August 23, 2011

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

Subject: Comments on Part 703 ANPR, Financial Derivatives Transactions to Offset Interest Rate Risk

Dear Ms. Rupp:

We appreciate the opportunity to comment on the ANPR for Financial Derivatives Transactions. We believe that credit unions should be provided access to appropriate tools that are necessary to effectively offset interest rate risk and pro-actively manage the balance sheet in a cost efficient and capital friendly manner. Interest rate derivatives, which have been a critical part of risk management practices for most financial institutions for the past 30 years, would help credit unions accomplish this goal.

With concerns over a rising interest rate environment coupled with our strong commitment to continue serving the long-term borrowing needs of our members, we feel strongly that there should be a permissible off-balance sheet mechanism for credit unions to hedge the potential detrimental effect on income and net economic value from interest rate movements. These capabilities also allow for risk mitigation strategies when on-balance sheet hedging options are limited due to capital constraints and other factors.

The uncertainty regarding the future of Fannie Mae and Freddie Mac and the ability to continue selling longer-term mortgages, coupled with the proposed Qualifying Residential Mortgage restrictions and possible requirements for covered bonds, could result in elevated balance sheet levels with a greater mix of long-term mortgages. This will cause more necessity for a derivatives solution in the credit union industry. By utilizing standard derivative products that have been common in the financial industry for over 30 years, a portion of these longer-term, fixed rate assets could be converted to shorter-term, variable rate assets by the judicious and prudent use of derivatives as insurance against adverse interest rate movements and potential deterioration of regulatory capital.

Another responsible use for derivatives would be to mitigate risk with regard to the market value volatility of mortgage servicing rights (MSR) portfolios that require periodic fair value adjustments to earnings and capital. While this risk can be partially hedged by assigning fair value accounting treatment to certain newly originated financial instruments on the balance sheet, it does not achieve a highly-correlated duration with the MSR asset in many interest rate path scenarios. A more effective hedging strategy would allow for the use of interest rate swaps and/or floors.

Community banks in the US and credit unions in Canada have had access to such useful risk mitigation tools for quite some time. They have been able to efficiently execute transactions through various channels in the financial industry.

We believe that appropriate attention should be focused on education, experience and controls regarding the use of derivatives to further ensure this tool is properly utilized to offset interest rate risk in a safe and efficient manner. We feel that credit unions should be allowed to engage independently in derivatives transactions with appropriate counterparties, given sufficient infrastructure, skill level and experience of staff and management. Counterparties should also have a bilateral collateral agreement in place that collateralizes 100% of market exposure.

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Limiting derivative authority to credit unions with a minimum net worth ratio of 7 percent and stable positive earnings for the past 12 months may prohibit credit unions from hedging when they may need it most. Banks and other financial entities are not prohibited from hedging based on earnings, capital levels and balance sheet composition and neither should credit unions. We believe the 7 percent net worth ratio threshold should be reduced to the adequately capitalized level of 6 percent. In addition, the guideline requiring 12 months of stable positive earnings should be removed. Fundamentally speaking, it is not sound to prevent a credit union from hedging its balance sheet just because it may happen to experience one quarter of negative earnings. It is also possible that earnings issues could actually be related to interest rate risk and the responsible use of derivatives would lessen those earnings challenges. Effective risk management tools should not be limited based purely on financial condition as long as both parties to the contract have the ability to fulfill their obligations under the respective contract.

We would also advise caution in requiring that derivative positions be terminated in cases where designated hedges fail the limits of hedge effectiveness. FASB accounting rules define the appropriate treatment that should be followed if hedge effectiveness is lost. The decision about whether the hedges should be terminated should depend on what action would cause the least harm, whether it is re-establishing effectiveness, re-allocating the hedges, or terminating the transaction.

In summary, we feel strongly that credit unions should have the ability to use derivatives for the efficient management of interest rate risk. Furthermore, we also believe it is imperative that the NCUA develop an effective regulatory framework that is not overly burdensome. It should also allow credit union management, with the appropriate expertise, the ability to execute derivatives transactions through a number of financial intermediaries, not just through a particular third party provider. A committed focus on effective and responsible risk management will be critical for credit unions in the future. In this regard, we believe interest rate derivatives should be available to credit unions. Thank-you for the opportunity to comment on this subject matter.

Please feel free to contact myself or my staff with any questions or comments with regard to this response. We would be happy to work together with the NCUA staff to design an effective solution.

Best regards,

Todd A. Gustafson, CPA
Senior Vice President & Chief Financial Officer
Baxter Credit Union