January 30, 2001

Mr. Robert S. Seiler, Jr.
Manager of Policy Analysis
Office of Federal Housing Enterprise Oversight
1700 G. Street, N.W. (Fourth Floor)
Washington, D.C. 20552

Dear Mr. Seiler:

I am writing in response to OFHEO's request for comments on Systemic Risk, published at 65 *Federal Register* 64718 (October 30, 2000).[1]

Your inquiry is a far-reaching one, exploring one of the most complex and murky subjects in all of finance. I want to commend OFHEO for considering the area of systemic risk. All financial regulators should think seriously about this area.

As a former officer of the United States Government charged with regulating this country's depository institutions, as a former senior official of one of America's largest financial institutions and as a long-time student of the area[2], I have strong views about how OFHEO is proceeding with such consideration as

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[1] I was first made aware of this request for comments by Fannie Mae for which I consult on a variety of capital and safety and soundness issues. However, I am not submitting these comments on behalf of Fannie Mae. Rather, the opinions expressed here reflect my own views based on my experience dealing with systemic risk issues as an officer of the United States Government with responsibility for such issues.

[2] The writer was the 27th Comptroller of the Currency of the United States, Chairman of the Federal Financial Institutions Examination Council, a member of the Board of the Federal Deposit Insurance Corporation and a member of the President's Working Group on Financial Institutions. He was Vice-Chairman of Bankers Trust and Deutsche Bank, and is currently the Managing Partner of the Promontory Financial Group. As Comptroller, the writer sponsored one of the very few comprehensive conferences ever held on the topic of Systemic Risk, generating presentations and studies by many of this country's leading scholars in the area.

well as views on what appear to be OFHEO's perspectives on several matters. I hope my views will be of assistance to you.

First, let me make some general comments.

While I commend OFHEO and its leadership for taking the issue of systemic risk seriously, and for implicitly recognizing the important role supervision plays in this context, at the same time, I would urge you to go about your study of this issue quite differently.

For an issue of this importance, complexity and sensitivity, it is not desirable to publicly single out individual institutions as the targets of such a study for several reasons.

Although I am a firm believer that proper governmental supervision of a financial institution can decrease the systemic risk potential of that institution, I also strongly believe that focusing public attention on any one institution in the context of this kind of inquiry is harmful. This is an extremely serious issue and a complex one. It is an issue about which academics and others can have serious disagreements, based not only on their interpretations of the facts but based on their own academic and other preconceptions.

Many of the most destructive financial debacles in history have arisen from a public loss of confidence in an institution or institutions. As professionals who operate as part of our Federal Government's high-quality regulatory umbrella, I would urge OFHEO to avoid creating public perceptions that can weaken the very institutions whose safety and soundness OFHEO works so hard to enhance. As with physicians, a regulators first goal should be to do no harm.

In addition, because systemic risk is a species of connected risk, to fully and fairly deal with the risk, it is important to view it in the context of **all** relevant players. In this regard, it is worth noting that systemic risk can arise from a whole variety of institutions taken alone or taken as a group. Indeed, some of the greatest sources of systemic risk arise from institutions that are not regulated either as financial institutions or otherwise.

One of the dangers of publicly focusing on any one institution or small group of institutions as a source of systemic risk is that it can give the casual observer an outsized view of the risks of the studied institutions as compared to other institutions. In the case of regulated versus unregulated institutions this can be particularly problematic since, as the Long Term Capital debacle of 1998

demonstrates, it may well be that the most serious source of systemic risk in our time is from unregulated institutions.

Accordingly, I would urge you to greatly broaden the focus of your analysis. For example, a focus on systemic risk issues in the housing finance area generally, including relevant financial markets, would I believe be an appropriately comprehensive area for your study.

Moreover, the length of the comment period suggests that the issues of systemic risk can be studied quickly and conclusions reached expeditiously. This, of course, is not at all the case. Indeed, as illustrated in Prof. George Kaufman's important book entitled Banking, Financial Markets and Systemic Risk,[3] even the definition of systemic risk is a controversial topic among scholars. It goes almost without saying that there are even sharper disagreements among scholars and others as to how systemic risk arises and the steps that can be taken to control it. Indeed, your request itself suggests this complexity when it asks not only for comments on the specifics but also for suggestions on the research methodology to be used.

I would urge you to take the time necessary to address these matters. On such a difficult subject and one of such importance, OFHEO should not set for itself a time line that is sub optimal in achieving a complete and thorough examination of the relevant issues and scholarly materials. In this regard, I would also urge you to include in your examination of these issues scholars, former regulators and financial executives who have had both academic and practical experience exploring these issues. This is certainly an area where drawing the wrong conclusions and taking actions based on those conclusions can have serious adverse consequences.

The remainder of this letter will focus on three more specific themes that I think should be central to any examination of systemic risk.

- First, the extreme financial turmoil that results from a systemic event is quite rare and almost always involves some major policy error on the part of the Government.

- Second, a great many steps have been taken since the Great Depression that lower the likelihood of a systemic event materializing.

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[3] Kaufman, George G., Banking, Financial Markets and Systemic Risk, Research in Financial Services Private and Public Policy Vol. 7, JAI Press 1995 (hereinafter "Banking and Systemic Risk").

- Finally, neither the lessons of history nor logic indicate that the mere fact that an entity is large makes it a major source of systemic risk. On the contrary, larger organizations frequently can reduce systemic risks, and the tinder for systemic crises of the past often have been smaller entities.

I will review briefly each of these issues, in turn, and then say a word about the housing finance market.

The Government's Role in Creating and Managing Systemic Risk

As Anna Schwartz emphasizes in her article, "Systemic Risk and the Macroeconomy,"[4] the last real systemic crisis in the U.S. occurred between 1930 and 1933. This crisis was the result fundamentally of the Government's failure to appreciate "a sequence of flights to currency and the need for it to provide liquidity to the fractional reserve banking system that was confronted with surges of repeated runs. Contagion then occurred in an environment in which the Federal Reserve permitted the money supply to decline drastically, rendering banks insolvent not because of their own actions but because of the collapsing economy. The lesson of the Great Depression is that contagion need not arise if open market purchases are adequate both to reassure the market and to prevent a collapse of the quantity of money."

Prior to the Great Depression, systemic events were somewhat more frequent, but here too Government action and inaction played a key role. That Government actions and inactions have been at the heart of financial crises is supported by the research of numerous other economists. For a listing of a number of well-regarded economists who share this view, I recommend that you review Robert Eisenbeis' article, "Systemic Risk, Bank Deposits and Credits."[5]

Lessons Learned

The Great Depression is a hard way to learn your lessons. But the fact is that Government did learn a great deal from the Great Depression. The Federal Reserve on several occasions since 1933 has learned to liquefy the markets before a panic ensues. This was demonstrated in connection with the stock market swoon of 1987, and again in connection with weaknesses in the commercial paper market brought on by the difficulties of Penn Central, and yet again in connection with difficulties faced by Continental Illinois.

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[4] Anna J. Schwartz, *Systemic Risk and the Macroeconomy,* Banking and Systemic Risk at 19.
[5] Robert A. Eisenbeis, *Systemic Risk: Bank Deposits and Credit,* Banking and Systemic Risk at 55.

In addition, today, market information is more readily available than in the past. Supervision of markets and financial institutions has improved. And, the Federal Deposit Insurance Corporation has clearly served to put a damper on the flames of contagion in respect of depository institutions.

Accordingly, the risk of a major systemic crisis caused by one major event or even a series of events is much less likely today, irrespective of the size and complexity of the institutions and markets of the 21st Century.

Institutional Size

The third theme I want to stress is that typically systemic events do not arise because a large entity fails. On the contrary, reviewing the history of systemic crises or near crises one finds at least three different patterns that tend to be repeated, even beyond Government's role in systemic crises noted above. First, frequently, as in the Great Depression, an economic environment that negatively impacts a large number of smaller players brings on systemic events. Second, systemic events tend to be highly correlated with market failures. And, third, for the most part, systemic events occur when the real economy affects finance, not the other way around.

The lack of correlation between systemic risk and institutional size seems counterintuitive. The common view is that the larger the entity, the more systemic risk potential we face. And yet, when we look back over this century it has often **not** been the larger entities that have been at the heart of our biggest systemic failures.

For example, the Great Depression was not caused by one or several large financial institutions all of a sudden going bust. On the contrary, the flexion point for the Great Depression was the demise of dozens and dozens of small agricultural banks, failing because of the extraordinary draught conditions in the Midwest, followed, as I have noted by counterproductive Governmental policy.

Similarly, the economic woes of the 1980s and early 1990s were not caused by the collapse of a large financial institution but rather by dozens and dozens of relatively small savings and loans that could not deal with a hostile interest rate and real estate environment. And, as we look to the future, one reason that equating size with systemic risk is far too simplistic is the burgeoning interconnected nature of markets and risks that are so much a part of our electronic future.

Indeed, an excessive concern about largeness per se in the context of systemic risk can be entirely counterproductive. Largeness and the attendant

sophistication that comes with largeness can actually reduce materially systemic risk.

For example, larger entities can afford to have the sophisticated risk management systems and risk managers that lower risk. Larger entities typically are able to diversify in ways that materially lower risk. Larger entities can develop the scale and expertise in the areas they do focus on which lowers risk. And, larger entities typically are subject, if they are financial entities, to enhanced governmental supervisory regimes.

Furthermore, as I note in greater detail below, in the specific case of Fannie Mae and Freddie Mac, these entities not only share the advantages of size that I have just enumerated, but they also serve as important sources of stability in the financial system as a whole. For example, their operations materially lower systemic risk by providing important opportunities for diversification and liquidity to thousands of smaller insured depositories.

In this regard, it is important to note that both Fannie Mae and Freddie Mac have recently entered into an agreement with Congressmen Richard Baker to take six important steps to improve their safety and soundness. These steps create best-of-class benchmarks that many other financial institutions will no doubt follow over the coming years. They lower risk both for the covered institutions and the financial system as a whole. The steps include: (1) issuing publicly traded, externally rated subordinated debt for each company that will equal or exceed 4 percent of on-balance-sheet assets following a three-year phase-in period; (2) maintaining more than 3 month's worth of liquidity assuming no access to the debt markets; (3) until the permanent risk-based capital regulations are finalized by the OFHEO, implementing an interim risk-based capital stress test; (4) publicly disclosing the results of interest rate sensitivity analysis on a monthly basis; (5) publicly disclosing new credit risk sensitivity data; and (6) providing the public and Congress with financial condition ratings from a nationally recognized statistical rating organization.

Now I do not mean to suggest that all large entities either operate well or better than all smaller entities. I for one am a big fan of regional and community commercial banks and have often found these entities to contain some of America's best bankers and operate in an exceptionally safe and sound manner.[6]

[6] For smaller institutions as with larger ones, Government action and inaction plays an extremely important part in the systemic risk equation. For example, one way in which Government can lessen liquidity strains for smaller institutions and lower the chance of a systemic event arising among smaller institutions is to adopt the thoughtful proposals of the FDIC to reform the deposit insurance system and to raise the deposit insurance limit above the current $100,000 level.

But what I am saying is that rather than over-regulating entities merely because they are large, what we should be doing is analyzing in a much more sophisticated way which entities, given their businesses and how those businesses are operated, present serious systemic risk concerns and which do not. Regulation is not a free good. Excessive regulation can actually increase risk in several ways: by making an entity less competitive in a dynamic market driven economy, by wasting precious management time, and/or by focusing management attention on the wrong areas.

Housing Finance

Of course for purposes of your inquiry, the housing finance area is of particular interest. It is indeed, a model of what has happened in other areas of finance where a combination of the increasing sophistication of the players and the markets have served in my view to decrease, not increase, systemic risk potentials.

Certainly, over the last decade, we have seen a continual improvement in the systemic risk characteristics of the housing finance area. Importantly, we have created a secondary mortgage market that is extremely broad and deep. The liquidity that this market affords tends to dampen excess and the proverbial race to the door in periods of stress.

Just as importantly, a number of the key market participants -- including Fannie Mae, Freddie Mac, many of the mortgage originators, and others -- have acquired expertise, quality personnel, and risk management systems that are sufficiently sophisticated and responsive as to reduce risk parameters.

Importantly too, the creation and increasing expertise of your agency has served to lower risks in the housing finance area. In this regard, I would emphasize the value of OFHEO's hands-on, specialized, on-site supervision of Fannie Mae and Freddie Mac, which has certainly been a significant factor in lowering risk at these institutions. From my own experience as a former regulator and as an officer and advisor to regulated institutions, I can think of almost nothing that Government does that lowers risk more at an institution than such hands-on supervision when it is handled in a manner that does not become excessively burdensome.

Risk management is not a spectator sport. It is a kaleidoscope of changing risk issues. While capital rules and other regulations have their place in lowering risk, government too often under-appreciates the tremendous importance of the hands-on supervisor. In this area in particular, OFHEO can take considerable pride in its accomplishments.

I also am strongly of the view that we dramatically under appreciate the risks caused by unregulated entities, as well as the risks caused when we heavily regulate one sector of the financial industry and do not regulate or under regulate other sectors that may be engaged in some of the very same businesses.

This does not mean we should be complacent. Clearly there is benefit in refining risk management systems and supervision.

However, typically, it is the lightening bolt that you do not see that kills you. In housing finance, we have a market that has focused a compulsive eye on risk, including systemic risk, and importantly on ways to contain it. As long as the industry continues to keep its eye on the risk/reward ball as it has done -- and, importantly, provided Government does not take policy steps that increase the likelihood of financial imbalance -- I think that other areas of the economy are likely to present considerably more systemic risk potential than this one.

Sincerely yours,

[signed Eugene A. Ludwig]

Eugene A. Ludwig