Comments
on
Systemic Risk: A Regulator's Perspective
by Eugene Ludwig

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AEI
February 6, 2004

Defining Systemic Risk

- Ludwig paper defines as “the risk that an ***event*** will trigger a loss of economic value or confidence in a substantial portion of the ***financial system*** that is serious enough to quite probably have significant adverse effects on the ***real economy***.”
- OFHEO Report defines a systemic ***event*** as “a financial crisis that causes a substantial reduction in ***aggregate economic activity***,” and defines systemic risk as the “possibility that a systemic event may occur.”

Focus on an "Event"

- Economists define systemic risk in terms of a ***shock***—new information that surprises the market and affects the larger economy
- The S&L debacle was not a systemic event; there was no shock and it was too small
- The Great Depression was not a systemic event; weakness in the wider economy affected the financial system, not the other way around

The Argument in the Paper

- Three points:
  1. Systemic events can be prevented by effective government action, AND
     - Policymakers have learned how to minimize systemic risk
  2. Size is not important
  3. Unregulated financial institutions are more dangerous than regulated institutions

Weak points in the paper

- Recall that systemic events are shocks that cause a reappraisal of relationships and affect the wider economy
- Size is obviously necessary here but not sufficient
- Unregulated institutions, although large, are not generally risky, because of market discipline
  - There have only been two industries that have ever collapsed—banks and S&Ls, both regulated

Strong points in the paper

Have policymakers learned anything?

- Yes, if we take each of the items the paper describes: enhanced supervision, strengthened capital, deposit insurance, increased transparency
- No, if Fannie and Freddie are examples
- The paper—rather than a defense—is an indictment

Better government policies prevent systemic risk

- Enhanced supervision
- Strengthened capital requirements
- Deposit insurance
- Increased transparency

Enhanced supervision

- Everyone agrees supervision of Fannie and Freddie is poor
- Fannie is fighting enhanced supervision, such as authority to set capital requirements, control expansion of mission, and receivership power
- Receivership powers are particularly important in systemic risk context

Enhanced supervision (cont.)

- Can companies as large and powerful as Fannie and Freddie ever be effectively regulated?
  - S&L experience
  - Political consequences of Increasing capital
  - Political consequences of reducing risk-taking

Enhanced regulation (cont.)

- If Fannie and Freddie are examples, it’s doubtful that policymakers have learned anything about the efficacy of enhanced regulation

- If we are to rely on enhanced regulation to protect us against systemic risk from F&F, it ain’t there.

Strengthened capital requirements

- Fannie and Freddie have leverage of about 40-to-1, despite the fact that they take huge interest rate risks that banks do not take

- Banks have leverage of about 20-to-1

Capital requirements (cont.)

- OMB writes: “The GSEs are highly leveraged, holding much less capital in relation to their assets than similarly sized financial institutions. A consequence of that highly leveraged condition is that a misjudgment or unexpected economic event could quickly deplete this capital, potentially making it difficult for a GSE to meet its debt obligations. Given the very large size of each enterprise, even a small mistake by a GSE could have consequences throughout the economy.”

CAPITAL HELD BY THE GSEs AND 10 OF THE LARGEST U.S. FINANCIAL INSTITUTIONS

Companies Ranked by Assets	Balance Sheet Assets	Stockholder's Equity	Capital Ratio: Equity to Assets
Citigroup Inc	$1,097,190	$86,718	7.9%
Fannie Mae	$887,515	$16,288	1.8%
Federal Home Loan Bank Syster	$763,631	$36,324	4.8%
JP Morgan Chase & Co	$758,800	$42,306	5.6%
Freddie Mac	$752,249	$31,330	4.2%
Bank of America Corp	$660,458	$50,319	7.6%
Wells Fargo & Co	$349,259	$30,358	8.7%
Wachovia Corp	$341,839	$32,078	9.4%
Bank One Corp	$277,383	$22,440	8.1%
Washington Mutual Inc	$268,298	$20,134	7.5%
FleetBoston Financial Corp	$190,453	$16,833	8.8%
US Bancorp	$180,027	$18,101	10.1%
American Express Co	$157,253	$13,861	8.8%
Average all companies	--	--	7.2%
Average GSEs	--	--	3.6%
Average excluding GSEs	--	--	8.2%
Source: FY05 Budget			

Capital requirements (cont.)

- Again, if Fannie and Freddie are examples, policymakers have learned very little over the years
- Again, if we are relying on capital requirements to protect us against systemic risk from F&F, we're defenseless

Deposit insurance

- S&L debacle: the result of a lack of market discipline

- Investors had no concerns about losing their deposits and so supported weak S&Ls

- Losses built up as weak institutions took risks

Deposit insurance (cont.)

- Fannie and Freddie operate under an implicit guarantee that is broader than deposit insurance
  – Covers all liabilities, including their MBS guarantee

- No market discipline

- Also, no closure authority
  – Losses can build up

Deposit insurance (cont.)

- If policymakers have learned anything about deposit insurance and the lack of market discipline, it’s not apparent from Fannie and Freddie

- Similarly, implicit government guarantee reduces market discipline and enhances the likelihood of systemic event

Increased transparency

- Transparency particularly important on systemic risk—avoidance of “shocks”
- No SEC registration legally required
  – Voluntary under 34 Act for stocks
  – Fannie and Freddie successfully opposing registration under 33 Act
  – Since voluntary registration there has been improved disclosure, showing that earlier disclosure was deficient

Transparency (cont.)

- Fannie has refused request from Sen. Hagel for a quarterly fair value balance sheet and a statement of losses on derivatives closed

- Derivatives are still a mystery
  - How much hedging does Fannie do, and with what counterparties?

Conclusion on Ludwig paper

- Paper is correct that various policies can reduce systemic risk

- However, these policies are not applied to Fannie and Freddie

- Therefore, F&F remain by far the greatest potential sources of systemic risk in the US today

Other points

- Paper does not consider the mechanisms by which Fannie and Freddie could cause systemic event

- These are unique:
  - Dominance of real estate market
  - Thousands of small banks hold their securities—in many cases more than 100% of capital

Other points (cont.)

Is it possible for GSEs to create systemic risk?

- Fannie was insolvent from 1979-1984 and still funded itself

Other points (cont.)

- Times have changed:
  - No surprise in 1979, because of high interest rates
  - Now bad news would be a major shock
  - Fannie was about 1/15 its current size
  - Little doubt that government could bail it out
  - Now F&F have over $3 trillion in obligations
  - Could be doubt in markets and Congress about whether taxpayers should take this loss