

Making Bank Regulation Work



Forum for College and University Faculty
Confronting Economic Uncertainty
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* The views expressed are those of the speaker and should not necessarily be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System.

Some Regulatory Policy Issues

- Damage occurs in a bust, but die cast in preceding boom
- Need for greater regulatory vigilance and restrictions in good times
- Policymakers grappling with alternatives for enhancing countercyclical aspects of regulatory policy
- Rapid innovation and change represent economic opportunity, but also significant regulatory challenge

Two Broad Areas for Improvement

- Require more capital during booms
- Brake against heightened risk-taking and speculation during booms

Cyclical in Bank Regulation

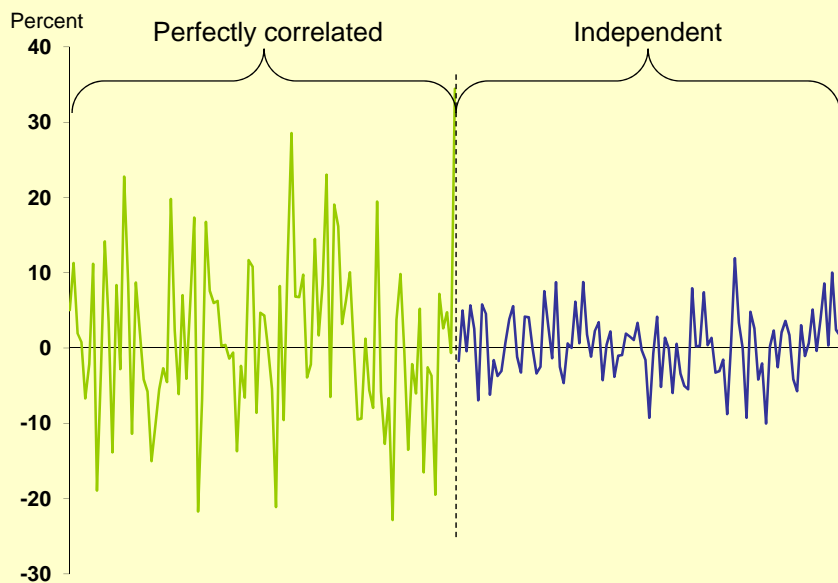
Insufficient Capital Requirements

- Statistical risk assessments often focus on recent history
- Appearance of low risk drives down required capital
- Metrics can feed industry bias toward low capital
- Judgment and conservatism often get little play
- Capital arbitrage (e.g. off-balance-sheet activities)

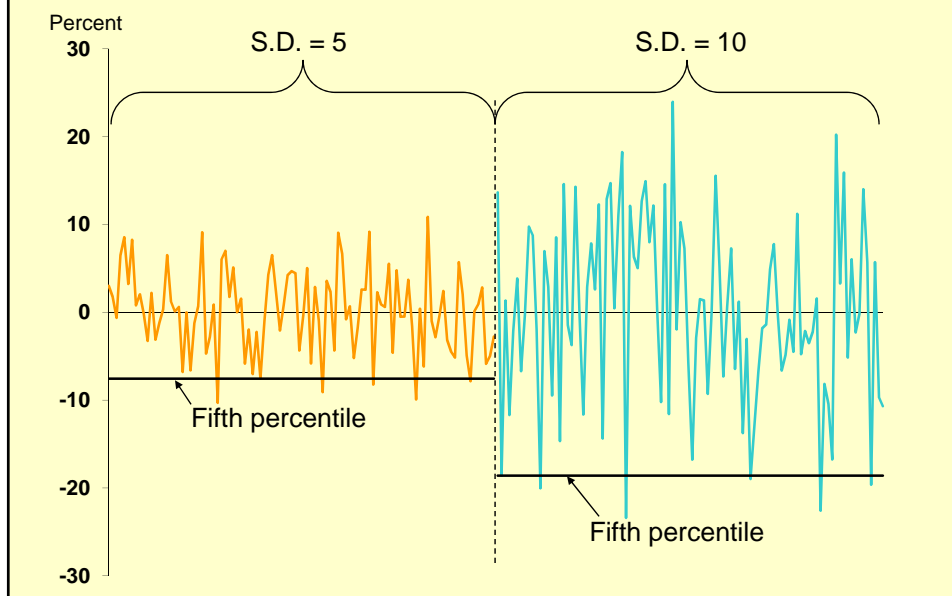
Phase Locking

- Low asset price correlations suddenly become high
- Many different asset prices suddenly move in tandem
- Diversification partly illusory

Danger of Phase Locking *Portfolio of Five Assets with S.D. = 10*



Phase Locking and Capital Requirements



Regulatory Challenge

Capital Requirements

- Modify capital requirements
- Dampen cyclicality in leverage
- Policymakers and regulators must stand strong against industry bias toward low capital in good times

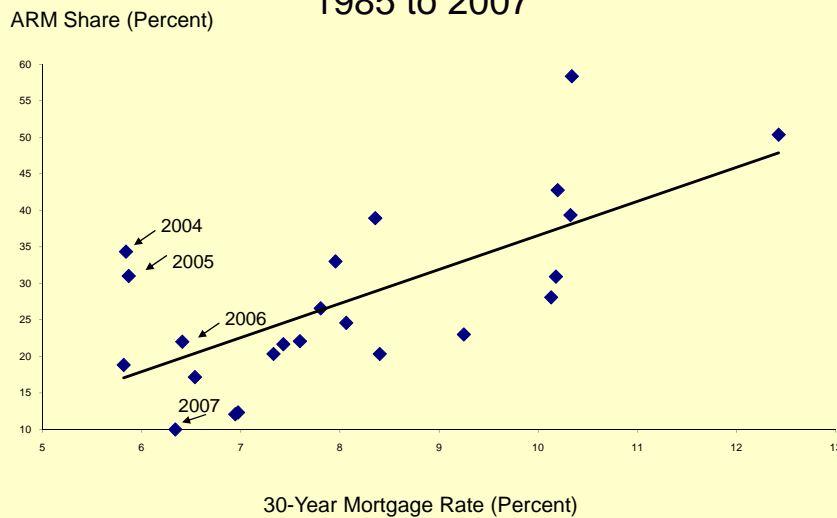
Cyclicality in Bank Regulation

Insufficient Restrictions on Risk-Taking

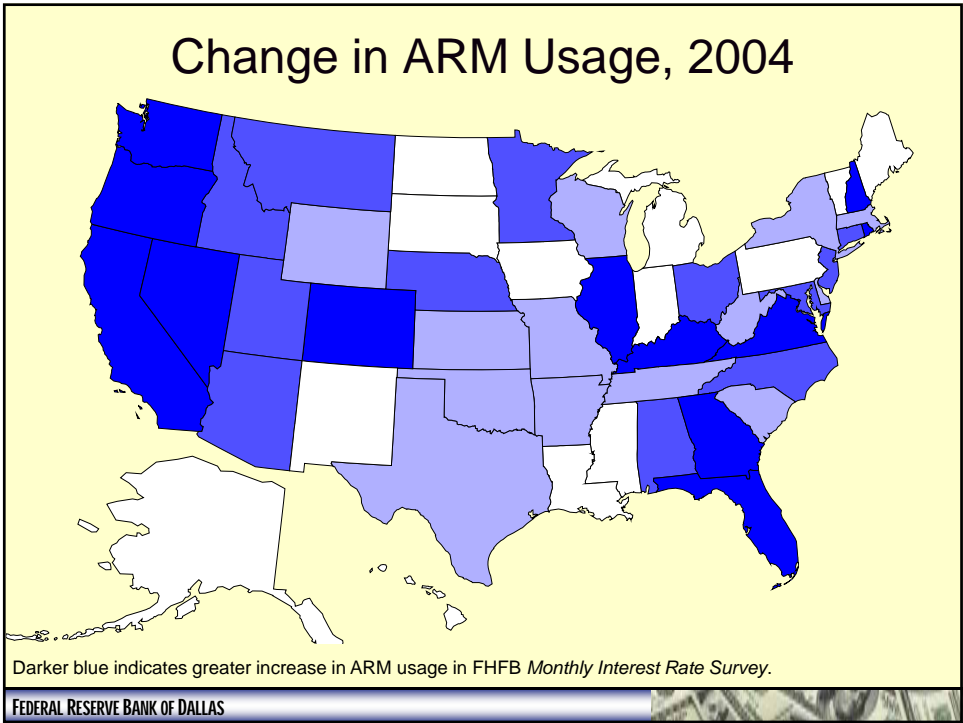
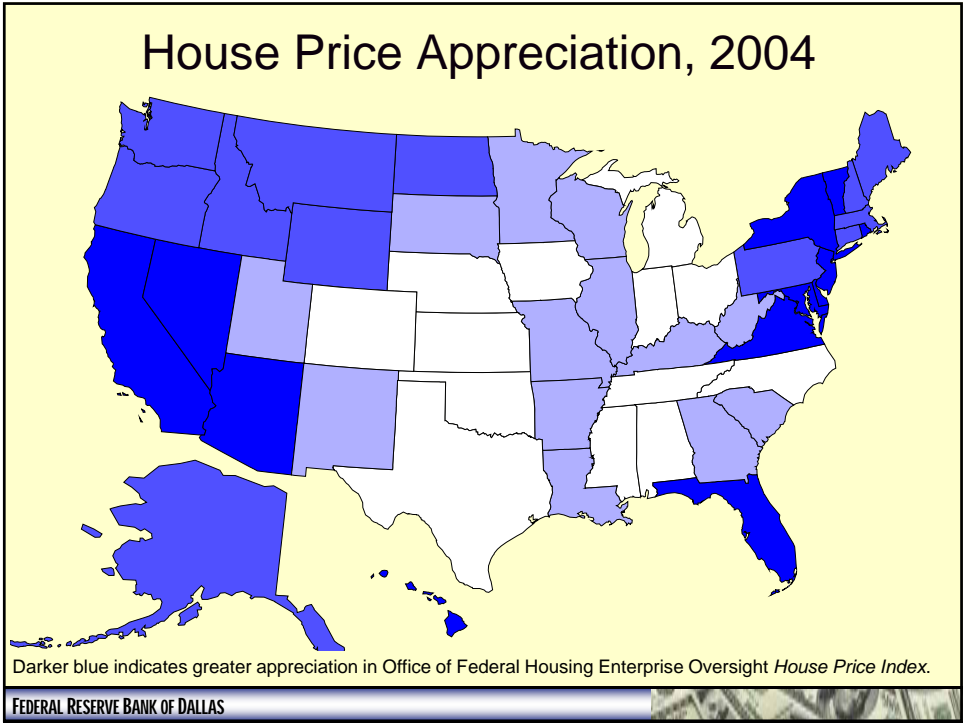
- Risk-taking and speculation accelerate during booms
- Regulation and supervisors could and should act to take some of the speculative heat out of boom periods
- Recent examples:
 - Home mortgage lending
 - Commercial real estate lending

Mortgage Rates and ARM Usage

1985 to 2007



Sources: Federal Housing Finance Board, *Monthly Interest Rate Survey*; Federal Reserve Board.



Risky Mortgage Red Flag

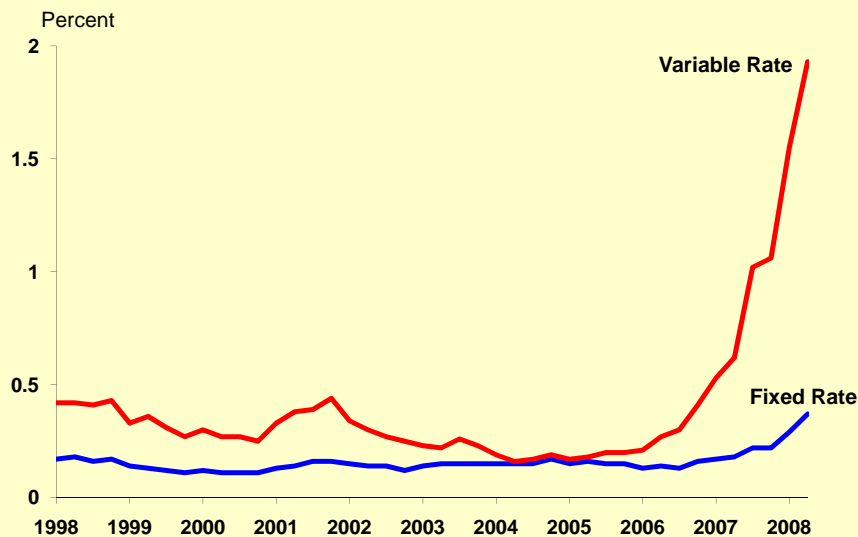
Southwest Economy (Sept./Oct. 2005)

“Has the Housing Boom Increased Mortgage Risk?”

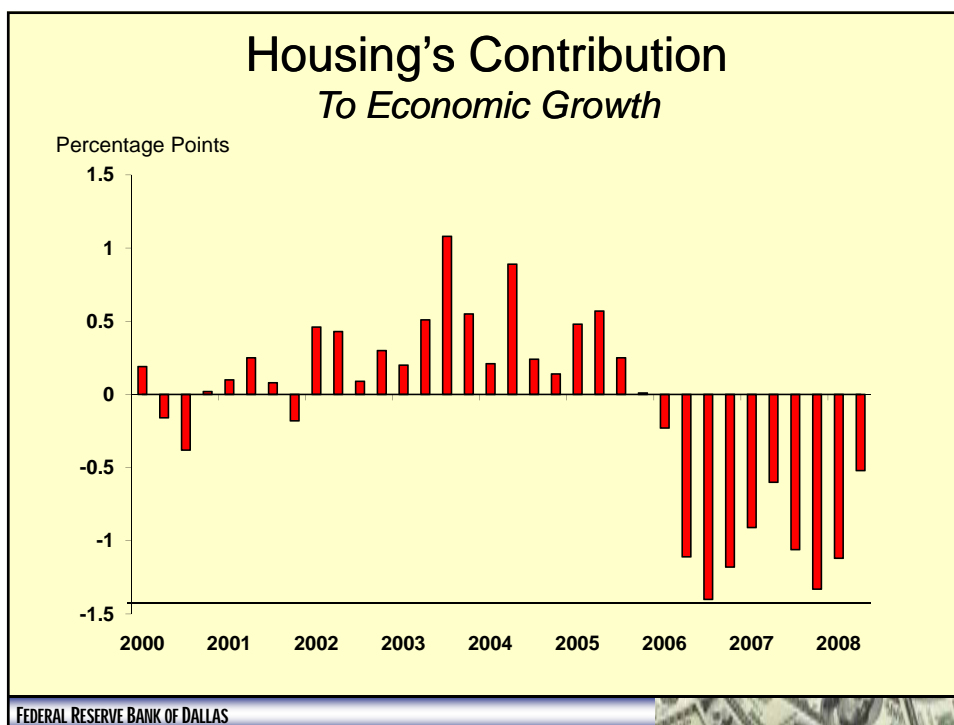
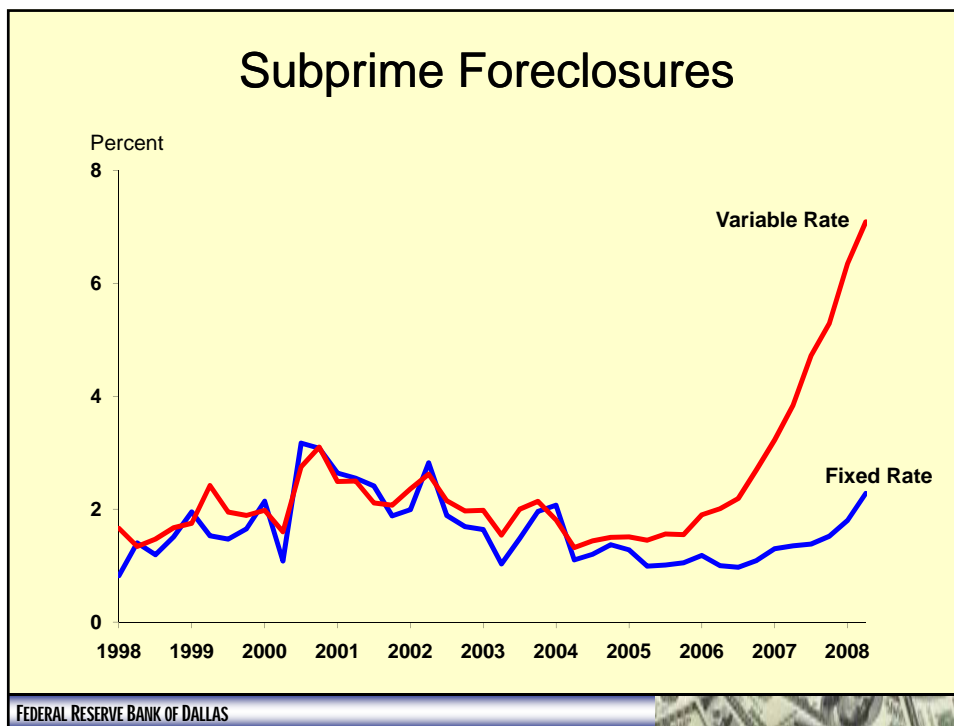
The results are consistent with a direct effect of the housing boom in encouraging the use of traditional ARMs and, by extension, other types of mortgages, such as interest-only loans, that reduce initial payments at the expense of higher payments later in a mortgage's life. While other aspects of our results point to some mitigation of the housing boom's effect in raising mortgage risk, the analysis overall indicates **concern is warranted**.

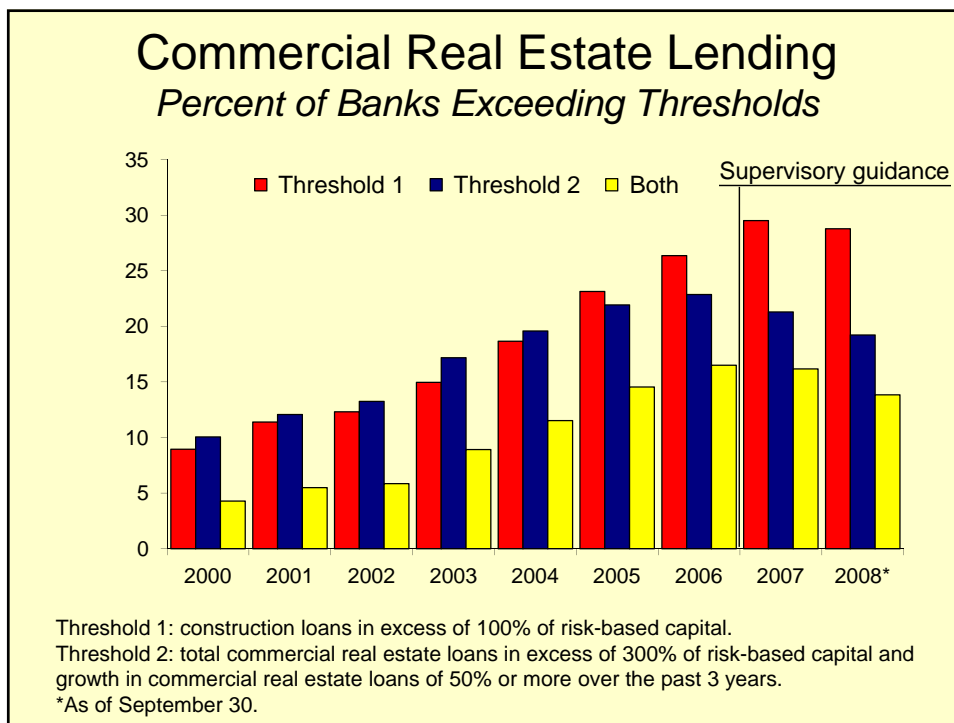
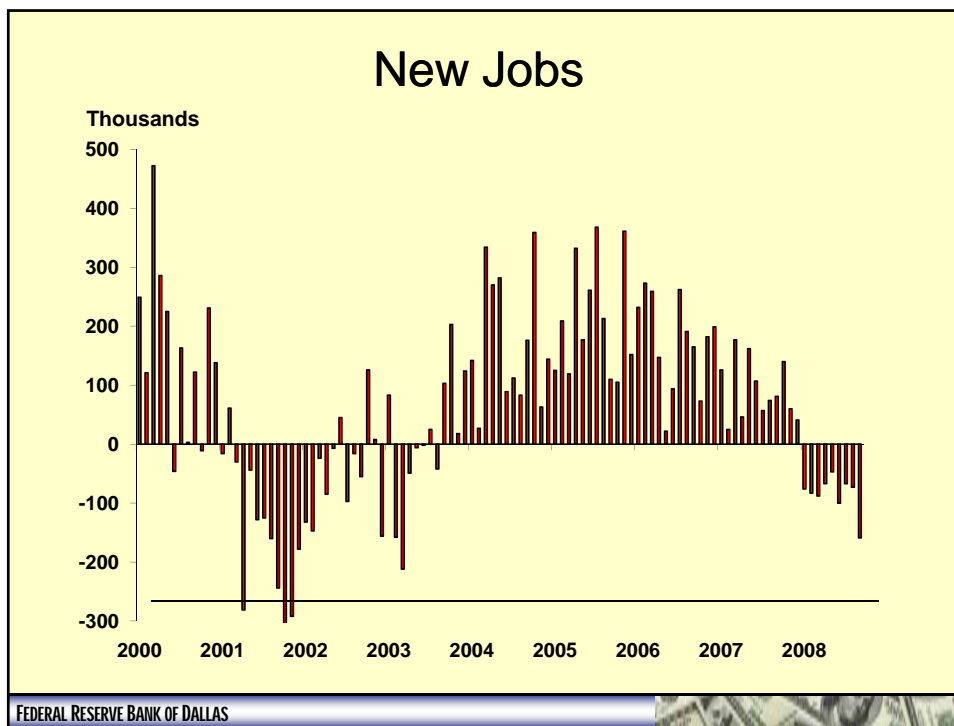
It is the possibility of stagnant or falling home prices in the future, combined with the potential, built into much recent borrowing, for increases in the level of mortgage payments relative to income, that **gives rise to concern**.

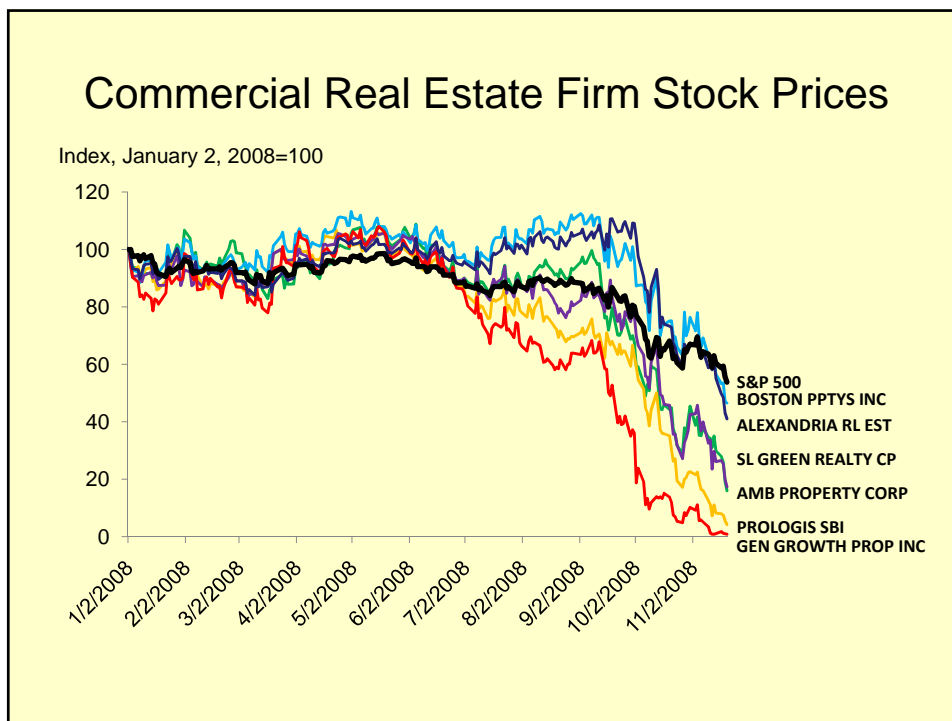
Prime Foreclosures



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Conclusion

- A lot of work needed to create a more proactive regulatory regime
- Considerable policy thought and discussion required to determine the best regulatory structure through which to make this happen
 - Regulatory consolidation?
 - Market stability regulator?
 - Global regulator?