Regulatory Reform

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What Keeps Me Awake at Night

- In the moment of crisis, special assistance will occur
  - Absent a much better resolution mechanism

- For asset price exuberance, monetary policy is a very blunt instrument
  - But there now is more pressure to use it
  - We need alternatives
My Take-Aways

- Need to avoid these situations in the first place

- Micro-prudential regulation is necessary, but not close to sufficient

- Success requires very early and courageous action
  - Problems build over years
  - Inherent uncertainty
  - Financial industry doesn’t easily part with the punch bowl
Examples of Calls for Early Action

- John Taylor says FOMC needed to act in 2003:
  - “Monetary policy was unusually accommodative”
  - I disagree regarding MP role, but early action…

- My S&R staff says:
  - To have avoided CRE disaster, needed to act in 2004 or 05

- Borio and White emphasize pre-emptive policies to enhance financial stability
  - Both macro-prudential and monetary
Imagine you’re an examiner concerned about a large financial institution’s CMBS warehouse in 2005

FI says:
- Transportation, not storage -- still selling CMBS quickly
- Real estate prices rising and delinquencies low
- Have hedges and adequate capital to absorb potential hits

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

- What should be the “Early Call” focus?
- When?
- How confident?
- What exactly should you do?
Commercial Real Estate -- CMBS

CMBS Volume

Real Estate Prices
(MIT Center for Real Estate Commercial Index, Loan Performance Residential Index)

CMBS Delinquencies as a Percent of Outstanding
(60+ days delinquent as a percent of total CMBS, source: CMSA)
Residential Real Estate -- RMBS

Securitized Mortgages: Residential vs. Commercial (60+ day) by dollar securitized

Source: CMSA, JPMorgan, LoanPerformance, Trepp, Inc.

Serious Delinquency, Subprime 1st lien

Source: NY Fed, Mortgage Bankers Association
Commercial Real Estate -- Community Banks

Construction and CRE Loan Concentrations
(ratio to risk-based capital)

Nonperforming Construction and CRE Loans
(percent)

Q4-2009
Strategies for Mitigating Macro-Risks

- **Usual suspects:** Contingent capital, resolution authority
  - Mitigate risks in-the-moment of distress

- **Pre-emptive actions:**
  - Supervisory guidance (micro-prudential)
  - Shouting (moral suasion)
  - Shouting and supervision

- **If the Fed is out of the S&R business**
  - Not easy to see that regulation is controlling risks
  - => More pressure to turn to monetary policy