COASTAL
federal credit union

August 18, 2011

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

Dear Ms. Rupp,

We are pleased to provide our comments on the ANPR regarding changes to Part 703 that would permit credit unions, under certain conditions, to use financial derivatives transactions to offset interest rate risk.

Our responses to the questions contained in the ANPR are provided in the attached document. In summary, we firmly believe that the NCUA should permit well-capitalized and well-managed credit unions to use financial derivative transactions as outlined in the ANPR as a tool to manage significant interest rate risks that are created when entering into loan or deposit arrangements with members, or when purchasing investments or borrowing funds. Additionally, we do not believe that credit unions should be exempt from clearing their derivatives transactions through a "derivatives clearing organization".

Respectfully Submitted,

Larry Wilson
Chief Executive Officer

Brad Miller
Chief Financial Officer

Att.

Coastal Federal Credit Union
Responses to ANPR Questions

## A. *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.*

   **For participants in the Bear Stearns Managed Leveraged fund, it would be beneficial for the program to continue to use derivatives to provide for an orderly wind down of the fund. This would eliminate the realization of unnecessary losses within the fund caused by the forced liquidation of securities. It should be noted that Coastal FCU is a participant in the Bear Stearns fund and it is currently managed by a subsidiary of J.P. Morgan.**

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

   **In order to provide for an orderly wind down and transference to compliance with the new regulation, there should be a "grandfathering" period but it should not be indefinite. All derivatives and/or securities trades executed under approved Pilot Programs should be allowed to mature in due course. Credit unions should not be expected to divest of securities or derivatives that were purchased under an approved Pilot Program.**

3. *Should NCUA permit FCUs to seek an end-user exception? Explain why or why not.*

   **No. An end user exception would diminish transparency, potentially increase credit risk and may not actually provide any relief from the burden of complying with the Commodity Futures Trading Commission's (CFTC) requirements for additional reporting given an end-user exception. Additionally, the spirit of the CFTC proposal is such that the exception is intended to apply to non-financial entities hedging in the ordinary course of their business. As financial institutions, the exemption if applied to credit unions would seem to run counter to the reason for the exemption.**

***B. Third Party Derivative Authorization***

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.*

   **This question seems to address two separate issues. The first being the credit quality of counterparties and the second issue being the vendors that a credit union may engage to assist in managing a derivatives program.**

   **In regards to the first issue, one inescapable lesson from the events of 2008 is that credit ratings are not intended to replace independent reviews of credit quality. We concur that the counterparties should always present a very low risk of default and that credit risk exposure to a counter party should not present a material risk to a credit union.**

   **In regards to the second issue, we believe that any third party utilized to assist in the management of a derivatives program should be a registered investment adviser, with either the SEC or appropriate state regulatory authorities. However, the size of the vendor does not provide any meaningful safeguards. As an example, of the five third parties recognized by the NCUA for pilot programs, three have failed or experienced the failure of their parent organization due to inadequate risk management practices.**

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 be safe and sound understanding of derivatives? In your answer, explain why this is sufficient minimum time or number of transactions.*

   **We do not agree that spending time in a third party program or doing a certain number of transactions necessarily leads to the expertise to run a program. Instead, training, oversight (potentially by a third party), and perhaps validation (again, by a highly qualified third party), may lead to adequate expertise. We strongly encourage the NCUA to look to appropriate training and oversight to ensure adequate expertise is in place. Nonetheless, the credit union's board and management should be allowed latitude in determining the length of time and depth of appropriate independent oversight.**

## *C. Independent Derivatives Authorization*

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

   **Yes. To repeat an earlier point, of the five entities already identified as third party derivatives providers, three have failed on their own due to failed risk management practices. Several credit unions are large enough to justify having a derivatives risk management infrastructure in house. Further, having the infrastructure in house may allow for more and better oversight of the risk management function, assurance that contingency and succession plans are adequate, and more control over personnel responsible for these activities.**

   **Another concern with a requirement to utilize a third party is that the industry may over concentrate its reliance on one or two providers. This could lead to systemic problems in the industry given a failure in that provider's ability to adequately measure and assist in the management of risk.**

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 criteria are similar to what the credit union's own board should consider. Does the credit union have scale to allow a derivatives program to provide a payback? Are there business reasons that justify a program such as a deposit base that provides funding of a shorter duration than the assets available to the credit union? Will the program provide benefits to the members in their roles as owners and customers?**

   **In no case should a credit union enter into a program unless they have sufficient capital and earnings to support a program.**

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.*

   **Yes. Succession planning for the personnel running the program, contingency plans, an internal audit function capable of overseeing the program (even if outsourced), assurance that the credit union utilizes independent CPAs with the expertise to opine on the program, as well as potential exit strategies. These are in addition to the resources and systems necessary to measure and manage risk.**

***D. Approval Standards for Derivatives Activities Through an Approved 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.*

   **No. These objectives may change over time. The objective of a program is always to manage risk, which is also the business that credit unions are in, managing risk. The reason for the program should be to maintain risk within acceptable parameters, but the actual objectives can and should change with the business cycle, the level of interest rates, and the credit cycle. Derivatives are an important tool in risk management.**

2. *Is it useful for an 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 to rely on an independent third party as it avails the benefits of economies of scale. Having said that, a credit union must have an understanding of the risks it is taking, it should not delegate that responsibility. Expertise must always exist in house to be able to evaluate what a third party is doing on behalf of the credit union.**

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.*

   **No. As the lessons of the past few years have taught, third party credit analysis is a tool, but it should always be verified on a periodic basis.**

## *E. Approval to Engage 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.*

   **This would be beneficial as it could spell out the potential levels of derivatives authority and the requirements to participate in a derivatives program. This would increase the predictability in pursuing a derivatives program.**

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.*

   **Yes. As indicated in the previous answer, reliance on a third party to evaluate creditworthiness of a counter party is not appropriate given lessons learned in the past few years.**

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.*

   **Yes. It is not possible to manage risk without a thorough understanding of the risks being managed.**

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.*

   **One year would be the minimum amount of time to accomplish the tasks necessary to begin a derivatives program. Board and management training, risk management systems identification and implementation, staff training are just examples of tasks that could easily devour a year. More time would be appropriate in many instances.**

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.*

   **One consideration that the NCUA should make is that credit unions of all types are in an increasingly difficult operating environment. Revenues have been harmed by legislation as well as a structural change in loan demand. Inability to evolve our**

**businesses by availing ourselves of risk management tools such as derivatives would be an additional competitive disadvantage to offering our members the best possible financial services.**