulate shadow financial markets, and the AFL-CIO supports addressing systemic risk.

The Congressional Oversight Panel made the following recommendations with respect to addressing systemic risk, recommendations which the AFL-CIO supports.

1) There should be a body charged with monitoring sources of systemic risk in the financial system.[1] The Panel did not make recommendations as to the precise structure of such a body; however, the AFL-CIO believes systemic risk regulation should be the responsibility of a coordinating body of regulators, chaired by the Chairman of the Board of Governors of the Federal Reserve System. This body should have its own staff, with the resources and expertise to monitor sources of systemic risk in institutions and products throughout the financial markets.

2) The body charged with systemic risk management should be fully accountable and transparent to the public in a manner that exceeds the general accountability mechanisms present in self-regulatory bodies such as the regional Federal Reserve Banks that execute the Fed's current regulatory responsibilities.

[1] Congressional Oversight Panel, Special Report on Regulatory Reform, at 22-24 (Jan. 29, 2009), *available at* http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf.

3) We should not identify specific institutions in advance as too big to fail, but rather have a regulatory framework in which institutions have higher capital requirements and pay more on insurance funds on a percentage basis than smaller institutions which are less likely to be rescued as being too systemic to fail.

4) Systemic risk regulation cannot be a substitute for routine disclosure, accountability, safety and soundness, and consumer protection regulation of financial institutions and financial markets, nor can reform in the area of systemic risk regulation be a substitute for strengthening the overall financial regulatory framework. Tieing systemic risk regulation to the weakening of routine regulation, as the Paulsen Treasury blueprint did, would be a potentially catastrophic mistake.

5) Ironically, effective protection against systemic risk requires that the shadow capital markets—institutions like hedge funds and products like credit derivatives—must not only be subject to systemic risk oriented oversight but must also be brought within a framework of routine capital market regulation by agencies like the Securities and Exchange Commission. We can no longer tolerate a Swiss cheese system of financial regulation. This is particularly true in light of announced plans to have the Treasury Department and the Federal Reserve fund transactions with these shadow market institutions as part of TARP.

6) Finally, there will not be effective reregulation of the financial markets without a global regulatory floor.

The Congressional Oversight Panel urged attention be paid to executive compensation in financial institutions, with particular attention to issues of incentives with regard to risk and time horizons. This is an issue of particular concern to the AFL-CIO that I want to turn to now in some detail in relation to systemic risk.

Executive pay in financial institutions is a source of systemic risk when companies structure their pay packages to effectively encourage executives to take risks that their firms' capital structure cannot support. There are two basic ways executive pay structures do this. First, by having short term time horizons that enable executives to cash out their incentive pay before the full consequences of their actions are known. The poster child for this problem is Countrywide's pay package for Angelo Mozilo, that allowed Mr. Mozilo to take out over $400 million in incentive compensation during the four year period before Countrywide collapsed.[2]

The second problem is the problem of risk asymmetry. When an investor holds a stock, the investor is exposed to upside risk and downside risk in equal proportion. For every dollar of value lost or gained, the stock moves proportionately. But when an executive is compensated with stock options, the upside works like a stock, but the downside is effectively capped—once the stock falls well below the strike price of the option, the executive is relatively indifferent to

[2] During the height of the real estate bubble between 2004 and 2007, Mozilo exercised stock options valued at $414 million, prompting an informal U.S. Securities and Exchange Commission (SEC) investigation into the sales. *See* Countrywide Seeks Rescue Deal, WALL ST. J. (Jan. 11, 2008).

further losses. This creates an incentive to focus on the upside, and be less interested in the possibility of things going really wrong. It is a terrible way to incentivize the manager of a major financial institution, and a particularly terrible way to incentivize the manager of an institution the Federal government might have to rescue.

This is highly relevant to the situation of sick financial institutions. When stock prices have fallen to close to zero, stocks themselves behave like options from an incentive perspective. Thus it is very dangerous to have sick financial institutions run by people who are incentivized by the stock price. You are basically asking them to take destructive risks from the perspective of anyone, like the federal government, who might have to cover the downside. This problem today exists at institutions like AIG and Citigroup not just for the CEO or the top five executives, but for hundreds of members of the senior management team.

A further source of asymmetric risk incentives is the combination of equity based compensation with large severance packages. As we have learned, disastrous failure in financial institutions sometimes leads to getting fired, but rarely leads to getting fired for cause. The result is the failed executive gets a large severance package. If success leads to big payouts, and failure leads to big payouts, but modest achievements either way do not, then there is once again a big incentive to shoot the moon without regard to downside risk.

These sorts of pay packages in just one very large financial institution can be a source of systemic risk. But when such packages are the norm throughout the financial services sector, they are a system wide source of risk; much as certain types of unregulated derivatives, or asset backed securities can be a source of system wide risk.

The AFL-CIO has sought to move executive pay practices away from asymmetric, short term structures. We have helped lead initiatives with the business community like the Aspen Institute's Principles for Long-Term Value Creation that address executive pay time horizons.[3] We have sponsored shareholder proposals at financial institutions seeking to require equity based pay be held beyond retirement.[4] Increased SEC disclosure can give long-term investors better tools, but for financial institutions there must be direct involvement by safety and soundness regulators in monitoring both the time horizons and risk sensitivity of pay packages, and the agency charged with systemic risk regulation must monitor pay structures within financial institutions as they would monitor the [development of new financial products?].

The remainder of my testimony deals in detail with a number of issues raised by the problem of systemic risk—including the definition and history of the problem, lessons from the current

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[3] The Aspen Institute, Long-Term Value Creation: Guiding Principles for Corporations and Investors, *available at* http://www.aspeninstitute.org/sites/default/files/content/docs/business%20and%20society%20program/FINALPRINCIPLES.PDF.

[4] The AFL-CIO has filed proposals at Bank of NY Mellon, Citigroup, JP Morgan Chase, and AIG (co-filed with the American Federation of State County and Municipal Employees) urging each company to adopt a policy requiring senior executives to retain 75% of the shares acquired through compensation plans for two years following the termination of their employment and to report to shareholders regarding the policy before the Company's 2010 annual meeting.

financial crisis, structural issues associated with systemic risk regulation, issues of how to substantively regulate systemic risk, and the powers a systemic risk regulator should have.

What is Systemic Risk

The concept of systemic risk is that financial market actors can create risk not just that their institutions or portfolios will fail, but risk that the failure of their enterprises will cause a broader failure of other financial institutions and that such a chain of broader failures can jeopardize the functioning of financial markets as a whole. As Chairman Bernanke has recently noted, systemic risk can reside in firms and products, in the infrastructure of the financial markets, in pro-cyclical regulatory policies, and in larger economic developments like imbalances in international fund flows.[5] The mechanisms by which this broader failure can occur involve a loss of confidence in information, or a loss of confidence in market actors' ability to understand the meaning of information, which leads to the withdrawal of liquidity from markets and market institutions. Because the failure of large financial institutions can have these consequences, systemic risk management generally is seen to both be about how to determine what to do when a systemically significant institution faces failure, and about how to regulate such institutions in advance to minimize the chances of systemic crises.

History of Federal Policy with Respect to Systemic Risk

Historically, the United States has had three approaches to systemic risk. The first was prior to the founding of the Federal Reserve System, when there was reluctance at the federal level to intervene in any respect in the workings of credit markets in particular and financial markets in general. The Federal Reserve System, created after the financial collapse of 1907, ushered in an era where the federal government's role in addressing systemic risk largely consisted of sponsoring, through the Federal Reserve System, a means of providing liquidity to member banks, and thus hopefully preventing the ultimate liquidity shortage that results from market participants losing confidence in the financial system as a whole.[6]

But then, after the Crash of 1929 and the four years of Depression that followed, Congress and the Roosevelt Administration adopted a regulatory regime whose purpose was to substantively regulate financial markets in a variety of ways.[7] This new approach arose out of a sense among policymakers that the systemic financial crisis associated with the Great Depression resulted from the interaction of weakly regulated banks with largely unregulated securities markets, and that exposing depositors to these risks was a systemic problem in and of itself. Such centerpieces of our regulatory landscape as the Federal Deposit Insurance Corporation and the Securities and Exchange Commission's disclosure based system of securities regulation came into being not just as systems for protecting the economic interests of depositors or investors, but

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[5] Speech to the Council on Foreign Relations, March 10, 2009, available at http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm.

[6] The Federal Reserve System: Purposes & Functions at 1-2, *available at* http://www.federalreserve.gov/pf/pdf/pf_complete.pdf.

[7] *Id* at 59-74.

as mechanisms for ensuring systemic stability by, respectively, walling off bank depositors from broader market risks, and ensuring investors in securities markets had the information necessary to make it possible for market actors to police firm risk taking and to monitor the risks embedded in particular financial products.

In recent years, financial activity has moved away from regulated and transparent markets and institutions and into the so-called shadow markets. Regulatory barriers like the Glass-Steagall Act that once walled off less risky from more risky parts of the financial system have been weakened or dismantled.[8] So we entered the recent period of extreme financial instability with an approach to systemic risk that looked a lot like that of the period following the creation of the Federal Reserve Board but prior to the New Deal era. And so we saw the policy response to the initial phases of the current financial crisis primarily take the form of increasing liquidity into credit markets through interest rate reductions and increasingly liberal provision of credit to banks and then to non-bank financial institutions.

With the collapse of Lehman Brothers and the federal rescues of AIG, FNMA, and the FHLMC, the federal response to the perception of systemic risk turned toward much more aggressive interventions in an effort to ensure that after the collapse of Lehman Brothers, there would be no more defaults by large financial institutions. This approach was made somewhat more explicit with the passage of the Emergency Economic Stabilization Act of 2008 and the commencement of the TARP program.

<u>Lessons from the Current Financial Crisis</u>

We can now learn some lessons from this experience for the management of systemic risk in the financial system.

First, our government and other governments around the world will step in when major financial institutions face bankruptcy. We do not live in a world of free market discipline when it comes to large financial institutions, and it seems unlikely we ever will. If two administrations as different as the Bush Administration and the Obama Administration agree that the federal government must act when major financial institutions fail, it is hard to imagine the administration that would do differently. Since the beginning of 2008, we have used federal dollars in various ways to rescue either the debt or the equity holders or both at the following companies—Bear Stearns, Indymac, Washington Mutual, AIG, Merrill Lynch, Fannie Mae, Freddie Mac, Citigroup and Bank of America. But we have no clear governmental entity charged with making the decision over which company to rescue and which to let fail, no clear criteria for how to make such decisions, and no clear set of tools to use in stabilizing those that must be stabilized.

[8] For a comprehensive discussion of deregulation from 1975 through 2000, see Wilmarth, Arthur E.,The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation and Increased Risks. University of Illinois Law Review, Vol. 2002, No. 2 at 240, 2002. Available at SSRN: http://ssrn.com/abstract=315345.

Second, we appear to be hopelessly confused as to what it means to stabilize a troubled financial institution to avoid systemic harm. We have a longstanding system of protecting small depositors in FDIC insured banks, and by the way policyholders in insurance companies through the state guarantee funds. The FDIC has a process for dealing with banks that fail—a process that does not always result in 100% recoveries for uninsured creditors. Then we have the steps taken by the Treasury Department and the Federal Reserve since Bear Stearns collapsed. At some companies, like Fannie Mae and Freddie Mac, those steps have guaranteed all creditors, but wiped out the equity holders. At other companies, like Bear Stearns, AIG, and Wachovia, while the equity holders survive, they have been massively diluted one way or another. At others, like Citigroup and Bank of America, the equity has been only modestly diluted when looked at on an upside basis. It is hard to understand exactly what has happened with the government's interaction with Morgan Stanley and Goldman Sachs, but again there has been very little equity dilution. And then there is poor Lehman Brothers, apparently the only non-systemic financial institution, where everybody lost. In crafting a systematic approach to systemically significant institutions, we should begin with the understanding that while a given financial institution may be systemically significant, not every layer of its capital structure should be necessarily propped up with taxpayer funds.

Third, much regulatory thinking over the last couple of decades has been shaped by the idea that sophisticated parties should be allowed to act in financial markets without regulatory oversight. Candidly, institutional investors have been able to participate in a number of relatively lightly regulated markets based on this idea. But this idea is wrong. Big, reckless sophisticated parties have done a lot of damage to our financial system and to our economy. I do not mean to say that sophisticated parties in the business of risk taking should be regulated in the same way as auto insurers selling to the general public. But there has to be a level of transparency, accountability, and mandated risk management across the financial markets.

Fourth, financial markets are global now. Norwegian villages invest in U.S. mortgage backed securities.[9] British bankruptcy laws govern the fate of U.S. clients of Lehman Brothers, an institution that appeared to be a U.S. institution.[10] AIG, our largest insurance company, collapsed because of a London office that employed 377 of AIG's 116,000employees.[11] Chinese industrial workers riot when U.S. real estate prices fall. These are just a few illustrations of how global our financial markets have become, yet we increasingly live in a world where the least common denominator in financial regulation rules.

[9] Steven Pearlstein, It's Not 1929, but It's the Biggest Mess Since, WASHINGTON POST (Dec. 5, 2007), *available at* http://www.washingtonpost.com/wp-dyn/content/article/2007/12/04/AR2007120402186_pf.html.

[10] Mathieu Robbins, Lehman's bankruptcy '10 times more complicated than Enron', THE INDEPENDENT (Nov. 15, 2008), *available at* http://www.independent.co.uk/news/business/news/lehmans-bankruptcy-10-times-more-complicated-than-enron-1019875.html.

[11] Gretchen Morgenson, Behind Insurer's Crisis, Blind Eye to a Web of Risk, NY TIMES (Sept. 27, 2008), *available at* http://www.nytimes.com/2008/09/28/business/28melt.html?em=&pagewanted=all.

Further Observations on Regulating Systemic Risk

Structure

Regulating systemic risk requires as much access as possible to all information extant about the condition of the financial markets—including not just bank credit markets, but securities, commodities, and futures markets, and consumer credit markets. As long as we have the fragmented bank regulatory system we now have, this body would need access to information about the state of all deposit taking institutions. The reality of the interagency environment is that for information to flow freely, all the agencies involved need some level of involvement with the agency seeking the information. Connected with the information sharing issue is expertise. It is unlikely a systemic risk regulator would develop deep enough expertise on its own in all the possible relevant areas of financial activity. To be effective it would need to cooperate in the most serious way possible with all the routine regulators where the relevant expertise would be resident.

While many have argued the need for a systemic risk regulator to be fully public in the hope that would make for a more effective regulatory culture, the TARP experience highlights a much more bright line problem. An effective systemic risk regulator must have the power to bail out institutions, and the experience of the last year is that liquidity provision is simply not enough in a real crisis. An organization that has the power to expend public funds to rescue private institutions must be a public organization—though it should be insulated from politics much as our other financial regulatory bodies are by independent agency structures.

Here is where the question of the role of the Federal Reserve comes in. A number of commentators and Fed officials have pointed out that the Fed has to be involved in any body with rescue powers because any rescue would be mounted with the Fed's money. However, the TARP experience suggests this is a serious oversimplification. While the Fed can offer liquidity, many actual bailouts require equity infusions, which the Fed cannot currently make, nor should it be able to, as long as the Fed continues to seek to exist as a not entirely public institution. In particular, the very bank holding companies the Fed regulates are involved in the governance of the regional Federal Reserve Banks that are responsible for carrying out the regulatory mission of the Fed, and could if the current structure were untouched, be involved in deciding which member banks or bank holding companies would receive taxpayer funds in a crisis.

These considerations also point out the tensions that exist between the Board of Governors of the Federal Reserve System's role as central banker, and the great importance of distance from the political process, and the necessity of political accountability and oversight once a body is charged with dispersing the public's money to private companies that are in trouble. That function must be executed publicly, and with clear oversight, or else there will be inevitable suspicions of favoritism that will be harmful to the political underpinnings of any stabilization effort. One benefit of a more collective approach to systemic risk monitoring is that the Federal Reserve Board could participate in such a body while leaving restructuring responsibilities to other members since involvement in restructuring activities would likely be problematic in terms of the Fed's monetary policy activity.

Regulatory Approach

On the issue of whether to identify and separately regulate systemically significant firms, another lesson of the last eighteen months is that the decision as to whether some or all of the investors and creditors of a financial firm must be rescued cannot be made in advance. In markets that are weak or panicked, a firm that was otherwise seen as not presenting a threat of systemic contagion might be seen as doing just that. Conversely, in a calm market environment, it may be the better course of action to let a troubled firm go bankrupt even if it is fairly large. Identifying firms ex ante as systemically significant also makes the moral hazard problems much more intense.

The AFL-CIO believes effective systemic risk management in a world of diversified institutions would require some type of universal systemic risk insurance program or tax. Such a program would appear to be necessary to the extent the federal government is accepting it may be in a position of rescuing financial institutions in the future. Such a program would be necessary both to cover the costs of such interventions and to balance the moral hazard issues associated with systemic risk management. However, there are practical problems defining what such a program would look like, who would be covered and how to set premiums. One approach would be to use a financial transactions tax as an approximation. The global labor movement has indicated its interest in such a tax on a global basis, in part to help fund global reregulation of financial markets.

More broadly, these issues return us to the question of whether the dismantling of the approach to systemic risk embodied in the Glass-Steagall Act was a mistake. It appears that we are now in a position where we cannot wall off more risky activities like credit default swaps from less risky liabilities like demand deposits or commercial paper that we wish to insure. On the other hand, it seems mistaken to try to make large securities firms behave as if they were commercial banks. Those who want to maintain the current dominance of integrated bank holding companies in the securities business should have some burden of explaining how their securities businesses plan to act now that they have an implicit government guaranty.

Finally, the AFL-CIO believes very strongly that the regulation of the shadow markets, and of the capital markets as a whole cannot be shoved into the category labeled "systemic risk regulation," and then have that category be effectively a sort of night watchman effort. The lesson of the failure of the Federal Reserve to use its consumer protection powers to address the rampant abuses in the mortgage industry earlier in this decade is just one of several examples going to the point that without effective routine regulation of financial markets, efforts to minimize the risk of further systemic breakdowns are unlikely to succeed. We even more particularly oppose this type of formulation that then hands responsibility in the area of systemic risk regulation over to self-regulatory bodies.

Powers of a Systemic Risk Regulator

As Congress moves forward to address systemic risk management, one area that we believe deserves careful consideration is how much power to give to a body charged with systemic risk management to intervene in routine regulatory policies and practices. There are a range of options, ranging from power so broad it would amount to creating a single financial services super regulator, e.g. vesting such power in staff or a board chairman acting in an executive capacity, to arrangements requiring votes or supermajorities, to a system where the systemic risk regulator is more of a scout than a real regulator, limited in its power to making recommendations to the larger regulatory community. The AFL-CIO would tend to favor a choice somewhere more in the middle of that continuum. We strongly support the view stated by Professor Jack Coffee of Columbia University that a systemic regulator should not have the authority to override investor and consumer protection rules, particularly disclosure related rules promulgated by the relevant regulators.

Finally, with respect to the jurisdiction and the reach of a systemic risk regulator, we believe it must not be confined to institutions per se, or products or markets, but must extend to all financial activity.

Conclusion

The AFL-CIO appreciates the opportunity to testify today, and commends this Committee for its leadership in this area, and its insistence that financial regulation needs to be strengthened. We urge the Committee to undertake a comprehensive strengthening of the financial regulatory system. The AFL-CIO would be pleased to assist this Committee in any way possible as the Committee takes up these critical tasks. Thank you.

Bank Bailouts

March 05, 2009

Miami, Fla.

AFL-CIO Executive Council statement

There has been a dramatic concentration of banking power since the Gramm-Leach-Bliley Act repealed New Deal bank regulation. More than 43 percent of U.S. bank assets are held by just four institutions: Citigroup, Bank of America, Wells Fargo and JP Morgan Chase. When these institutions are paralyzed, our whole economy suffers. When banks appear on the brink of collapse, as several have repeatedly since September, government steps in. The free market rules that workers live by do not apply to these banks.

Since Congress passed financial bailout legislation in October, working people have seen our tax dollars spent in increasingly secretive ways to prop up banks that we are told are healthy, until they need an urgent bailout. In some instances, institutions that were bailed out need another lifeline soon after. The Congressional Oversight Panel, charged with overseeing the bailout, recently found that the federal government overpaid by $78 billion in acquiring bank stock.

The AFL-CIO believes government must intervene when systemically significant financial institutions are on the brink of collapse. However, government interventions must be structured to protect the public interest, and not merely rescue executives or wealthy investors. This is an issue of both fairness and our national interest. It makes no sense for the public to borrow trillions of dollars to rescue investors who can afford the losses associated with failed banks.

The most important goal of government support must be to get banks lending again by ensuring they are properly capitalized. This requires forcing banks to acknowledge their real losses. By feeding the banks public money in fits and starts, and asking little or nothing in the way of sacrifice, we are going down the path Japan took in the 1990s—a path that leads to "zombie banks" and long-term economic stagnation.

The AFL-CIO calls on the Obama administration to get fair value for any more public money put into the banks. In the case of distressed banks, this means the government will end up with a controlling share of common stock. The government should use that stake to force a cleanup of the banks' balance sheets. The result should be banks that can either be turned over to bondholders in exchange for bondholder concessions or sold back into the public markets. We believe the debate over nationalization is delaying the inevitable bank restructuring, which is something our economy cannot afford.

A government conservatorship of the banks has been endorsed by leading economists, including Nouriel Roubini, Joseph Stiglitz and Paul Krugman. Even Alan Greenspan has stated it will probably be necessary.

The consequences of crippled megabanks are extraordinarily serious. The resulting credit paralysis affects every segment of our economy and society and destroys jobs. We urge President

Obama and his team to bring the same bold leadership to bear on this problem as they have to the problems of economic stimulus and the mortgage crisis.

Financial Regulation

March 05, 2009

Miami, Fla.

AFL-CIO Executive Council statement

Deregulated financial markets have taken a terrible toll on America's working families. Whether measured in lost jobs and homes, lower earnings, eroding retirement security or devastated communities, workers have paid the price for Wall Street's greed. But in reality, the cost of deregulation and financial alchemy are far higher. The lasting damage is in missed opportunities and investments not made in the real economy. While money poured into exotic mortgage-backed securities and hedge funds, our pressing need for investments in clean energy, infrastructure, education and health care went unmet.

So the challenge of reregulating our financial markets, like the challenge of restoring workers' rights in the workplace, is central to securing the economic future of our country and the world. In 2006, while the Bush administration was in the midst of plans for further deregulation, the AFL-CIO warned of the dangers of unregulated, leveraged finance. That call went unheeded as the financial catastrophe gathered momentum in 2007 and 2008, and now a different day is upon us. The costs of the deregulation illusion have become clear to all but a handful of unrepentant ideologues, and the public cast its votes in November for candidates who promised to end the era of rampant financial speculation and deregulation.

In October, when Congress authorized the $700 billion financial bailout, it also established an Oversight Panel to both monitor the bailout and make recommendations on financial regulatory reform. The panel's report lays the foundation for what Congress and the Obama administration must do.

First, we must recognize that financial regulation has three distinct purposes: (1) ensuring the safety and soundness of insured, regulated institutions; (2) promoting transparency in financial markets; and (3) guaranteeing fair dealing in financial markets, so investors and consumers are not exploited. In short, no gambling with public money, no lying and no stealing.

To achieve these goals, we need regulatory agencies with focused missions. We must have a revitalized Securities and Exchange Commission (SEC), with the jurisdiction to regulate hedge funds, derivatives, private equity and any new investment vehicles that are developed. The Commodity Futures Trading Commission should be merged with the SEC to end regulatory arbitrage in investor protection.

Second, we must have an agency focused on protecting consumers of financial services, such as mortgages and credit cards. We have paid a terrible price for treating consumer protection as an afterthought in bank regulation.

Third, we need to reduce regulatory arbitrage in bank regulation. At a minimum, the Office of Thrift Supervision, the regulator of choice for bankrupt subprime lenders such as Washington Mutual and IndyMac, should be consolidated with other federal bank regulators.

Fourth, financial stability must be a critical goal of financial regulation. This is what is meant by creating a systemic risk regulator. Such a regulator must be a fully public agency, and it must be able to draw upon the information and expertise of the entire regulatory system. While the Federal Reserve Board of Governors must be involved in this process, it cannot undertake it on its own.

We must have routine regulation of the shadow capital markets. Hedge funds, derivatives and private equity are nothing new—they are just devices for managing money, selling insurance and securities and engaging in the credit markets without being subject to regulation. As President Obama said during the campaign, “We need to regulate institutions for what they do, not what they are.” Shadow market institutions and products must be subject to transparency and capital requirements and fiduciary duties befitting what they are actually doing.

Reform also is required in the incentives governing key market actors around executive pay and credit rating agencies. There must be accountability for this disaster in the form of clawbacks for pay awarded during the bubble. According to Bloomberg, the five largest investment banks handed out $145 billion in bonuses in the five years preceding the crash, a larger amount than the GDP of Pakistan and Egypt.

Congress and the administration must make real President Obama’s commitment to end short-termism and pay without regard to risk in financial institutions. The AFL-CIO recently joined with the Chamber of Commerce and the Business Roundtable in endorsing the Aspen Principles on Long-Term Value Creation that call for executives to hold stock-based pay until after retirement. Those principles must be embodied in the regulation of financial institutions. We strongly support the new SEC chair’s effort to address the role played by weak boards and CEO compensation in the financial collapse. With regard to credit rating agencies, Congress must end the model where the issuer pays.

Financial reregulation must be global to address the continuing fallout from deregulation. The AFL-CIO urges the Obama administration to make a strong and enforceable global regulatory floor a diplomatic priority, beginning with the G-20 meeting in April. The AFL-CIO has worked closely with the European Trade Union Congress and the International Trade Union Confederation in ensuring that workers are represented in this process. We commend President Obama for convening the President’s Economic Recovery Advisory Board, chaired by former Federal Reserve Chair Paul Volcker, author of the G-30 report on global financial regulation, and we look forward to working with Chairman Volcker in this vital area.

Reregulation requires statutory change, regulatory change, institutional reconstruction and diplomatic efforts. The challenge is great, but it must be addressed, even as we move forward to restore workers’ rights and revive the economy more broadly.

Corporate Greed and Retirement Security

August 05, 2008

Chicago

AFL-CIO Executive Council statement

Corporate greed and spiraling executive compensation reinforce the growing inequality in our society. In the area of retirement, some companies are shedding their pension plans by declaring bankruptcy, letting CEOs keep their golden parachutes and leaving workers and retirees holding the bag. The long-term health of pension plans, and the retirement security of the workers and families who rely upon them, also are threatened by conflicts of interest on Wall Street and in the boardroom, a lack of accountability of executives to shareholders and outright corporate fraud.

In their assault on retirement security, well-paid chief executives have decided that secure defined-benefit pensions are too expensive for everyone except themselves. In 1980, roughly half of the nation's private-sector workers were covered by defined-benefit pension plans, with typical employer contributions of about 8 percent of payroll. Today, less than 20 percent of the private-sector workforce participates in such plans. More than 40 percent (according to the Bureau of Labor Statistics) have a 401(k) or other defined-contribution account, with employer contributions averaging less than 3 percent of pay. Hidden in this change is a 5 percent real pay cut.

In the midst of this attack on secure retirement, we now learn that companies are raiding worker pensions to fund already lavish CEO retirement packages. According to a recent news report, companies have "collectively moved hundreds of millions of dollars in obligations for executive benefits into rank-and-file pension plans." This enables companies to capture tax breaks "intended for pensions of regular workers and use them to pay for executives' supplemental benefits and compensation." (The Wall Street Journal, 8/4/08)

This outrageous practice threatens the long-term health of worker's pension plans and forces taxpayers to finance already excessive executive compensation. According to the same article, companies and their consultants have deliberately sought to hide this practice, and it appears that the IRS and other regulatory authorities have failed to monitor and police this tax dodge.

Workers' deferred wages in the form of pensions are not piggy banks for tax avoidance by conflicted consultants and overpaid executives. We urge Congress to investigate this practice fully, provide for greater transparency and close loopholes that allow this to occur.

Congress must also adopt measures to preserve and protect existing pension plans, ensure that employees have a voice in governing their own pension assets, prevent corporations from using the bankruptcy courts to escape pension obligations while richly rewarding executives and ensure adequate retirement security and income through a national pension policy.

Financialization, Financial Market Deregulation and the Credit Crisis

March 05, 2008

San Diego

AFL-CIO Executive Council statement

The implosion of the housing market and the cascading crises in the credit markets are the direct consequence of a 30-year experiment of trying to create a deregulated, low wage economy where high consumer spending is propped up by easy credit and asset bubbles. Real solutions must be based on restoring the economic health of the American middle class through good jobs, health care, retirement security and a voice at work for all. And an important part of the solution must be the thoughtful, comprehensive re-regulation of the financial markets.

The AFL-CIO has long favored greater investor protections and regulatory oversight of participants in the U.S. financial markets. As we meet, much of the mortgage market, the municipal bond market, the market for riskier corporate debt, and in the last week the student loan market, are frozen—the result of speculative excess and a massive loss of confidence in the information available to investors. Only thoughtful re-regulation can restore that confidence and the ability of the markets to properly function.

The damage to working families is real, and growing. Working people are losing their homes at an alarmingly rate. Jobs in residential construction, one of the largest construction industry markets, are disappearing. Perfectly good companies are unable to finance their businesses. And workers' pension funds have suffered tens of billions of dollars in losses from their investments in financial services companies and housing-sector companies battered by subprime losses.

Reining in financial intermediaries after a 30-year free-for-all will be a complex task requiring coordinated action involving Congress and regulators at the state, federal international levels. Given the irresponsible attitude of many in the Bush administration, we must assume that at best only the first steps will be possible while that administration remains in office.

Effective regulation must be implemented to ensure the transparency and accountability of mortgage lenders, investment banks, credit-rating agencies, hedge funds, private equity funds, off-balance-sheet lending vehicles and other structured credit products, as well as Sovereign Wealth Funds. The AFL-CIO has called repeatedly for transparency and clear fiduciary duties to investors by all pools of private capital and capital market intermediaries. The reasons for such transparency have never been clearer.

The AFL-CIO also has warned repeatedly of the danger of market accounting in contexts where there are no functioning markets or where such accounting can contribute to a downward economic spiral unrelated to the actual business activity of companies. We are now living through a bubble followed by a downward spiral in the credit markets, made worse by applying mark to market accounting where markets have frozen.

As a first step, policymakers must revisit the inherent conflict that exists when fee-based investment banking is combined with the business of taking and investing insured deposits. The repeal of the Glass-Steagall Act by the Gramm-Leach-Bliley Act left this dangerous conflict without any effective oversight. In particular, Congress and the regulators must address compensation structures that reward the taking of excessive risk with federally insured deposits.

Furthermore, regulators here and around the world must deal with the fundamental problem that if a lender can pass off bad loans to an unsuspecting public, keep none of the risk and collect large fees, that institution has no incentive not to make the bad loan in the first place. The AFL-CIO supports the effort of House Banking Committee Chairman Barney Frank to work on these issues on an international basis with the European Parliament.

Credit-rating agencies that gave securitized subprime loans triple A ratings are one of the major causes of this debacle. Congress needs to increase the Securities and Exchange Commission's power to regulate these agencies, possibly through an independent body like the Public Company Accounting Oversight Board created by the Sarbanes-Oxley Act.

Like all investors that rely heavily on borrowing to finance their investments, hedge funds and private equity funds will suffer as lenders tighten their standards. The high-profile failures of leveraged buyouts led by prominent private equity firms including Blackstone and J.C. Flowers are indicative of the difficulties ahead. As we have said in the past, Congress should act (1) to give the regulators power in this area to protect investors and (2) to ensure that our tax system is fair by taxing hedge fund and private equity fees at ordinary income rates.

As a result of nearly three decades of self-destructive trade and energy policies, our trade deficit has given birth to the Sovereign Wealth Funds. Our flagship financial institutions, crippled by their catastrophic involvement in the subprime markets, have recently turned to these funds, who have gained significant levels of ownership in these important institutions. As a result of our trade deficit, our economy has come to depend on flows of foreign capital, and we cannot look to exclude such funds from our markets or take away their rights as investors. Nonetheless, we strongly support the efforts of Sens. Jim Webb, Charles Schumer and Evan Bayh to address the challenges posed by the rise of Sovereign Wealth Funds.

Specifically, Sovereign Wealth Funds should be required to comply with all of the disclosure requirements that apply to domestic investors. In addition, Congress should strengthen the process for U.S. government review when foreign governments invest in U.S. companies by (1) removing provisions that allow foreign investors to escape government review when shares are non-voting, and (2) lowering the ownership level that triggers optional governmental review from 10 percent to 5 percent.

However, not all Sovereign Wealth Funds are the same. Norway's Government Pension Fund provides retirement security for all Norwegians and is a leader in efforts at transparency in the global capital markets. The Norwegian fund should be looked to as a model of the transparency and accountability we should expect from all Sovereign Wealth Funds.

Financial re-regulation will not by itself restore our economy to health. That will require middle class restoration. But thoughtful re-regulation of financial markets is part of what must be done.

We urge Congress and the regulators to act without delay to address the conflicts within financial institutions, bring transparency to opaque pools of capital, and protect consumers and the public interest in the capital markets.

Private Equity and Hedge Funds

August 08, 2007

Chicago

AFL-CIO Executive Council statement

In the past year, the global labor movement has mobilized to address the issue of what John Monks, president of the European Trade Union Confederation, has labeled the "financialization" of the global economy.

Financialization describes the growing dominance of finance over the real economy, and, in the United States at least, over politics as well. At the heart of financialization are the growing size and power of hedge funds and leveraged private equity funds—leveraged private pools of capital that benefit from extensive tax subsidies and are unregulated and shrouded in secrecy.

The AFL-CIO has long favored greater investor protections and regulatory oversight of hedge funds, as the Executive Council reaffirmed in its statement last March. However, the recent dramatic growth in both leveraged private equity and hedge funds has made it necessary to state the labor movement's views on the challenges these funds pose to policymakers, to workers and their unions and to fiduciaries entrusted with workers' capital.

Leveraged buyout funds and hedge funds have been around for years and are not going to disappear. Pension funds and other institutional investors have used them properly in modest amounts to help round out their portfolios and offset the volatility of other investments. But it is both dangerous and illusory to believe that pension funds in general can achieve sustained above-market rates of return for large portions of their portfolios by investing in leveraged asset pools. And there is no reason why these funds should be secretive or unaccountable. Finally, there is no reason why the individuals who manage private equity and hedge funds should receive tax subsidies that leave the burden of paying ordinary tax rates to working people.

It is easy to generate high returns to equity with a combination of cheap debt financing and tax subsidies. That is not a long-term strategy, nor does it require genius—and there is a real cost. There is a hidden cost to the investors who are paying for the leverage with risk, a real cost to workers and their companies that are managed for short-term return and a real cost to the rest of us who subsidize the massive redistribution of our wealth and tax dollars to billionaires.

While leveraged buyouts can provide needed capital to troubled companies, a mania for leveraged finance sets in motion a dynamic in which companies are acquired and hollowed out to make them appealing candidates for being flipped back into the public markets. Workers' jobs, their health and retirement benefits and, in the end, their communities are nothing more than costs that can be converted into debt repayments. America's workers experienced this dynamic in the late 1980s, and now we are experiencing it again.

In response, the AFL-CIO's policy on private equity and hedge funds addresses government policymakers, pension fund fiduciaries and private equity and hedge fund managers themselves.

First, policymakers should enforce our existing laws, protect investors and, most of all, ensure that our tax system is fair. Private pools of capital should be required to play by the same set of rules as everyone else.

The Securities and Exchange Commission should enforce the Investment Company Act and require private equity and hedge funds that wish to sell interests in their underlying investment pools to register as investment companies.

The IRS should look into self-dealing tax avoidance schemes by private equity funds and hedge funds going public. The IRS and the SEC should investigate whether the positions taken by these funds going public with each agency are mutually consistent.

The AFL-CIO strongly endorses both the Grassley-Baucus bill, S. 1624, and the Levin-Rangel bill, H.R. 2834. The Grassley-Baucus bill requires private equity firms and hedge funds that go public to either provide investors with the protections they are entitled to under the Investment Company Act or pay corporate taxes on their earnings, while the Levin-Rangel bill requires hedge fund and private equity managers to pay ordinary income tax rates on their wages like other Americans. We commend the authors and co-sponsors of these bills for their leadership in this area, together with those in Congress who have asked the regulators to enforce the existing tax, investor protection and national security laws. Both bills are badly needed correctives to a tax system that has become grossly unfair.

The AFL-CIO calls upon politicians who think billionaires should have lower tax rates than firefighters and teachers to explain why they deserve the votes of working people.

The AFL-CIO recommends that fiduciaries exercise great care in investing workers' capital in leveraged or opaque private investment vehicles. We urge fiduciaries to invest only in hedge funds that are registered with the SEC as investment advisors, and to ask hedge fund managers to agree to be bound by key protective provisions of ERISA. Some funds also have adopted policies that address the workplace practices of private equity and their impact on long-term value creation.

We particularly urge fiduciaries to work with their asset consultants to ensure the total exposure to either of these categories is modest and the expectations in relation to long-term risk-adjusted returns are realistic.

Finally, the AFL-CIO calls upon the hedge fund and private equity industries to act responsibly—to engage in dialogue both in the United States and globally around investor protection, taxation and workers' rights in the companies they control and influence. There are models for responsible behavior—leveraged buyout firms with a significant history of working productively with workers and their unions, both in the United States and overseas, generating healthy returns while preserving jobs and treating workers with respect.

We particularly urge the industry to engage in a dialogue around investor protection, tax fairness and workers' rights with the global labor movement. America's workers and their unions stand in solidarity with our brothers and sisters around the world in facing the challenge of financialization.

FACT SHEET

MYTHS AND FACTS ABOUT PRIVATE EQUITY AND HEDGE FUNDS

As generally occurs when great wealth and power are concentrated in the hands of a few people, hedge funds and leveraged private equity funds promote a variety of myths about themselves. Fiduciaries and policy makers need to cut through the paid propaganda and focus on the truths behind financialization.

- Neither the term “private equity” nor the term “hedge fund” really describes an asset class. Private equity is a code word for leveraged buyout. There are leveraged buyout firms that borrow money to buy companies, and there are venture capital firms that invest equity in start-up businesses. Almost every “private equity” deal really is a leveraged buyout. As to hedge funds, any asset management strategy can be pursued in the hedge fund form. A hedge fund is a legal structure that avoids regulation in search of an asset class.

- Leveraged private equity and hedge funds do not create money from nothing. Leveraged trading strategies generate high returns by taking on risk through borrowing. That’s what the term “leverage” means. Recent studies from Harvard Business School suggest that after adjusting for the high fees and the risk from the leverage, private equity firms may not outperform public markets.

- The business strategy of leveraged buyouts puts them inherently at odds with workers’ interest in maintaining living standards, and at odds with our member’s interests in having employers and pension funds that focus on long-term value.

- Leveraged buyouts are cyclical—they thrive when risky debt is cheap and stocks are depressed. Recently, long-term debt has been very cheap as China and other countries that run trade surpluses with us look for places to put all the dollars they are accumulating. Tightening credit markets let the air out of leveraged buyouts and can lead to serious losses for leveraged buyout investors.

- Leveraged buyout firms, like their hedge fund relatives, charge their investors extraordinary fees—2 percent of assets managed and 20 percent of the total fund earnings over a benchmark—and pay their partners extraordinary amounts of money. The top 25 hedge fund managers last year earned $14 billion dollars, enough to pay New York City’s 80,000 public school teachers for nearly three years.

- Leveraged buyout firms and hedge funds are forms of pooled money management, just like mutual funds. When they try to sell interests in themselves to the investing public, no matter how complex the structure they use to disguise what they are doing, they must be subject to the investor protections of the Investment Company Act.

- Leveraged buyout firms and hedge funds and the people who run them get extraordinary tax breaks that are not justified and that may not in all cases be legal. Private equity and hedge fund managers pay 15 percent capital gains rates on their money management income (called the "carried interest") even though they put no money at risk. Private equity firms and hedge funds that go public tell the SEC they are in the business of active management of companies—but then tell the IRS they are in the business of passive management of securities to get an exemption from paying corporate taxes.

Investor Protection and Corporate Accountability

March 06, 2007

Las Vegas

AFL-CIO Executive Council statement

Since the collapse of Enron and WorldCom, America's workers and their benefit funds have experienced firsthand the consequences of failures in corporate governance for our retirement security, our health care and our jobs. With each passing year, fewer workers have pensions or adequate health care while executive compensation continues to explode, as documented on the AFL-CIO's Executive PayWatch website. In the past year, we have seen scandalous examples of stock options abuses at hundreds of companies and runaway executive pay and exit packages.

Runaway executive pay is the most flagrant example of the growing inequality in American society. We read of Wall Street executives receiving tens of millions of dollars in bonuses and ordering $15,000 bottles of wine—an amount larger than a year's worth of work at the minimum wage. At Pfizer and Home Depot, failed executives left with exit packages exceeding $200 million each.

Excessive executive pay increasingly allows CEOs to gain political influence, in some cases funding political campaigns from their own personal resources. For example, Massey Energy CEO Don Blankenship—who in 2005 alone received $28.8 million in total compensation—spent more than $6 million over the past three years on state elections in an effort to defeat pro-worker candidates and ballot initiatives, according to published reports. America's working families today live in a society in which the wealthy and very wealthy increasingly control political power.

Meanwhile, our nation goes further into debt. In military hospitals without the money to provide proper care, our wounded soldiers suffer¾in many instances from wounds received due to lack of proper equipment. And 18 months after Hurricanes Katrina and Rita struck the Gulf Coast, more than 100,000 people still are unable to return home because the government lacks the resources to act.

These developments are not unrelated to the increased power of short-term investors in the capital markets. Today, hedge funds control more than $1.5 trillion and are subject to almost no oversight, even though much of the money invested in hedge funds comes from workers' pension funds. The international labor movement has become increasingly focused on the combination of hedge funds and private equity funds driving what John Monks, head of the European Trade Union Congress, calls the "financialization" of whole economies. As a result of court decisions and the weakening of ERISA protections by the last Republican Congress, workers' pension assets invested in hedge funds today are less well protected than they ever have been.

Workers and their pension funds are the leading voices in our capital markets for reining in executive pay, holding corporate boards accountable to shareholders, improving our accounting and auditing systems, and fighting to keep companies and investment managers focused on the long-term goal of creating value for investors and all Americans. Union-affiliated investors now account for a majority of shareholder proposals, addressing such issues as stock option abuse, corporate political contributions, the independence of compensation consultants, the election of company directors (requiring a majority vote) and, for the first time this year, the right of long-term investors to nominate their own directors to corporate boards. The AFL-CIO and our affiliates have worked closely with the regulatory agencies on a bipartisan basis to ensure that workers' interests as investors are protected through both thoughtful regulation and enforcement.

Although the case for continued reform has never been stronger, powerful corporate interests have been working to attack the investor protections we already have. Their efforts are funded by individuals such as the disgraced former CEO of AIG, Hank Greenberg, and Wilbur Ross, the CEO of the company that owns the infamous Sago coal mine. Through reports by ideological groups, they seek to lower our system of investor protections to the point that companies controlled by the Chinese government can feel safe selling their stock to U.S. investors. They seek to subsidize the jobs of investment bankers by putting at risk the retirement security of millions of America's workers.

In response, the AFL-CIO believes increased accountability and responsibility must be required of our corporations and our capital markets. We call upon the new Congress to begin comprehensive hearings on the continuing failures of our corporate governance and capital market regulation systems. These hearings should address (1) executive pay excesses and the apparent widespread and flagrant legal violations involved in the stock options scandals; (2) the impact of the growth of hedge funds and private equity on the health of our capital markets and our economy overall; (3) the effect that corporate America's retreat from providing pensions has on our system of corporate finance; and (4) the relationship of our increasingly regressive tax system to the explosion in executive pay, our growing budget deficit, and our inability to fund basic governmental obligations.

We call upon Congress and the independent regulatory agencies charged to protect investors to reject calls to weaken investor protections. Our system of investor protection is our competitive advantage in the world capital markets, attracting the foreign capital we require to fund our out-of-control trade deficit.

We call upon Congress to restore full ERISA coverage of hedge funds and to give the Securities and Exchange Commission the clear power to regulate hedge funds as it regulates other forms of money management.

We call upon Congress and the Securities and Exchange Commission to give long-term investors the tools they need to ensure that corporate and mutual fund boards are composed of and led by independent directors ready to hold management accountable to the long-term best interests of public corporations. These tools include the ability of investors to have a voice on executive pay, the requirement that corporate directors have the affirmative support of a majority of the shareholders before they can be elected to a board (majority vote), and a viable method for long-term investors to nominate psychologically independent directors to corporate boards (proxy access).