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Senate Committee on Banking, Housing & Urban Affairs

Subcommittee on Economic Policy

Hearing on Short-termism in Financial Markets

April 29, 2010

Good morning Chairman Brown, Ranking Member DeMint and members of the Committee. I am very pleased to appear before you today on behalf of the American Federation of Labor and Congress of Industrial Organizations to discuss the challenge of lengthening the time horizons of U.S. capital markets. The AFL-CIO has worked for a number of years with the Aspen Institute to foster a dialogue on this issue between business leaders, institutional investors, the labor movement and the academic community. That dialogue has led to both the Aspen Institute Principles on Executive Compensation and last fall's statement "Overcoming Short Termism: A Call for a More Responsible Approach to Investment and Business Management," signed by AFL-CIO President Richard Trumka and a number of leaders in the business and institutional investor community, including Warren Buffett and Pete Peterson.

Capital markets and financial institutions' purpose is to transform savings into investment. Investment means new capital equipment and new software, developing employee skills, financing research and development teams. I can save money by putting it my mattress, and it has not been invested. I can also save money and use it to fund my visits to Las Vegas, and that is also not investment, even if I win at blackjack.

The U.S. economy needs investment with long term time horizons. We need investors to fund our $2.2 trillion infrastructure deficit, to finance our transformation to a low carbon economy, to finance upgrades to our workforce's skill set, and perhaps most importantly, to fund research and development work all across our business landscape that is essential if our companies are to remain competitive in a globalized economy. All these tasks require patient capital—capital willing to commit for the long haul.

Instead, by measure after measure, our system of financial markets and financial institutions appears to have rapidly shortening time horizons. The average mutual fund holding period for investments in equities has shrunk to less than a year. A recent study of 991 equity fund managers by Mercer found that from 2006 to 2009, two thirds exceeded their target turnover rates, with the average annual turnover rate at 72%. While data is not available, most market participants believe holding periods for the several trillion dollars invested in hedge funds is significantly shorter. Leveraged buyout funds, now renamed private equity funds, assert they are long term holders because sometimes they make five year investments. And in the aftermath of the financial crisis, the large financial institutions that dominate our markets have turned to proprietary trading to make up for their losses in the credit markets. In the extreme, proprietary trading takes the form of high frequency trading, the use of computer algorithms to generate thousands of trades a day—a technique apparently pioneered by Goldman Sachs, which according to press reports has paid stock exchanges for the privilege of placing Goldman's computers literally in the same room as the exchanges' to get a little bit of a timing advantage—a practice called co-location.

There are multiple sources of short termism in our capital markets. The rise of cheap credit for risky activity, funded by our trade deficits, has made a variety of short term strategies far more tempting than would have been true in the past. The decline of defined benefit pension plans has meant that both those pension plans that remain and individual workers trying to provide for retirement on their own have been forced to look for higher rates of return than are available through buy and hold strategies. The fact that these higher rates of return are illusory has not stopped both individuals and institutions from pursuing them.

Deregulation of our financial markets has been a potent contributor to the rise of short termism. We have deregulated the use of leverage in our equity markets—both directly and indirectly through the regulatory loopholes hedge funds operate in. We have allowed the development of a shadow credit and insurance system in the form of derivatives, without meaningful transparency and capital requirements, and we have allowed our major financial institutions to become short term actors in the securities markets, rather than providers of long term credit to productive enterprise.

Our tax system also contributes to the short term orientation of our capital markets. While capital gains taxes do have a time differential associated with them, it is a simple one year cliff, structure. The result is that billionaire private equity fund managers use the carried interest tax loophole to pay income tax rates lower than that paid by middle class Americans for the profits on investment strategies whose time horizon is shorter than a turn of the economic cycle. In addition, vast pools of capital devoted to retirement savings are properly tax exempt, so the tax system provides no incentive for long term investment of those funds. Finally, and perhaps most importantly, the tax treatment of executive pay makes no distinction in giving tax preference to performance based pay between short term and long term performance based pay.

Finally, there has been a culture of misunderstanding of fiduciary duties in the world of pension fund management. Fiduciaries clearly have duties to maximize the long term risk adjusted rate of return on their funds. But throughout the chain of investment management decision making, fund service providers have financial incentives to seek short term gains, often at the expense of the long term health of the plan, or to look at investment decisions in isolation from the plan's overall portfolio and investment objectives. Actions by the Bush Administration in its waning days exacerbated these tendencies by issuing guidance letters that appeared to discourage fiduciaries from policing service providers or companies plan assets were invested in, or considering either plan's overall portfolios or their actual investment objectives.

All these factors contribute to a corporate governance system that has tilted severely in the direction of short term time horizons. The most radical version of this is the story of Countrywide Financial and its CEO Angelo Mozillo, over who took $400 million in total compensation out of that company during the real estate bubble, only to have the company go bankrupt. But though Countrywide is an extreme case, there was nothing unusual about the basic nature of its pay packages. Typical corporate pay packages provide for the vesting of stock based pay in three years, a time period short enough to be exploited, and a structure that allows, and in fact encourages executives to manage their firm with an eye toward a specific date, rather for the long term health of the firm. A 2005 study of 400 public company financial executives found the majority would not initiate a positive net present value project if it negatively affected the next quarter's earnings

And so what has the result of the tilt toward short termism been for our capital markets? The ten year rate of return on the U.S. equity markets is negative in nominal terms—adjusted for inflation it is significantly worse. And for our economy—we have seen a period of jobless growth during the real estate bubble be replaced by a period of disastrous job loss. In the last ten years we have lost over 5 million manufacturing jobs. Workers' incomes were stagnant in real terms before the bubble burst, and now they have declined much further. Poverty rates have risen. And our capital markets have simply failed to invest in the key long term needs of our society—as evidenced by our $2 trillion infrastructure deficit.

So how can we return our capital markets and financial institutions to a long term perspective, the kind of perspective necessary for those markets and institutions to return to their proper purpose of channeling savings into investment, rather than speculation?

The AFL-CIO strongly supports the recommendations in the Aspen Institute letter. We also believe that the Wall Street Accountability Act of 2010 contains many significant steps that would encourage a more long term focus in the capital markets, and must be enacted.

However, rather than discuss each item in the Aspen letter, or the details of the Wall Street Accountability Act, I would like to focus the remainder of my testimony on tax policy—because the AFL-CIO believes capital markets tax policy is central to the future of our nation. Later today, AFL-CIO President Richard Trumka will be leading a march of more than 10,000 workers to Wall Street under the banner "Good Jobs Now, Make Wall Street Pay." I want to explain what we mean by Make Wall Street Pay, and why though it may sound a little odd, that if we make Wall Street pay for the harm the financial sector has done to Main Street in the right way, we will encourage Wall Street to return to its proper function as an intermediary between savings and investment, which will be good for our financial system and good for our country.

The AFL-CIO has a four point program for reform in the way we tax the financial system. We support President Obama's bank tax, The first item in the Aspen Institute letter is an item encouraging Congress to consider either changes in capital gains taxes or an excise tax to discourage short term speculation in the capital markets. An excise tax to discourage short term speculation is essentially a Financial Speculation Tax.

A Financial Speculation Tax is the very simple idea of assessing a very small tax on all financial market transactions—stocks, bonds, commodities, derivatives, futures, and options. Senator Harkin and Congressman DeFazio have sponsored bills proposing a 25 basis point tax with an exemption for retirement plans. A broad coalition in Europe has suggested a 5 basis point tax. The Congressional Budget Office estimates the Harkin-DeFazio proposal would generate over $100 billion a year in revenue. Leading European economists have estimated a 5 basis point tax implemented across the major economies could generate 3% of global GDP in revenue. A Financial Speculation Tax has been endorsed by the governments of the leading economies of the world, including the United Kingdom, France, Germany, Japan and Brazil. If the United States led in this area, it is clear we have willing partners.

But as important as the revenue implications of the Financial Speculation Tax are at a time of vast unmet public needs, the true power of such a tax is what the Aspen letter seeks—which is a reorientation of our capital markets toward investing, toward long term value rather than speculation.

On behalf of the AFL-CIO, I want to commend the Subcommittee for holding this hearing. The question of capital markets time horizons is critical for our future as a nation. As a result of the good work of the Aspen Institute, Congress has the benefit of a consensus among business leaders, labor, and institutional investors. The AFL-CIO stands ready to assist you in acting in this area. Thank you.