
Some Perspectives on Regulatory Reform Proposals

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The views expressed herein are my own and do not necessarily reflect the views of the Federal Reserve System or the Federal Open Market Committee.

Proposals for Regulatory Reform

- **Use monetary policy to fight asset bubbles**
 - Identification problematic
 - Blunt tool

- **Strengthen the current micro-prudential regulations**
 - Proposals by the Basel Committee on Banking Supervision
 - ◆ **capital and liquidity standards**

- **Introduce macro-prudential regulations**
 - Horizontal review and analysis
 - Dynamic capital requirements, loan loss provisions

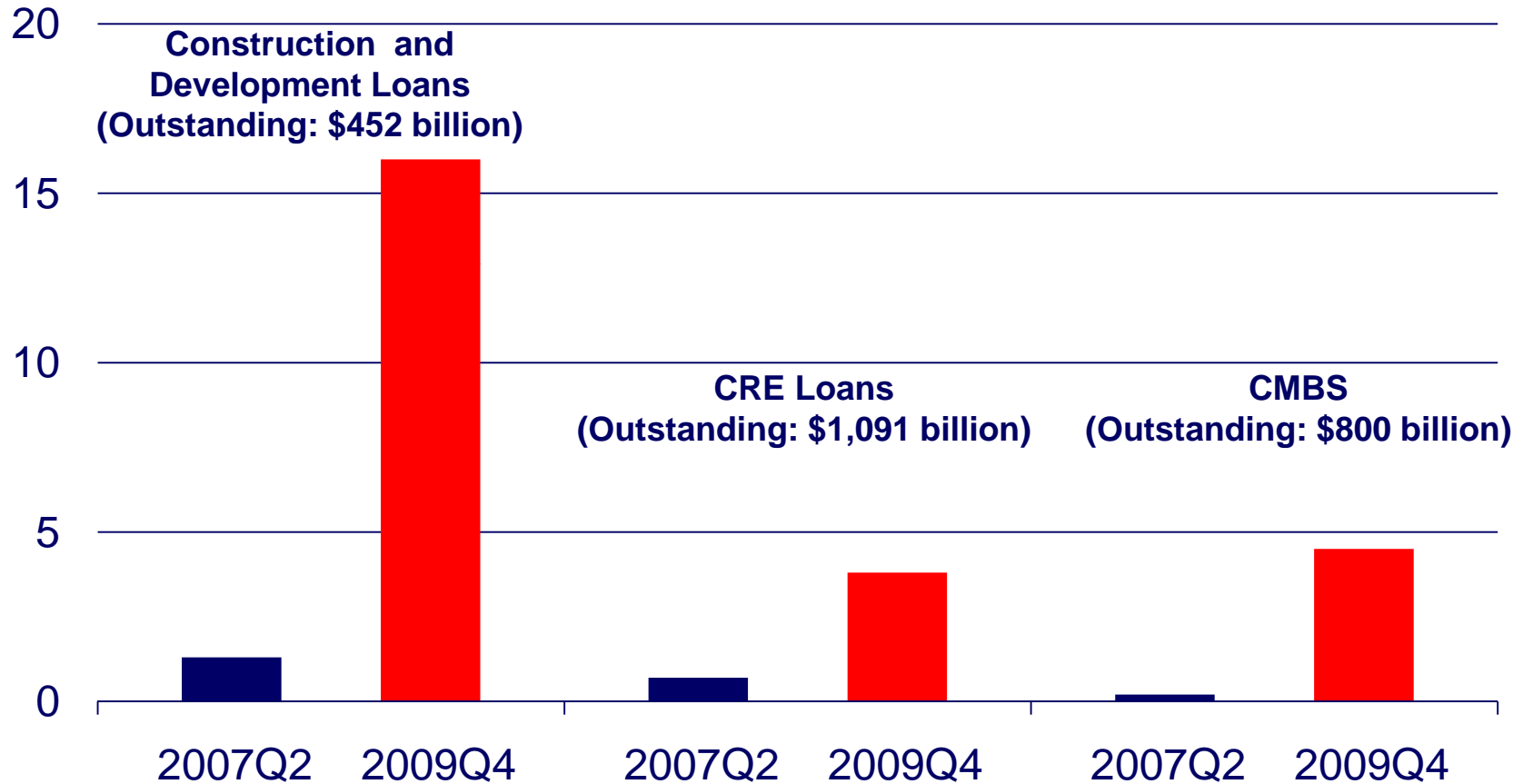
- **Resolution authority**

My Take-Aways

- **Need a multi-pronged approach to deal with complex problems**
- **Micro-prudential regulation is necessary, but not close to sufficient**
- **Success requires very early and courageous action**
 - Problems build over years
 - Inherent uncertainty
 - When do you take action?
- **Macro-prudential regulation is also necessary, but may not be enough**

Commercial Real Estate (CRE)

Noncurrent Loans/Total Loans* (Percent)



*Noncurrent loans are loans that are 90 days or more delinquent plus loans in nonaccrual basis. For CMBS, the delinquency rate shown is for loans that are 60 days or more delinquent.

Micro-Prudential Supervision is Not Enough

- **Imagine you're an examiner concerned about a large financial institution's CMBS warehouse in 2005**
- **Financial Institution says:**
 - Transportation, not storage -- still selling CMBS quickly
 - Real estate prices rising and delinquencies low
 - Have hedges and adequate capital to absorb potential losses
- **Examiner critiques, but eventually is convinced:**
 - Micro risks to FI and insurance fund seem small
- **Problem: Sum of micro risks < macro risk**
 - Not everybody can get through the exit at once

Macro-Prudential Analysis -- Pros

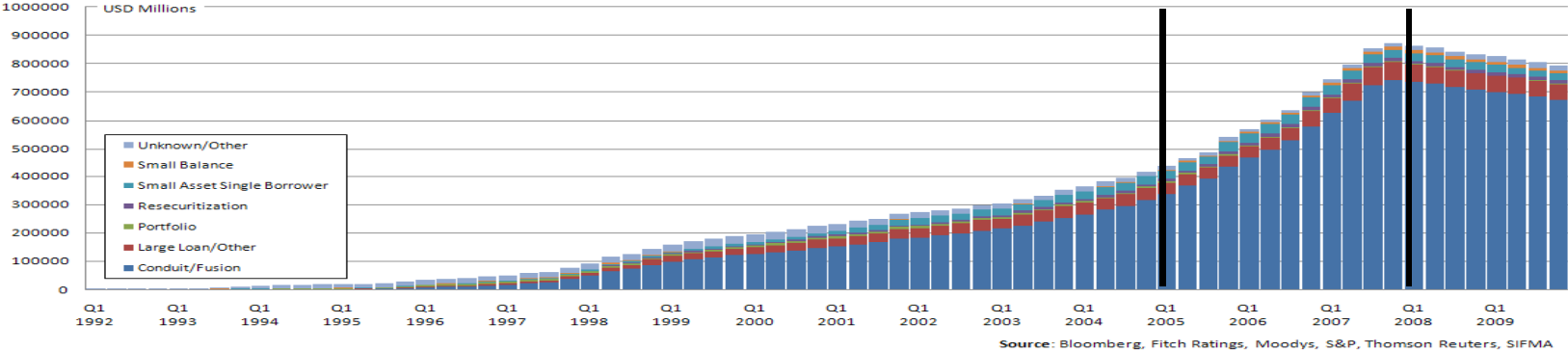
- **Identify and control system-wide risks**
- **Experience with Supervisory Capital Assessment Program – the “stress tests”**
 - Horizontal, simultaneous review of 19 largest banks
 - Apply consistent set of assumptions and conditions
 - Identify risks at individual banks PLUS
 - Correlations of risks across banks
 - Forward-looking stress analysis
 - Identify and disseminate best risk-management practices

Macro-Prudential Analysis -- Challenges

- **What should be the “Early Call” focus?**
- **When?**
- **How confident?**
- **What exactly should you do?**

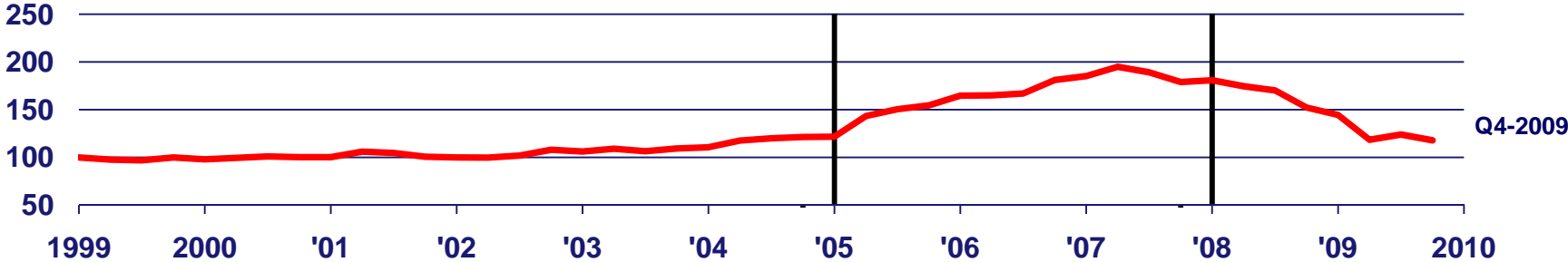
Commercial Real Estate -- CMBS

Commercial Mortgage-Backed Securities Outstanding



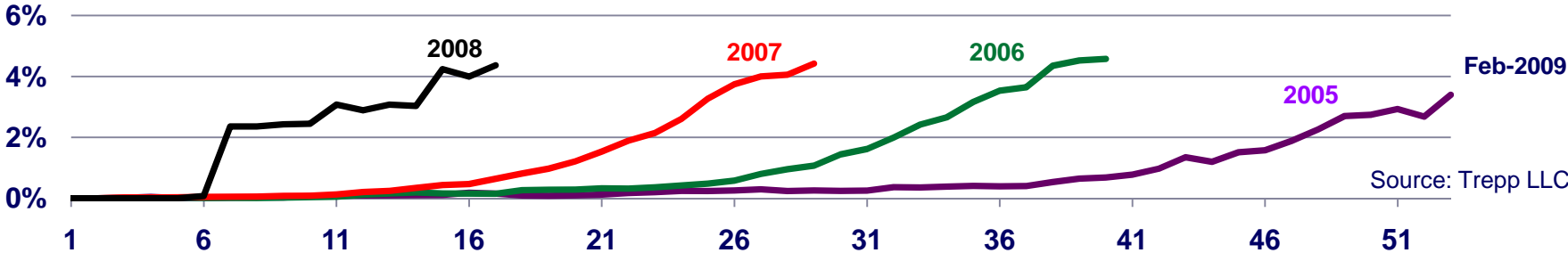
Real Estate Prices

(MIT Center for Real Estate Commercial Index)



CMBS Delinquencies by Vintage

(60+ days delinquent as a percent of CMBS conduit since month of origination)



Strategies for Mitigating Macro-Risks

- **Pre-emptive actions:**
 - Supervisory guidance (micro-prudential)
 - Shouting (moral suasion)
 - Shouting and supervision
- **If in doubt of the effectiveness of one tool, use the other tools more intensively**
 - Higher capital requirement, liquidity standards, etc.
- **Resolution authority**

The Role of the Central Bank in Supervision

- **Well-known synergies between monetary policy and supervision**
- **Unique ability: lender of last resort**
 - Inevitable involvement in combating crises
- **Traditional monetary policy**
 - Potential trade-off between price stability and maximum sustainable employment
- **Add additional responsibility (financial stability) but no additional tools (supervision or regulation authority)**
- **May use monetary policy more actively than otherwise**
 - Possible dilemmas with traditional policy goals

