Chevron Federal Credit Union

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James E. Mooney
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Ms. Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

**RE: Advance Notice of Proposed Rulemaking:
Financial Derivatives Transactions to Offset Interest Rate Risk**

Dear Ms. Rupp:

Thank you for the opportunity to comment on the proposed rulemaking pertaining to the use of derivatives for purposes of mitigating interest rate risk.

As the first natural person credit union authorized to use derivatives to mitigate interest rate risk, Chevron Federal Credit Union (CFCU) is able to provide comments grounded on many years of experience managing such a program. During that time, we have effectively met the real estate borrowing needs of our members due in no small part to our ability to manage the attendant interest rate risks through derivatives-based hedging. Such hedging has enabled us to significantly enhance our ROA while maintaining robust net economic value (NEV) in interest rate shock scenarios.

We recognize that the use of derivatives may not be appropriate or appealing to all or even most credit unions. However, we are unequivocal in our belief that derivatives are a potentially valuable tool for any financial institution and that their use should be a permissible activity for natural person credit unions.

We would specifically like to address the following issues for comment:

A. Existing Pilot Programs

Based on our lengthy experience in the Pilot Program, we are convinced that derivatives hedging activities should be permitted to continue, whether in the current Pilot Program form or, more preferably, as a permissible activity.

CFCU has demonstrated its ability over the past 12 years to offer products demanded by our membership and – through derivatives-based hedging – effectively manage certain risks associated with those offerings. Our utilization of derivatives has significantly enhanced our ROA by enabling us to retain high-quality assets with long durations – and much higher yields than alternative investments. Despite a substantial portfolio of long-term fixed rate mortgage loans, we have consistently maintained NEV levels of only "moderate" risk, per NCUA examinations. To maintain the same NEV levels in the absence of derivatives, we would currently need to sell more than $400 million in fixed rate mortgages that generate a net yield of 4.19% and invest those proceeds into funds yielding 0.30%.

We have dedicated substantial resources over the last several years to build an efficient loan production operation. The ability to portfolio loans and earn yields superior to those available in the investment market allows us to offer attractive loan rates. This ability has also allowed us to remain an active lender when others could not, as when many financial institutions suspended lending during the 2008 financial crisis.

Derivatives hedging is not the only tool we utilize to mitigate interest rate risk, but it is often our most effective. We have used long-term borrowing as an offsetting liability to real estate loans, but the balance sheet and capital ratio implications make it highly inefficient. We also sell loans to Fannie Mae, but more often find such sales uneconomic, particularly when we are already in a position of surplus liquidity. Looking to the future, we are further concerned by the uncertain outlook for loan sales into a secondary market so long dominated by Fannie Mae and Freddie Mac, each of whose continued existence is in some doubt.

The elimination of derivatives as a tool to manage interest rate risk would require a significant shift in our strategy; would likely require us to increase loan rates to maintain ROA and capital; and would put us at a disadvantage versus competing financial institutions that have these tools at their disposal.

B. Third Party Derivative Authorization

CFCU generally supports the standards established in this section, whether for third parties or for credit unions wishing to act independently. Indeed, this language largely reflects provisions of our current policy. We wish to offer our perspective on three issues:

(1) The proposed standards require credit unions to document the hedge type as cash flow or fair value, and specifically identify the assets or liabilities to be hedged, consistent with FAS133 Hedge Accounting requirements. In our experience, it is very difficult to qualify for FAS133's effectiveness requirements. Specifically, one may need to abandon traditional market indicators and permit an underlying index to drive product pricing.

As addressed under GAAP – and as currently permitted to CFCU – credit unions should be allowed to obtain and classify derivatives as "economic" hedges and demonstrate their impact on specified ALM metrics, recognizing that this approach will introduce volatility via periodic mark-to-market adjustments to the income statement. These mark-to-market adjustments reflect projected future period cash flows that will invariably sum to zero over the life of each derivative as interest rates change and actual income and expense are recognized. Accordingly, CFCU has elected to monitor "core ROA" and "core net capital," i.e., ROA and net capital absent the mark-to-market adjustments, as well as the true economic value of our hedging program. We recommend that NCUA recognize such "core" metrics as well.

(2) We have concerns about the proposed requirement to terminate derivatives transactions in the event that a counterparty is downgraded to BBB or equivalent. As a general principle, we believe it is unwise to compel a potentially uneconomic transaction in response to fluctuations in a guideline or metric. While a credit union should be prohibited from entering into any new agreements with a credit-challenged counterparty, the circumstances must be fully evaluated to determine whether it is in the credit union's best interests to terminate existing transactions at the time of such a downgrade.

(3) The counterparty requirement of a minimum AA- rating severely limits the number of available counterparties with which a credit union may do business, particularly in the aftermath of the 2008 financial meltdown. Moreover, it is our understanding that Dodd-Frank mandates the removal of references to credit ratings from existing rules. Accordingly, we suggest that evaluation of counterparty strength be based instead on some combination of capital ratios, troubled asset measures, earnings or any other objective measures.

C. Independent Derivatives Authorization

We believe NCUA should allow credit unions that meet the proposed NCUA standards (with exceptions noted above) to independently engage in derivative activities. In doing so, credit unions would be ensured equal footing within the financial services industry. Financial institution balance sheets are typically comprised of long duration assets funded by short duration liabilities. Our competitors in the banking industry have access to derivatives to help them manage their risks; restricting access for credit unions would put us at a competitive disadvantage.

Additionally, we believe that a credit union employing a derivatives hedging program – whether managed internally or through a third party – must demonstrate a minimum understanding of the risks associated with such a program as well as an ability to effectively monitor it. Such understanding, and the analytical skills that underlie it, is no less critical for a third party program than for one managed independently. Given this overlap, we do not see a strong basis for limiting participation to third party programs.

D. and E. Approval to Engage in Derivatives

We support the Pilot Program standards for a credit union engaging in third party derivatives with the exceptions noted above. Credit unions requesting approval to engage in any derivatives program should demonstrate their need by quantifying the risk within their balance sheet (through, for example, NEV or NII analysis) and model the improvement that would result from derivative usage.

Although there is likely to be a correlation between a credit union's asset size and its ability to effectively manage a derivatives-based hedging program, we believe that establishing a size threshold would necessarily be arbitrary. If a credit union, whatever its size, can demonstrate the necessary attributes for utilizing derivatives, it should be permitted to do so.

Thank you again for the opportunity to comment on this important matter. Please contact me at (510) 627-5180 if you have any questions or concerns regarding our comments.

Sincerely,