Self-Help

Ownership & Economic Opportunity for All

November 20, 2017

Mr. Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Via e-mail: boardcomments@ncua.gov

Re: Self-Help Comments on Regulatory Reform Agenda

Dear Mr. Poliquin,

We are writing to provide comments on behalf of the members, board and management of Self-Help Federal Credit Union and Self-Help Credit Union (collectively, "Self-Help"). Our credit unions served a combined 145,000 members in five states – California, Florida, Illinois, North Carolina and Wisconsin – and have $1.8 billion in total assets.

We have two specific proposals in the Regulatory Reform Agenda that we wish to support. First, we ask that you immediately eliminate the existing derivatives volume limits in Part 703. Second, we ask that you promptly reduce the burden on loan purchases by federally-insured credit unions in parts 701 and 741.

<u>Self-Help requests that you immediately eliminate the existing derivatives volume limits in Part 703. This rule has no parallel in regulatory practice. It is outdated, unnecessary and ineffective.</u>

We urge you to address the shortcomings in NCUA's derivatives rule in 2018, rather than waiting until 2020.[1] The derivatives volume limits, particularly the "WARMN" (Weighted Average Remaining Maturity Notional) have no parallel in the regulatory practice of any other FFIEC regulator, nor any state regulatory body that we are aware of. Similarly, the arbitrary fair value limit threshold of negative 25% of regulatory net worth is not evidence that a credit union has failed to hedge its assets properly.

Self-Help has substantial experience using interest rate swaps to mitigate interest rate risk. Self-Help Federal Credit Union was an authorized participant in ALM First's derivatives pilot program and was one of, if not the first, federal credit unions granted independent derivatives authority under the revised Part 703 in 2014. Self-Help Credit Union was granted independent derivatives authority by its state supervisory authority in 2003. Over the past 15 years, these two

[1] Part 703 changes are listed as a "Tier 2" proposal that would be "implemented in year three" per the task force.

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credit unions have entered into $624 million of notional amount of "plain vanilla" swaps, i.e., pay fixed/receive floating swaps. Self-Help Ventures Fund, our jointly-managed, affiliated community development financial institution loan fund, has entered into $612 million of swaps since 2002. Our comment is based on the experience of these three institutions in managing an effective asset-liability management program using a combination of member deposits, borrowings and interest rate swaps.

As we have described previously, we believe that the failure to manage interest rate risk (IRR) is the greatest mid-to-long term financial threat facing credit unions, and therefore, the National Credit Union Share Insurance Fund. This IRR is created by serving members' needs through long-term real estate lending – the most viable lending product that credit unions can produce at sufficient scale to both serve their members' needs and sustain themselves financially. Credit unions and the NCUSIF have been lucky that we have gone through a sustained period of low interest rates. Luck is not a risk-mitigation strategy.

The need for hedging is significant:

- 49% of CU loans are real estate loans, a portfolio that continues to grow at 10% per year.
- Only 15% of CU mortgages loans are adjustable rate loans.
- 33% of CU assets are long-term, whereas only 4% of credit union deposits are longer that three years.

Part 703 already provides the governance and approval framework required to ensure that credit unions do not use derivatives for speculative purposes or in ways that inadvertently create harm to their net worth. The derivatives volume limits do not, unto themselves, reduce risk. To the contrary, they limit the capacity of credit unions to adequately hedge the IRR inherent in their business practice, thereby creating risk to the credit unions, and thus, the NCUSIF.

The perceived impact of removing the derivatives volume limit does not immediately impact a broad number of credit unions, which is why the Task Force may have listed it as a "Tier 2" proposal. We believe that this classification actually <u>increases</u> the burden on federal credit unions compared to NCUA's standard regulatory review practices because it defers the regulation's revision.

NCUA's long-standing practice is to revisit one-third of its regulations every three years. Derivatives authority was approved by the NCUA Board on January 23, 2014. NCUA's annual regulatory review in 2015 included Part 703. At that time, derivatives authority was not reviewed, presumably because the authority had been granted one year prior.

If you use January 2014 as the regulation's date of issuance, the agency should have considered it for review at the beginning of 2017. If you use the most recent Part 703 review date of 2015, the agency should review the regulation in 2018. The classification of this section as a "Tier 2" regulation defers consideration until 2020, at the earliest. This designation "creates a serious inconsistency or otherwise interferes with regulatory reform initiatives and policies", which is one of the minimal criteria that Executive Order 13777 requires of subject agencies in their regulatory reform agendas.[2]

We disagree with the Regulatory Reform Task Force's designation of the effort associated with revising this rule as "high". Unlike other rules, the derivatives volume limits appear in a narrow section of Part 703. The invention of these artificial limits created more work than removing them would. Given that the Task Force conceded that the impact of revising this rule would be "high", we do not understand why it is not a "Tier 1" proposal – high impact and low effort. **If review of the overall derivatives rule is delayed, we urge NCUA to fix the WARMN limit immediately.**

Tying notional value limits to a small multiple of net worth, as opposed to the amount of long-term assets the FCU holds, fails to match permissible risk mitigation to the risk created by holding those long-term assets. If an FCU has 10% net worth and mixes its swaps between 5 and 10 years to cover the longer-end of its fixed-rate loan portfolio, a 100% WARMN means the FCU cannot have notional swaps of more than 13.33% of assets.[3] Such a limit is sufficient if the FCU has long-term assets limited to 25-30% of its assets, but it is probably insufficient if an FCU has more long-term assets.

For example, a CU with 60% of its assets in mortgage loans should be permitted to hedge at least 50% of this amount with long-term swaps, or roughly 25% of assets (or 250% of net worth).[4] If instead the CU can only hedge 13.33% of assets, as short-term rates rise sooner than assets mature, the CU's net worth can quickly dissipate, given the fact that a large share of the long-term assets are largely un-hedged.

Put more simply, the current WARMN limit means that a credit union with 10% net worth can only hedge 10% of its balance sheet with 10 year pay-fixed interest rate swaps. This is simply insufficient for the large percentage of credit unions engaged in mortgage lending. The current WARMN limit dramatically increases interest rate risk for the credit union system overall. We cannot wait two to three more years, with nothing more than a hope that unhedged interest rates will remain stable and low.

Self-Help Federal Credit Union is a case of a credit union that would be substantially impacted by this decision. SHFCU has total assets of $973 million, including $548 million of fixed-rate

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[2] While NCUA is not subject to the Executive Order, it seems incongruous to defer regulatory review that would have taken place in 2017 or 2018 in an attempt to "comply with the spirit of Executive Order 13777" as NCUA states as the lead in Part II of the Notice.

[3] 10% net worth x WARMN limit of 100% = 10% net worth at 10 years maturity. Average of 5 & 10 year maturity equals =0.75. 10%/0.75 = 13.33% WARMN limit.

[4] This assumes that most credit unions can hedge the portion of their fixed rate assets that have less than 5 year duration using deposits. We do not accept this assumption for non-maturity shares, but adopt it for simplicity in our analysis.

mortgages.[5] With $137 million of net worth, SHFCU is more than well-capitalized, with 14% net worth-to-assets. SHFCU has $200 million of notional swaps outstanding with a weighted average remaining maturity of 6.56, which generates a WARMN of 96%.

The credit union is on track to originate in excess of $80 million of fixed-rate residential mortgages to its members in 2017. Assuming that we produce a like amount of mortgages in 2018 and seek to hedge the longest half (5-15 years) of those mortgages using swaps, we would seek to execute $40 million swaps next year with an average maturity between 5-15 years. Assuming a 7.5 year average maturity, that generates a marginal WARMN of $30 million on our new swaps. This amount is more than 20% of our existing net worth, and would put SHFCU over the current 100% WARMN limit, despite a slight shortening of our existing derivatives portfolio over the coming year.

<u>Self-Help recommends that you amend the purchase, sale, and pledge of eligible obligations rules as promptly as possible</u>. We believe that credit unions ought to have broad authority to purchase loans from other originators, particularly other federally-insured depositories.

As you know, during the Great Recession, billions of dollars poured into credit unions as investors pulled funds out of the markets in a flock to safety, which was accelerated by Congress' decision to raise the insurance limit to $250,000.

At the same time, job loss and financial stress for both members and credit unions drove down loan demand, leaving credit unions with substantial liquidity and few investment options. The resulting income crisis was exacerbated by the Federal Reserve's stimulus programs and the international flight to quality, which drove down yields below their fundamental values on all reasonable investments. In particular, agency and treasury securities were over-priced for the risks – primarily duration and optionality – contained therein because the Fed bought trillions of dollars of these securities.

Self-Help has found that purchasing loans from other financial institutions can be a risk-appropriate, well-priced alternative to purchasing low-yielding, over-priced securities. While many credit unions were drowning in excess liquidity during the Great Recession, a handful continued to have strong demand for quality loans, based on strong fields of membership that were less impacted by the recession. Those institutions can be a good source of whole loans to purchase that provide much stronger risk-adjusted yields than securities.

In particular, we believe that NCUA has the authority under the FCU Act to allow credit unions to purchase whole loans from non-credit unions, e.g., banks and other potential sellers.[6]

[5] SHFCU owns no long-term, fixed-rate investments, such that nearly 100% of our fixed-rate assets are loans.

[6] As a side note, we would be grateful if the agency would clean up the language in §701.23. It is perhaps the single most confusing regulation governing FCU powers and has triggered the creation of flow charts on white boards throughout our office to make sure we understand what Self-Help FCU can and cannot purchase!

As an additional concern, we believe that NCUA's assertion that a federally-insured state-chartered credit union must obtain NCUA approval prior to buying loans from anyone other than a federally-insured credit union is an overreach of NCUA's authority as federal insurer of state instrumentalities. We see nothing in Title II of the FCU Act that gives NCUA the authority to proscribe the loan purchase powers of a state chartered credit unions. As a result, we think NCUA should eliminate the loan seller restrictions governing FISCUs in §741.8.

As with the derivatives rule, we encourage NCUA to make these changes promptly. The proposed classification of amending §701.23 as a "Tier 2" regulation defers consideration of that regulation until 2020. Given that the regulation was part of the triennial regulatory review in 2015, revisions should be considered in 2018.

Thank you for your consideration of our comments. We appreciate the agency's willingness to consider reasonable regulatory changes that empower credit unions to serve their members without taking on undue risk.

Sincerely,

Martin D. Eakes

Martin D. Eakes	Randy Chambers
Chief Executive Officer	Chief Financial Officer