

Recommendations from Squam Lake

The Squam Lake Report: Fixing the Financial System. By 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, Princeton, N.J., Princeton University Press, 2010, 167 pp., \$19.95/cloth.

In the fall of 2008, in the midst of what would become the longest recession since World War II, 15 economists from academic institutions across the country met at New Hampshire's Squam Lake to discuss non-partisan steps to address short- and long-term financial reforms. The economists' recommendations revolved around the simple notion that any negative result of risks taken should be borne by the risk taker, rather than society at large, and they proposed legislation that would ensure that end.

The participants agreed that each country should create a single regulatory agency charged with overseeing the stability of its financial system. In their opinion, central banks are particularly well-suited to this purpose, as they are generally already responsible for macroeconomic policies that promote stability. Regulations should address "systemic" risk; that is, risk to the overall financial system. These risks may be the sum of actions by individual actors or the risks posed by large institutions—those often

deemed "too big to fail." The economists recommended that this systemic focus by the regulatory agency keep pace with innovations in the financial industry, not simply enforce existing financial regulation, and ensure consumer protections (which they stated are functions more effectively dealt with by regulators in separately established agencies). Per the financial reform legislation passed by Congress in the summer of 2010, the U.S. Treasury Secretary is charged with the responsibility of systemic regulation in the United States, and an independent consumer bureau was established within the Federal Reserve.

Once the authority of the systemic regulator is established, the regulatory agency can then concentrate on a number of specific areas necessary for financial system reform: improved information gathering, retirement plans, capital requirements, executive compensation, hybrid securities convertibility, living wills, and credit default swaps. The requirement for improved information gathering recognizes the interconnectedness of financial system risk; that is, a seemingly healthy financial institution may be at risk both by the failure of a trading partner (counterparty risk) and the risks posed by a price drop due to the sale of a large volume of securities (fire-sale risk). In order to evaluate the extent of counterparty and fire-sale risk, the systemic regulating agency would need to be aware of the interactions between firms, not simply evaluate an individual firm in isolation; hence, financial institutions would be required to provide information not only about their own financial stability, but about their ongoing transactions with their

trading partners. Retirement plan recommendations of the Squam Lake group include the standardization of information about the costs, risks, and fees associated with a given investment; automatic enrollment for employees who do not specifically opt out of a plan; and limits on the amount of company stock that an employee can hold. Although these suggestions are certainly worthy of consideration, it is not clear to this reviewer why the authors think these particular regulatory reforms should be attached to the systemic regulation of the financial system rather than entrusting them to a consumer protection agency. In the remaining proposals the link between the proposed regulation and the potential systemic risk is clearly delineated, including raising capital requirements. The economists proposed that large banks have higher capital requirements simply because their very size poses a risk to the financial system (as a result of the risk of default or fire-sale pricing) that would not necessarily be posed by a smaller institution. And, for the purpose of encouraging executives to take a long-term view of their organization's health (rather than focus on short-term profits), the economists further recommended that executive compensation in important financial firms be restructured so that 1) a fixed proportion of compensation be deferred and 2) payments be contingent on the firms not going bankrupt or needing a government bailout.

In order to encourage undercapitalized institutions to recapitalize, rather than sell assets or wait for a government bailout, the Squam Lake economists proposed the creation of a long-term debt instrument

that converts to equity when certain distress conditions occur. The hoped for result is that the institutions would remain solvent, and would continue to lend at the expense of the banks' investors rather than the taxpayer.

Regarding living wills, the economists recommended that important financial institutions provide the systemic regulator with the information necessary to determine whether it is worth taxpayer dollars to support the institution, to restructure it, or to dissolve it in the event of a failure. The repository of this information, called a "living will," would be filed on a quarterly basis and would include such information as an itemization of assets and liabilities, a list of counterparties, a description of

the ownership structure, and a "distress scenario," with suggestions for institutions that might be available to assume a troubled firm's obligations in the event of a failure.

In the area of credit default swaps (which according to the economists are inherently sensitive to economic conditions and where large exposures pose systemic risks) the economists recommend either that they be cleared through well-regulated clearinghouses or that higher capital requirements be instituted on contracts that have not been cleared.

The *Squam Lake Report* points out important areas of focus for policymakers and regulators. In a concise way, the economists describe a problem area, make recommendations, justify their decisions, and include

cautions and caveats. The *Report* provides a solid basis for policy analysts, policy makers, and the informed general public to come to their own conclusions about how financial reform should be structured and which areas of financial reform deserve close consideration. Finally, the non-partisan approach used by these 15 economists from academic institutions with competing schools of thought, scattered across the country, provides an example to all of us of the cooperation necessary to work through a crisis.

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