

August 23, 2011

National Credit Union Administration  
c/o Mary F. Rupp, Board Secretary  
1775 Duke Street  
Alexandria, VA 22314-3428

BY EMAIL: [regcomments@ncua.gov](mailto:regcomments@ncua.gov)

RE: Sandler O'Neill Comments on Part 703 ANPR, Financial Derivatives Transactions to Offset Interest Rate Risk

Members of the Board:

Sandler O'Neill + Partners, L.P., is pleased to comment on the NCUA Board's June 17, 2011 Advance Notice of Proposed Rulemaking ("ANPR"), *Financial Derivatives Transactions to Offset Interest Rate Risk; Investment and Deposit Activities*. In the ANPR the Board requests public comments regarding whether and how to modify its rule on investment and deposit activities to permit a natural person credit union ("CU") to engage in the purchase and sale of financial derivatives for the purpose of offsetting interest rate risk.

Sandler O'Neill is a full-service investment-banking firm focused on the financial services sector.<sup>1</sup> Our clients include a wide variety of financial firms, among them some 1,000 banks, thrifts, and credit unions ("financial institutions"). Our Balance Sheet Advisory Services ("BSAS") group provides modeling expertise and advice to financial institutions on managing their balance sheets. Our Interest Rate Products Desk ("Rates Desk") advises financial institutions on structuring and executing transactions, as well as counterparty risk mitigation and ongoing management of interest rate products, including derivatives.

## Overview

The Board notes that the Federal Credit Union Act authorizes the purchase and sale of financial derivatives for the purpose of offsetting interest rate risk.<sup>2</sup> By regulation, the Board has generally prohibited CUs from engaging in financial derivatives transactions

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<sup>1</sup> For further information on Sandler O'Neill + Partners, L.P., see <http://www.sandleroneill.com>. Mr. Chandonnet heads Sandler O'Neill's BSAS group and Rates Desk; Mr. Duffy works closely with credit unions.

<sup>2</sup> 12 U.S.C. § 1757(17); NCUA General Counsel Opinion No. 99-0229 (Feb. 23, 1999).

to offset interest rate risk except pursuant to Pilot Programs that the Board has approved for CUs or third-party providers that meet certain prudential standards. CUs generally do not need to obtain NCUA approval for participation in an approved third-party Pilot Program.<sup>3</sup>

We believe that the existing Pilot Program options are generally serviceable in providing both large and small CUs the opportunity to use financial derivatives to manage interest rate risk. For the reasons explained below, we also believe the two types of Pilot Programs provided for in the Board's regulations should be retained, with such modifications as may be suggested by changed circumstances, and that the Board should encourage greater participation in these Pilot Programs.

### **Financial Derivatives in Context**

Financial derivatives, used to hedge various risks, are a key set of tools that financial institutions, including credit unions, should have at their disposal. Specifically, the January 6, 2010 interagency *Advisory on Interest Rate Risk Management* makes clear that financial institutions, including CUs, are expected to measure exposure to interest rate risk and to take appropriate steps to mitigate it.<sup>4</sup>

In a first-quarter 2010 conference call for several hundred financial institutions on ways to mitigate the risk of rising market interest rates, Sandler O'Neill's Rates Desk identified 14 different strategies available to financial institutions, 8 of which require the use of financial derivatives in the form of a cap or a swap. The Board's Pilot Programs are therefore needed to equip CUs with more than half of the tools we identified for the management of the risk of rising market interest rates. At a time of unprecedented – some might say dangerously low – interest rates, now is a particularly good time for the Board to reaffirm and improve Pilot Programs enabling CUs to avail themselves of prudent means of managing interest rate risk.

In many cases the use of financial derivatives is the most efficient means of managing interest rate risk, particularly in protecting the capital and earnings of a financial institution. For example, if a financial institution wishes to reduce its exposure to rising market interest rates but is limited to on-balance-sheet strategies, the financial institution will likely confront equally unacceptable options. Specifically, such a financial institution must either generate one-time losses as it unwinds and restructures assets and/or liabilities, or it must give up earnings by selling higher-earning assets to avoid taking losses. A financial institution such as a CU might have been able to avoid this dilemma by using a cap or a swap.

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<sup>3</sup> See generally 12 C.F.R. § 703.19.

<sup>4</sup> Released on January 7, 2010, the interagency guidance is available on the FFIEC's website at <http://www.ffiec.gov/press/pr010710.htm>.

## Managing the Risks of Financial Derivatives

We acknowledge that financial derivatives have specific risks in addition to those associated with other instruments such as borrowings and bonds. However, we do not believe these risks are any more unusual than, for instance, the risk involved in purchasing certain types of securities. Pre-purchase analysis that assesses risk as part of an ongoing framework for managing it is an established supervisory expectation for the use of all financial instruments. For this reason, we believe the only basis for singling out instruments such as caps, floors and swaps is the relative unfamiliarity of some financial institutions with them. Moreover, we believe the best means of addressing this state of affairs is supervisory encouragement of greater familiarity with and prudent use of such instruments.

We agree with the Board that the two risks specific to financial derivatives are (i) counterparty risk, the risk that a counterparty defaults on its obligation, resulting in losses; and (ii) accounting risk, the risk that a CU doesn't properly apply derivative accounting under Accounting Standards Codification ("ASC") 815,<sup>5</sup> leading to income statement volatility resulting from restatement.

We offer the following observations by way of addressing these two "special" risks:

*First, in a change from the pre-Lehman-meltdown world, it is now possible to get full bilateral collateral terms on a derivative contract.* For example, Sandler O'Neill's Rates Desk, which advises financial institution clients on the use of these instruments, generally will not place a trade with a counterparty that is unwilling to collateralize the exposure it presents to our client. This requirement dramatically reduces counterparty risk, reduces the risk-based capital charge,<sup>6</sup> and greatly simplifies accounting since it eliminates the need to incorporate Credit Valuation Adjustment ("CVA")<sup>7</sup> into the mix.

This is an important recent development in the market that largely renders moot the discussion of whether CUs will be required to clear trades pursuant to the Dodd-Frank Act or apply for an "end user exemption." In fact, in speaking with large derivative counterparties such as swap dealers, we have heard from most that they expect collateral requirements imposed under Credit Support Annexes ("CSAs") on uncleared

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<sup>5</sup> ASC 815 codifies guidance originally issued as Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, June 1998.

<sup>6</sup> Basel III provides a strong regulatory capital incentive for counterparties to clear derivative trades through central counterparties to reduce allocated risk weighting of the exposure. (Central counterparties will likely require full collateralization of exposure.) As well, to the extent that credit unions are required to comply with Basel III, there may be a deduction from Tier 1 common equity for gains from cash flow hedges unless the associated liability is also fair valued.

<sup>7</sup> CVA is an adjustment made to the market value of a derivative contract to take into account the unsecured credit risk of the counterparty.

trades to be at least as stringent as those applied to cleared trades by clearing firms. Thus, we believe that the enhanced use of collateralization will reduce counterparty risk, either as is currently the case under a bilateral CSA or under clearing requirements implementing the Dodd-Frank Act.

If trades are not cleared, CUs will need to have the ability, either directly or through outsourcing, to monitor the value of their positions and collateral so they can verify margin calls against them and know when they should be calling for margin. (On cleared trades the clearing agent does this.) Such assistance is a basic service that Sandler O'Neill's Rates Desk provides on all derivative trades for which we act as advisor or agent.

*Second, we observe that factors other than notional amount affect the risk profile of a financial derivative transaction. We applaud the NCUA for requiring that policy limits on the use of financial derivatives be implemented and approved by the CU's board of directors. However, we believe that a policy emphasizing limitation of the notional amount of interest rate derivatives is inadequate because it does not address the vastly different risks posed by various types, structures, and maturities of derivatives, and by differences in collateral terms and other credit mitigants that could materially alter the amount of counterparty risk taken in such transactions. The following example illustrates these differences by comparing the market risk and counterparty risk of two hypothetical interest rate swaps with the same notional amount but different durations and collateral received.*

**Swap 1**

Notional Amount: \$10,000,000  
 Type of Swap: Generic Pay-Fixed vs 3-Month Libor  
 Maturity: 2 Years  
 Collateral Terms: Full Bilateral/Cash or US Treasurys  
 Duration: 1.9 years

Unrealized Gain if Rates Rise 3%: **\$570,000** (1.9 \* 3% \* \$10,000,000)  
 Unsecured Counterparty Exposure: **\$0** (fully collateralized)

**Swap 2**

Notional Amount: \$10,000,000  
 Type of Swap: Generic Pay-Fixed vs 3-Month Libor  
 Maturity: 10 Years  
 Collateral Terms: None  
 Duration: 9.2 years

Unrealized Gain if Rates Rise 3%: **\$2,760,000** (9.2 \* 3% \* \$10,000,000)  
 Unsecured Counterparty Exposure: **\$2,760,000** (no collateral received)

Despite having the same notional amount, these two interest rate swaps represent materially different risks to the CU because of their different maturities/durations and collateral terms. A policy emphasizing notional amount limits could inadequately address these differences. Thus, we believe that a limitation on notional amount of derivatives as a percentage of capital does little to further the Board's objective of ensuring proper risk controls over the use of financial derivatives.

*Third, the complexity of accounting for financial derivatives created by FASB Statement 133 and associated Derivatives Implementation Group ("DIG") issues has significantly lessened since 2005 as a result of four notable developments.*

- There is now an established set of hedge-accounting trades/designations common to financial institutions that are generally accepted across external audit firms, leading to little to no interpretation/restatement risk on the use of these specific trades.
- The use of the "short-cut" method of hedge accounting, which had been the biggest cause of earnings restatement, has fallen out of favor, leading to very few accounting mishaps in the last five years.
- The FASB's proposed update of derivative accounting,<sup>8</sup> if adopted as proposed, would greatly simplify the ongoing testing/documentation process that has tripped up financial institutions in the past (as well as eliminate "short-cut" treatment altogether).
- A number of specialized consultants and software providers now offer very affordable "long-haul" hedge accounting services, which have been vetted with all the major accounting firms.

As a result, we contend that the accounting risk in the use of financial derivatives can be mitigated by following a well-established path, using either qualified internal resources or third-party providers.

## **Conclusion**

CUs should be permitted to use financial derivatives to mitigate interest rate risk, subject to the same pre-purchase due diligence (including understanding how market conditions impact an instrument's value) required for other capital markets trades, as long as:

- The CU secures counterparty protection in the form of collateral, either through a bilateral CSA or clearing.

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<sup>8</sup> Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities (Topics 825 & 815)*, May 26, 2010.

- The CU has the ability to monitor ongoing collateral requirements, or outsources such monitoring to a qualified third party.
- The CU has established policy limits related to the amount of market risk, both gross and net of collateral, it is permitted to carry in financial derivatives, and can demonstrate the ability to measure and monitor that risk, either by using internal resources or by outsourcing that expertise to a qualified third party.
- The CU can demonstrate a fundamental understanding of the basics of how derivatives accounting will impact the balance sheet, income statement, and capital.
- The CU has the resources and knowledge to apply well-established hedge accounting to commonly executed transactions, or outsources such accounting to a qualified third party.

We would be pleased to discuss points presented in this letter, as well as such other matters as the Board or its staff may desire. Mr. Chandonnet may be reached at 212-466-7816 or [rchandonnet@sandleroneill.com](mailto:rchandonnet@sandleroneill.com) and Mr. Duffy at 212-466-7871 or [pduffy@sandleroneill.com](mailto:pduffy@sandleroneill.com).

Sincerely,

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