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RE-REGULATION IN THE AFTERMATH OF THE GLOBAL FINANCIAL CRISIS

POSITION PAPER, NOVEMBER 2008

Executive summary

- 1 The latest phase of the financial crisis that broke out in the summer 2007 was marked by a dramatic turn in mid-September with the collapse of Wall Street, US insurance group AIG, and the subsequent asset destruction process that hit the OECD banking sector front on. Stock market indices have fallen to pre-2000 levels. According to the latest OECD projections, it is now certain that the US and Europe will fall into recession in 2009, while the Japanese and Korean economies will stagnate. The ILO predicts that unemployment will rise by an estimated 20 million people, the number of working poor living on less than a dollar a day by 40 million and those on 2 dollars a day by more than 100 million. The fall in world equity indices will inevitably put pressure on the funding of pension funds, notably in the US, Canada, the UK, the Netherlands and the Nordic countries, as will the expected implosion of the alternative industry in 2009 – hedge funds and private equity – in which pension funds have been investing heavily over the past five years.
- 2 The current economic crisis began in the US as a conjunction of a housing crisis, a credit market crisis and, increasingly, an employment crisis. The crisis has revealed the unsustainability of the model of growth that has prevailed across OECD economies in the past decade, particularly in the US: a model that was based not on the real economy with wage increases reflecting productivity growth, but on debt-financed consumption and investment and the excessive leveraging of the private sector.
- 3 Neither governments nor the central banks foresaw the bubble that grew in the US mortgage market up to 2006, which imploded in the first quarter of 2007. What accelerated the crisis was the complex and lightly regulated structured finance industry that securitised the credit risks of the US mortgage market. Coupled with “pro-cyclical” accounting rules

and rigid prudential rules, the credit crunch that followed created a self-perpetuating, asset depressing process in the banking sector.

- 4 Regulators and governments were content to let the structured finance industry develop outside their jurisdiction. Structured finance is founded on the belief that spreading risk ultimately mitigates risk, reduces the cost of capital and thereby enhances economic growth. It created the illusion of low risk, low-cost capital. Being managed by “sophisticated” investors, regulators believed that the business did not need regulation. As it happened, however, this created major complications for regulators. Light regulatory approaches helped to blur the boundaries between regulated and un-regulated financial services. Off-balance sheet operations allowed regulated banks and insurance groups to practice double accounting.
- 5 The current crisis reveals the threat that the “shareholder value” model of corporate governance can pose to market integrity in much the same way as the Enron episode did in 2001-2002. The banks that were hit by the crisis were ruled by “imperial CEOs” and did not have proper risk management procedures in place. Departing directors and traders have benefited from grotesquely large compensation packages and golden parachutes. The money that was wasted in generous dividends and share buybacks in the past 2003-2006 growth cycle, is now badly needed as banks search for fresh money to recapitalise their balance sheets.
- 6 For months, banks have been struggling to clean up their bad assets by writing down the value of their holdings and have tried to raise capital to maintain acceptable prudential ratios. International institutions, including the OECD, expected market “self-correction” to resolve the crisis. It did not, however, work that way. The only way out was to use public money. Since 15 September 2008, OECD governments and financial authorities have introduced numerous initiatives to help restore solvency in the banking sector. These initiatives have highlighted the weakness in international capacity to manage such a large scale financial catastrophe. Governments have appeared behind the curve at every step of the development of the crisis. In the immediate aftermath of the introduction of urgent measures, there will be a requirement for political-level international cooperation and dialogue to put content into the *quid pro quo* for bailing out the financial system. Re-regulation should address the flaws in the global financial systems, which have been exposed by the current crisis:
 - *An unsustainable model of growth*, fuelling wage compression, predatory lending, debt-financed consumption and the transfer of market risks on to workers (pensions, housing);
 - *An un-controlled ‘structured finance’ industry* in which credit risks were not spread but hidden: a system that lacked regulation, was riddled with conflicts of interests and, when coupled with rigid prudential and accounting rules, created a self-perpetuating feeding asset depressing process;
 - *Widespread institutionalised regulatory arbitrage* between jurisdictions and within financial institutions which has helped to blur the lines between regulated and shadow banking, letting financial groups practice double accounting by using off-balance sheet operations and encouraging irresponsible risk-taking and leverage investment strategies;
 - *Corporate short-termism and “shareholder value” governance* undermining market integrity and stakeholders’ long term interests. The crisis has exposed weak risk management by ineffective Boards of Directors and

turned the spotlight on the money that has been wasted in the past years in grotesquely large executive compensations, dividend proceeds and share buy-back programmes.

- 7 At the outset, any discussion on financial regulation should begin with defining the public function of financial services, which is to serve the real economy. Financial regulation is commonly associated with three objectives: (i) to maintain financial stability by ensuring solvency of market participants, (ii) to protect investors against failures and fraud, and (iii) to ensure “efficient and effective” financial markets. Any discussion on re-regulation also needs to identify the exact underlying objective of “effectiveness” in financial markets: is the target economic growth in absolute terms or should it be a more qualitative understanding of growth combined with a fair distribution of wealth within society?
- 8 Following on from the Global Unions’ “Washington Declaration” submitted to the G20 Summit, held on 15 November 2008, this paper identifies some issues and questions designed to initiate a trade union discussion on the re-regulation of financial markets and the future shape that this should take. The discussion of such a road map needs, however, to be placed within the broader context of the rethinking of economic policy and growth models. The Washington Declaration included the following demands: in the short term “initiate a major recovery plan” and in the medium term “establish a new structure of economic governance for the global economy” and “combat the explosion of inequality in income distribution that lies behind this crisis”. The discussion issues are grouped under three broad objectives:
 - *Strengthening financial safeguards and international cooperation* (prudential regulation, public accountability of central banks, conditions for capital market opening, offshore financial centres (OFCs), staffing of public administration);
 - *Diversifying finance and protecting social development goals* (the rights of households against predatory lending, community-based financial services and pension regulation, international taxation);
 - *Spreading responsibility throughout the investment chain* (credit risk transfers and credit rating agencies, private investment funds and conglomerates, executive compensation, corporate short-termism).

“The initial trigger was the unsustainable model of growth that has prevailed across OECD economies: a model that was based not on the real economy with wage increases reflecting productivity growth, but on debt-financed consumption and investment and the excessive leveraging of the private sector.”

The crisis

- 9 The latest phase of the financial crisis that broke out in the summer 2007 was marked by a dramatic turn in mid-September with the collapse of Wall Street, US insurance group AIG, and the subsequent asset destruction process that hit the OECD banking sector front on. Stock market indices have fallen to pre-1998 levels. According to the latest OECD projections, it is now certain that the US and Europe will fall into recession in 2009, while the Japanese and Korean economies will stagnate. The ILO predicts that unemployment will rise by an estimated 20 million people, the number of working poor living on less than a dollar a day by 40 million and those on 2 dollars a day by more than 100 million. The economic and social impacts of the crisis will be closely monitored by trade unions. This current paper, however, addresses only the financial aspects of the crisis: the causes and the lessons from the early responses by governments and central banks. From there the paper proposes several possible avenues for a new re-regulation agenda.

10 The fall in world equity indices will inevitably lead to pressure on the funding of the pension industry, notably the in US, Canada, the UK, the Netherlands and the Nordic countries. Pension funds may also come under pressure from the expected implosion of the alternative sector in 2009 – hedge funds and private equity – in which pension funds have been investing heavily over the past five years.

11 The current economic crisis began in the US as a conjunction of a housing crisis, a credit market crisis and, increasingly, an employment crisis. The initial trigger was the unsustainable model of growth that has prevailed across OECD economies in the past decade, particularly in the US: a model that was based not on the real economy with wage increases reflecting productivity growth, but on debt-financed consumption and investment and the excessive leveraging of the private sector. Wage compression has been a key feature of the recent 2002-2006 “growth cycle” across the OECD. In the US in particular, the bargaining power of American workers has been eroded considerably under the Bush administration and as a result of the hostile attitude of employers to collective bargaining and freedom of association. Household debt has been substituted for labour-generated income in financing consumption and access to housing. Mortgage loans were calculated not on the basis of household income, but on the speculative future value of their property. The system worked as long as property prices were booming, which led to a market bubble. As credit lending standards were relaxed in the later stage of the bubble in 2004-2006, unscrupulous mortgage lenders took advantage of the situation by contracting ever more risky loans, while passing on the credit default risks to the markets via securitised debt obligations. Signs of collapse of the market appeared in the second half of 2006 when the rate of foreclosures and defaults on household repayments jumped.

The ‘structured finance’ business and the illusion of risk spreading

12 What accelerated the crisis was the widespread use of the “originate-to-distribute” model of credit risk transfer (CRT) in global credit markets: credit default swaps (CDS), collateralised debt obligations (CDO), collateralised loan obligations (CLO), asset-backed securities collateralised debt obligations (ABS CDOs), etc.¹. Under CRT arrangements, housing loans – as well as corporate bonds, private equity leverage loans, any other credit paper – originated by the banks are packaged with other debts and then sliced into several tranches with different credit risk ratings. These ‘structured products’ are then offloaded from the originator’s balance sheet to un-regulated offshore investment entities and are sold to institutional investors outside regulated trade exchanges. The CRT structured products contaminated the entire global credit market. This meant that the credit default risk of a single household mortgage loan in the US was potentially shared by thousands of institutional investors across the globe. For example, the US insurance giant AIG – which so far has been bailed out twice by the US government for a cumulative sum of \$120bn – has been writing CDS for years, which were sold to banks to protect them against default risks of the CDOs they had invested in.

1 There are several types of credit risk transfer products: (i) credit default swaps (CDS) transfer to the market (ie, securitisation) the credit default risk of a single issuer (such as a corporate bond); (ii) collateralised debt obligations (CDO) securitise a pool of debts (be it corporate bonds, residential or commercial mortgages) and their credit risk; (iii) collateralised loan obligations (CLO) are CDOs that are specific to “leveraged loans” which are used for private equity leveraged buy-out operations; and asset-backed securities collateralised debt obligations (ABS CDOs) and synthetic CDOs are CDOs investing in other CDOs (hence creating a ‘double securitisation’ of the credit risk transfer).

“ Instead of spreading risk, the business of structured finance was hiding it.”

13 The financial innovation of the originate-to-distribute model of managing credit risk is founded on the principle that (i) no regulation is needed to prevent information asymmetry or conflicts of interest that may bias asset valuation process, and from there (ii) spreading risks ultimately mitigates risk, reduces the cost of capital and thereby enhances economic growth. Financial innovation – it was argued – would profoundly change the organisation of credit markets and the way credit risks would be managed. The model was so attractive that it became a trading activity in its own right: investment banks, hedge funds, commercial banks were buying and selling CDS not to protect against default of the underlying loans and obligations – which they did not own and had no intention of owning – but to earn money on the trading of CDS. In effect, mainstream banks across the OECD were making a profit out of betting on the probability of defaults in the global credit markets. The business of structured finance was highly profitable on the supply side: banks, investment banks, insurance groups and rating agencies. Since 2003, the residential mortgage-backed securities alone produced \$2000bn in fees. Wall Street’s top five investment banks – Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns (groups which were most involved in the structured finance business) – paid over \$3bn to their executive directors between 2003 and 2007².

14 Regulators and governments were content to let the structured finance industry develop outside their jurisdiction. Money was cheap, interest rates were low and the surpluses generated by structural imbalances between OECD countries and emerging economies guaranteed a sustained demand for structured products. It created the illusion of low risk, low-cost access to capital. Cheap money, combined with the absence of regulation, in turn encouraged excessive leveraged and risk-taking behaviour to the great benefit of lightly regulated private funds. Regulators and governments were not concerned because they considered the investors who traded these products to be “sophisticated” people and that the products did not require regulated consumer investor protection legislation. They “knew what they were doing”.

15 These structured products were hard to value, however. Because of the lack of standardisation – each structured product being almost unique – trading on publicly regulated exchanges has been minimal (with the exception of corporate CDS). Most transactions are OTC. In the absence of a supply and demand price fixing mechanism, valuation relies exclusively on credit rating agencies. Information asymmetry – a classic problem in market trading – becomes an issue as only those who created the structured products actually know what is in them. Detailed data on global CDO issuance do not exist in the public domain³. Being un-regulated and prone to conflict of interests – not least from the credit rating agencies themselves – led to a weakening of discipline in the credit rating process, to say the least. In fact rotten debt was distributed through the markets disguised as ‘triple A’ securities. Instead of spreading risk, the business of structured finance was hiding it. The growth and size of the un-regulated OTC markets, compared with equivalent regulated traded contracts, has been staggering over the past years.

2 As the subprime crisis was already in full flow in 2007, they distributed \$66bn to their 186,000 employees, of which \$39bn was granted in “bonuses”. In the case of AIG, the derivative trading division, around 350 people, collected between \$423 and \$616m per year since 2001.

3 Access to the database of the US-based Securities Industry and Financial Markets Association (SIFMA) – the most comprehensive source of information on CRT products – requires an annual membership fee of USD2400,-

- 16** Structured finance was attractive for banks as it allowed them to channel investments below the radar screen of regulators to off-balance sheet entities and then through securitisation, while reaping hefty fees at every step of the process. Commercial banks, whose balance sheets were supposed to be highly regulated, were contaminated on their asset side by toxic structured products which they themselves had created – or helped create – to get rid of the risks on their liability side. This shadow system did not work for Spanish banks however: unlike its peers, the Spanish Central Bank prohibited off-the-book entities several years ago.
- 17** The wave of credit defaults that was triggered in the US “subprime” mortgage market during 2006 (i.e., the most risky tranches of CDOs funding the US housing market) created a vicious circle of de-leveraging in the banking sector. Banks were forced to write down the value of their holdings in structured assets. In turn, they had to instantly adjust their balance sheets to comply with marked-to-market accountancy rules. The resulting depreciation forced the banks either to raise new capital, or to sell assets in order to comply with prudential ratios under the Basel II Accord⁴. In sum, the complexity of the structured finance industry coupled with “pro-cyclical” accounting rules and rigid prudential rules created the self-perpetuating, asset depressing process of the past eighteen months. Lightly regulated private funds, including hedge funds, were forced to sell their holdings in disproportionate levels in other asset classes, in order to cover the losses of their highly leveraged investments in the derivatives markets. Ultimately, the collapse of the structured finance industry led to fire selling and herding behaviour on a global scale: so much for the principle of risk diversification and risk spreading that these structured products were meant to sustain.

Investment banks, conglomerates and the cost of regulatory arbitrage

- 18** Concern over regulatory gaps was not restricted only to the products and transactions of the structured finance industry, but also the financial institutions that benefited from the industry. Wall Street investment banks in particular have been at the heart of the development of the structured finance industry. Investment banking has expanded rapidly in the past decades following the gradual dismantling of the 1933 Glass-Steagall Act between 1975 and 1999. The Act enforced strict separation of deposit and investment banks, with a view to shielding the former from the market risks generated by the latter in trading activities and mergers and acquisitions operations. The repeal of the Act allowed investment banks to diversify their activities, which started with betting their own money on the markets (and hence creating conflicts of interests with the trading carried out on behalf of their clients) and more recently included engaging in private investment funding and derivatives. Investment banks faced a major constraint in this diversification process: unlike the regulated banks they could not tap into the reservoir of households’ bank deposits. Being comparatively undercapitalised, they increasingly relied on leveraged financing for expanding their businesses.
- 19** And lack of regulation helped sustain their expansion. Unlike retail banking, investment firms are not bound by regulated capital ratios and the leverage rules that exist under the Basel II Accord. While commer-

⁴ The Basel II Accord, effective as of 2008, follows on 1988 Basel I, sets at the international level the prudential rules that should prevail in the banking sector. In particular it determines the minimum capital requirements that banks should comply with in determining the maximum size of their liabilities. The new rules had been widely anticipated by the banks before effective entry into force.

cial banking is tied by capital ratios of total assets on their balance sheet, investment banks are allowed to trade with a lower mobilisation of capital. With leverage ratios of up to 30 times, the return on equity profits was inflated in the current period of low interest rates.

20 Conversely, light regulation also helped to blur the distinction between investment and commercial banking activities. Off-balance sheet operations allowed regulated banks and insurance groups to practice double accounting with regard to regulated capital ratios and, more fundamentally, to expand their business lines beyond their jurisdictions of origin – brokerage, trading, private investments and asset management. By concentrating different lines of businesses, large conglomerates have had access to economies of scale (but also to privileged market information and insider dealing), while exposing group-level risk management policies and procedures to ever more market risks. Ironically, rather than increasing competition among institutions, the dis-intermediation of the financial system has given birth to global and diversified conglomerates. AIG exemplifies this practice. The fall of the group was precipitated not by its regulated activities – non-life and life insurance, car and house insurance – but by “AIG Financial Products”, the London-based unit which had more than \$300bn in CDS with European banks⁵.

21 That has come at a cost for regulators. The balance sheets of subsidiaries are regulated nationally, but the parent company centralises cash and liquidity reserves. In principle, the headquarters can move assets and cash within the group to optimise “regulatory arbitrage”: for example, moving risky assets away from a highly regulated bank subsidiary to a less-regulated insurance subsidiary⁶. Similar concerns exist in the US. Following the repeal of the Glass-Steagall Act, the rule has been for global institutions to keep their regulator of origin: the Federal Reserve for deposit banks, the Securities Exchange Commission (SEC) for quoted investment companies and state insurance regulators for insurance groups. Regulatory gaps are also relevant in a transatlantic perspective and with regard to the use of OFCs. European subsidiaries in the US and, vice versa, US subsidiaries

“Off-balance sheet operations allowed regulated banks and insurance groups to practice double accounting.”

5 The derivative trading branch was run by Joseph Cassano, formerly with Drexel, the investment bank of the 1980s specialised in the issuance of “junk bonds”, the ancestors of today’s CDOs.

6 The issue is taken seriously in Europe, where an EU-level group is following the issue and includes national European supervisory authorities for both the insurance and the banking sectors.

TABLE 1: Capital injections, share buy-backs and executive compensations in Wall Street firms

In USD Bn	Non-OECD SWF injections (pre-Sep08)	Other fund raising (pre-Sep08)	US Gvt injection (post-Sep08)	Buybacks 2006-07	Debts to executives (incl. pension)
Bank of America			25	17.5	1.3
Merril Lynch*	8	1.2		14.4	2.2
Citigroup	7.5		25	7.8	5
Goldman Sachs			10	16.8	11.8
JP Morgan Chase			25	12.1	8.2
Bear Stearns**	1			1.7***	1.7
Morgan Stanley	5			7.1	
Lehman Brothers****		4		5.3	

* Purchased by BoA for 50bn; ** 1.2bn purchased by JP Morgan Chase following the offloading of toxic assets valued at 29bn on to US taxpayers; *** 2007 only; **** entered into bankruptcy on 15 September 2008. Source: WSJ (3 Nov. 08) & Lazonick 2008.

in Europe have been used to bypass US and European prudential rules respectively.

Shareholder value model of corporate governance and corporate short termism

- 22 Although different in size and nature, the current crisis has some similarities with the Enron episode of 2001-2002. Many banks that have been hit by the crisis were ruled by “imperial CEOs” who faced no counter power at the Board of Directors and did not have proper risk management procedures in place. At the time of the collapse of Lehman Brothers, out of the ten non-executive directors, one was a theatre producer, another a former military officer and only two had direct experience financial services. And as with the Enron crisis, the current restructuring in banking sector is accompanied by the stories of grotesquely large compensation packages and golden parachutes that reward corporate executives for their failures⁷. The management of the crisis also revealed the conflict between protecting shareholder value against short-termist speculative trading and ensuring market transparency. Many corporate executives were economical with the truth, to say the least, about the state of their company’s finances for fear of a sudden drop in share value. Share-lending by long term investors, including well established pension funds, to hedge funds that practice short selling exacerbated that fear⁸.
- 23 The current insolvency and undercapitalisation that characterise the OECD banking industry also raises questions about how profits were distributed in the recent 2002-2006 growth cycle, the short-termist behaviour of corporate boards and, from there, the implications for future corporate governance regulation. Profits can either be retained to strengthen the company’s balance sheet or they can be distributed to shareholders, though dividend proceeds or, increasingly, through share buyback programmes (the company repurchases its shares to artificially inflate shareholder value). In the major OECD economies, the growth of dividends paid to shareholders has outpaced the growth of corporate profits⁹. “Free cash flow” should be given back – we were told – to create “value for shareholders”, rather than be allocated to the retained earnings of the company. That money is now badly needed as the economy is in a process of de-leveraging and the banks require fresh money to recapitalise their balance sheets. As shown in Table 1, there is a very telling comparison between the funds raised by Wall Street firms before the September crisis (mainly with non-OECD sovereign wealth funds) and the US govern-

7 Merrill Lynch CEO John Thai and the company’s trading-division head Thomas Montag would walk with a total \$47 million in golden parachutes should they decide to leave Bank of America which bought Merrill Lynch on 15 September. Chuck Prince, CEO of Citigroup, was left with a golden parachute of \$16m. The CEO of Wachovia, Ken Thompson, left the group with an exit package of more than \$5m. Overall CEO compensation in 2007 raised by over 20% to an average of \$18.8m, compared with a growth of 3% in corporate revenues. In 1980, CEOs were paid 40 times the average worker. Today they are paid 600 times more.

8 Early September, Lehman Brothers’ CFO was confident enough to tell analysts that the company had “taken care of [its] full-year needs” in capital. Two weeks before its forced takeover for \$1 a share by Citigroup, Wachovia’s CEO, Robert Steel, said “we have a great future as an independent company”. Alan Schwartz, head of Bear Stearns, saw no “pressure on our liquidity, let alone a liquidity crisis” days before his group was rescued by the US authorities and sold for \$2 a share to JP Morgan. Speaking of his AIG derivative trading division, end-2007 Cassano said that it was “sitting on a great balance sheet, a strong investment portfolio and a global trading platform where we can take advantage of the market in any variety of places”. The derivative unit ended with a loss of \$25bn ten months later.

9 Between 2001 and 2005 marginal payouts – defined as the change in dividends divided by the change in profits – grew by 51% in the US, 92% in Italy, 88% in the Netherlands, and 78% in France – and was positive in all major OECD countries. Share buybacks were a minor source of shareholder remuneration a decade ago but have now become widespread across the OECD. In 2007 the US S&P 500 companies spent \$597bn in buybacks, compared with \$120bn in 2003.

ment equity injections in October on the one hand, and the money that was spent in share buy-back programmes in the previous two years and the debts accumulated with their executives in the forms of bonus, other compensation, and most importantly, pension packages, on the other.

Government management of the crisis

24 In response to the crisis in the global credit markets, OECD governments and their central banks have gradually upgraded their lines of defence. The first line of defence was, and still is, the massive injection of liquidities by central banks and cuts in lead interest rates to revive the inter-bank lending markets, which have ceased to function since summer 2007. These actions proved insufficient, hence revealing a much deeper crisis of solvency and market confidence among peers. International institutions, including the OECD, expected “market self-correction” to produce a price clearing process, setting a floor under the valuation of the structured finance products and allowing the resumption of asset trading. It did not work that way. The proposal that was made at the end of 2007, that Wall Street firms create a “special investment vehicle” to park the toxic assets, did not find traction neither. The only way out was to use public money. Forced mergers and takeovers took place with government guarantees against structured product-related liabilities. The two remaining US investment banks, Goldman Sachs and JP Morgan, have agreed to re-regulation of their activities under the US deposit bank jurisdiction. In sum, despite the market response – the US and OECD banking landscape is changing fast – the insolvency crisis continues and has yet to be resolved. Write-downs on the banks’ balance sheet now amount to \$500bn and exceed the available capital that was raised on the markets (\$200-\$360bn).

“Free cash flow – we were told – should be given back to create “value for shareholders”, rather than be allocated to the retained earnings of the company.”

The US bailout and subsequent OECD government rescue plans

25 Since 15 September 2008, OECD governments and US and European financial authorities, in particular, have introduced numerous initiatives aimed at managing the solvency crisis and trying to re-capitalise the financial system. In Europe, governments have used public money to support and recapitalise the banking sectors and mortgage lenders, while the European Central Bank (ECB) and the Bank of England continue to inject liquidities in the banking system. On 8 October 2008, the ECB reversed its long held position on high interest rates and agreed to a coordinated reduction of lead interest rates with other key OECD central banks, including the Federal Reserve and the Central bank of Japan. One by one, European member states have taken emergency measures, first enhancing or removing limits to deposit guarantee schemes for domestic household accounts, then enhancing access to credit for SMEs and finally taking direct stakes in large banks. The UK Government rescue plan which was designed along those lines in early October 2008, has since been copied across Europe.

26 On 3 October 2008, the US Congress approved a \$700bn bailout plan. The agreed Emergency Economic Stabilisation Act (EESA) sets out a “troubled asset relief programme” (TARP) divided into three successive tranches; \$250bn, \$100bn and \$350bn respectively. The initial plan was to purchase troubled assets from US-based banks and other financial insti-

tutions.¹⁰ Details of the bailout raised questions however, including uncertainties about the pricing of the “toxic” assets and potential conflicts of interests in the effective auctioning and purchasing process¹¹. Importantly, there were doubts about the effectiveness of the plan to tackle the solvency crisis. In principle, the bailout would have had a positive impact on the solvency of participating firms because it would have reduced the asset side of the balance sheet, and thereby alleviated pressure on the capital charge. However, no public ownership of the companies was foreseen in the US Treasury plan (although the Act allowed the US treasury to exercise non-voting warrants – options to buy shares with *no voting rights*). As in Europe, fair risk sharing in such a massive government bailout precisely would require the US treasury to take effective control of a proportion of share capital of the participating groups that is commensurate with the relief provided by such public support. As advocated by the Global Unions, under such exceptional circumstances governments should become “activist investors” to protect the public interest and ensure that taxpayers are eventually reimbursed. That is what the Swedish government did when it successfully bailed out the domestic banking sector in the early 1990s. On 13 November 2008, the US treasury reversed its position: just as the private sector solution of a “super SIV” in which all toxic products would be parked was abandoned at the end of 2007, the initial mandate of the TARP was dropped and its funding redirected to direct recapitalisation schemes of US banks.

27 In Europe, the lack of coordination between member states – as seen in the disagreements on a US-model type bailout fund, or on the harmonisation of national deposit guarantee schemes – has highlighted the weakness in EU-level capacity to manage such a large scale financial crisis. Some large European banks with significant cross-border investments have become not only “too big to fail”, but also “too big to be saved”, given the gap between their multinational spread and the nationally-based grid of specialised supervisors and central banks. Unlike the US, no EU-level authority has the power to engage solvency operations on the scale of the US bailout, and the mandate of the ECB is limited to the injection of liquidities against collateral assets. While active in this field, the ECB mistakenly raised interest rates as recently as summer 2008.

A financial crisis that turns political

28 It is still too early to draw definitive conclusions on the management of the crisis by central banks and governments. At the time of writing, new European initiatives to recapitalise the banks themselves and to support the access of SMEs to credit have been announced, but the details are still unknown. Even for the US bailout plan, it will take weeks before the

10 In addition, the Act raises the deposit insurance limit from \$100000 to \$250000 per account, empowers the government to facilitate renegotiation of mortgage loans to prevent foreclosures, and to enforce “strict executive compensation guidelines” with participating firms – including claw back provision and prohibition of golden parachutes. It would also allow the US Treasury to receive non-voting warrants from participating institutions. Finally, it empowers the SEC to suspend market valuation of a listed group if required by public interest.

11 The original EESA was meant to buy distressed assets at a discount with a view to sell them later once the markets have stabilised. The goal was to set a floor under the prices of the assets so that markets can trade them again. In practice, it would have been difficult to fix a price that would reflect the “fair value” of the assets, and at the same time be attractive enough for companies participating in the scheme as well as be politically acceptable. Some of the toxic assets have no current valuation, others are rated at 75% discount of their face value. Unlike in previous credit crunches, such as the saving & loans crisis in the early 90s, the structured products are not homogenous and are not easily compared. Given the opacity and complexity of the structured products, the US government would also need to outsource the effective auctioning, pricing and purchasing arrangements. Not many investment firms have the necessary expertise, other than those that created these products. Conflicts of interest and public accountability of the process may need to be closely monitored.

scheme is effectively implemented and an assessment can be undertaken. At this stage, one can only draw very general conclusions. First, US and European authorities have appeared behind the curve at every step of development of the crisis. Neither governments nor the central banks foresaw the bubble that grew in the US housing market up to 2006, or the fundamental weaknesses in the structured finance industry. Whether this is a result of staff incompetence or of an informed decision to let the bubble burst remains an open question. Once the crisis erupted, however, it was apparent that central banks were left with outdated mandates and tools to respond to the crisis, injecting liquidities in the markets that, whilst providing a much needed lifeline for the balance sheets of the large banks, failed to revive the inter-banking credit markets. International cooperation has been weak as well. The Bretton Woods institutions, the International Monetary Fund (IMF) in particular, played no real role in the early management of the crisis. The Bank for International Settlement (BIS) was of no help either. Being a standard-setting body, it has no operational responsibility.

29 Clearly, the crisis caught governments and international institutions by surprise. On 10 October 2008, the G7 Finance Ministers issued a strong statement calling for the coordination of government and central banks' rescue operations. This was to be followed by a roadmap to be developed at an exceptional G20 summit¹². But earlier statements in 2008 indicated that the international community was unprepared to act to prevent the deepening of the crisis¹³. The reluctance of the G8 and G7 Finance Ministers to engage in discussion on leveraged institutions and the opacity of the structured finance industry is not new. In 2007, attempts by the German presidency for the G8 to consider the strengthened regulation of hedge funds, were thwarted at an early stage by the US and the UK. It is apparent that massive political lobbying of financial supervisory and regulatory authorities and policymakers by the financial industry has allowed light regulatory approaches to prevail. In that sense, the current crisis should not be understood in technical terms only. The crisis exposed a more structural crisis of democracy and how policies and decisions that are supposed to serve the public interest have been undermined by private interests of the financial lobby.

“The crisis exposed a more structural crisis of democracy and how policies and decisions that are supposed to serve the public interest have been undermined by private interests of the financial lobby.”

30 Public perception of the role of government in financial markets has clearly been affected by the way governments and central banks have reacted to the crisis since 15 September 2008. In the US the initial proposal of a \$700bn bailout plan – which was presented in a 3-page note by the US Treasury with no pre-conditions for participating companies – sparked a heated political debate, which ultimately ended in its rejection by the US House of Representatives. The initial design of the bailout was portrayed, at best, as the result of a political vacuum and lack of leadership and, at worst, as the latest manifestation of the extent to which political elites had been influenced by the interests of the private, global financial industry. Washington

12 Including the G8, China, Chile, South Africa, Mexico, Brazil, Turkey, South Korea, India, Indonesia & Mexico, as well as the EU presidency.

13 In April 2008, the same G7 Finance was optimistic about the resolution of the crisis and merely called for the implementation of the recommendations of the Financial Stability Forum (FSF) issued few weeks before. The main focus of the FSF recommendations is on prudential regulation of banks (Basel II and other internal risk management procedures, regulators' and central banks' cooperation), on credit rating agencies, and on transparency and valuation of structured products and off-balance sheet transactions. On the other hand the G7 Finance statement in April – which was re-affirmed in the final statement of the G8 in June – remains silent on the role of leveraged institutions, such as hedge funds and private equity funds, in the current financial crisis. In fact, the April 2007 statement goes into the opposite direction calling for further opening of capital markets and facilitating of cross-border capital markets services.

elites would use taxpayers' money to bailout the friends of "Wall Street's greed and corruption". Facts about the close personal connections between the US investment firm Goldman Sachs and key supervisory authorities in the US and globally, did not help appease suspicions in this regard.

Re-regulation for the real economy

- 31** The aftermath of the introduction of urgent measures will require political-level international cooperation and dialogue to introduce content to the *quid pro quo* for bailing out the financial system. Work on a new regulatory architecture must commence. At the outset, any discussion on financial regulation should begin by addressing the public function of financial services, which is to serve the real economy. Financial regulation is commonly associated with three objectives: (i) to maintain financial stability by ensuring solvency of market participants, (ii) to protect investors against failures and fraud, and (iii) to ensure "efficient and effective" financial markets. The need to regulate against insolvency, failure and fraud is self-evident and as such does not lend itself to much polemical debate other than the means: public/binding rules versus market-based/non-binding instruments. The third objective however – to ensure the "effectiveness" and "efficiency" of markets – can take different roads. A discussion on re-regulation of financial market thus requires the identification of the exact underlying objective of "effectiveness" in financial markets: is it economic growth in absolute terms that is targeted or should it be a more qualitative understanding of growth combined with the fair distribution of wealth within society?
- 32** Much of the economic ideology that so far has prevailed in the international financial institutions (IFIs) – the Washington Consensus – states that financial markets by definition are efficient and that the real economy and society at large can only benefit from the fruits of that efficiency. Debates on the impact of financial markets on growth and inequality have been brushed aside by these IFIs as being largely dependent on "societal choices": some societies are believed to be more "receptive" to the issue of equity than others. There is no single approach to the effectiveness of financial markets – it is argued – and any wealth distribution objectives should be fixed *ex-post* by governments, notably in the form of social safety nets.

Issues and questions for future regulation

- 33** Re-regulation would require important changes in the international mechanisms for international cooperation. The current regime dates back to the Bretton Woods Agreement in 1944. A new architecture would be needed, not to regulate exchange rates as was the objective in 1944, but to ensure regulatory coverage of international financial markets – that is coverage of both financial products *and* institutions – and cooperation to effectively deter and detect excessive risk-taking behaviour in the global financial system.
- 34** Greater regulation is needed in order to harness financial markets to the needs of the real economy. Regulation should aim to spread responsibility, not risks, among institutions and within markets and to protect social objectives and development, including the right of working families to housing and to a decent retirement. More fundamentally, re-regulation should address the flaws in the global financial systems, which have been exposed by the current crisis:

“Regulation should aim to spread responsibility, not risks”

- *An unsustainable model of growth, fuelling wage compression, predatory lending, debt-financed consumption and the transfer of market risks on to workers (pensions, housing);*
- *An un-controlled ‘structured finance’ industry in which credit risks were not spread but hidden: a system that lacked regulation, was riddled with conflicts of interests and, when coupled with rigid prudential and accounting rules, created a self-perpetuating feeding asset depressing process;*
- *Widespread institutionalised regulatory arbitrage between jurisdictions and within financial institutions which has helped to blur the lines between regulated and shadow banking, letting financial groups practice double accounting by using off-balance sheet operations and encouraging irresponsible risk-taking and leverage investment strategies;*
- *Corporate short-termism and “shareholder value” governance undermining market integrity and stakeholders’ long term interests. The crisis has exposed weak risk management by ineffective Boards of Directors and turned the spotlight on the money that has been wasted in the past years in grotesquely large executive compensations, dividend proceeds and share buy-back programmes.*

35 The remainder of this section identifies some issues and questions, which are designed to address the above and to start discussion on the re-regulation of financial markets and the future shape that this should take. They are grouped under three broad objectives:

- *Strengthening financial safeguards and international cooperation;*
- *Diversifying the financial sector and protecting social development objectives;*
- *Spreading responsibility throughout the investment chain.*

Strengthening financial safeguards and international cooperation

36 Consensus has emerged on the need to strengthen the three safeguards that exist across OECD economies, namely: (i) prudential rules for banks, (ii) harmonisation of the deposit credit guarantee schemes, and (iii) coordination of central banks as lenders of last resort. Strengthening existing safeguards – notably ensuring strict prohibition of all forms of off-balance-sheet transactions – are much needed, but would not insulate the real economy from the excesses of financial markets. The mandate and public accountability of central banks, the overarching regime for international flows of capital, as well as international cooperation between regulators – banks, insurance, other financial services, tax – may need to be reconsidered in this respect.

Review the mandate and public accountability of central banks

37 Central banks have provided generous liquidity support ever since the crisis erupted. This did not stop the liquidity crisis from transforming into a broader insolvency crisis, but it did keep the system afloat and prevent a total collapse of the banking sector. On the other hand, central banks were particularly inept at anticipating, let alone preventing, the formation of the speculative bubble in the market for credit and for credit transfers.

- Central banks should have the necessary mandate to deter and detect speculative financial bubbles and to react when prices of a given class of financial assets have become “irrational”.

38 In addition, the management of the crisis by some independent central banks, most notably the ECB, has been criticised heavily by trade unions for not having taken a pro-real economy approach to the crisis, particularly with regard to the management of lead short term interests. The independence of central banks may be needed to protect monetary policy from undue political influence. However institutional independence should not run counter to the imperative requirement of public accountability that these institutions should be subject to given the impact of their decisions on the real economy and working families.

- Good governance principles would require regulated representative institutions of the real economy, including social partners (trade unions and employers) to have a say in the policy-making process of the central banks.

Ensure fair prudential regulation for banks

39 What is the purpose of regulated accounting and banking oversight if one can so easily offload liabilities outside the balance sheet? The expected strengthening of capital requirements across the OECD and beyond may have potential side effects. One could see the banks passing on the additional cost of new prudential measures to customers by way of higher borrowing costs and/or transfers of interest rate risks (for example, proposing variable interest rate loans only). Another negative side effect would see prudential rules have “pro-cyclicality” effects on the risk management behaviour of banks as seen in the current combination of cycle sensitive marked-to-market valuation with fixed capital ratios. The issue of pro-cyclicality effects of regulated capital requirements is not new and has been debated extensively as part of the implementation of Basel II. What would count from a real economy perspective is that regulated banks prioritise the building of “buffers” during growth cycles – so as to prepare for any potential economic downturn – and that they do so not at the expense of customers and companies.

- All forms of off-balance sheet transaction should be prohibited.
- Regulators should ensure active supervision, proper counter-cyclical asset requirements and accounting rules for banks and large financial conglomerates.

Reign in international flows of capital

40 Where should the line be drawn between proper regulation of all investment entities and freedom of foreign investments and capital flows? Policy frameworks for international investments as advocated by institutions such as the World Bank, the IMF and the OECD have forced unconditional opening of trade and capital markets in many developing countries. The current crisis shows that any loosening of international capital flows restrictions must be subject to conditions so as to ensure robust domestic regulation and strong public and private institutions. Current negotiations on trade in services under the World Trade Organisation’s (WTO) General Agreement on Tariffs and Services (GATS) should be reviewed in this regard.

- Access to foreign investments and capital flows should be conditioned to proper domestic regulation, including observance of internationally recognised governance and transparency standards.

Putting an end to OFCs

41 Do the crisis and the role played by lightly regulated investment entities change the terms of the debate on international cooperation to monitor OFCs? Intra-group and jurisdictional regulatory arbitrage and

the un-controlled growth of private investment funds as exposed below cannot be treated within the OECD zone only. OFCs as they exist within and beyond the OECD still resist basic standards of transparency by applying strict bank secrecy, criminal penalties for disclosure of client information and a policy or practice of non-co-operation with the OECD International Tax Dialogue. More broadly, strong action is required to stem the loss of revenues to tax havens. Tax payers cannot be expected to bail out failing financial institutions when the same institutions have used tax havens to avoid paying their fair share of tax. All governments need to take the necessary steps to protect their revenue base and to offset expected substantial reductions in corporate tax receipts.

- Cooperation and political support should intensify to ensure proper monitoring of OFCs so as to bring them in line with onshore regulations.

Ensure proper staffing of supervisory and enforcement authorities

42 Even the ‘smartest’ regulations will be of no use if at the same time the public administration that is assigned to their implementation is understaffed and lacking in equipment, technology and expertise. In some OECD countries, budget cuts have considerably weakened government expertise and overall capacity to ensure proper monitoring of the financial sector.

- Governments should ensure adequate levels of staffing, access to expertise and technology for public supervisory and enforcement authorities.

Diversifying finance and protecting social development goals

43 Financing basic rights such as access to decent housing or retirement cannot be ruled by for-profit institutions only. Financial institutions that have regulated social objectives, such as the provision of pension funds and solidarity-based financial services, should be protected and promoted. More broadly, it is the landscape of the financial sector that needs to be reconsidered and, for that matter, diversified, taking into account public state-owned mechanisms.

Protect households against predatory lending

44 Household consumer protection against insolvency needs to be reinforced to crack down on unscrupulous middlemen. More fundamentally, access to housing should be based on household earnings and not on the capacity of the household to absorb excessive debt. Mortgage loans should be tied to the wage earnings of households and not the speculated future value of the property that is being financed. Access to credit consumption should be framed by regulation that ensures full transparency and sets ceilings on the cost of credit, as well as financial education programmes, notable for low-income households.

- Governments should review and where necessary improve consumer protection legislation so as to protect households against predatory lending and aggressive sales policies by banks.

Diversifying the financial sector and support community-based financial services

46 Access to housing should not be ruled by shareholder value and annual growth in earnings per share. Alternatives to pure for-profit financial industries, such as cooperative banks, credit unions and mutual insurance groups need to be supported by active public policies, so as to ensure

“Tax payers cannot be expected to bail out failing financial institutions when the same institutions have used tax havens to avoid paying their fair share of tax.”

diversity in the financial services industry. In addition, the phenomenal growth of sovereign wealth funds (SWFs), particularly in emerging countries, has profoundly changed the asset ownership landscape.

- Community-based financial services such as cooperative and mutual systems and targeted micro-finance schemes negotiated with national social partners should be actively supported by public policies.
- Diversification of the financial industry will require a renewed debate on the role of state-owned investment funds and the need to ensure these institutions meet proper public accountability criteria.

Protect workers' pension schemes

47 Do governments recognise that pension funds are distinct financial institutions because of the social objectives of decent retirement that they pursue? What would that imply for both funding and investment regulations of the schemes? The funding rules and investment policy of pension funds should be regulated to ensure strict prudential principles and to limit exposure to high risk products. Accounting rules applying to corporate pension liabilities should be flexible enough to ensure smoothing and avoid pro-cyclicality effects on the sponsor's balance sheet.

- The social purpose of pension schemes to provide decent retirement should be emphasised in both pension funding and investment regulations.

48 Furthermore, the crisis demonstrates the danger of individual retirement savings accounts. The crisis has also revealed the dangers of excessive investments in Employee Share Ownership Plans (ESOPs), which expose workers to corporate risks twice: through their jobs and through their savings. Although ESOPs may have value in some specific circumstances, they should not be substituted for fair worker remuneration or pension retirement schemes.

- Existing individualised defined contribution pension schemes and other un-protected savings accounts should be reformed with a view to ensuring decent retirement for their workers.

International taxation

49 It may be time to revisit models of international taxation of financial flows in the light of short term speculative behaviour in commodity markets. The initial Tobin Tax proposal on spot transactions of currencies aimed to curb volatility induced by short-term speculation. Whether such objectives can be better achieved by other means is open for debate. On the other hand, international taxation has proven to be a powerful instrument to ensure funding for "public good" purposes including fighting global inequalities and funding solidarity initiatives, such as fighting AIDS in Africa.

- An international regime for taxing financial transactions should be considered, the proceeds from which could help support financial institutions that pursue social objectives.

Spreading responsibility throughout the investment chain

Reform the credit rating industry

50 The calls for reinforcing supervision and mechanisms to prevent conflict of interests of credit rating agencies are welcome. Like the corporate auditing industry during the Enron episode in 2001-2002, the oligopolistic structure of the credit rating industry does not appear to be compatible with the overriding need for independent assessment that is free from conflict of interests. Beyond strengthening transpar-

ency and preventing conflicts of interests of the credit rating agencies, is the oligopolistic structure of the industry acceptable? Should alternative publicly accountable rating institutions be promoted instead? How does this issue relate to the development of sustainability and other non-financial rating practices?

- The oligopolistic structure of the credit rating agency industry should be addressed by government, including by establishing public agencies and developing non-financial sustainability rating.

Regulate credit risk transfers and derivatives

S1 The current discussion on regulation of credit rating agencies is welcome but fails to tackle the heart of the problem, which is the opaque and unregulated nature of the structure financed industry (asset backed securities, credit default swap). Simply relying on good internal governance and “sophisticated” risk management techniques will not solve the problem. Following a phasing out of the existing products, international cooperation should ensure that all future originate-to-distribute models of credit risk transfer are created, approved and traded under strict supervision of securities and exchange commissions or equivalent public watchdogs. In addition, the originators should retain ownership of a substantial proportion of the structured products they create.

- All forms of credit risk transfer should be brought under the supervisory authority of public exchange and securities commissions.

S2 Certain forms of trading on stock and commodity markets have been identified by public authorities as having a negative impact on markets. Hedging against future price fluctuations without real ownership of the underlying asset has fuelled speculative rise in commodity market prices.

- Regulatory controls should limit speculative behaviour in trade exchanges including commodities and energy markets.

Regulate private investment funds and conglomerates

S3 What is the rationale for letting private investment firms and the limited partnership agreements that rule their funds operate across borders and outside proper regulatory scrutiny? The regulatory black hole created by the growth of the hedge fund and private equity industries should be eliminated. Because they are un-regulated and are excessively leveraged, private investment groups and the funds they run create externality costs, not only for the financial system but for the real economy as whole. Because of their size and the blurring of boundaries with regulated institutional investors – insurance groups, pension funds and banks – governments should ensure proper licensing, transparency and capital charge requirements of these institutions. Convergence may happen in the near future between private equity firms, hedge funds and the investment banking industry. The distinction between Goldman Sachs and KKR or Blackstone, which has expanded its business lines to include advisory services, is becoming harder to identify. The current restructuring of the banking sector in the US has accelerated that process. The European Parliament Resolution on private equity and hedge funds of September 2008, is a positive step in so far it calls for pan-European legislation on private equity funds.

- Private investment firms such as hedge funds and private equity should be regulated to ensure level playing field with other collective investment schemes.

“Simply relying on good internal governance and “sophisticated” risk management techniques will not solve the problem.”

54 Is the accumulation of different financial services – banking, insurance, market trading and private investment – in different jurisdictions within a single financial group a healthy situation from a regulatory point of view? Rather than increasing competition between institutions, the dis-intermediation of the financial system has given birth to global conglomerates that accumulate different lines of businesses, which are in turn subject to different regulations and hence different supervisory authorities.

- National and international regulatory and supervisory coverage of financial conglomerates and their cross border and intra-group activities should be reinforced.

Ensure executives' and intermediaries' perverse incentives are reversed

55 The design and approval of compensations for all market participants – corporate executives, asset managers, bankers, credit agencies, etc. – need to be aligned with the objective of long term stability and the performance of the real economy. Aligning incentives of the financial industry with the needs of the real economy can only be achieved by enforceable regulations and targeted tax incentives. “Self-regulation” and voluntary standards are not effective.

- Compensation of financial middlemen and corporate executives should be regulated by law and designed to achieve multi-annual contractual objectives, in line with organisation-wide performance and approved by relevant independent third parties, such as the AGM.
- Claw-back provisions should be systematised and golden parachutes should be prohibited.

Combat corporate short-termism

56 Other than executive compensation, the current crisis has some similarities with the corporate short-termism of the Enron crisis of 2001-2002. Beyond Board incompetence and massive failures in Board risk management, the current crisis shows that “old” problems of Board governance and accountability have yet to be resolved across the OECD. For example, many banks that were hit by the crisis were ruled by “imperial” CEOs that faced no counter power from the Board of Directors. Also, the same financial groups gave generous dividends and share buybacks programmes to their shareholders during the recent growth cycle 2003-2006. “Free cash flow” should be given back – we were told – to create “value for shareholders”, rather than being allocated to the retained earnings of the company. The money that was given away to shareholders is now badly needed as those same groups need to be recapitalised.

- Tax and regulatory incentives should be in place to ensure that the distribution of corporate profits – dividend proceeds, share buybacks and retained earnings – is in line with the long term sustainability of companies.
- Beyond risk management, it is the accountability of the Board of Directors, including strict separation of CEO and chair functions, which must be reinforced in national corporate governance regimes.

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TUAC's mission is to contribute to the establishment of the social, economic and political conditions which are essential to safeguard the principles of free citizenship and democratic institutions, and which above all can ensure a progressive improvement in the life and labour of the people”.

Vincent Tewson, then General Secretary of the British Trades Union Congress (TUC) elected as the Trade Union Advisory Committee's first Secretary 1948.



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