January 30, 2001

Mr. Robert S. Seiler, Jr.
Manager of Policy Analysis
Office of Federal Housing Enterprise Oversight
1700 G. Street, NW, Fourth Floor
Washington, DC 20552

Re: Solicitation of Public Comment on Systemic Risk
65 FR 64718 (October 30, 2000)

Dear Mr. Seiler:

America's Community Bankers ("ACB")[1] welcomes the opportunity to provide comments in response to the Office of Federal Housing Enterprise Oversight's ("OFHEO") solicitation of public comments on systemic risk as part of OFHEO's effort to examine the nature and magnitude of risks Fannie Mae and Freddie Mac may pose to the financial system.[2]

Systemic risk occurs when the insolvency or perceived insolvency of a large financial institution threatens financial market stability. Systemic risk also arises if a large financial institution might suffer funding or other financial problems. We have learned that appropriate safety and soundness regulation of financial institutions of all sizes is important to avert failures in public confidence and to ensure that financial markets remain stable. Regulations requiring prompt corrective action can be important to prevent a larger-scale domino effect. Also, the size of an organization is an important contributing factor to systemic risk; the failure or the perceived problems of a single large financial institution can affect domestic and international financial stability. The federal government must establish and maintain a regulatory regime to minimize potential systemic risk and to react swiftly to deal with problems when they arise. Congress and the regulators must remain vigilant to prevent the systemic risk associated with a very large financial institution from affecting broader financial markets.

Considerable discussion has been generated regarding the systemic risk that may be associated with the government sponsored enterprises (GSEs) based on their size and the level of debt issuance. ACB believes that the GSEs currently are well managed and do not pose an undue risk to the marketplace. However, the current favorable risk profile and management practices of Fannie Mae and Freddie Mac do not obviate the need for OFHEO to maintain appropriate oversight to control potential systemic risk.

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[1] ACB represents the nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.
[2] 65 Fed. Reg. 64718 (October 30, 2000), and extension notice 65 Fed. Reg. 79904 (December 20, 2000).

ACB believes that Fannie Mae and Freddie Mac clearly fall into the large institution category. Congress and the regulators should carefully structure regulations that encourage the intended activities of GSEs, while seeking to limit or control exposure to systemic risk that derives from mission or non-mission related activities. In particular, Congress and OFHEO should ensure that there is an adequate flow of data and other communications with Fannie Mae and Freddie Mac so that material changes in their unique characteristics and risk profiles are well understood and anticipated. Secondly, Congress and OFHEO must determine that regulatory tools and authorities are sufficient to protect the public interest. ACB supports a thorough review of these tools and authorities.

The first line of defense against systemic risk is sound capital rules. The capital rules for each of the housing sector GSEs are especially important because these rules are the basic safeguard against demands that might extend to the taxpayer. The financial sector's difficulties in the mid- to late-1980s and the early 1990s involved the federal deposit insurance funds and the Farm Credit System. Fannie Mae had earlier shared the problems of the entire mortgage lending business in the high rate period of the early 1980s. Fannie Mae was successful in restructuring its operations and risk exposure, and has rebuilt its aggregate capitalization to record levels. Although not yet published in final form, the proposed risk-based capital rules issued by the OFHEO and the supporting methodology by which the risk-based component of their capital requirements are calculated should create capital requirements that reflect the underlying quality of the GSEs assets, the risks of their activities and their risk management strategies.

A considerable share of the GSEs' debt and their mortgage-backed securities (MBS) is held by insured depository institutions. These instruments represent a significant share of the financial assets of many insured depositories and also serve to help meet the community reinvestment and qualified thrift lending requirements to which they may be subject. These holdings should be carefully considered as both a stabilizing factor and an added element in the consideration of systemic risk. These holdings at present do not represent a concern. It is also important to recognize that by establishing and maintaining a secondary market for residential mortgage loans originated and held by insured depositories, the GSEs purchase activities provide a stabilizing factor by enhancing liquidity and helping to foster asset generation and profitability at insured depository institutions. We strongly recommend that OFHEO coordinate any actions that might affect depository institutions with the Federal Financial Institutions Examination Council.

Limiting systemic risk in all sectors of the financial system must be an important priority. ACB believes that legislation and regulation must focus on maintaining GSE capital adequacy and mission focus to limit systemic risk and potential demands on the taxpayer. Subject to appropriate safeguards over proprietary information, terms of business and business strategies, regular and thorough public disclosure of financial performance is a valuable tool in monitoring performance and bringing a degree of market discipline to the GSEs' risk profile.

One element of the GSEs' risk profile is credit risk, which is derived almost exclusively from mortgage loans and mortgage-backed securities held in portfolio. Although the modern day operation of GSEs was conceived as a means to securitize mortgage loans to be held by institutional investors best equipped to handle risk, in recent years GSE investments in whole loans and MBS have skyrocketed. Though this trend may not yet pose a systemic risk concern, ACB believes that a continuing build up of credit exposure will require increasing regulatory scrutiny and an examination of the regulatory tools available.

Another element of the GSEs' risk profile is interest-rate risk. ACB believes this is a critical element and merits the closest scrutiny and monitoring. Although information on the nature of the GSEs' interest rate risk exposure is limited, ACB has no reason at present to believe that this risk is not adequately managed. However, just as increased holdings of whole loans and MBS have increased credit exposure, so have increased holdings multiplied interest rate risk. If GSEs hold increasing amounts of interest rate risk rather than transfer that risk to institutional investors, systemic risk issues could emerge. It is imperative that regulators have the tools to enforce adequate risk-based capital rules to guard against such an outcome.

We believe that the voluntary disclosures of interest-rate and credit risk to which the GSEs have committed will be a useful regulatory tool. The issuance of subordinated debt, voluntary disclosure of liquidity management practices, public disclosure of an annual independent credit rating and other recently announced commitments will be helpful in establishing and maintaining market discipline which will encourage prudent management practices. However, markets are not infallible, and market forces can never be an adequate safeguard, especially when moral hazard is present. Such beneficial agreements as those reached between Congress and Fannie Mae and Freddie Mac in 2000 should be considered not as an end, but as a component of legislation designed to ensure continued GSE mission fulfillment with appropriate safety and soundness.

In conclusion, we wish to compliment the Office of Federal Housing Enterprise Oversight on raising the issue of and seeking public comment on whether and to what extend Fannie Mae and Freddie Mac contribute to or mitigate systemic risk, and what actions could be taken to limit such risks.

ACB appreciates the opportunity to comment on this important matter. We welcome the review of these issues by OFHEO. If you have any questions, please contact the undersigned at (202) 857-3121.

Sincerely,

[signed: Charlotte M. Bahin]

Charlotte M. Bahin
Director of Regulatory Affairs
Senior Regulatory Counsel