<u>STANDARDS FOR PARTICIPATING CREDIT UNIONS AND THIRD-PARTY DERIVATIVE PILOT PROGRAM APPLICANTS</u>

Credit Union Requirements

<u>Financial Condition</u>

The credit union must have:
- Minimum net worth ratio of 7 percent or more; and
- Positive, stable earnings for preceding 12 months.

<u>Board of Directors</u>

The credit union board must:
- Approve the counter-party or counter-parties.
- Update, at least quarterly, the credit rating and analysis of approved counter-parties.
- Approve the proposed types of derivative transactions, the maximum limits for aggregate notional principal amounts permitted for each type of transaction deemed appropriate by the credit union board. The maximum limit on derivative exposure in notional terms should be stated as a percentage of net worth. The maximum notional limit for swaps plus the value of the underlying securities in option transactions must not exceed 250% of net worth.
- Determine hedge objectives and parameters and designate what correlation measures will be utilized. Approve correlation targets and tolerance limits prior to execution of each individual transaction.
- Understand, review and approve each transaction prior to execution and affirm that transactions will be used solely to reduce interest rate risk.
- Ensure management monitors the effectiveness of the hedge on at least a quarterly basis (preferably monthly) and reports this information to the board.
- Require management demonstrate it has adequate knowledge to understand and monitor hedge positions using derivative instruments.

<u>Accounting Standards</u>

The credit union will:
- Commit to an annual independent audit of financial statements. The statements will be prepared in accordance with generally accepted accounting principals (GAAP) including FASB Statement No. 133 as amended and interpreted. The audits will be performed in accordance with generally accepted auditing standards (GAAS) by a certified public accountant or public accountant licensed by the appropriate state or jurisdiction to perform those services.
- Have external auditors review its accounting policies and procedures prior to the first transaction. The external auditors will opine that the policies are suitable for these transactions.

Counter-party Credit Quality

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

Hedge Transactions

The credit union will:

- Identify the circumstances leading to the decision to hedge; and
- Specify derivative transactions to be employed and definition of:
  - Hedge type (fair value, cash flow, etc); and
  - Analysis to demonstrate effectiveness of hedge.

Shock analysis will not demonstrate correlation. Hedge effectiveness requires correlation through time, must be set prospectively, and effectiveness must be assessed retrospectively. Hedge effectiveness reporting will be required of the participating credit union and validated by the applicant. Accounting rules require that hedges be linked to specific assets or liabilities and cannot be related to overall balance sheet risk. Reports of the macro effects of the hedge should be limited to the impact of this on the interest rate risk of the balance sheet.

Modeling

Any model used to evaluate any hedge transaction using derivatives must include the ability to capture all options embedded in the transaction. For example, option pricing or option adjusted spread modeling using simulation methods may be needed. It must be clear that the model functionalities capture the specific behavior of the instrument to be hedged and the hedge itself.

Internal Controls

The credit union must have the following procedures and controls in place prior to execution of the first transaction.

- Designation of the individual(s) with responsibility for purchasing derivative instruments.
- Designation of the individual(s) or departments that have accounting and risk reporting responsibilities for the derivative instruments and hedge transactions.
- Segregation of duties for the individual(s) obtaining the prices of the derivative instruments, hedged items, and other instruments associated with reporting the hedge transaction and of those that execute the transaction.
- Segregation of duties for the individual(s) with derivative instrument reporting and risk assessment responsibility and of those involved in the hedge execution.
- Requirement for monitoring hedge performance by the asset/liability committee and the board.

- Requirement that the derivative and the hedged item be priced by an independent third party.

Legal issues

- The credit union's legal counsel must opine that the proposed transactions are legal.
- There must be an International Swap and Derivatives Association (ISDA) agreement between the counter-party and the credit union.
- The ISDA agreement must be supplemented by a bilateral collateral agreement between counter-party and the credit union. The bilateral collateral agreements must require the posting of collateral by either party this 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.

Transaction Termination

Any cases where designated hedges fail the limits of FAS 133 effectiveness must be reported to the board and the transaction terminated as soon as practicable. Also, termination of the transaction is required as soon as practicable once a counter-party is downgraded to BBB (or equivalent) as noted above.

Regional Approval

The credit union must request permission from its regional office for authority to participate in the program and it must demonstrate adequate expertise and infrastructure to engage in these transactions prior to execution of any transaction and provide documentation to the pilot program provider.

Third-Party Provider Requirements

Contractual Agreement

The contract will document the nature of the relationship between the third-party provider and the credit union including any services to be provided by the third-party provider to the credit union. The contract should specify whether the third-party provider will perform all the activities referred to in these standards as the independent third-party.

On-going Risk Assessment

The third-party provider must independently assess the credit union's hedge position at the time of the transaction and at least quarterly thereafter. The results of the independent assessment must be submitted to the credit union's board. Any model used must meet the same standards as those required of the credit union. Risk assessment, however, is not limited to modeling questions or evaluation; it is a determination of the risk exposure of the credit union. The third-party provider is expected to define and suggest acceptable risk threshold to the credit union to justify and monitor compliance with the standards.

Internal Controls

The third-party provider should conduct a review of the credit union's infrastructure addressing interest rate risk management policies, procedures, practices and capabilities. Recommendations should be made to enhance or improve the credit union's infrastructure.

Reporting to NCUA

Monthly, the third-party provider must provide to NCUA the names of the credit unions participating in the program, types of derivatives, notional amounts of the derivatives, and net deficit and surplus positions for the hedge.

Credit Union Education

The third-party provider must demonstrate that it can properly educate credit unions on all aspects of derivative transactions, including hedge effectiveness and FASB Statement No. 133 requirements.

Number of Participants

A maximum number of 50 federal credit unions may participate in the program.