WESTERN BRIDGE
CORPORATE FEDERAL CREDIT UNION
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August 12, 2011

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

RE: Response to Financial Derivatives ANPR

Dear Ms. Rupp:

Thank you for the opportunity to comment on the proposed rule making enabling access to financial derivatives market for Credit Unions.

The attached comments are based upon over 28 years of practical application of these products in financial institutions including the experiences gained operating an approved Derivatives Pilot Program at Western Corporate FCU.

We hope that you find these comments constructive. We are available should you require further clarification of any points raised.

Regards,

Joseph F. DeMichele
SVP Chief Investment Officer and CFO

Introduction:
We are very pleased to see that the NCUA is considering making it easier for federally chartered credit unions to access the financial derivatives market. We have assumed that the ANPR is only addressing transactions involving interest rate risk management products (interest rate swaps, caps, floors etc.) and not Credit Default Swaps.

Financial institutions have been using financial derivatives for well over 25 years to manage the interest rate risks inherent in their balance sheets. This has enabled financial institutions to consistently provide loan and deposit products to their customers regardless of the prevailing market conditions, their own internal views on the prevailing yield curve and rate expectations. Since its inception nearly 30 years ago, financial derivative transactions that manage U.S. Dollar denominated interest rate risk now represents the largest and most efficient market in the world.

In the United States, banks have gained efficiencies by optimizing economies of scale through mergers and acquisitions. Most major banks now have national footprints and are able to bring enormous resources to the table. No credit union has the financial wherewithal to out-muscle these giants in a competitive situation. While they have the benefit of the member – owner relationship with their particular members, they are still required to offer a comprehensive range of competitively priced products in a timely and efficient manner. In order to be effective, credit unions need to have available every tool in their product tool-box. And financial derivatives are a primary tool that they must be able to routinely access in a timely manner

There have been several well-publicized examples of abuses that involved derivative products and resulted in some very large losses. However, these represent only a tiny fraction of the successful use of these products around the world. Indeed, when examining those problem cases, it can be clearly seen that a minimum of control, reporting and common sense rather than over-optimism and simple greed, would have prevented or at least minimized the impact of these situations. Indeed, many authoritative and respected people have highlighted the considerable benefits that derivatives have brought to end –users of all types and to the U.S. economy.

> ***In testifying before the Senate Agriculture Committee, then Fed Chairman Alan Greenspan said "Over-the-counter derivatives have come to play an exceptionally important role in our financial system and our economy. These instruments allow users to un-bundle risks and allocate them to the investors most willing and able to assume them." Treasury Secretary Summers added "The over-the-counter derivative market offers important benefits to the U. S. economy by allowing investors to hedge their risks efficiently and pass on the benefit of lower costs to consumers and businesses."***

That credit unions need access to the financial derivatives market to proactively manage their inherent interest rate risk, is unquestionable. The only question is what they must do to be able to access the market in a safe and sound manner. The WesCorp Pilot Program was successful for those members that were able to take advantage of it. It enabled program participants to proactively manage their interest rate risk as they introduced or held on balance sheet, assets with higher interest rate risk profiles. While the program was successful for those that took advantage of it, many were not able because the timeline necessary to qualify under the rules of the program was too long to be a viable

alternative. The situation was also exacerbated by continuing confusion and changes made by the rule making Financial Accounting Standards Board.

At that point, many resorted to the expensive and capital inefficient "on- balance sheet" hedging approach. They took down fixed rate advances from their corporate or the Federal Home Loan Bank then lent the proceeds in short-term investments. Their concerns over their interest rate risk profile may have been temporarily addressed but with inherent long-term limitations and associated costs. They paid the credit spread on the advance, reduced available liquidity, gave up income and reduced their capital ratios – limiting future growth potential. This approach obviously also has limitations as to the amount and term that lenders will advance and restricts the credit union's on-going ability to provide higher interest rate risk profile products to its members.

The Pilot Programs are specifically designed to use derivatives to help credit unions ***reduce*** the interest rate risk that is inherent in their operations. Credit Unions have recognized that many products currently offered to their members – e.g. mortgage loans – carry a large amount of interest rate risk. By applying derivative based hedging solutions, much of this risk can be significantly reduced, enabling the credit union to continue offering these products and, indeed, provide a broader range of products to their members. **The real risk is that credit unions are not able to access the derivatives market and, in attempting to satisfy the demands of their members, allow the interest rate risk inherent in their balance sheet to grow to unacceptable proportions. However, as the vast majority do not have in-house expertise in using derivatives, having third-party oversight to monitor interest and counterparty risk and to ensure effective and realistic structuring and reasonable pricing upon execution will ensure safe and sound application.**

NCUA QUESTIONS

Section A – Existing Pilot programs (Pages 8-9)

A: Q 1: Should existing Pilot Programs for FCUs to engage in derivatives for IRR management be permitted to continue?

NO – they should not be allowed to continue in their current form. The NCUA needs to review the lessons learned from those programs and redefine and simplify program rules such that participating FCUs can effectively and efficiently access the markets.

The NCUA needs to provide a framework that allows all FCUs access to derivatives regardless of the size or in-house expertise of individual credit unions. The NCUA currently has provisions that allow FCUs to apply for direct access to using derivative transactions. The applications submitted by those that have been granted permission were able to satisfy the NCUA that the necessary controls and expertise was available at the credit union to use derivatives in a safe and sound manner. However, many that recognize the need for hedging capabilities do not have the necessary expertise and so were able to take advantage of approved Pilot programs.

Some Pilot Programs are where the program operator simply acts as agent to transactions for a fee. Other programs, such as the one operated by WesCorp was different in that the program operator itself was counterparty to the transaction - which helped expedite transacting business and reduced costs.. While the program operated by WesCorp was able to allow several credit unions to hedge their interest rate risk using derivative transactions, many found that the timeline needed to satisfy all demands set for the program to be too long to be practical given their specific needs.

It is therefore recommended that operators re-apply for Derivative Pilot Program status within NCUA guidelines that will allow FCUs the same access that state chartered credit unions enjoy..

A: Q 2: Should such Pilot Programs be permitted to continue by "grandfathering" the previous approvals into Part 703?

As noted in the response to the prior question, all previously approved Pilot Programs should be terminated. However, the requirements set for Pilot Programs should be reviewed such that a true "fast track" method can be applied. Rather than have all steps completely satisfied before any transactions can be consummated, the requirements should require that those policies, procedures and assigned responsibilities are in place to ensure a safe and sound operating environment with third-party monitoring. More meaningful continuing education can then take place using actual outstanding transactions in an actual operating environment. This would place the onus on the program operator to ensure that the program participant has the key policies and procedures (as agreed with the NCUA) in place and is willing and able to provide on-going "after sales" service and support.

Section B – Third-Party Derivative Authorization (Page 14)

B: Q 1: These third-party standards (pages 10-14) 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?

The NCUA has indicated that counterparties must be rated "AA-" (or equivalent) or better at the time of any transaction and is also required to cancel any outstanding transactions if a counterparty is downgraded to "BBB" by any rating agency. The NCUA additionally requires bilateral collateral agreements that provide for the posting of collateral by either party in a net deficit position and that the collateral must be permissible for FCUs to own and must be held by an independent third party. No indication is provided as to the amount of credit risk a credit union may be willing to take with a counterparty before any collateral is require to be posted. The minimum rating means that no corporate credit union can be a counterparty to a derivatives transaction, even though they are probably the best judge of the need and competence of their members. Given the unique position held by corporate credit unions, they should be exempt from any minimum ratings requirement

While these conditions may be a theoretical way of avoiding all counterparty risk, it is highly unlikely that any market-maker would agree to such terms – particularly with credit unions who will inevitably be relatively infrequent users of the market. Clearly there are no corporate credit unions that can currently qualify as acceptable counterparties so that means using "AA-" rated domestic banks – who are now few and far between. A bank counterparty would also take serious exception to giving credit unions the right to cancel transactions based upon credit ratings when the counterparty would not be allowed to cancel transactions with a credit union based upon laws passed by Congress and set forth in the Credit Union Act. They will also take exception to collateral being held by a third-party. It should be remembered that the vast majority of credit unions that want to access the derivatives market will be unrated, small (by banking measurements) and infrequent users. In other words, credit unions would not be a very attractive client for market makers particularly if the requirements set out by the NCUA are mandatory. A credit union would be hard pressed to find any counterparty and then would have to accept any price offered. Rather, if corporates are not allowed to act as an intermediary, it would be better for credit unions to be accepted by the CFTC as "financial entities" and use the clearing house for their trades. That would alleviate all counterparty credit risk and enable a credit union to deal with any counterparty in the market, "shop" to obtain better pricing and allow any counterparty to deal with a credit union.

B: Q 2: If FCUs lacking 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 a safe and sound understanding of derivatives? In your answer explain why this is sufficient minimum time or number of transactions.

Most credit unions do not have the necessary in-house skills to operate in the derivatives market in a safe and sound manner. Indeed, most cannot afford to attract and retain such expertise given their limited transaction needs. So using a Third Party Program is an excellent way of building a level of in-house expertise that could eventually enable them

to operate independently. However, it should be left to each individual credit union and their regulator to determine if they have the expertise to be independent. The NCUA should not rely on some artificial measure of time in a program or number of trades consummated as proof of expertise. Each credit union should be judged individually on the merits of its application.

The section also seeks to set exposure limits on the gross outstanding notional amount to 250 percent of net worth. The "exposure" or risks associated with derivatives is either counterparty credit risk or potential volatility in earnings should transactions fail to maintain correlation. Such artificial limits fail to capture real exposure. Counterparty limits are minimized by netting and bilateral collateral agreements or by using a CFTC clearing house. A credit union can easily be in a position where it has no risk to a counterparty or even negative risk. It may have outstanding an old transaction where it is paying fixed to hedge member loans and then enter into a transaction where it is receiving fixed with identical maturity to convert newly issued fixed rate certificates to floating rate. It could actually be in a negative risk position depending where rates have moved over time. The section is also silent on how caps, floors and collars would impact any volume driven limit.

Income volatility as a result of a transaction failing the correlation test is a more likely event. Maintaining correlation is fundamental in setting up a hedge in the first place and recognizing what potential problems may occur. If the credit union feels it can withstand the impact of a correlation failure, it consummates the transaction. This would highlight the need for a strong accounting system or service and regular (monthly) testing. The earlier a potential problem is recognized, the easier and cheaper it will be to take corrective action.

Section C – Independent Derivatives Authorization (page 15)

C: Q 1: Should the NCUA Board consider allowing credit unions to engage in derivatives activity independently?

There is no reason to not allow credit unions to engage in derivatives activity IF they can demonstrate the ability to do so in a safe and sound manner. The NCUA can, and has, reviewed and granted applications from credit unions seeking independent authority to access the derivatives market. This should continue with the NCUA providing clear guidance as to what an application must contain.

C: Q 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 NCUA should consider each application on its merit. Size is no guarantee of sophistication or available expertise. The risks tolerance is not uniform across the industry – nor should it be. Each credit union should decide what products it offers its members and how much interest rate risk it is prepared to accept. There can be no set limit for either case. However, a credit union requires access to the tools that are available to proactively manage its interest risk profile – which puts derivatives at the top

of that list. The key to any safe and sound operation will be clear internal policies and reporting lines that do not permit any "exotic" (leveraged) transactions.

The fall back safeguard will be monthly correlation tests performed by qualified personnel. Correlation testing is complex and many credit unions have used external sources to perform this task. This has worked very well for those credit unions in the WesCorp Pilot Program. As correlation is required prior to consummating a transaction, the third party can also provide indications to the credit union on the pricing being indicated by the counterparty – a help for the credit union when negotiating the price.

C: Q 3: Are there specific actions that an FCU should expect to take in preparation for applying to engage in derivatives activities independently?

The NCUA must specify exactly what is needed for a credit union to be approved to operate in the derivatives market independently in a safe and sound manner. The NCUA should set standards for how much proven expertise in practical application and operating structure supporting derivatives transactions, is required in-house and what is acceptable to be outsourced. With that template, any credit union can quickly assess whether it can satisfy those requirements in a cost effective manner. If it can, it can submit an application. If it cannot satisfy the minimum requirements (as most will certainly decide), it can apply to join an approved Third Party Program and begin to build internally the expertise to a level at which it feels that it can meet the requirements for independent operations should it so choose.

Section D – Approval standards for Derivatives Activity through an Approved Third Party

D: Q 1: Should NCUA require an FCU to state a balance sheet management plan to hedge IRR based risk objectives as a condition of approval?

For the most part, credit unions serve consumers and small businesses. In low rate environments, borrowers seek term fixed rate loans while investors & savers seek short-term loans. When rates are high the opposite is the norm – borrowers take short-term advanced and savers seek long term fixed rate investments. As a financial institution attempting to service the needs of its members, credit unions must be able to respond positively within the prevailing interest rate environment with pertinent and competitively priced products.

This means their hedging needs will change over time based upon prevailing market conditions and, potentially, the introduction of new products. The result will be that almost every credit union would submit similar plans. The NCUA should include in its analysis of an application, the internal controls that are being used to monitor and report on transactions and permit the credit union the flexibility needed to prudently and proactively manage its risk profile.

D: Q 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 on-going and dynamic basis or should the FCU be required to demonstrate it has the expertise internally as a condition for approval?

Effectiveness must be considered from a business perspective and an accounting perspective. The business perspective is the most important. Transactions must be structured to reduce a targeted risk profile. That risk profile must be clearly identified and measured. The legal documentation must be clear and equitable to both parties such that the transaction will stand the test of time. The transaction must be cost effective. The fact that a transaction is afforded hedge accounting under prevailing accounting rules but is fundamentally a bad transaction, must not be allowed.

The accounting rules that are required to be applied to derivative transactions are both complex and onerous and frequently have been historically subject to additional interpretation – requiring changes to outstanding contracts. For most FCUs using derivatives, the cost of building internal expertise with competent support systems is far too expensive given their probable modest usage. Rather, using specialist external services can prove a much more reliable and cost efficient solution. Under WesCorp's Pilot Program, most active participants used a third party service that proved to be very competent, readily accepted by external auditors and very reasonably priced. I would think that relying on internal expertise would require the NCUA to look very closely at that expertise and its support systems, how well it is able to perform and what back-up would be available.

D: Q 3: Is it useful for an FCU to rely on the expertise of a third party to assess the credit quality of derivatives counterparties?

Given the limited number of market-maker counterparties that will be available to credit unions given the restrictions suggested, coupled with the bilateral collateral agreement requirements, counterparty approval should not be a significant problem. Today, credit unions are taking counterparty credit decisions in their normal course of business – selecting clearing services, depositing funds in transaction accounts, selling Fed Funds, buying certificates, entering into repurchase agreements as well as other activity. The limited credit risk that is applicable to derivative transactions would be part of a normal bank or investment bank credit review and the amount of acceptable credit risk documented as the trigger in a bilateral collateral agreement.

Section E- Approval to Engage Independently (Pages 17-18)

E: Q 1: Should approval of an FCU to engage in derivative activities be in the form of additional authorization similar to expanded authority available under Appendix B to Part 704 – Expanded Authorities Requirements?

If a credit union wishes to be able to access the derivatives market based solely upon their own internal expertise, they should be able to apply to the NCUA for such permission. However, the NCUA should clearly define – in the form of an "expanded authority" document – exactly what is required for approval. Indeed, the NCUA has already set a precedent by defining the minimum standards needed for credit unions to do business lending. This guidance would help the credit union from ascertaining whether it can meet the required hurdles or not. It would also allow the NCUA to readily determine if the credit union has met its required standards and respond quickly to the application. In either case where requirements cannot be easily met, the credit union can join one of the

approved Third Party Programs to allow it to proactively manage its risk profile and, at the same time, build its internal expertise.

E: Q 2: Should an FCU demonstrate enhanced credit functionality in terms of the experience of the FCUs personnel, credit analysis and reporting infrastructure in order to evaluate the creditworthiness of derivative counterparties?

As noted in the response to Section 3 Question D, there would be relatively little counterparty credit risk associated with derivative transactions given the credit rating and bilateral collateral requirements. This should be more than enough to enable the credit union to set an appropriate trigger to instigate collateral requirements. The adoption of clearing house settlements would negate the need for counterparty credit and allow the credit union access to a much broader range of potential counterparties.

E: Q 3: Should an FCU demonstrate enhanced hedging expertise based on the experience of FCU's personnel or on additional derivatives management infrastructure?

YES BUT even large credit unions will be very modest users of derivatives in terms of transaction volumes and notional amounts outstanding. To build a big infrastructure to handle what should be limited to "plain vanilla" U.S. Dollar denominated interest rate swaps is not necessary nor desirable. Credit unions should be encouraged to use these transactions to minimize interest rate risk and better serve their members – not be subject to onerous and expensive rules. Therefore, using a third party provider is preferable.

E: Q 4: Is one year 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?

A credit union should prepare an application that addresses all specified requirements set by the NCUA as soon as it is able to satisfy those requirements. That said, it will need some in-house expertise and that expertise will be difficult and expensive to acquire and even more difficult to retain over a long period of time of inactivity. The NCUA must be prepared to react quickly to all applications – having set the various yard- sticks necessary for approval. It would be better for a credit union to join an approved Third Party Program and get supervised practical experience and then apply when it feels it has the necessary ability to operate independently.

E: Q 5: Are there any additional aspects of the FCU besides items (i)-(v) above (page 17) which NCUA should consider in its approval for the FCU to engage in derivatives activity independently?

Financial Derivatives carry low, to no, credit risk but do require good underlying business and risk management and monitoring processes to be effectively applied and ensure protection from deliberate or unintended abuse. Again, this adds weight to corporate operated Third Party Programs with on-going oversight responsibilities. While not all credit unions should be allowed to access or even need access to this market on an independent basis, there should be no restrictions on credit unions using approved Third

Party Programs except for the financial strength of each individual credit union. As with the WesCorp Pilot Program, participation approval was forthcoming within a week.

It has been noted throughout that credit unions must have access to the derivatives market in order to be able to provide pertinent and competitive products to their members and, at the same time, proactively manage the interest rate risks inherent in such activity at levels that they deem appropriate given prevailing market conditions.

The NCUA should therefore provide a practical environment wherein credit unions can quickly access this market in a safe and sound manner.