August 18, 2011

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

**RE: ANPR related to the use of financial derivative transactions by credit unions.**

Dear Ms Rupp:

On behalf of the Credit Union Association of New York, I would like to take this opportunity to comment on the NCUA's Advanced Notice of Proposed Rulemaking (ANPR) regarding the use of derivatives. Given the unsettled financial and economic conditions in which credit unions are currently operating, the issues addressed in this ANPR are significant for a small but important segment of the credit union community. We are submitting our comments in the hopes of assisting the NCUA in quickly formulating regulations that will allow credit unions with both the expertise and the need to appropriately use derivative swaps as a hedge against the potential volatility of interest rates in the coming years.

**Overview**

This may seem like a strange time to be advocating for expanded use for derivatives; after all, a consensus is forming that the use of derivatives significantly contributed to the financial crisis. However, it is important to distinguish types of derivatives, and the purposes for which derivatives should be used. Properly utilized derivative swaps can mitigate interest rate volatility. The next several years could make mortgage portfolios particularly vulnerable to interest rate swings, as the NCUA has recognized in proposing that credit unions develop policies and procedures to address this risk. In addition, in 1993 NCUA warned credit unions against the dangers of holding excessively large concentrations of fixed rate mortgages in their lending portfolios. The Administration pointed out that for many of these fixed low-interest rate mortgages "if risk management is not managed effectively, {such loans] represent high exposure to rising interest rates." (See NCUA letter to credit unions 3-CU-15 September 2003.)

As in 1993, credit unions are operating in an environment of exceedingly low interest rates and it is possible that notwithstanding the recent commitments to hold down interest rates made by the Federal Reserve, the economic environment is uncertain enough that properly used derivatives should be made available for some credit unions.

**Specific Questions**

Questions 1-2. NCUA generally asks whether credit unions authorized to buy and sell derivatives under its existing pilot program should be permitted to continue if amendments are made to Part 703.

Credit unions currently authorized to use derivatives should be permitted to do so without interruption and should be grandfathered in to any subsequent regulatory changes. Since the existing requirements for credit unions participating in the pilot programs are already stringent and will most likely be used as a touchstone for future regulation in this in this area, the credit unions in the pilot program have adequate expertise.

Question 3. Should federal credit unions be authorized to seek an exemption from the mandated use of clearinghouses by institutions with $10 billon or more in assets?

Yes – credit unions, which are, of course, small compared to their for profit counterparts, should have as much flexibility as possible consistent with safety and soundness. The cost associated with derivative compliance will often be the decisive element in a credit union's decision to use interest rate swaps and it will be cheaper for credit unions not to utilize clearinghouses. Keeping in mind the relatively small size of credit unions, a default on a derivatives contract will not result in the type of systemic risk this requirement is intended to avoid. Furthermore, allowing credit unions to avoid mandatory clearinghouse requirements still permits them the option of utilizing a clearinghouse in the event that they find this is more beneficial than the registration of their swap data.

**Third Party Relationships**

Question 1. Are the current third party operating standards used by NCUA's pilot program appropriate to govern use of derivatives with a third party?

Yes. The need for ongoing monitoring, extensive board revision and to clearly articulate the rationale of a credit union's derivatives purchases provide an adequate framework to protect the safety and soundness of credit unions that enter into third party relationships.

The Dodd-Frank Act necessitates that credit unions no longer rely exclusively on rating agencies when making investment determinations. While it may ultimately be beneficial to develop appropriate risk measurements that can be adopted on an industry-wide basis, the lack of such a matrix will be more than offset by adequate due diligence.

Question 2. What period of time and/or what number of transactions is reasonable to ensure that credit unions have an understanding of derivatives sufficient to allow them to buy and sell them without third party assistance?

It is our opinion that two years is enough time to acquire adequate expertise. This period of time is consistent with NCUA's existing requirement regarding minimum expertise of third parties and credit unions engaging in member business lending. Two years has been enough time to ensure that employees are adequately trained about the loans of any given program.

**Independent Derivatives Authorization**

Question 1. Should the NCUA board consider allowing credit unions to engage in derivative activity independently?

Yes. No regulation should categorically assume that all credit unions lack the sophistication necessary to enter into derivative transactions without the assistance of a third party. When a credit union can demonstrate that it already has the internal expertise necessary to model economic risks, adjust its lending in reaction to these conditions and the legal expertise to buy derivatives, it should be allowed to do so.

Question 2. What are the criteria such as asset size…that NCUA should consider before allowing a credit union to engage in derivatives independently?

In gathering information in response to this ANPR, many credit unions indicated that asset size should not be a predominant factor in authorizing credit unions to engage in derivative transactions. Instead, a stringent due diligence requirement and proven modeling expertise can be used to determine if a credit union is qualified. In addition, for a vast majority of credit unions, the benefits of using derivatives will be more than offset by their expense. Only credit unions that can show not only that they have the expertise but a reason to utilize swaps to offset potential risks rather than simply as investment vehicles, should be allowed to purchase them.

The Association anticipates that there is a small group of predominantly larger credit unions for which derivatives should be considered a basic tool of financial management. It is for this reason that we feel the NCUA should develop regulations to authorize the use of derivative swaps while putting adequate safeguards in place.

Sincerely,

William Mellin
President/CEO
Credit Union Association of New York

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