

## The Squam Lake Report: Reforming the Financial System?

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Ken French and Robert Shiller were among a group of leading economists who, in the fall of 2008, convened what was to become known as the Squam Lake Group. Their recently released and much-talked about book offers its authors' collective best answer to a defining question of our day: How can the financial system be organized to facilitate economic growth without the lingering need for government bailouts and other recurring taxpayer support? The authors' answers boil down to two broad principles:

1. *Focus on the system, not just individual firms* — When developing and enforcing regulations, government officials must consider their implications not only for individual institutions but also for the financial system as a whole.
2. *Minimize “socialization of losses”* — Regulators must create conditions that force them to internalize the costs of their own failure, minimizing the likelihood of bailouts that impose those costs on taxpayers and the broader economy.



Recommendations supporting these principles are as follows:

1. **Appoint a systemic regulator for financial markets** — A regulator, such as the Federal Reserve Bank, should be tasked with overseeing the health and stability of the overall financial system. Such a regulator would need adequate resources, independence and an explicit mandate to maintain the stability of the financial system. Its goal should be to prevent financial crises without stifling financial innovation or long-term economic growth. Long before the recent financial crisis, such a competent systemic regulator would have flagged Fannie Mae/Freddie Mac as a source of risk for the system, triggering action to mitigate those dangers.
2. **Institute a new information infrastructure for financial markets** — Require all large financial institutions to report, according to standardized measures, asset positions and risks each quarter. This information must be shared across regulatory agencies (SEC, Fed, FDIC, CFTC), and, after a proper time lag, released to the private sector. Annually, the systemic regulator should prepare a “risk of the financial system” report for the legislature. Such a report might have induced more



prudent choices among regulators, financial firms, home builders and buyers in the run-up to the 2008 crisis.

3. **Regulate retirement savings** — Standardize disclosures of mutual funds offered in defined contribution plans to encourage comparison-shopping based on more than just past performance. Highlight expenses and exclude past performance from the standard disclosure label. Automatically enroll employees unless they explicitly opt out, make default contribution rates high, and only allow the standard part of an employees' contribution to be invested in diversified, low-cost products. Strictly limit the amount of company stock that can be held in a defined-contribution account. This is vastly different from common practices before the financial crisis. At the time of Bear Stearns' takeover, for example, employees were estimated to have held more than 30% of its outstanding shares.
4. **Reform capital requirements** — Capital requirements should be higher, all else equal, for larger banks, banks whose positions are less liquid, and banks that finance more of their operations with short-term debt. Under these reforms, Bear Stearns and Lehman Brothers both would have been required to hold more capital during their pre-crisis expansions.
5. **Regulate executive compensation in the financial services industry** — Governments should not regulate the *amount* of executive compensation, but rather the *structure*. Systemically important financial institutions should withhold a significant share (a fixed dollar amount, not a share of stock or options) of each senior manager's total annual compensation for several years. Employees would forfeit these holdbacks if the firm goes bankrupt or receives extraordinary government assistance. Compensation holdbacks would have generated more pressure for Lehman to find a buyer without government support, and clawbacks on Bear Stearns' \$17 billion in employee compensation over the five years before it was absorbed by JP Morgan would have reduced the risk of the Fed's guarantee of the deal.
6. **Expedite the recapitalization of distressed financial firms** — Governments should promote a long-term hybrid debt security that converts to equity under specific conditions. If triggered, the automatic conversion from debt to equity would transform an undercapitalized bank into a well-capitalized one at no cost to taxpayers but at substantial cost to the banks' investors. Conversion would occur only if two conditions are met: 1) the systemic regulator declares a systemic crisis and 2) the bank violates the covenants in the hybrid security contract. Such a security would help avoid ad hoc measures taken under extreme time constraints and would shift costs from taxpayers to the banks' investors. These securities would have greatly helped Bear's and Lehman's financial positions during the crisis.
7. **Improve resolution options for systemically important financial firms** — The standard bankruptcy process does not work well for financial firms, because credit-



ors and clients can flee at the first sign of trouble. Cross-country resolution processes are imperative, given the global nature of large financial firms. All systemically important banks and financial institutions should be required to file a “living will” every quarter, explaining how the firm can be legally dismantled in the event of failure. Banks whose wills suggest a long resolution process should be required to hold more capital or more hybrid securities. The systemic regulator should review all plans each quarter and fines should be levied against firms with deficient plans. Lehman, for example, operated in 40 countries, with over 900 operating companies. 16 different administrators are now presiding over the bankruptcy in different jurisdictions. It will take years to resolve its case.

8. **Improve clearinghouse structure for derivatives** — Banks and important financial firms should be encouraged by the systemic regulator to clear CDSes and other derivatives through a central clearinghouse, or else be subject to dramatically higher capital requirements. Clearinghouses themselves should be highly regulated and well-capitalized. To improve transparency, a trade reporting system (a la TRACE for bonds) should be developed for standardized derivatives. Regulator knowledge and tracking of AIG’s derivative positions could have triggered risk-control conversations with AIG long before the fateful Lehman bankruptcy, potentially leading to a reduction of Lehman’s systemic importance.
9. **Minimize the risk of “runs” on prime brokers and dealers** — Client assets should be segregated from prime broker assets, and systemically important broker-dealers should be subject to stiff liquidity and capital requirements. In order to avoid a “race to the bottom,” prime brokerage regulations for firms outside the U.S., particularly in the U.K., should be tightened so that segregation requirements for customer assets are at least as tight as in the U.S. Bankruptcy created chaos in Lehman’s brokerage and clearings operations because many of its customers’ assets had been commingled with Lehman’s own assets. Customers have therefore been left as general creditors of the company, and many have yet to recover their money. Tightened liquidity requirements might have induced greater segregation of client assets.

Taken together, the authors’ proposals would reduce the likelihood and severity of future financial crises. Existing rules in the U.S. and other countries have led to ad hoc, emergency interventions to save unprofitable banks at great current and future cost to taxpayers and significant collateral damage to the broader economy. The authors offer ideas to foster a robust regulatory system that would be better prepared to allow struggling banks to fail and less prone to crisis.

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