Innovation
Knowledge
Development

The Open University

FINANCIAL INSTITUTIONS & ECONOMIC SECURITY (FIES)

Conference Report: Key Messages

Fall 2009

This Financial Institutions and Economic Security (FIES) conference report has been produced for The Open University *Innovation, Knowledge, and Development (IKD)* Centre. The FIES conference was held in London, UK on 21-22 May 2009 and considered the influence of financial institutions on employment security, retirement security, and housing security, as well as the interrelations among these forms of economic security in North America and Europe. The key messages of the FIES conference are summarised in this report. For elaborations of these messages, please see the IKD FIES Policy Briefs on employment security, retirement security, and housing security by William Lazonick and Öner Tulum. For further information on the FIES project, working papers and upcoming events, please email: ikd-enquiries@open.ac.uk

Introduction

The Conference on Financial Institutions and Economic Security took place against the background of the most severe economic downturn of modern times, precipitated by the banking crisis that has engulfed all the developed economies. The Conference explored three interconnected areas where the behaviour and performance of financial institutions impact directly on everyday life: employment, housing and retirement. This Key Messages document highlights the most important conclusions. Briefing Notes on each of the topics provide a more detailed summary of the debates.

Employment Security

Security of employment was a traditional value of the 'Old Economy Business Model'. The norm of career-long employment with the same company has been undermined by global competition and rapid changes in technology, causing and also enabling companies to seek cheaper labour costs abroad. This trend has been accelerated by companies using profits that could have been available for investment instead to enhance shareholder value by buying back their own stock, creating a conflict of interest for senior management whose personal wealth depends in large part on stock options.

There has been a global shift towards the primacy of shareholder value, notably in the USA and UK, over the interests of other stakeholders, particularly employees. Shareholders are interested less in the internal operation of a company itself and more in how external financial markets value it, which has in turn had a marked impact on investment decisions in technology and innovation.

In the French economy, these trends have led to a decline in business-financed investments in technology, R&D intensity, wages, and employment security, especially for younger workers. However, social pressures in France favouring a strong welfare system have limited the extent of change. The impact of globalisation and international financial markets on the German system of collective bargaining has caused companies to maximise shareholder value by restructuring in ways that limit worker participation. However, there are also examples of companies adopting strategies that depend on a high degree of worker commitment and involvement. Although there has been a marked shift towards shareholder interests, the European system of stakeholder capitalism is still much in evidence.

The primacy of shareholder value has distorted the allocation of resources between and within companies in favour of those able to extract value from the economic system through speculation and manipulation. To achieve stable and equitable economic growth Governments must favour economic entities that will invest in creating stable employment and generating the goods and services that the population needs at prices that the population can afford.

Housing

Ensuring access to decent and affordable housing is a priority for all governments, whether through rental or home ownership. However, ownership can only be achieved through the provision of mortgages, which normally requires stable and remunerative employment to service them. Unstable and low-income employment eliminates the option of home ownership except under two very different conditions: either the State must intervene to underwrite the risks; or banks and other lenders must devise ways of profiting from the desire of people with low and unstable incomes to become homeowners (and then to find ways to continue to finance their homes). It was the latter that led to the sub-prime mortgage crisis in the USA.

Even for those initially in a strong position changes in personal circumstances or sharp increases in interest rates can put them in difficulty. Banks and other lenders may then respond with various schemes to enable struggling home owners to keep their homes. However, in the changed financial circumstances in which they now find themselves, the effect may be deepen their economic plight. It was argued that there is a need for stronger Government regulation of such schemes.

However, many home owners have seen the value of their houses rise substantially as they pay off the original mortgage, giving a substantial share of the equity in the value of the property. Financial innovations, in particular the securitsation of mortgage debts, have made it much easier for home owners in some countries to access the equity represented by their homes. The extraction of housing equity has fuelled the growth in household consumption in Australia, Ireland, the Netherlands and the UK, as well as the US. The US represents an extreme case where a combination of the availability of Home Equity Lines of Credit (HELOCs) and low interest rates led many households to overextend their total mortgage indebtedness, and they are now faced with foreclosure and forced sale of their homes.

The regulatory framework governing mortgage equity withdrawal (MEW) varies widely between countries. In Germany and Hungary MEW is available only in case of financial hardship or after retirement. In general European societies regard housing equity as a means of supplementing pension provision. However, in every case, the critical factor in maintaining access to housing whether through rental or home ownership, is secure employment. With security of employment comes the possibility of home ownership over a period of years which can create additional equity available later in life to provide for a comfortable retirement.

Housing therefore sits between the two other concerns of the Conference; housing security is dependent on security of employment, and housing security can contribute to security in retirement.

Retirement Security

Historically, security in retirement has been seen to rest on three pillars: state pension provision, company pensions, and personal savings. While previously concern had centred around long term issues of increasing longevity and the capacity of the three pillars to support people throughout their retirement, more recently concern has focussed on the immediate limits to state pension provision and the widespread replacement of company defined benefit plans of globalisation and international financial markets by defined contribution (DC) plans, placing more and more of the burden on individual savings. These problems have been further exacerbated by a collapse in property values and the sharp fall in returns on savings, placing many retired people in a very difficult position.

More generally, the instability of financial markets wreaks havoc not only with home equity but also with the value of DC accounts, such as the tax-deferred individual retirement accounts (IRAs) and 401(k) plans popular in the United States. In a world of highly volatile financial markets, marketised retirement plans, whether funded by governments, companies or households, are unable to bear the weight of people's retirement needs. A strong case was argued for greater state involvement through the continuation of 'pay-as-you-go' state pension provision (i.e. funded from general taxation at the time of payment of the pension rather than through investment during the course of a working lifetime) and measures to stabilise the value of DC and other retirement savings.

Understanding the risk exposure of retiree households is critical to the development, implementation and evaluation of retirement systems. People today are struggling with the uncertainty of generating income to ensure their economic security during their retirement period. If the retirement system is left to continue in the direction it has been heading, only those who are able to maintain stable employment will be able to save for their future and ensure their economic security in retirement. Yet, even with stable employment, savings in marketised non-state retirement plans have been shown to be inadequate for providing economic security to retirees.

Policymakers should shift their vision of retirement security from a crumbling three pillared structure to a more sturdy and sustainable two-legged bench, where state-backed retirement plans are supplemented by stabilised individual retirement accounts to ensure economic security during retirement.

Conclusions

The Conference reviewed a large body of data on current economic trends, all pointing towards increasing insecurity for individual citizens as a result of the operation of financial markets. Crucially, the erosion of secure employment has put at risk both security of housing and retirement. The securitisation of mortgages has encouraged excessive indebtedness, and some of the schemes offered to deal with the resulting problems have only made matters worse for those caught up in them. The early withdrawal of housing equity has placed even greater reliance on declining state and company pension provision, leading to the risk of poverty in retirement. Because the risks associated with defined benefit pension schemes may be too great for companies to sustain, it is essential that governments ensure the security of state pensions and the value of individual savings in retirement.

Key Messages

- The primacy of shareholder interests must be rebalanced towards other stakeholders, in particular employees, to ensure sound investment of profits and to provide secure employment.

- The way that finance is provided for and equity is released from home ownership must be more closely regulated to protect home ownership as a resource for retirement in the face of less secure patterns of employment.

- The value of state pensions and the return on individuals' retirement savings must be protected to counterbalance the decline in pension provision by companies.