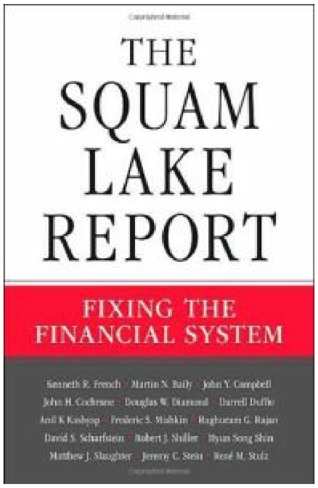

Report The Squam Lake Report

Fixing the Financial System

The Squam Lake Group
Princeton UP, 2010
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Recommendation

This slim volume is named after the isolated New England resort where 15 renowned economists, academics and policy makers met in the fall of 2008 to devise solutions to the “World Financial Crisis.” That they convened amid fast-paced, seismic economic events adds to the star-chamber aspects of their collaboration. Still, these éminences grises – all nonpartisan, without commercial sponsorship or political axes to grind – developed their ideas by sharing their expertise. Their recommendations cover reforms in banking, financial products, regulation, compensation, pensions and hedge funds – all the named villains of the last crisis. Why did they issue these ideas? So they could educate political and fiscal leaders – if they would only listen – about possible laws that could help avert or lessen the likelihood and impact of future meltdowns. *BooksInShort* recommends this sound advice to students of and participants in the global economy.

Take-Aways

- In 2008, 15 economists met at Squam Lake, New Hampshire, to hash out global economic problems in the wake of the “World Financial Crisis.”
- Their nine recommendations for new laws addressing the issues, conflicts of interest and banking catastrophes that unfolded during the crisis include:
- Institute a “systemic regulator for financial markets” using central banks as overseers.
- Establish “a new information infrastructure for financial markets” to shed light on the “shadow banking system” of hedge funds, derivatives and the like.
- Regulate “retirement savings”. Govern financial executives’ compensation.
- Regulate “hybrid securities” and create faster, better crisis “resolution options.”
- Establish clearinghouses and exchanges to monitor and control credit default swaps.
- Build up bank “capital requirements” to mitigate runs by requiring liquidity and institutional “living wills.” Make brokers separate client funds from institutional funds.
- New reforms should place failure’s onus on financial institutions, not on taxpayers.
- If the Squam Lake proposals had been in effect before the World Financial Crisis, Bear Stearns, Lehman Brothers and AIG may have had completely different histories.

Summary

Squam Lake

Amid the raging economic storm of autumn 2008, 15 top economists assembled at tranquil Squam Lake, New Hampshire, to construct a series of recommendations. Their objective? To educate and assist politicians and policy makers on financial system reform. The 15 gurus especially wanted to mitigate the negative, “unintended consequences" that well-intentioned legislation often introduces.

> "We have aspired to help guide the evolving reform of capital markets – their structure, function and regulation."

Despite the rapid pace of events that fall, the economists focused on long-term issues and their solutions. They analyzed and concurred on nine major areas: banking regulation, financial transparency, pension reform, capital requirements, executive compensation, bank capitalization, moral hazard, and the "shadow banking system" of hedge funds, credit default swaps, brokerages and investment banks. They collaborated on reports, outlining their reasoning and conclusions on each topic. To insert their findings into "policy conversations in real time," they subsequently conferred with members of the US Congress, the Federal Reserve, the European Central Bank, the Bank of England, the Banque de France and other global, high-level government institutions.

> "Though informed by the lessons of the Crisis, our proposals are guided by long-standing economic principles."

Two precepts underlie the Squam Lake recommendations: First, the experts want legislators to consider the impact of reform on financial markets as a whole, not just on single companies. Second, any new rules should put "the costs of failure" squarely on financial firms, not taxpayers. Eliminating "too big to fail" thinking would lead to more sensible risk taking among the firms. Events in the fall of 2008 – the US government takeover of Fannie Mae and Freddie Mac; Lehman's demise; the AIG, ING and UBS bailouts – all figured in the global credit shortage. "Fascinating market pathologies" seized up liquidity for banks, plus hedge funds, arbitrageurs and other shadow banking world operators. The crisis bared four drawbacks to the financial system:

1. **"Conflicts of interest"** – The "highly uncertain future payoffs" inherent in financial transactions mean that traders will assume more risk when they're paid handsomely on good trades, but not made to suffer on bad ones. Shareholders face a similar conflict, or "agency problem," with a firm's managers, who may take undue risk when their compensation isn't sufficiently tied up in shares. Investors discourage troubled banks from raising new capital because they fear the dilution of their shares, resulting in "debt overhang." Conflicts pit financial investors against society's best interests: Healthy financial institutions spur growth and jobs, but failing banks can cause economic breakdowns, so governments rescue them. These "privatized gains and socialized losses" mean shareholders come out whole at the expense of taxpayers. Too-big-to-fail thinking adds risk to the system and chips away at the freedom of capitalist societies.
2. **"Bankruptcy and resolution procedures"** – In the US, bankruptcy rules allow companies to continue operating while their financial side undergoes repair. But that doesn't work for banks, all of whose operations are financial. Plus, because of banks' short-term funding, lenders who beat a hasty retreat at the first signs of trouble will bring down firms quickly. Even insured depositors may "run" on their banks, preferring to withdraw their cash now than wait for a government bureaucracy to pay them. Troubled banks have to conduct "fire sales" of their assets that can drive prices down precipitously, endangering other banks. Intricate connections among financial institutions create domino-like scenarios when one is failing. Institutional knowledge disappears when a bank does, and the loss of a lender can threaten its commercial clients.
3. **"Bank runs"** – Financial entities underwent "a modern version of bank runs" during the World Financial Crisis. Investment banks that fund themselves overnight with commercial paper, repurchase agreements and other collateralized borrowings saw many of their traditional counterparties head for the exits. Due to market uncertainty, lenders wanted more collateral and turned away from even secured transactions. Hedge funds that settle trades through investment banks' prime brokerage units pulled their collateral and business from any firm they considered doubtful. Bear Stearns saw $5 billion in cash vanish when a major client withdrew its business; within a week – after churning through $18 billion in liquidity – Bear failed, a victim of a "destructive and self-fulfilling" run.
4. **"The inadequacy of the regulatory structure"** – Financial regulation, declining for years, did not keep pace with financial innovation. New products and structures can improve the economy, but can also undermine markets if not properly monitored. Creativity often arises from legal limits. Piecemeal regulations centered on single banks are inadequate for proactively monitoring complex, interrelated fiscal markets.

> "We believe our recommendations will help prevent or mitigate future crises even though we do not fully understand all the causes of the last one."

Each of the following policy proposals, had they been in place before 2008, might have lessened or even prevented many of the World Financial Crisis's worst results.

"A Systemic Regulator for Financial Markets"

Current regulatory schemes that focus strictly on individual banks' safety and soundness overlook the interrelationships among firms and markets, and the changes wrought by financial innovation. Look no further than the shadow banking system, which transacts freely under no current legislative control. Instead, "one regulatory organization in each country should be responsible for overseeing" its fiscal system's "health and stability." This systemic regulator should be divorced from consumer protection, which can be inherently short sighted and political. A central bank should take this role: It is the hub of economic activity, it interacts with market participants, it is typically apolitical and it has the monetary heft to intervene in crises.

"A New Information Infrastructure for Financial Markets"

Lack of good information dogged the administrators working to save AIG and other firms. Making financial entities supply data about derivatives would highlight related exposures among counterparties; information on "bonds, mortgages and asset-backed securities" would reveal the extent of "fire-sale risk" in case of forced liquidation. Governments need an information infrastructure that can collect, analyze, report on and react to indicators of emerging crises.

"Regulation of Retirement Savings"

More US corporations offer "defined contribution pension plans," where employees choose how to invest their nest eggs. While such plans give workers control over their investments, protection from employer bankruptcies and job-change portability, they also place a huge burden on people to understand investing. Governments have a stake in citizens' investment choices, since people's earnings can relieve pressures on entitlement programs. A "simple, standardized disclosure label" on products offered for retirement accounts, similar to those on food, should note an investment's fees and risk profile, but not its past returns, which can be misleading. Workers who do not expressly opt out should, by default, have 5% of their salaries automatically invested in their firms' retirement plans, in diversified investments with limits on their stakes in employer shares.

"Reforming Capital Requirements"

Economies still depend on banks moving money from savers to borrowers, so banks need capital requirements that better reflect their relative risk profile. Big banks with broad networks should hold more capital than small local banks. Similarly, self-financed banks with riskier short-term debt should hold more reserves than banks relying on dependable customer deposits. The less liquid a bank's assets are, the higher its capital charges should be. Regulators will have to mitigate the potentially negative aspects of increased capital requirements, such as banks becoming less price-competitive, driving consumers to smaller or even overseas financial institutions.

"Regulation of Executive Compensation in Financial Services"

Although high executive pay draws lots of press, regulators should not legislate bankers' compensation. Markets can best dictate remuneration. Real financial skill is discernable and powerfully profitable, while failure is brutally expensive. An investment banker can turn an idea into a disaster or can succeed and promptly decamp to a rival firm. Still, the salary in "systemically important financial institutions" is fair game for regulation, especially if that can mitigate bankers' incentives to take incautious risks. Firms should withhold a significant, fixed-dollar part of senior executives' annual pay for several years. If the employee quits or is fired, or if the firm dissolves or accepts government aid, the "holdback" is lost. Such holdbacks also can give firms a capital cushion during crises.

Regulate "Hybrid Securities"

To avoid taxpayer bailouts, financial entities should issue long-term hybrid securities – before rocky times – that begin as bonds but turn into equity under specific conditions. The systemic regulator would trigger this change by declaring a crisis. The conversion would result in an immediate infusion of capital in troubled markets. Thus, the onus of maintaining a bank's solvency stays with its shareholders, not the public. Policy makers and bank executives should collaborate on the details of such securities.

"Improving Resolution Options"

Complex international firms that needed government intervention during the financial crisis presented supervisory bodies with many challenges. Regulators could not claim proper "legal authority" to sell or restructure private firms that were subject to myriad regulatory systems; nor could they understand all the networks and connections among a firm's subsidiaries and external counterparties. Systemically crucial financial institutions should file quarterly "living wills," road maps for unwinding or reorganizing in a crisis. Such "rapid resolution plans" would supply up-to-date details on legal structure, shareholders, contingent liabilities, contracts, major assets and the like. Banks with inordinately complex operations should maintain more capital. Global regulators now should begin negotiating a "unified cross-country resolution process."

"Credit Default Swaps, Clearinghouses and Exchanges"

Economic downturns can send systemic tsunamis across the $25-trillion credit default swap (CDS) market. Clearinghouses acting as buffers between parties to a CDS could help a failure's systemic impact. Counterparties would not be directly exposed to each other, but to the clearinghouse, which would net outstanding amounts, reducing overall exposures. The clearinghouse – which should clear other derivative products as well – must hold enough capital and maintain effective controls on its operations by legislative fiat. Institutions should trade recurring derivatives on an exchange or within a reporting system.

"Brokers, Dealers and Runs"

Brokers can, to a certain extent, commingle client assets from their clearing and prime brokerage units with their own proprietary assets for short-term funding. Therefore, when panic ensues, hedge funds and other clients create runs as they withdraw their collateral. Mandating greater segregation of funds would cut the likelihood of runs. "Liquidity requirements" on broker-dealers and banks would disregard client assets as a stable source of financing.

If Only...

Had these proposals been in effect prior to the World Financial Crisis, Bear Stearns could have relied on its hybrid securities and compensation holdback for capital, and its living will could have given regulators vital data at a critical time. A systemic regulator would have seen Fannie's and Freddie's risks and forced them to raise more capital. Lehman's regular reporting of its positions and its derivatives clearing would have lessened its risk to the system; its bankruptcy would have been more orderly. And AIG could have used every Squam Lake recommendation.

About the Author

The Squam Lake Group is a non-partisan, non-affiliated group of academics who offer guidance on the reform of financial regulation. Dartmouth Professor Kenneth R. French coordinated 15 contributors, including former, current and future American Finance Association presidents; an ex-Federal Reserve governor; a former IMF chief economist and several former Clinton and Bush Council of Economic Advisers members. They are: Kenneth R. French, Martin N. Baily, John Y. Campbell, John H. Cochrane, Douglas W. Diamond, Darrell Duffie, Anil K. Kashyap, Frederic S. Mishkin, Raghuram G. Rajan, David S. Scharfstein, Robert J. Shiller, Hyun Song Shin, Matthew J. Slaughter, Jeremy C. Stein and René M. Stulz.