SELF HELP

CREATING OWNERSHIP AND ECONOMIC OPPORTUNITY

August 19, 2011

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

RE: Self-Help Federal Credit Union Comments on Part 703 ANPR, Financial Derivatives to Offset Interest Rate Risk

Via e-mail: regcomments@ncua.gov

Dear Ms. Rupp,

Thank you for providing Self-Help Federal Credit Union with the opportunity to comment on NCUA's Advanced Notice of Proposed Rulemaking on Financial Derivatives Transactions to Offset Interest Rate Risk. We believe that one of the greatest threats facing credit unions over the next decade is the interest rate risk associated with serving members' needs through long-term real estate lending – the most viable lending product that credit unions can produce at sufficient scale to both serve their members' needs and sustain themselves financially.

Self-Help FCU supports expanding the number of FCUs using derivatives to effectively manage their interest rate risk. Such derivatives, unlike credit default swaps, held up during the 2008 financial crisis and have been a standard component of managing interest rate risk in the market for two decades. We support granting independent authority to credit unions that have the knowledge and operational tools to implement a derivatives program. We also support the establishment of multiple third-party derivatives advisors that can help FCUs that are less familiar with derivatives develop their own programs.

Self-Help Federal Credit Union is authorized to use derivatives via the ALM First Pilot Program, though it has yet to enter into any derivatives under the program. Self-Help Credit Union, our affiliated federally-insured state-chartered credit union, and Self-Help Ventures Fund, our affiliated non-depository community development loan fund, have almost ten years of experience using interest rate swaps. Our comments are based on the substantial experience of these institutions in utilizing and managing a portfolio of interest rate swaps to manage interest rate risk.

In sum, the parameters established in the NCUA Derivatives Pilot Program provide sound oversight for a more permanent program of both third-party programs and independent authority. However, we would like to recommend three changes to those parameters that will better manage interest rate risk, counterparty credit risk and operational risk:

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1. Maximum notional amount of derivatives outstanding: The current requirement that the notional amount of swaps outstanding cannot exceed 250 percent of a credit union's net worth is inadequate to manage interest rate risk and creates an artificial limit unrelated to the true interest rate exposure to the credit union. We recommend replacing this limit with a net notional limit on derivatives that does not exceed the FCU's long-term real estate assets outstanding. The average credit union now holds over 50 percent of assets in long-term real estate loans and has 10 percent net worth. The 250 percent of net worth cap only allows FCUs to hedge 25 percent of assets (10% net worth x 250%). 25 percent of assets only covers half the interest rate risk associated with the average credit union's long-term real estate loans.

2. Counterparty risk management: NCUA should be less focused on counterparty risk *assessment*, and more focused on counterparty risk *mitigation*. The current regulation does not provide any maximum thresholds between an FCU and its counterparties as a component of the legal agreement ("ISDA") governing a derivatives relationship. FCUs should be required to establish appropriate counterparty risk limits via the use of tight thresholds in a bilateral collateral agreement to an ISDA and have the demonstrated capacity to implement those limits through daily valuations and margin calls. We recommend a 5 percent of net worth limit for any single counterparty and a 20 percent of net worth aggregate limit for all active counterparties. FCUs may negotiate lower limits with counterparties, but should not be permitted to exceed these limits.

3. Board transaction review: The current NCUA mandate to have the FCU's board review and approve individual transactions prior to their execution is not feasible. A board must understand and approve the purpose for which derivatives are used, and establish policy parameters. Implementation of policies is the purview of management and should be done on a timely basis once IRR exposure has been identified. Waiting for a board meeting to execute a transaction introduces unnecessary speculation and risk into an FCU's IRR. An FCU's board should receive regular reports that allow it to monitor the derivatives portfolio and its effectiveness at mitigating risk.

In addition to those simple changes to NCUA's existing guidelines, we wish to respond to NCUA's specific questions, as follows.

A. Existing Pilot Programs

1. Should existing Pilot Programs for FCUs to engage in derivatives for IRR management be permitted to continue? Explain why or why not.

Yes, the existing Pilot Program offered by ALM First should be continued by incorporating it as a permissible activity, rather than as a pilot program. Similar third-party providers should be identified to provide the same services as ALM First, if possible. The ALM First program provides a good entry point for FCUs that wish to use derivatives for the first time to manage interest rate risk and have limited or no experience using derivatives. The fact that ALM First is not itself a counterparty allows it to provide independent advice to an FCU. As such, it is a good model for additional third party partners.

The ALM First program provides a critical aggregator function for many credit unions that may not have enough derivatives volume to go into the market and negotiate ISDAs with multiple counterparties. Credit unions the size of Self-Help FCU – with $390 million in assets – and smaller struggle to develop relationships with many counterparties, let alone negotiate a reasonable ISDA and obtain competitive pricing without having someone that can bring multiple credit unions to a group of counterparties. Eliminating the aggregator function of a third-party program would effectively limit derivatives authority to only the very largest credit unions. While most very large credit unions have sufficient resources to manage a derivatives portfolio, they are not the only credit unions that would benefit from, and have the ability to manage, a derivatives portfolio.

The existing Pilot Programs developed by WesCorp and Southwest CUSO should not be continued with either of their successors. Existing derivatives, if any, with both of these counterparties should remain on the books until maturity or novated to another counterparty. This allows the credit union that entered into the derivatives to be adequately protected from the risks that those positions were, and are, intended to protect against.

In particular, to the extent that Western Bridge Corporate FCU retained the Pilot Program authority originally issued to WesCorp, we have explicit concerns about that Pilot Program. It is our understanding that the bilateral collateral agreement that WesCorp used had very high minimum transfer amounts and thresholds for posting collateral that effectively left credit unions at risk of substantial mark-to-market credit exposure to WesCorp. Had interest rates been higher when WesCorp failed, such that the credit unions were in a net position with WesCorp that was in their favor, those credit unions would have faced catastrophically high losses on their derivatives positions with WesCorp, as unsecured creditors of an insolvent institution.

2. Should such Pilot Programs for FCUs be permitted to continue by ‘‘grandfathering’’ the previous approvals into Part 703? Explain why or why not.

We support grandfathering the ALM First Pilot Program as a fully permissible activity, with the modifications noted in our introduction related to net notional amount of swaps, counterparty risk and board approval of individual transactions.

However, even if NCUA cancels the WesCorp and Southwest CUSO Pilot Programs, any existing derivatives executed via those Pilot Programs should be grandfathered, as we assume the risk that such a transaction was intended to off-set still exists for the credit union that entered into the transaction.

3. If FCUs seek an end-user exception from mandatory clearing as contemplated by the CFTC's proposed rule, they would need to provide items of information to a registered swap data repository. In view of this requirement, should NCUA permit FCUs to seek an end-user exception? Explain why or why not.

Eligible credit unions – those with less than $10 billion in assets – should have parity with similarly eligible small banks, savings associations and farm credit institutions. We generally support the creation of a standard derivatives clearing organization. Such a clearinghouse should improve pricing and transparency, and as such, credit unions should not seek an exception above-and-beyond the authority granted to other eligible institutions.

If CFTC's proposed rule is finalized with limited or no modification, we see no harm in permitting FCUs to seek an end-user exception, provided such an exception is available to other like-sized institutions. CFTC's proposed rule would still require exempt credit unions to report derivatives positions to a registered swap data repository and provide other certain items of information. As a result, NCUA, CFTC and other regulators would have ready access to the swap data activity of a credit union in order to supervise the credit union's derivatives activity.

B. Third Party Derivative Authorization

1. These third party standards 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? Explain why or why not.

No, Self-Help does not believe that the credit quality standards in the Pilot Program are appropriate. While the general requirement to review the credit quality of a counterparty at inception and on a quarterly basis is prudent, such review is inadequate to mitigate counterparty risk.

<u>Counterparty Risk Management</u>

The most effective way to mitigate counterparty risk to a derivative counterparty is to have low effective thresholds in the bilateral collateral agreement section of an ISDA. The existing Pilot Program parameter stating that "bilateral collateral agreements must require the posting of collateral by either party that is in a net deficit position on any derivative that has been transacted" is vague and allows unduly large thresholds that create real counterparty risk.

The credit risk of a properly-executed, non-speculative derivative is in the change in fair value of the position over time and the exposure that can create for both parties to a transaction. Swaps, like most derivatives, generally start with a value of zero at execution based on the expectation that each party will pay the same amount of interest to each other over time, on a discounted basis. However, as interest rates change, the expected future cash flows change, creating one party as the expected net receiver of cash and other party as the net payer of cash. The net receiver now has an asset, while the net payer has a liability. The asset is essentially an unsecured credit until collateral is provided by the net payer to secure that credit.

Credit Ratings and Other Subjective Analyses are Inadequate to Mitigate Counterparty Risk

Credit ratings and reviews simply do not protect credit unions from derivatives counterparties. WesCorp's failure (see our comments to A.1. above) to require tight bilateral collateral thresholds could have created a substantial loss to the credit unions that had derivatives positions with WesCorp when WesCorp was deemed insolvent, but for the fact that interest rates had moved down in the months leading up to its insolvency. This was a stroke of luck that saved the credit unions that had positions with WesCorp, rather than a result of prudent counterparty risk management and regulation. Similarly, Lehman Brothers had investment grade ratings immediately before its collapse. Critics rightfully question the value of credit ratings and the events that trigger a crisis for a financial institution are generally beyond the ability of analysts to predict accurately or timely.

Relying on credit ratings (or their equivalent) would also substantially reduce the size of the prospective counterparty market. For example, BNP Paribas is the only primary dealer and Wells Fargo is the only top 10 U.S. Bank that currently have at least AA- or equivalent ratings from all three major rating agencies (Standard & Poor's, Moody's and Fitch). Given that the primary dealers and large banks are the most active derivative counterparties, requiring an AA- or better rating from all three major rating agencies effectively creates an oligopoly on price, terms and execution for derivatives for FCUs.

We are particularly concerned about the requirement that a transaction must be terminated "as soon as practicable" based on a counterparty's credit downgrade. While we recognize that a sub-investment grade rating is a serious concern, a bilateral collateral agreement with low thresholds and daily margin calls minimizes the actual risk for a given derivatives position.

Requiring an FCU to terminate a position while retaining the IRR that the position was hedging leaves the FCU unexpectedly exposed to the associated IRR without the necessary hedge. In the event that the FCU is in a net liability position on its derivative position(s) with a down-graded counterparty, the FCU would convert an unrealized loss into a realized loss by terminating the position and still leave itself further exposed to interest rate risk.

We therefore encourage NCUA to follow the mandate in Dodd-Frank to reduce the reliance on credit ratings and similar subjective assessments of the strength of large institutions. Instead, NCUA should mandate that credit unions include provisions in their policies that limit the threshold, or unsecured exposure, to any single counterparty and all derivatives counterparties, combined.

Tight ISDA thresholds are a better tool to limit counterparty risk.

The real risk to a credit union isn't the rating of its counterparty, but rather how large the unsecured exposure can become to that counterparty, and all counterparties. That is why Self-Help Credit Union's derivatives policy prohibits the credit union from having more than 5 percent of net worth at risk with any counterparty and 20 percent of net worth exposure to all of its swap counterparties, combined. "At risk" is defined as the uncollateralized exposure to the counterparty as permitted by the ISDA threshold used. NCUA prudently prohibits a credit union from placing more than 15 percent of net worth at-risk on a loan to any member, and limits the amount of unsecured credit a member can have, regardless of the credit history, income and collateral of the member. NCUA should similarly limit the exposure to a single derivatives counterparty, rather than relying on subjective analyses like credit ratings.

While Self-Help Credit Union's actual ISDAs provide for thresholds that are well below these limits, we believe NCUA could adopt these standards for FCUs. Self-Help Credit Union's experience is that most counterparties are comfortable with a threshold of $250,000-$1,000,000. Using a $250,000 threshold at 5 percent of net worth would allow a credit union with $5 million of net worth to enter into a derivatives relationship. With average net worth of 10 percent, this makes derivatives available to any credit union over $50 million, which would cover most credit unions with substantial long-term real estate portfolios. A 20 percent of net worth aggregate cap allows an FCU to have at least four counterparties, which allows for competitive bidding of potential transactions. At the same time, the probability of all four counterparties failing at the same time and the FCU being at its maximum exposure to all four is extremely low. In this catastrophic and low probability event, the average credit union would remain well-capitalized, dropping from 10 percent net worth to 8 percent net worth. A credit union with 7.5 percent net worth would remain adequately-capitalized, at 6.0 percent, after such an extreme event.

Self-Help Credit Union marks its swaps to market every day and makes margin calls on any counterparty that exceeds the effective threshold. Therefore, the most Self-Help Credit Union can be exposed to a counterparty in the event of its bankruptcy is the threshold plus any single day change in position value that it is unable to collateralize. Though an intra-day change in rates can lead to real dollar exposure, the probability of such exposure exceeding even 1 percent of assets, and therefore doing serious harm to net worth, is highly unlikely.

Self-Help Credit Union has, in fact, often used the thresholds in its board-approved derivatives policy as justification for requiring a counterparty to accept tight thresholds. A tight regulatory mandate would give FCUs an even stronger stick to wield against any counterparty that seeks a high threshold.

An additional step that Self-Help and its counterparties have taken in some ISDAs is to write into the bilateral collateral agreement a reduction in the effective threshold based on the financial condition and/or credit rating of one or both parties. For example, a reduction to a sub-investment grade credit rating could lower the threshold to $0, effectively limiting the credit union's risk to a single day's change in value on the day that the counterparty fails in the event of bankruptcy. Not all counterparties would accept such terms, so we are not in favoring of making such terms mandatory, but they are an option that FCUs should consider.

<u>Maximum notional amount of derivatives outstanding</u>

We do not support the existing maximum limit of 250 percent of net worth for the notional amount of swaps outstanding plus the value of underlying securities in option transactions. We propose that NCUA limit the <u>net</u> notional swaps outstanding to 100 percent of long-term real estate assets.

Swaps positions should be matched to the interest rate risk created by holding long-term real estate loans funded by shorter-term liabilities, primarily member shares, rather than tied to net worth. Interest rate swaps should be structured, generally in a maturity ladder, to hedge both the likely cash flows coming from the long-term loans and the borrowing members' option to prepay. An FCU that has 50 percent of assets invested in long-term real estate loans should generally have hedges in place with a net notional amount equal to 80-100 percent of those loans, with swaps laddered out over a 2-to-10 year period to mimic the likely cash flows generated by the hedged loan portfolio.

The 250 percent-of-net worth limit provides an undue incentive for FCUs to enter into longer duration swaps with lower notional amounts. Longer-term swaps appear to limit net economic value ("NEV") at risk in a shocked interest rate scenario. However, long duration swaps are ineffective at matching potential changes in interest rates in the short-to-mid term and give the FCU less flexibility to dynamically re-balance its balance sheet as its asset mix changes an/or prepayment speeds change.

We use the term "net notional" in our proposed limit because one way to offset the IRR protection of a swap that is no longer needed is to enter into an offsetting swap of like term, amount and structure. For example, if a credit union decides to sell a portion of its long-term real estate portfolio, the credit union may need to cancel the swap it entered into to hedge that portfolio. Rather than recognizing an immediate gain or loss by terminating the swap prematurely, the credit union might enter into an offsetting swap that effectively cancels the hedge. While the total notional amount outstanding has doubled, the two positions effectively cancel each other out. A credit union should not be precluded from making this decision by an artificial limit based on its net worth.

2. If FCUs lacking prior 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.

No, we do not believe that a fixed period of time or number of transactions is appropriate to determine whether an FCU's board and management have developed adequate systems for independent authority. Very few FCUs will seek to use derivatives. As a result, NCUA should evaluate each applicant FCU based on their individual merits. Self-Help FCU, for example, benefits from the nearly ten years of experience of its affiliated organizations. As a result, Self-Help FCU may be ready to use derivatives independently today. On the other hand, ten years ago, Self-Help Credit Union engaged a qualified provider, similar to ALM First, as it first developed its derivatives program, in recognition of the credit union's limited experience.

C. Independent Derivatives Authorization

1. Should the NCUA Board consider allowing credit unions to engage in derivatives activity independently? Explain why or why not.

Yes, credit unions, with appropriate controls and regulatory supervision, must be able to engage in derivatives transaction independently. Limiting credit unions to participating in third party programs puts credit unions at the mercy of a limited number of gatekeepers. NCUA's own experience with third-party programs – where two of the three Pilot Program providers became insolvent and were ultimately liquidated, leaving ALM First as the sole gatekeeper for third party derivatives authority – shows the risk of having a limited supply of providers.

While Self-Help Federal Credit Union has a good relationship with ALM First and is pleased to participate in their Pilot Program, credit unions should not be limited to a single provider. Self-Help Credit Union was granted independent derivatives authority by the N.C. Credit Union Division in 2003 using parameters that were similar to NCUA's derivatives Pilot Program parameters. Under this authority, Self-Help Credit Union has entered into multiple swap transactions over a period of years. Rather than being limited to the counterparties offered by an aggregator like ALM First, Self-Help Credit Union was able to negotiate ISDAs with a variety of counterparties, including primary dealers, major national banks and a large regional bank. Both Self-Help FCU and Self-Help Credit Union have the staff and technical tools – Bloomberg access, in-house ALM/valuation software and a robust database – to manage a derivatives portfolio. Limiting a credit union to a third party creates additional cost – the third party's cost of doing business – and an unnecessary middle man between the two counterparties for those credit unions with the training and infrastructure to manage their own derivatives function.

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.

We do not believe it is appropriate to limit a credit union's ability to use derivatives based on asset size or balance sheet composition. The counterparties will effectively regulate the asset size and capital adequacy of FCUs that they are willing to do business with. Counterparties will want certain minimum net worth – both in dollars and percentage of assets – and total assets in order to justify the work related to entering into a relationship.

NCUA's role as a safety and soundness regulator is to ensure that credit unions mitigate risk. We therefore encourage NCUA to ensure credit unions do not take on undue interest rate risk without appropriate mitigation, regardless of the specific makeup of their balance sheet. Once an FCU and NCUA determine that derivatives are an effective and appropriate tool, NCUA needs to ensure that the FCU do not take on undue accounting, operational and counterparty risk through prudent supervision of the use of derivatives.

3. Are there specific actions an FCU should expect to take in preparation for applying to engage in derivatives activities independently? Specify and explain any actions which are needed.

An FCU should take the following actions, at a minimum, before applying to engage in derivative activities independently:

- Demonstrate the capacity to adequately measure and monitor interest rate risk, by the use of a qualified third-party ALM analysis vendor or third-party software operated by qualified in-house personnel. The rigor of third-party analysis and/or software ensures that a credit union is using a widely-accepted model for measuring and monitoring IRR rather than using in-house developed tools that have not been reviewed and tested by others. If an FCU runs its own ALM model in-house using outside software, NCUA may want to consider requiring the FCU to have its ALM model validated by a qualified third-party from time-to-time – perhaps biennially. A third party validation ensures that the modeling that drives the decision to use derivatives is sound.
- Establish a derivatives policy that describes the objectives and parameters under which derivatives will be used, including established limits for counterparty exposure.
- Develop GAAP compliant accounting procedures for derivatives.
- Install information systems that can accurately value the FCU's derivatives positions daily.
- Provide adequate personnel to make and respond to daily margin calls.

The goal of a derivatives program – policies and procedures – should be to allow the credit union to serve its members through savings and lending, while minimizing interest rate risk to avoid creating undue risk to net income/net worth, and limit counterparty exposure. Defining the objectives of the derivatives program and the accounting procedures to be used in implementation should mitigate any undue risk to net income and net worth. Appropriate information systems and adequately-trained personnel, when coupled with prudent risk parameters on counterparty exposure, can substantially reduce counterparty risk.

D. Approval Standards for Derivatives Activities Through an Approved Third Party

1. Should NCUA require an FCU to state a balance sheet management plan to hedge IRR based on risk management objectives as a condition for approval? Explain why or why not.

Yes, an FCU should clearly state its objectives for managing IRR in its board-approved policies. Objectives should both be programmatic, e.g., to reduce the interest rate risk created by funding long-term fixed rate loans to members with short-term deposits from members, and quantitative. For example, after a +/- 300 basis point instantaneous interest rate shock, Self-Help FCU's ALM policy requires net economic value ("NEV") to still exceed 6 percent and the change in NEV to not exceed 35 percent of base NEV.

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 ongoing and dynamic basis or should the FCU be required to demonstrate it has this expertise internally as a condition for approval? In either case explain why or why not.

It is useful for an FCU to use third-party expertise in determining the effectiveness of the use of derivatives. However, management is ultimately responsible for risk management – interest rate risk, accounting risk, counterparty risk. – and therefore should never rely on a third party to manage these risks on behalf of the members.

Self-Help Credit Union, for example, originally used a qualified third party to model interest rate risk and assess the hedge effectiveness of its derivatives. However, management reviewed both the IRR model and the hedge effectiveness tests no less than quarterly with the third party, had ultimate responsibility for assumptions that drove the IRR model, and was responsible to its outside CPA firm for demonstrating hedge effectiveness. Over time, Self-Help Credit Union brought both the modeling and the hedge effectiveness assessment in-house, as it developed the expertise and systems to manage these risks directly.

Derivatives create too much risk for a credit union for their management to be entirely outsourced to a third party. Instead, third parties should advise credit unions.

3. Is it useful for an FCU to rely on the expertise of a third party to assess the credit quality of derivative counterparties? Explain why or why not.

No; as discussed previously in Sections A and B, the most important way to mitigate counterparty credit risk is through a strong bilateral credit agreement with a low threshold in every ISDA. The agreement should limit counterparty exposure for each individual counterparty and all counterparties combined. These thresholds will limit net worth at risk. If a position changes in value that is positive to the FCU, that change becomes an asset. Such an asset is effectively a long-term unsecured credit to the counterparty until collateral is obtained pursuant to the threshold described in a bilateral collateral agreement. Such positions must be monitored and adjusted daily in order to limit the size of the unsecured credit.

While such a process does not eliminate counterparty risk, we encourage NCUA to focus a derivatives regulation on crafting appropriate counterparty risk exposure limits and mandating that FCUs have the capacity to comply with such limits. At the same time, it is critical for an FCU to regularly assess the credit quality of derivative counterparties, just as it would a large borrower to whom it could be similarly exposed. Third-party analyses of counterparties – credit rating agency reviews, analyst reports and the like – could be a component of such assessments. Ultimately, the FCU could effectively be extending credit to a counterparty, and therefore, must have ultimate responsibility for the decision to enter into business, and manage the relationship, with that counterparty.

E. Approval To Engage Independently

1. Should approval of an FCU to engage in derivatives activities be in the form of additional authorization similar to the expanded authority available under Appendix B to Part 704— Expanded Authorities and Requirements? Explain why or why not.

Yes, approval to engage in derivatives activities could be in form similar to the expanded authority available under Appendix B to Part 704, inasmuch as that authority is based on an informed agreement between credit union and regulator related to board and management, operational systems, risk management/mitigation and compliance/legal. As we note throughout our comments, a credit union that engages in derivatives activity must effectively manage interest rate risk, counterparty risk and accounting risk, which can only be done by qualified, informed board and management using operational systems that are adequate to the task.

However, other than the concerns we have expressed about certain parameters – a cap on the notional amount of swaps outstanding based on net worth rather than long-term IRR; no limits on thresholds for bilateral collateral; and the requirement to have a board approve each individual transaction – we generally believe that the existing derivative pilot program parameters could be used. In fact, Self-Help Credit Union used similar parameters in documenting its program in order to obtain approval from the N.C. Credit Union Division to enter into interest rate swaps in 2003. Self-Help FCU used the Pilot Program's standards to obtain authorization to participate in the ALM First Pilot Program in 2010.

2. Should an FCU demonstrate enhanced credit functionality in terms of the experience of the FCU's personnel, credit analysis and reporting infrastructure in order to evaluate the creditworthiness of derivative counterparties? Explain why or why not and describe any minimum expectation.

As noted previously, an FCU must have the infrastructure to monitor and respond to counterparty exposure. Counterparty exposure occurs through changing market value of derivatives as well as counterparty credit deterioration. An FCU must demonstrate its capacity to value its derivatives positions daily and make (and respond to) margin calls in order to minimize credit risk. However, as noted in our response to question B.1., counterparty monitoring itself would not have protected an FCU from exposure to Lehman Brothers or WesCorp. The former's credit rating were investment grade until the day they went bankrupt.

3. Should an FCU demonstrate enhanced hedging expertise based on the experience of FCU's personnel or on additional derivatives management infrastructure? Explain why or why not, and describe any minimum expectation.

An FCU should demonstrate adequate hedging expertise, just as it must demonstrate adequate underwriting expertise in order to enter into member business lending. Such expertise could be demonstrated via personnel experience at other institutions, formal training and/or working via a third-party program for some time prior to obtaining independent authority.

It is absolutely critical for an FCU to have robust derivatives back-office infrastructure in accounting, reporting and valuation. An FCU has to be able to value all of its positions daily and make margin calls of each counterparty. While third-party technology, such as Bloomberg, should be used to value derivatives, such systems have to be operated by qualified personnel that are equipped to engage with their counterparties on a daily basis.

4. Is one year a 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? Explain why it is sufficient or why more time may be required.

One year should be more than adequate for an FCU to document its ability to independently engage in derivatives to offset IRR. With appropriate in-house expertise, either acquired under the support of a third-party program or through other means, an FCU with qualified personnel and adequate systems that needs to use derivatives to hedge its IRR should be able to manage a derivatives program.

5. Are there any additional aspects of the FCU besides items (i)–(v) above which NCUA should consider in its approval for the FCU to engage in derivatives activity independently? If so, explain why the item should be considered.

Self-Help strongly believes that expanded derivatives authority is critical to the survival of credit unions. An increasing number of credit unions rely on long-term real estate loans to serve their members. Decreased access to the auto lending market leaves credit unions with fewer options to meet their members' credit needs, other than through increased residential mortgage lending. Long-term real estate loans now make up well over half of the loan portfolio of the average credit union.

Such real estate portfolios, which are almost entirely funded with shorter-term deposits, leave credit unions unduly exposed to interest rate risk. That scenario leaves FCUs with two options – sell their real estate loans to reduce IRR or hedge that risk appropriately. The first choice is not feasible. Selling loans leaves FCUs with no place to deploy their members' deposits other than in low-risk, low-yielding bonds, cash and other short duration investments, and a modest portfolio of smaller consumer loans. Such assets generally earn insufficient income to cover expenses, let alone grow net worth. FCUs, like thrifts and commercial banks, have to be able to hedge their interest rate risk appropriately through the use of derivatives in order to stabilize net income and build net worth.

While derivatives present the primary method for mitigating such risk, we recognize that derivatives, when used speculatively and without appropriate controls, actually amplify risk. We therefore strongly believe that FCUs should learn to walk before they run. That means appropriate regulation, similar to the parameters established in NCUA's Pilot Program in terms of in-house expertise, capital adequacy, accounting procedures, and counterparty risk management.

Thank you for your attention to this critical matter. We are pleased to see NCUA proactively working with credit unions to adapt to a changing financial environment where credit unions are increasingly the lender of choice for their members' real estate loan needs. Helping credit unions access the tools to prudently manage the interest rate risk associated with such lending is a crucial step forward for credit unions and NCUA.

Sincerely,

Randy Chambers
Chief Financial Officer