



Americans for Financial Reform
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May 19, 2011

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551.

Re: Notice of Proposed Rulemaking – Financial Market Utilities (RIN 7100-AD71)

On behalf of Americans for Financial Reform, thank you for the opportunity to comment on the proposed rule promulgating risk-management standards for certain financial market utilities that are designated as “systemically important” by the Financial Stability Oversight Council under the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). Americans for Financial Reform is an unprecedented coalition of over 250 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, religious and business groups as well as prominent economists.

The proper regulation of financial market utilities (FMUs), particularly Central Counterparties (CCPs), is absolutely central to the success of financial reform and the maintenance of financial stability. The new derivatives framework will move the credit exposure for trillions of dollars in currently over-the-counter (OTC) derivatives off banking books to CCPs. The run on clearing banks for tri-party repo, another major CCP, played a significant role in creating the 2008 financial crisis. The lack of regulation for the multi-trillion dollar repo market was cited by the Financial Crisis Inquiry Commission as a major contributor to the financial crisis.

Title VIII of the Dodd-Frank Act gave the Federal Reserve an important backstop role in oversight of systemic risk created by FMUs, as well as risk management by FMUs. It also permitted designated FMUs access to Federal Reserve funding in certain cases. In light of the importance of CCPs to the stability of the financial system proper oversight of this risk management is essential.

Comments

In general, the standards and principles laid out in this regulation are sensible and prudent. However, they are also very broad and general, and they appear to be drawn from recommendations and standards that were established well before the financial crisis of 2008. To take one example, the CPSS-IOSCO standards referenced in the proposed rule were promulgated in 2001 and 2004.¹ It would be useful to see more specificity in these standards, especially given the fact that FMUs are private sector entities who may face conflicts of interest in their interpretation of broad and general standards. It would also be useful and appropriate to see a discussion of the lessons learned in the financial crisis regarding systemic risk management and whether and how such lessons have influenced these rules. This is true generally, but is particularly important in the case of repo clearing banks.

Several specific recommendations are given below that would strengthen these standards to provide sufficient protection against systemic risk.

Standards Should Reflect Issues Related to Tri-Party Repo Clearing Banks

The Financial Stability Oversight Commission (FSOC), not the Federal Reserve, is given the responsibility for designating systemically important FMUs, and it is as yet unclear whether repo clearing banks will be so designated. However, they certainly fit the criteria of systemic significance and do serve a key utility function, so they are appropriate for designation. This is particularly true in light of the fact that the potential failure of these entities clearly created a systemic risk in 2008 and motivated the Federal Reserve to establish a number of special credit facilities during the crisis.

The Payments Risk Committee sponsored by the Federal Reserve Bank of New York has issued an extensive report with multiple detailed recommendations that would reduce systemic risk at clearing banks.² It is surprising that some of these lessons drawn specifically from the financial crisis were not incorporated into the risk management directives for FMUs, and indeed were not referenced at all in the proposed rule. Should repo clearing banks – or other future entities that perform a similar function – be designated as FMUs the Federal Reserve should incorporate specific risk management directives (such as the elimination of intraday credit risk) aimed at lessening systemic risks at these banks.

FMUs Should At Minimum Be Required to Hold Sufficient Capital To Meet A “Cover Two” Requirement, or, Better, A Percentage of Risk Requirement

Section 234.4 (a) (18) of the proposed rules requires the FMU to withstand a default of its single largest counterparty (a “cover one”) requirement. The Board requests comments on the

¹ See footnote 6, at p. 18447 of the Proposed Rule.

² See Payments Risk Committee, Task Force on Tri-Party Repo Infrastructure, [Report](#), May 17, 2010.

choice between a “cover one” requirement and a “cover two” requirement (which would require the FMU to hold sufficient resources to cover simultaneous defaults by its two largest counterparties). Given the choice between these options, AFR favors the “cover two” requirement. During a period of extreme market stress it cannot be guaranteed that there will be only a single default. Given the potential access of private, for-profit FMUs to public financial support through the Federal Reserve, it is important that rules require key financial market entities to internalize the costs of protecting against systemic risk.

However, basing this key capital decision on simply the number of counterparties seems highly arbitrary. Systemic risk can be generated by the failure of an FMU which has many counterparties, no one of which is particularly large, if the various counterparties are highly interconnected. In such a case, the failure of multiple interconnected counterparties could occur at once. AFR agrees with the proposal in the comment by Better Markets that the resource requirements for FMUs should be based on a percentage of aggregate exposures, not simply the number of counterparties. The test should be based on the larger of (a) the member representing the largest exposure to the CCP, or (b) members constituting at least 33 percent of the exposures in aggregate to the CCP. This approach captures the risk of a diverse, but interconnected, membership.

Model Validation Must Be Performed By A Truly Independent Third Party

The margining requirements are the key protection against failure of a CCP and the need for public financial assistance or the creation of systemic risk. However, private FMUs may face competitive pressures to lower their margins in order to attract business and increase profits. In light of this conflict of interest, the models setting margin requirements should be validated by a genuinely independent third party. The proposal in this rule, which simply requires the validation by an individual who has not been involved in creating the model, is inadequate. No employee of the FMU is fully independent of the profit pressures at the FMU.

The independent third party should be qualified and must have no financial stake in the outcome of the validation. Another possibility is to set up a procedure by which the models could be validated by the regulators themselves.

We appreciate the opportunity to comment on the proposed rule. If you have any questions, please contact Marcus Stanley, the Policy Director at Americans for Financial Reform, at Marcus@ourfinancialsecurity.org or (202) 466-3672

Sincerely,

Americans for Financial Reform

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AARP
- AFL-CIO
- AFSCME
- Alliance For Justice
- Americans for Democratic Action, Inc
- American Income Life Insurance
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company
- Home Actions

- Housing Counseling Services
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group
- United Food and Commercial Workers
- United States Student Association
- USAction

- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

Partial list of State and Local Signers

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA

- Empire Justice Center NY
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA

- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

