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August 23, 2011

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

Re: ANPR, Financial Derivatives

Dear Ms. Rupp:

The Pennsylvania Credit Union Association (PCUA) is a state-wide advocacy organization that represents a majority of the 537 credit unions located within the Commonwealth of Pennsylvania. PCUA appreciates this opportunity to comment on the National Credit Union Administration's (NCUA) advance notice of proposed rulemaking (ANPR) that addresses financial derivatives transactions to offset interest rate risk (IRR).

PCUA enlisted the assistance of its Regulatory Review Committee and State Credit Union Advisory Committee (the Committees) to review the ANPR. The Committee members are the chief executive officers of credit unions representing all peer groups based on asset size. The comments contained in this letter reflect the input of the Committees and PCUA staff.

As a general proposition, the Committees welcome and support amendments to NCUA Regulation Part 703, 12 CFR 703, that would enable federal credit unions to engage in financial derivatives transactions to mitigate IRR. The Committees also stressed and supported the proposition that investment authority of this nature be coupled with appropriate safety and soundness guidelines.

Federally Insured, State-Chartered Credit Unions

The ANPR and any amendments to 12 CFR Part 703 would apply to federal credit unions (FCUs). As NCUA considers enhancing the investment powers of FCUs for the purpose of IRR, in the interests of competitive equality, federally insured, state-chartered credit unions (SCUs) should receive due consideration. Pursuant to the Pennsylvania Credit Union Code, Pennsylvania's SCUs enjoy parity with FCUs subject to conditions or limitations that might be imposed by the Pennsylvania Department of Banking. 17 P.S. § 501.(e). Nevertheless, it would be extremely valuable to Pennsylvania's SCUs if NCUA would include a policy statement in its formal rulemaking signaling that financial derivative transactions for the purpose of IRR management constitutes appropriate investment authority for federally insured SCUs if established in a manner that is substantially similar to 12 CFR Part 703 and with adequate supervision by the state regulator.

Financial Derivatives as a Hedge

The Committees support and advocate the ANPR to the extent any final regulation would authorize FCUs to utilize financial derivative transactions to manage IRR. Credit unions have operated in a low interest rate environment for some time. This trend is likely to continue given existing economic conditions. Accordingly, authority to engage in financial derivative transactions is a welcomed tool to manage IRR and the balance sheet. Financial derivatives are especially appropriate as a hedge for longer term loans that cannot be readily sold on any type of secondary market.

The competitive environment renders it prudent to expand the investment authority for FCUs. Credit unions are striving to become primary financial institution of the consumers within their fields of membership. To accomplish that goal, it is necessary for a credit union to offer products and services that are similar to those offered by competing financial institutions. Expanding FCU investment authority to include financial derivative transactions offers an opportunity to take advantage of a worthy balance sheet/IRR management tool thereby enabling an FCU to operate on equal footing with competitors.

Safety and Soundness Requirements

The Committees agree and support the proposition in the ANPR that appropriate safety and soundness guidelines must apply to financial derivative activity. Any credit union seeking to utilize financial derivatives should have the appropriate expertise, either in-house or acquire it through a reputable third party. Whether a credit union engages in financial derivatives independently or through a third party, it should have the appropriate infrastructure and internal controls. In terms of rulemaking, we maintain that one set of rules should apply whether an FCU ventures into financial derivatives independently or via a third party. We appreciate NCUA's recognition of the value of third party assistance. Retention of third-party providers would likely afford the IRR or asset-liability management benefits of financial derivatives to FCUs with relatively smaller asset sizes.

While we agree with many of the safety and soundness requirements described in the ANPR that are part of NCUA's current pilot programs, we offer some additional thoughts and comments.

<u>Capital, Earnings</u>: We support the requirement that any FCU that desires to engage in derivatives activity must be well capitalized and demonstrate positive earnings. Financial derivatives carry significant risk. It is good public policy to establish rules aimed at prohibiting an under-performing credit union from turning to derivative activity for speculative purposes.

<u>Role of the Board of Directors</u>: We would support a rule that requires the Board of Directors to adopt policies that set the objectives and outside limits for derivative activity. Requiring the Board to approve each transaction would prove to be cumbersome and impractical. Like other investments, movement on a derivative transaction requires timing. Accordingly, management should be free to execute a transaction within the policy established by the FCU's board. Likewise, management should conduct the due diligence on counter parties and select such parties consistent with the policy adopted by the board. We support rules that would require management to report on derivative activity, including those counter parties selected, to the FCU's board on a periodic basis.

<u>Counter Party Credit Quality</u>: It is good policy to establish a rule requiring FCUs to engage with reputable counter parties. The ANPR or Pilot Program relies on credit ratings. As NCUA undertakes formal rulemaking on this subject, it would be valuable to take note of regulatory changes that are impacting the rating agencies and to have public discussion on the appropriate weight, deference or

reliance to be placed upon such credit ratings.

Internal Controls: We support the proposed internal controls. A strong system of internal controls is integral to safety and soundness. Further, by adopting rigorous internal controls supports our argument that the role of the Board of Directors should be defined as setting policy and monitoring. Management, through adherence to the policy and internal controls, executes the FCU's policy and provides adequate reports to the board on such activities.

Conclusion

Including financial derivatives transactions within the investment authority of FCUs is a welcome tool to effectively manage IRR and extend services to members. Derivatives involve risk and require expertise to manage. Therefore, we support many of the safety and soundness parameters articulated in the ANPR with some modest adjustments. As NCUA contemplates this investment authority for FCUs, we encourage NCUA to articulate a policy statement signaling that federally insured state-chartered credit unions should also have an opportunity to engage in financial derivatives activity provided that substantially similar safety and soundness prerequisites are in place.

Sincerely,

PENNSYLVANIA CREDIT UNION ASSOCIATION

James J. McCormack
President/CEO

JJM:RTW

cc: Association Board
The Honorable Glenn E. Moyer,
Secretary of Banking
Regulatory Review Committee
State Credit Union Advisory Committee
M. Dunn, CUNA