PUSH THE RESET BUTTON - A LINE BETWEEN SPECULATION & INVESTMENT

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The Lehman Brothers Collapse – Five Years After

We all remember that fateful day – 15 September 2008 when the merchant bank, Lehman Brothers, filed for bankruptcy triggering a series of events that led to the worst financial crisis and global recession since the Second World War.

The G20 was thrust into prominence as the central economic policy coordination forum in the near financial meltdown of 2008. In its first year of meeting, at the Leaders' Summit, the G20 showed the necessary political will to avert a second Great Depression. The ILO estimated that this coordinated action of 2008 and 2009 saved nearly 30 million jobs. An ambitious Financial Action Plan was adopted at the London Summit in April 2009. The then G20 Chair, Gordon Brown, said "never again will the financial sector be in control of the real economy". In September 2009 in Pittsburgh, the G20 committed to "putting quality jobs at the heart of the recovery".

However, in 2010, the G20 governments panicked in the face of strident financial markets and abruptly shifted from supporting global growth, jobs and economic rebalancing to cutting public expenditure, jobs, wages and bargaining rights in extraordinary austerity measures. The result, five years later, is a massive slump in demand, intractable unemployment, higher debt to GDP ratios in crisis countries and an impoverishment of millions with a "recovery" nowhere in sight.

The fact is the global economy is no more stable than it was six years ago.

IMF forecasts for global growth, standing at 3.1%, have been revised downward six successive times, and the emergent trouble in the BRICS along with the threat of currency instability in ASIA is not a recipe for confidence. Recorded unemployment is still some 50% higher in the industrialised countries than before the crisis, and 100 million more people in the developing countries live in extreme poverty.

In some countries even on the basis of the most optimistic assumptions, it will take five more years for income per head to return to pre-crisis levels. Cohorts of young people are being scarred by the experience of joblessness.

This is the formal sector, and with an additional 40% of the workforce in the desperation of the informal sector, where there are no rules but increasingly a supply chain engagement, the picture is even more frightening.

The underlying causes of the crisis remain unaddressed. The financial lobby has effectively watered down the policy measures necessary to re-regulate the financial sector. The Financial Stability Board and its members have collectively failed to meet deadlines. Ownership of the banking sector is now more concentrated than it was before 2008, despite the commitments made to ensuring there could no longer be banks that were "too big to fail". And speculation has increased not decreased.

Austerity has failed both people and growth. Two decades of rising inequality in most G20 countries before the crisis have not been reversed.

The most recent report of the OECD (2013) shows that market income inequality increased further and more rapid than ever before. The increase between 2008 and 2010 was as strong as in the twelve years prior to the crisis.

In the UK disposable income is now back to 1987 levels.

In Germany, despite its celebrated economic success, 40% of workers earn less than 15 years ago.

And of course US workers have a wage share approaching a 35-year low.

The height of corporate greed is evident in the US where one US family – the Walmart Waltons – own the same wealth as 40% of Americans.

Plus just a few weeks ago the Forbes 400, an annual list of the wealthiest Americans, published Monday, showed that the combined wealth of America's 400 richest swelled 19 percent over the past year to a record $2 trillion, more than the annual gross domestic product of Canada.

And the US has successfully exported the exploitative supply chain model that fuels such greed. In a word 'Bangladesh'.

In the developing world, despite the hype that the World Bank and others claim about reducing poverty, the benchmark is still $1.25 US a day and 1.2b people try to survive on less than this. Further, one billion people don't have access to adequate drinking water with 2.6 billion lacking proper sanitation.

Indeed, mortality rates have increased not decreased in 37 countries over the past three decades.

Food security is a major issue. Put simply for us, when the price of staples such as onions in India, cabbage in Korea and maize in Africa are priced out of the reach of people due to speculative investment manipulating pricing, then we need to act. The income distribution tools of collective bargaining, a minimum wage on which people can live and social protection must play a central role.

The system is sick and even if you dismiss stagnant demand, inequality and income distribution, human and labour rights, social unrest or climate change, you must acknowledge that just the specter of risk of any one or more requires your attention. Modern portfolio theory has failed and we need a dedicated approach to inclusive growth.

We need to rebuild our economies – an economic model that returns to old principles: full employment, decent work – the dignity of work where people's rights are respected – and a universal social protection floor.

In turn this requires a new investment model. An investment model that realises jobs – jobs, jobs and jobs.

It is urgent to rebuild trust.

The ITUC presented to the G20 an economic and social outlook based on the ITUC's 2013 Global Poll, inclusive of China and India, and covering more than half of the world's population. It paints a picture of profound insecurity and mistrust.

- One in two working families are directly impacted by the loss of jobs or the reduction of working hours.
- 78 % say they have seen their family incomes fall behind the cost of living or remain stagnant. Two-thirds of respondents (63 %) rate their national economy as bad.
- The majority of people (61%) percent think employment prospects for young people are getting worse and 55% think future generations will be worse off.

When it comes to fighting unemployment and defending the interests of working families, global citizens feel abandoned by their governments.

- A dramatic 80% of respondents say their government has failed to tackle unemployment effectively.
- People do not believe that current labour laws provide adequate job security (63%) and fair wages (65%).
- Only 13 percent of people think governments are acting in their interests and 28 percent are disenchanted – or worse disengaged – with the belief that governments are acting in the interest of neither people or business. This is a serious reflection of disenchantment at best, and at worst disengagement from democracy.

The good news is that people know what they want: jobs, decent wages and social protection.

- Jobs: Investment in infrastructure, new green technologies and industries – 92 percent support public investment in education, research and new technologies to create jobs.
- Strong labour laws – 92% of people agree or strongly agree that international companies should adhere to international rules irrespective of where they are, 95% say employees should pay a reasonable wage no matter where they work and 89 percent of people support the right to join a union.
- And people are prepared to take responsibility when 78% support international labour rules that meant workers were better paid by multi-national companies, even if it meant paying a little more for goods or services.
- A social protection floor: There is 90 percent plus for a social protection floor with active incomes measures. Affordable access to health care (97 percent in favour). Affordable access to education (97 percent in favour). Decent retirement incomes (96 percent in favour). Affordable access to childcare (92 percent in favour). Unemployment benefits (88 percent in favour).

- An end to tax avoidance and a call for fair taxation. 86 % support policies to stop large and multi-national corporations avoiding tax, and 80% percent are open to raising taxes on large companies.

While people know what they want, this can only be realised if the investment model changes.

Eight G20 Summits have now passed since 2008, and finally the language of the Leaders' Declaration in the most recent St Petersburg Summit has again shifted in direction. The need for inclusive growth, quality jobs and even collective bargaining are all recognised. The action plan on tax evasion 'BEPS' (Base Erosion and Profit Shifting) and principles for long-term investment have been endorsed.

While the gap between the language of the Declaration and the implementation of policies on the ground remains vast, the framework for action is on the right track, and this audience can play a significant role in realising the necessary shift to patient capital and transparency this will require.

Institutional Investors' Shifting to the Long Term

The need for institutional investors to adopt long-term investment (hereafter LTI) strategies and in particular to increase portfolio 'exposure' to infrastructure projects (including infrastructure, software, R&D, housing, energy & clean energy), has become central policy priority at the international level as seen at the last G20 Summit in St Petersburg, but also at the OECD, the Financial Stability Board (FSB, the forum through which G20 commitments on financial reform are to be implemented) and the European Commission.

What is long-term investment?

There are two approaches: a positive list one (what LTI is) and a negative list approach (what it is not).

The OECD, as outlined in the new G20 Principles defines LTI as "patient, productive and engaged capital" that is:

"Patient capital allows investors to access illiquidity premia, lowers turnover, encourages less pro-cyclical investment strategies and therefore higher net investment rate of returns and greater financial stability;

"Engaged capital encourages active voting policies, leading to better corporate governance;

"Productive capital provides support for infrastructure development, green growth initiatives, SME finance, etc., leading to sustainable growth."

These new G20 Principles on Long-Term Investment by Institutional Investors are a new tool for pension funds and policy makers to shift to the long term.

The G20 High-Level Principles of Long-Term Investment Financing by Institutional Investors set out preconditions to long-term investment for governments and investors to observe as well as specific requirements regarding the governance of asset owners, the accountability of asset managers, transparency and reporting along the entire investment chain, including informing and educating consumers.

If observed and implemented effectively, the G20 Principles could make a difference in helping workers' pension fund shift further, and as appropriate, toward long-term investment strategies. The G20 text is particularly welcome where it calls upon:

- Observance of other key social and environmental standards, such as the OECD Guidelines for Multinational Enterprises and the United Nations Principles for Responsible Investment (UN PRI) (Preamble)

- The development of "collectively organised long-term savings and retirement plans" to help mobilise investors for the long term (Principle 2.2)

- Defining long-term risks as including environmental, social and governance risks (3.4) "contract clauses of fund managers' and senior executives' remuneration" to be based on long-term, risk-return criteria (3.7)

- Any public support to private finance to be carried out on a cost-benefit analysis and "appropriately priced" (5.1)

- Disclosure "with sufficient granularity" by institutional investors on how they address long-term risks (7.3, 7.4)

While the OECD definition is a welcome, it does not elaborate further on the conditions for productive capital to lead to "sustainable growth". In particular there is nothing that would suggest in the OECD approach that environmental, social and governance (ESG) criteria should be taken on board, and indeed mainstreamed in the investment policy of institutional investors and in the reporting framework of asset managers and of invested companies.

This is again a critical area of importance in regard to the PRI principles.

All this requires some changes in reporting and confidence to eradicate the schizophrenia of institutional investors proclaiming a sustainable approach who finance projects and infrastructure with a clear long-term sustainability goal and at, the other end of the portfolio, increase exposure to hedge funds and high frequency trading.

At intergovernmental level, words like speculation and short termism are still not acceptable terms. To give a practical example, during the round of negotiations that took place at the OECD regarding the above mentioned OECD/G20 Principles, the last part of the sentence "taking a long-term view also allows investors to appraise and benefit from the fundamental value of their investments, rather than be guided by short-term speculation" was deleted in the final version that was made public at the St Petersburg summit in September 2013.

The Central Role of Pension Funds

In the discussion on LTI by institutional investors, it is important to distinguish between "asset owners" (pension funds, insurance companies, sovereign wealth funds) and asset managers (asset management firms, bank asset management branches) and to give primacy to the former over the latter. That is particular true for pension funds with liabilities that can span over 20-30 years, (i.e., the time needed to accumulate capital to finance workers' right to retirement). With over USD30tr assets under management, pension funds represent an important class of asset owners.

Importantly, pension funds have a social purpose, that of financing workers' right to retirement and most often they are established as part of a collective bargaining agreement and include member-nominated representatives on their board of directors. Given their social purpose, it would make sense for pension funds to embrace fully both a negative and positive list approach to LTI – shifting away from short-term to long-term investments, mainstreaming responsible investment practices, greater portfolio exposure to infrastructure and job creation projects.

The case of pension fund investment in climate change-related assets provides for a good example of how investors' potential could be unleashed for LTI. The long-term horizon of climate change finance happens to match the liability profile of pension funds. In reality however, pension funds' exposure to climate change is limited today – despite the risk profile of increasing climate catastrophe shockingly barely 2%. Yet it is possible and for us imperative to raise pension funds' investment in climate change-related assets to reach 5% of their total portfolio in a three-year period, thereby generating some USD300bn in annual flows in the first years after. Market maturity will grow as a result.

For the first time ever, I think, we see mainstream portfolios engaging in climate financing in a direct and thoughtful manner – the work done by The World Bank and other early issuers have enabled this activity and the contributions from institutions like the Climate Bonds Initiative to map the potential market and raise awareness. This and other measures can and will deliver mature green markets, and you can lead.

However, barriers to LTI are also to be found in inconsistent policy and regulatory frameworks. The most obvious case of lack of policy coherence is clean energy. For a first, there is a lack of marketable products that meet the scale and liquidity requirements for institutional investors to shift toward clean energy investing. The green bond market value is estimated at USD16bn compared with the +USD95tr world bond markets, while annual green bond issuances (i.e., the net inflows) are in the range of USD1-2bn (compared with some USD6tr issued worldwide). More fundamentally, as long as policymakers will let fossil fuels subsidies co-exist with pro-active clean energy policy, there is little chance that investors will trust and have confidence in a meaningful, stable and predictable price on carbon emissions, and hence on the comparative financial returns of clean energy.

The concerns about the unintended consequences of post-crisis financial reforms have been exploited, if not manipulated, by opponents to reforms. Bankers in particular have exaggerated the impact of the new Basel III prudential framework. Yet policymakers and regulators need to be able to distinguish between 'productive risk' (or 'good risk') and 'unproductive' or speculative risk, when setting or reviewing financial prudential norms for institutional investors, banks and insurance groups and funding rules for pension funds. Making such distinction is possible in theory, but it has not penetrated at government and policymaker level.

Further down the investment chain, it is imperative for issuers (listed or private companies) to observe long-term reporting requirements and to disclose and report on key environmental, social and governance (ESG) performance and impact, making sure that the right information is available to investors regarding responsible LTI. And we are still far away from mainstreaming ESG reporting.

Leadership by Asset Owners, Accountability of Asset Managers

Finally, for LTI to take place, there needs strong asset-management accountability. And to that end asset owners should exercise strong leadership to hold asset managers to account. This is needed because asset managers may have vested interests that are not aligned with those of their clients; they want to sell their own products and investment strategy to their clients (asset owners). Unlike asset owners they are not bound by long-term liabilities and therefore have no structural incentive to engage in LTI.

Yet, asset owners are not visible in the policy debate about the structural shortage of long-term capital. In the case of pension funds, leadership requires board independence that prevents conflicts of interest with asset managers and other financial service providers. That in turn requires accountability to members of the pension schemes through member-nominated trustees.

In the short and medium term, considering the regulatory challenges ahead and the time for transition to an LTI-friendly policy and regulatory environment to take place, public financial support to investors would still be needed. The most common form of support is a government guarantee on the credit default risk of an asset. With a few notable exceptions, all green bond issuances to date have been accompanied by explicit guarantees by governments, by regional development banks or by the World Bank. Government support can take other forms: subsidised low-interest direct loans, export credit insurance and facilities, foreign exchange risk insurance and subsidised support services to investment deals. Government-funded/run venture capital fund can also take "first equity loss" positions in private investment deals.

There are good reasons to support and indeed expand government guarantees to help increase private financial flows to LTI. However, past experience with the post-2008 bailing out of crisis-hit banks shows that government guarantees is a delicate policy issue. These massive public guarantees benefiting bankers have in effect transformed the entire industry into a publicly subsidized business. Andrew Haldane of the Bank England estimates that the explicit and "implicit" public guarantees represented a net saving of some USD160bn in 2009 for 13 banks in the UK alone.

Public support to private finance therefore does not come free. It needs to be priced appropriately. Fair and transparent risk-sharing arrangements should prevail whenever public money is used to support private projects. This is needed to protect public interest (i.e., avoiding "privatising gains and socialising losses") but also to avoid unfair competition in the financial sector.

While supporting the need for market maturity with government and/or IFI backing for the transformation of the investment model and for dramatic industry shifts in green technology and services, it can't be ignored that PPPs have proven in many cases to be a flawed model that can lead to over-priced public services as well as to situations where gains are privatised, while losses are socialised. In contrast to traditional public procurement, PPPs have many hidden costs and are excessively complex contracts for governments to handle. So caution is essential.

Likewise, the loss of confidence in bonds might suggest some creativity is necessarily to create new investment pools that guarantee a moderate rerun over a longer term but equally allow the market to operate beyond such guarantees.

But this argument is mute unless the tax base of Governments is restored and certainty of tax treatment is created to ensure that transparent assessment of corporate behaviour is possible. This is why BEPS should also be central to your advocacy.

The OECD Action Plan on Base Erosion and Profit Shifting

National tax laws have not kept pace with the globalisation of corporations and the digital economy, leaving gaps that can be exploited by multi-national corporations to artificially reduce their taxes.

The Base Erosion and Profit Shifting (BEPS) Action Plan is a roadmap comprising 15 measures to curb MNEs' aggressive tax planning aiming at (i) reducing the taxable income base ("base erosion") or (ii) moving profits away from economically relevant but high tax-jurisdictions to economically irrelevant but low-tax jurisdictions ("profit shifting"). The Action Plan emphasises the specific challenges of the digital economy and the treatment of 'hard to value' intangibles (patents, brands, research and developments).

If successful it will see an end to

- Manipulating intra group transfer pricing;
- Excessive deduction of debt interest and other payments;
- Hard to value and shifting of intangibles;
- Avoiding permanent establishment status; and
- Opacity of MNE tax schemes and the need to shift to country-by-country reporting.

"Tax administrations have little capability of developing a "big picture" view of a taxpayer's global value chain"

For example, the Italian tax authorities only have access to documentation relevant to the Italian subsidiary. The OECD Action Plan emphasises the need for greater corporate reporting to tax administrations (although "taking into consideration the compliance costs for business") and for such reporting to be delivered on a group-wide consolidated basis.

Action #13 requires "MNEs provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template". In essence this is a requirement for country-by-country tax reporting.

At this stage the OECD only foresees such reporting to be made to tax authorities, not publicly, but we will continue to campaign for full transparency.

The OECD Action Plan would require country-by-country tax reporting to national tax authorities, but it should go further and require full public disclosure of tax paid locally, in line with recent reforms in the US and in the EU. The Dodd-Frank Act requires country-by-country tax disclosure but only for the oil, gas and mining companies. In the EU, the new Transparency and Accounting Directives enforce similar requirements for companies in the extractive sector. The draft negotiated between the Council (i.e., Member States) and the European Parliament around the new capital requirements.

Further, the Action Plan calls for facilitating the use of “mutual agreement procedure” between a tax authority and a MNE, thereby promoting private arbitration as opposed to traditional judicial procedure. There must be no secret deals when hundreds of millions of tax revenue dollars may be at stake. Publication would also improve the system, by establishing a record of the principles applied, to guide other taxpayers.

The Action Plan does not address the impact on workers employed by the MNE, wherever contractual arrangements do not reflect the economic substance of the MNE structure. Central to this discussion is whether the profit shifting and tax base erosion schemes have an impact on the salary levels and collective bargaining of current and future workers. Another missing element is whether the opacity created by aggressive tax planning constitutes a barrier to workers’ right to information and consultation about the MNEs’ business plan and foreseeable risk factors, which is a legal requirement in many OECD countries.

In this regard we will pursue the development of specific guidance on the observance of the tax chapter (XI) of the OECD Guidelines for Multinational Enterprises which would help holding business to account on their tax schemes.

It would seem in line with PRI principles that it is important to address the extent to which workers’ pension funds actively address the risk of BEPS through their shareholdings in listed assets, but also their business relationships with private funds, including hedge funds and private equity groups.

The Road Ahead

The road to shifting institutional investors toward long-term investment strategy may at first sight look like a long and bumpy journey. It is however imperative, not least because of the long-term liability profile of investors, and of pension funds in particular, and importantly because it would help divert investors away from short-termist speculative behaviours. The crucial challenge is to restore accountability along the investment chain, and to rebalance the power relationship between asset owner and asset managers, together with strong reporting requirements. Financial regulation and prudential norms should to the extent possible help distinguish between ‘good’ and ‘bad’ forms of risk.

And where Government is in the mix, there needs to be clear caveats that ensure people are not deprived of the core business of tax dollars providing citizens with strong public institutions and quality public services.

However, while we have some confidence that the road ahead is now finally on the drawing board, the current use of workers’ capital is in a highly questionable space.

With 25 trillion dollars invested in the global economy in pension funds and more in mutuals with significant emerging funds in China amongst other nations, we are clearly unhappy about the current situation.

Despite the long history of ESG and the signatures to the PRI, the global compact, the GRI and an $80 billion industry around CSR, there is a conspiracy of silence on the abuse of workers’ rights and an opposition to environmental imperatives that must be ended.

Despite the risk of climate catastrophe, the corporate opposition to a price on carbon or industry policy-based subsidies for start-ups in new energy – let alone the major fossil fuel giants fight against a comprehensive climate agreement – is without moral or sustainability virtue. Yet many of the same major companies file their sustainability reports without conscience.

And their approach to the workers whose labour fuels their profits is criminal. Ask any CEO if they would like their sons or daughters to work in the textile factories in Pakistan, the mines in the Congo, manufacturing plants in Central America, with the beer women in Cambodia or the slave state of Qatar and they shudder. But at the same time they allow the wilful perpetuation of these horrors in the supply chains of their corporations and we have workers capital invested in them.

The model is neither humane nor sustainable. Yet many corporations promote their practice as responsible. Just check the sustainability reports of the retailers that sourced from Rana Plaza in Bangladesh.

There can be no more excuses, no more deaths from fire, occupational injuries or disease, no more work-related poverty and no more denial of human and labour rights.

The PRI principles remain a strong floor for sustainability across all areas of ESG, and you have enormous authority to effect change. But you must be more activist in your approach, and to that end I congratulate you for the increasing vigilance of signatories, but so much more can be done.

It wouldn't be lost off any of you that there is tension in our ranks. Workers and their unions in key countries have supported this model – have been prepared to bargain for deferred wages and advocate legislative guarantees to build a huge slice of capital with the dual purpose of secure retirement incomes and job-centered growth and development. Their faith and good will is shaken.

Confidence can only be shorn up if we are serious about a new investment model, and that is why it time to push the reset button on pensions funds now.

You can help us win back this confidence. Let's be serious about disclosure, allow the asset owners to have the debates about the beliefs that should drive investment. While I congratulate funds like Calpers, AP and others for their openness, I have seen great resistance to the AODP, for example, which just requests transparency. If we are demanding it of corporations, surely it is fair to have equal treatment for our own investments.

Disclosure, democratic debate and decisions in the interests of dignified retirement incomes, justice and sustainability. These ambitions are interdependent and the basis for the new investment model we require.

Workers want their capital put back to work.