ALM FIRST
for a partnership built on trust.

August 15, 2011

Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Dear Ms. Rupp:

On behalf of the partners of ALM First Financial Advisors and its management staff, I am writing in response to the Advanced Notice of Proposed Rulemaking - Derivatives. I thank you for this opportunity.

The Credit Union industry is in need of tools to safely manage interest rate risk while continuing to serve its members. The proper use of derivatives has allowed financial institutions regulated by other Agencies to safely build their balance sheets and serve customer needs while offsetting their interest rate risk. The use of derivatives will allow credit unions to better serve their members and compete.

Without the regulatory authority to raise capital through secondary market offerings, financial stability must come from balance sheet management and retained earnings. It is critical for credit unions to manage their balance sheets to generate income, ensuring financial stability. Generally, this can be performed by duration mismatch and convexity risks within the balance sheet. Duration and convexity risks within the balance sheet can generate short-term increases in income, but certainly come with a higher likelihood of future loss. On the other hand, the conservative practice of selling mortgage loans and avoiding other longer duration asset classes can be equally devastating if rates remain low for an extended period of time. For institutions that need to grow capital, this practice could threaten growth and possibly even survival. One solution is to grant natural person credit unions hedging powers to actively and safely manage interest rate risk.

ALM First was granted its authority to engage in derivative activities for credit unions in 2002. At the time, there was very little demand for the reasons cited below:

- Credit unions in general have a low tolerance for interest rate risk
- ALM First sought out alternative methods to hedge interest rate risk, such as embedding options in borrowing structures (double-cap structures) and liability duration extension.
- Counterparty risks
- The burdens of board education, and regulatory and accounting requirements

Although generating net income has always been a goal, the burdens of a hedging program have historically outweighed the incremental need for income. This has changed as spreads have tightened, and expenses have increased. Today, credit unions are retaining more mortgage loans. Further, as the NCUA has recognized the need to manage interest rate risk and the industry has recognized the difference between speculation and the use of derivatives for insurance purposes, interest in hedging programs has risen.

Derivatives that hedge interest rate risk are fairly straightforward and they performed extremely well during the credit crisis. Corporate credit unions have successfully used interest rate derivatives since the early 1990s. The demise of some corporates was not caused by these derivatives but, rather, from credit losses of non-conforming securities.

For these reasons, we believe derivative authority should be granted to individual credit unions that have the infrastructure to support such activity and to third-party providers that meet certain restrictions.

Issues for Comment

A. *Whether to discontinue allowing Pilot Programs for FCUs and third parties to engage in derivatives activities to offset IRR and, if so, whether to terminate such existing Pilot Programs.*

   1. *Should existing Pilot Programs for FCUs to engage in derivatives for IRR management be permitted to continue? Explain why or why not.*

      The use of derivatives should not be contained within a pilot program, but should be written within the NCUA rules as permissible, given limitations.

      Our understanding is that pilot programs were organized for the NCUA to gradually enter a market that they deemed uncertain. Although the use of derivatives for the purpose of hedging interest rate risk for natural person credit unions has been limited, the performance of swaps and caps were unscathed throughout the credit crisis.

   2. *Should such Pilot Programs for FCUs be permitted to continue by "grandfathering" the previous approvals into Part 703? Explain why or why not.*

      ALM First's derivative service is the only remaining service under the NCUA pilot program. We believe the service should be grandfathered into an approved third-party provider to ensure that service is uninterrupted. If additional requirements under the new guidelines arise, then the NCUA should allow ALM First a 90-day period in which to comply.

   3. *If FCUs seek an end-user exemption from mandatory clearing as contemplated by the CFTC's proposed rule, they would need to provide items of information to a registered swap data repository. In view of this requirement, should NCUA permit FCUs to seek an end-user exemption? Explain why or why not.*

      The regulations authorized by the Dodd-Frank Act will not begin to appear until late 2011 and in some cases 2012. Until then, how agencies like the Commodity Futures Trading Commission

(CFTC)[1], the Securities and Exchange Commission (SEC)[2], and Federal Reserve will implement these new regulations remains somewhat unknown. For this reason, we believe the NCUA should not use its authority to prohibit a credit union from an exemption, especially when there might be unforeseeable consequences for such action.

A clearing and settlement infrastructure provider is a third-party entity that plays a purely operational role in the clearing and settlement process. Derivatives will most likely continue to be traded over-the-counter (OTC), but cleared through a central counterparty (CCP).

Benefits of mandatory clearing include:

- Enhanced efficiencies of the credit risk management process
- The CCP will be a single counterparty, which ultimately reduces counterparty credit evaluations
- Transparency and consistency of pricing for margin and funds settlement
- Default
    - OTC-cleared derivatives are negotiated with a CCP, therefore, the transactions can be more easily offset or unwound following a clearing member default. In addition, losses in excess of margin at a defaulting CCP clearing member are absorbed by the risk capital structure of the CCP. Losses can include some of the CCP's own financial resources, external risk capital (*e.g.,* clearinghouse guaranties), and a mutualized risk capital layer in which other clearing members cover losses arising from defaulted clearing members[3]. *However, additional volume could place significant exposure directly to the CCP and could result in systematic risks.*

Problems associated with mandatory clearing are:

- Uncertainty of which derivatives are required to be cleared
- Higher end-user costs due to CCP usage fees
- Higher costs associated with zero dollar minimal transfer amounts and twice-a-day mark to market settlements, which can be unnecessarily burdensome
- The required posting of an initial margin. For OTC derivatives, there may or may not be a margin requirement in the form of an upfront independent amount
- The need for customized derivatives

"In the past decade, OTC-cleared derivatives have enjoyed tremendous growth, but that growth has occurred in markets and products where CCPs and derivatives participants alike perceived the benefits of OTC clearing as exceeding its costs. For some participants and products, however, the benefits of OTC-cleared derivatives have *not* exceeded the costs."[4]

---

[1] *The CFTC regulates non-exempt commodities, futures and futures options, futures exchanges, futures commission merchants, and other institutions involved with commodities or futures trading.*

[2] *The SEC protects investors, maintains fair, orderly, and efficient markets, and facilitates capital formation.*

[3] *OTC-Cleared Derivatives: Benefits, Costs, and Implications of the "Dodd-Frank Wall Street Reform and Consumer Protection Act.*

[4] *OTC-Cleared Derivatives: Benefits, Costs, and Implications of the "Dodd-Frank Wall Street Reform and Consumer Protection Act.*

B. *Whether to allow FCUs to engage in such derivatives activities through a third party on a case-by-case basis (i.e., by waiver) provided the FCUs meet prudential standards applicable to the third party and the FCU;*

1. *These third party standards would require replacement of credit quality references by functional equivalents. With this change, are the third party operating standards required in NCUA's Pilot Program generally appropriate to govern the use of derivatives by an FCU approved to engage in these activities through a third party? Explain why or why not.*

Credit Criteria

Although important, credit quality of the counterparty can be mitigated with the use of central clearing or with strict bilateral or tri-party agreements.

In the case of OTC clearing, counterparty risk has already been tested. One of the largest clearing houses is the London Clearing House (LCH). In 1999, LCH established SwapClear, which clears plain vanilla interest rate swaps. In 2008, SwapClear was the CCP for $215.5 trillion of interest rate swaps.

> "The failure of Lehman Brothers was an important test for LCH.Clearnet's SwapClear. When Lehman failed on September 15, 2008, it had a total notional amount of $9 trillion (comprised of 66,390 trades across five major currencies) in SwapClear. LCH.Clearnet (with assistance from outside professional traders) immediately began to hedge the market risk of Lehman's defaulted portfolio. From September 24, 2008, to October 3, 2008, SwapClear managed a competitive auction process for the assumption of the defaulted Lehman swaps. The auctions were completed successfully, and the margin that had been collected by LCH.Clearnet from Lehman was sufficient to ensure that neither the CCP nor its clearing members incurred any default-related losses"[5]

For OTC trades that are not cleared through a CCP, rating standards can be replaced by choosing primary dealers for counterparties or establishing minimal asset and credit criteria. We would suggest $100,000 or lower for margin threshold amounts for lesser credit counterparties.

Changes to the Third Party Operating Standard

Truly expanded hedging powers should allow institutions to not only hedge with over the counter swaps, caps, floors, and swaptions but also exchange traded futures and options on these futures. Institutions managing their interest rate and convexity risks using derivatives would be better served having an expanded menu of derivatives to accomplish their risk management goals. Many benefits accrue to institutions using exchange traded instruments for hedging like Eurodollar futures, U.S. Treasury futures and call and put options on these instruments. Liquidity is generally higher, price discovery is generally clearer, and counterparty risk is generally lower. The Chicago Mercantile Exchange (CME), the Chicago Board of Trade (CBOT), and The Chicago Board Options Exchange (CBOE) are all well established, CFTC regulated exchanges used by bona fide hedging institutions daily to accomplish their risk management goals. We feel that risk

[5] *LCH.Clearnet, 2008, "$9 trillion Lehman OTC Interest Rate Swap Default Successfully Resolved, "Press Release (October 8).*

management programs within the U.S. credit union industry would be more complete if exchange traded futures and options were permissible items.

Excessive mark ups, along with the promotion of market integrity, are what Congress is attempting to regulate through the Dodd–Frank Act. Mark ups on derivative trades can be costly, especially to an unknowing investor.

We therefore believe the additional restrictions should be added to the standard:

a. Third-party advisors should be able to perform ALM analytics in the form of a net economic analysis (NEV) on the entire balance sheet to ensure that hedging activity is really necessary. Income simulations, while important for other measures, cannot be used to realign duration mismatches. The analytics should be conducted at least on an annual basis or as a validation to internal models. At ALM First, we require a separate team to perform the NEV as an internal validation.[6] For a credit union to be granted authority to use a third-party hedging service, it is imperative that the staff have sufficient knowledge of ALM analytics as well as the ability to understand and question modeling assumptions.

b. Third-party providers that participate in the program must not have conflicting interests in providing hedging advice and generating undisclosed commission by marking up trades. Third party providers that aggregate and face the credit union directly as a counterparty would have no competition, and fees could be excessive. Additionally, upon termination of a trade, fees are paid to maturity as the marked up coupon warrants a lesser market value. If working as an aggregator, the third-party provider should have the same credit restrictions as the end-user counterparty required under the ruling and be required to disclose commission mark ups, at the very least.

c. Third-party providers should be required to open multiple counterparty lines on behalf of their clients.

Revision of Current Standards

We also believe the following standards, as currently held by the ALM First pilot services should be revised:

- <u>Financial Condition</u>
  The NCUA should not require the credit union to have positive, stable earnings for the preceding 12 months. On occasion, a credit union with significant capital might desire to obtain lines to execute derivatives. Temporary causes that prevent positive income or a change of management may exist. Additionally, a credit union could potentially need to hedge due to earnings pressure and the need to retain longer mortgages to enhance income.

[6] *ALM reports at ALM First are performed by one of six "teams" of employees assigned to an account. We have set a requirement internally, that for derivative clients, the ALM analysis must be performed by a team other than the assigned team to ensure accuracy.*

The credit risk of the credit union is to the counterparty, not the NCUA. The main risk to the NCUA is losses due to speculation.

- Board of Directors
  Boards of Directors must understand the fundamental risks and benefits of hedging; however, it is difficult for them to determine hedge objectives and parameters and designate what correlation measures will be utilized. It is also difficult for Boards to approve correlation targets and tolerance limits *prior* to execution of each individual transaction. We suggest that this be delegated to a special committee or to a team of senior staff members.

- Accounting Standards
  It has been very difficult to obtain approval from external auditors on accounting policies and procedures prior to the first transaction. We suggest that policy approval be obtained during the course of a credit union's annual audit. Experienced staff members of third-party providers should be able to opine on these documents prior to the first trade.

- Counterparty Credit Quality
  All counterparties must be AA- (or equivalent) or better at the time of any transaction. Termination of the transaction is required once a counterparty is downgraded to BBB (or equivalent). When there is a split rating, the lower rating will prevail.

  We assume that this requirement will be altered with the restrictions of the Dodd-Frank Act. If not, we suggest that the rating reference be B (or equivalent) if collateral is posted in accordance with the bilateral agreements. For further protection, the bilateral agreement should have verbiage for zero initial threshold requirements and low threshold margin requirements (outside of the required independent amount).

  We also recommend that termination of the trade be clarified to mean termination "as soon as practical" in order to not conflict with the verbiage under "Transaction Termination" which reads, "*Any cases where designated hedges fail the limits of hedge effectiveness must be reported to the board of directors and the transaction terminated as soon as practicable. Also, termination is required as soon as practicable once a counterparty is downgraded to "BBB" (or equivalent) as noted above."*

- Legal issues
  The ISDA agreement must be supplemented by a bilateral collateral agreement between counterparty and the credit union. The bilateral collateral agreements must require the posting of collateral by either party that is in a net deficit position on any derivative that has been transacted. The agreement should further specify that the collateral must be permissible for federal credit unions to hold and will be held by an independent third party.

  We suggest that bilateral agreements not be required if the credit union utilizes a Federal Home Loan Bank.

A third-party custodian should be suggested, but should not be a requirement. Reasons are cited below:

- When the credit union's trade is "in-the-money", the counterparty delivers collateral to the credit union's choice custodian as long as the custodian's credit standards comply with the ISDA documents; therefore, the collateral is held tri-party.
- When the credit union's trade is "out-of-the-money", the credit union delivers collateral to the counterparty under a bilateral Credit Support Annex (CSA). Collateral is held in the credit union's name in an omnibus account with a subaccount for each counterparty. The market value loss of the trade should equal the collateral minus the threshold variance and daily market movement.
- Throughout the industry's experience with billions of dollars of derivative trades, mainly being executed by the corporate credit unions, bilateral agreements have always been the practice and is the market norm.
- The AA rating requirement for counterparties is higher than most custodian ratings.
- The delivery of collateral to a third-party custodian will generate operating expenses and other punitive costs by the counterparty that will be passed on to the credit union.
- There currently are only four counterparties that meet the NCUA's strict requirements as an approved counterparty and are willing to supplement the ISDA agreements with bilateral agreements. As a side note, the current restrictions are so conservative that ALM First cannot use the Federal Home Loan Banks as counterparties, as they only offer unilateral agreements and will therefore not post collateral bilaterally, much less on a tri-party arrangement.
- These four counterparties will be disinclined to work with smaller credit unions if tri-party agreements are required. This could prevent credit unions from entering into the program or have lines open to only one counterpary. Only one line will prevent a request for multiple offerings for optimal price execution.

2. *If FCUs lacking prior experience with derivatives were required to spend a period of time within a third- party Pilot Program, what period of time and/or number of transactions is reasonable to a safe and sound understanding of derivatives? In your answer explain why this is sufficient minimum time or number of transactions.*

   We believe the requirement should be the execution of at least five different derivative trades with the accompanying analytics and at least one year of experience commencing on the date of the first trade.

C. *Whether to allow FCUs to independently engage in such derivatives activities by waiver provided they meet prudential standards.*

1. *Should the NCUA Board consider allowing credit unions to engage in derivatives activity independently? Explain why or why not.*

Yes, as long as the credit union is able to demonstrate that it has the experience and will abide by comparable standards required by clients that participate in the third-party program.

2. *What are the attendant criteria, such as, asset size, capital adequacy, the balance sheet composition of a credit union, or risk exposure with and without derivatives, that NCUA should take into consideration in evaluating an FCU's request for approval to engage in derivatives independently? Specify and explain any criteria that are essential.*

   The primary attendant criterion is the experience of staff. We believe that a credit union should have assets of at least $100 million to participate. We don't believe the credit union should be in a high-risk position to receive powers. Sophisticated credit unions acknowledge that risk might be within current guidelines, but might not stay within acceptable limits if rates rise rapidly. In addition, risk tolerance is vastly different among credit unions. For this reason, we do not believe criteria should be set upon a current "high risk" valuation of the ALM reports but, rather, that the NCUA should evaluate on a case-by-case basis if the credit union can use these tools in a safe and sound manner to manage interest rate risk.

   We suggest the following as criteria:

   - Derivative experience within the staff of the credit union that would comprise the execution of trades within a financial institution, the knowledge of back office work, and derivative analytics.
   - Comfort with the staff that derivatives will not be used to speculate on the markets.
   - Capital adequacy of at least 6.50 percent.
   - Guidelines that experience can be achieved by hiring experienced personnel or by obtaining guidance through third-party consultants.

3. *Are there specific actions an FCU should expect to take in preparation for applying to engage in derivatives activities independently? Specify and explain any actions which are needed.*

   - The credit union should attempt to meet all standards as outlined by the third-party provider. Most important are staff experience, board education, and analytical modeling.
   - The credit union should be capable of opening several counterparty lines.
   - The credit union should be able to price derivatives to ascertain mark ups.

D. *What approval standards should be established to govern the evaluation of an FCU's request for approval to engage in derivatives through a third party?*

   1. *Should NCUA require an FCU to state a balance sheet management plan to hedge IRR based on risk management objectives as a condition for approval? Explain why or why not.*

      It depends on the definition of a "management plan". Normally, a credit union that does not have derivatives experience would not have the knowledge to put together a management plan that incorporates the use of derivatives. This underscores the credit union's need for a third-party consultant.

We suggest that the application be based more on why the credit union wants to hedge and the strength of the third-party provider if applicable.

2. *Is it useful for a FCU to rely on the expertise of a third party to assess the effectiveness of derivatives to hedge IRR on an ongoing and dynamic basis or should the FCU be required to demonstrate it has this expertise internally as a condition for approval? In either case explain why or why not.*

   It is useful for a FCU to rely on the expertise of a third party to assess the effectiveness of derivatives to hedge IRR on an ongoing and dynamic basis as long as the third party is not the counterparty of the trade. However, the credit union must have the in-house knowledge to adequately review its ALM reports and assess the need to hedge. That is, the credit union must have the expertise in house to ensure that hedging activity is truly within its strategic plan. Alternatively, the credit union should have its ALM reports validated.

   If the credit union has a sufficient amount of internal expertise, it should be allowed to deal directly with counterparties unless oversight is needed or if it believes it will be unsuccessful in obtaining lines on its own.

3. *Is it useful for an FCU to rely on the expertise of a third party to assess the credit quality of derivative counterparties? Explain why or why not.*

   Yes, as long as the third party is not the counterparty of the trade or competes directly with the counterparty.

E. *What approval standards should be established to govern the evaluation of an FCU's request to engage in derivatives independently?*

1. *Should approval of an FCU to engage in derivatives activities be in the form of additional authorization similar to the expanded authority available under Appendix B to Part 704 – Expanded Authorities and Requirements? Explain why or why not.*

   It depends. The appendix is based on various levels of additional powers and subsequent levels of risk that can be taken (as measured by the NEV). Hedging powers is one activity and should either be approved or not approved. Additionally, having hedging authority should not allow the credit union to take additional interest rate risk, as it is through the use of these powers that the credit union is attempting to contain risk.

   However, we believe the NCUA should outline guidance for an FCU to apply, similar to the form of the "Guidelines for Submission of Requests for Expanded Authority".

2. *Should an FCU demonstrate enhanced credit functionality in terms of the experience of the FCU's personnel, credit analysis and reporting infrastructure in order to evaluate the creditworthiness of derivative counterparties? Explain why or why not and describe any minimum expectation.*

   No, credit is not necessarily the most pertinent need.

The credit risk of derivative trades depends on the governing ISDA agreement and the attached Schedule and Credit Support Annex. The required bilateral agreements will mitigate counterparty exposure. If trades are cleared through the clearing house, it will also simplify the credit valuation process.

3. *Should an FCU demonstrate enhanced hedging expertise based on the experience of FCU's personnel or on additional derivatives management infrastructure? Explain why or why not, and describe any minimum expectation.*

   The experience of the credit union should not be limited to employee experience, but should also include access to system capabilities. Infrastructure should include ALM modeling experience, as well as derivatives trading experience.

4. *Is one year a sufficient amount of time for an FCU to fully prepare a self-assessment and application for approval to independently engage in derivatives to offset IRR? Explain why it is sufficient or why more time may be required*

   This depends on what type of experience the credit union has had over the period of one year. We believe at least five separate trades should be conducted, as well as experience in setting up counterparty lines, such as negotiating ISDA agreements, and the development of the hedge process and back office operations. It is not unusual for the start-up process to take at least six months. Trading experience should entail at least one full year after the execution of the first trade.

5. *Are there any additional aspects of the FCU besides items (i)-(v) above which NCUA should consider in its approval for the FCU to engage in derivatives activity independently? If so, explain why the item should be considered.*

   ALM First has no additional suggestions.

Again, thank you for the opportunity to respond to this request. We hope the NCUA finds these suggestions useful and welcome any future dialogue.

Sincerely,

Emily Moré Hollis, CFA
Founding Partner