July 17, 2001

Alfred M. Pollard
General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street, N.W.
Fourth Floor
Washington, DC 20052

Re: Proposed Prompt Supervisory Response and
Corrective Action Rule, 12 CFR Part 1777; RIN 2550-AA12

Dear Mr. Pollard:

I am writing in response to OFHEO's request for comments on proposed prompt supervisory response and corrective action rules published at 66 *Federal Register* 18694 (April 10, 2001).[1]

Safety and soundness supervision of financial institutions is among the most complex and important undertakings in which the federal government engages. Knowing when and how to respond to negative developments is a particularly challenging supervisory responsibility. OFHEO should be commended for exploring and carefully considering new rules to enhance supervision when negative trends may arise.

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. I hope my views will be of assistance to you.

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. These comments reflect views on the proposed rules, which I have expressed to Fannie Mae.

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

Prompt Corrective Action

The Federal Government's safety and soundness supervisors are highly trained professionals. Several of OFHEO's safety and soundness supervisors are among the federal government's best. Where they supervise entities as large as Fannie Mae, these supervisors focus essentially their entire time on the economic health of the entity and the steps, which should be taken to help ensure that well being.

It is, indeed, of considerable importance for supervisors responsible for the safety and soundness of large, complex financial institutions to keep on top of developments that are both internal and external to the entities they supervise. And, where negative or potentially negative developments occur, it is just as important for supervisors to respond with vigor to such developments.

In our dynamic, intricate economy of the 21st century, there is considerable danger in forcing the supervisor to respond to either internal or external financial triggers in the same way in every case. The large-entity safety and soundness supervisor is the government's expert. He or she has both the skills and the information to be able to make the best decisions as to what the government's response should be in a particular situation. Prompt Corrective Action ("PCA") rules can be useful as a way of ensuring consistent supervisory actions are taken at certain critical points, as long as they are narrowly focused on capital. But making them too broad underestimates the potential complexity and variety of difficulties with which a supervisor may have to deal. Taking discretion away from the supervisor, and relying on a "one size fits all, all the time", rule is sub-optimal.

Accordingly, where a legislatively mandated PCA regime exists in the capital area, such as the one OFHEO administers, it is incumbent upon federal safety and soundness agencies not to extend the Congressional PCA mandate but rather the agency should limit the mandate to precisely the scope specified by Congress. OFHEO's proposal goes further than it should in this regard.

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.

Prompt Supervisory Response

There are reasons Congress chose the area of capital adequacy in which to focus its PCA rules. Capital adequacy involves reasonably accurate, mathematically determinable benchmarks on which to base actions. Moreover, there is a reasonably strong consensus that capital adequacy is the most important or certainly among the most important responsibilities of a financial services entity. And, ensuring capital adequacy is ipso facto among the most important responsibilities of the regulatory agencies.

It is thoughtful of OFHEO to ponder other benchmarks in addition to capital adequacy. As important as capital may be, it is overly simplistic to reduce the safety and soundness of large, multifaceted financial institutions in the 21st century to a single factor analysis. However, I would strongly urge OFHEO not to proceed with enshrining the supervisory triggers it has set forth in its proposed rule or any other supervisory triggers with a prompt supervisory status in the manner it is proposing. I advocate not proceeding in this fashion for several reasons.

First, as noted above in my discussion of PCA generally, safety and soundness is enhanced when the supervisor has the latitude to react and is not constrained by "one size fits all" rules.

Second, it is not at all clear that the supervisory triggers OFHEO has set out are, or in our dynamic environment will be, the correct triggers on which to focus.

Third, by placing excessive weight on these triggers, OFHEO will have a tendency, I believe, to place too heavy emphasis on triggers that may not at all be the most important safety and soundness benchmarks for Fannie Mae and Freddie Mac.

Fourth, making the prompt supervisory triggers public is particularly dangerous. It suggests to the public more certainty to the importance of these triggers for the financial well being of Fannie Mae and Freddie Mac than anyone can be sure exists. By causing the public to focus on these supervisory triggers, it also ensures some public reaction when the trigger lines are crossed, reaction that is almost certain to be pro-cyclical and destabilizing. Indeed, public reaction to the crossing of these trigger lines could be both violent and inappropriate, given the circumstances of the time.

Moreover, by making supervisory triggers and the responses to these triggers public, OFHEO is degrading the quality of the supervisory relationship. To my mind, the best governmental safety and soundness supervision occurs when a relationship of complete trust and frankness is established between the supervisor and the supervisee. Safety and soundness professionals recognize that safety and soundness in the real world is rarely based on absolutes but more commonly on probabilities. And, the ability to discuss such probabilities frankly and openly between supervisor and supervisee is critically important to enhancing the quality of safety and soundness supervision.

At the same time, it is important for the public to have access to top quality financial information about the financial services entity. The emphasis among United States supervisors and Congress on public transparency is both commendable and important.

But drawing the right balance between transparency and the sanctity of the supervisory relationship is also important. In part, I believe that line exists between what is fact and what is a speculation. One key problem with making the OFHEO's supervisory triggers into public PCA triggers is that it places much too much weight on a few variables which may not in an individual case turn out to be all that important.

OFHEO may well want to consider the supervisory triggers as part of its internal examiner guidance. But, I would strongly advise that it not elevate these triggers and the response to these triggers as it has done in the proposed rule.

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I hope these comments prove helpful to you. I would be pleased to answer any questions you might have with respect to these comments.

Very truly yours,

[signed Eugene A. Ludwig]

Eugene A. Ludwig

cc: Armando Falcon