Derivative ANPR Response

A. <u>Existing Pilot Programs</u>

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

Answer: Credit unions should be able to use derivatives to mitigate risk under some form of managed process. Access to any program, third party or independent, should be reserved for credit unions that demonstrate the knowledge, skill, expertise and infrastructure to engage in the safe, efficient use of derivatives. Existing pilot programs (both current and previous) that have operated safely and proven valuable should be allowed to continue and new providers should be permitted to attain Pilot Program status until a longer term solution is put into place. The existing third party model should be the basis for a permanent, managed process (third party or independent) that brings derivatives as an interest rate risk management tool to credit unions.

Question2: Should such Pilot Programs for FCUs be permitted to continue by "grandfathering" the previous approvals into Part 703? Explain why or why not.

Answer: Yes. Credit unions already approved into existing Pilot Programs have spent a great deal of time and effort in meeting the guidelines and operating standards set forth to implement these programs. These credit unions followed the regulations and guidelines set forth, and should not be required to spend additional time recompleting these steps, unless they are seeking independent authority. Their participation in an existing or new third party provider system should be grandfathered.

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

Answer: Credit unions should have the option to seek an end user exception and should be required to submit all of the requisite documentation and comply with the guidelines.

B. <u>Third Party Derivative Authorization</u>

Question 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.

Answer: Adjustments should be made to the existing third party standards:

a) Financial Condition – limiting hedging to credit unions with a net worth ratio of 7 percent and stable positive earnings for 12 months preceding may prohibit credit unions from hedging when they might need it most. Banks and other financial entities are not prohibited from hedging based on earnings, capital levels and balance sheet make-up and neither should credit unions. The 7% net worth ratio should be reduced to 6% (adequately capitalized), and applications should be evaluated and NCUA-approved exceptions should be allowable on a case by case basis for credit unions that fall below this level. In addition, the guideline requiring 12 months of stable positive earnings should be removed, as it makes a risk management decision a function of financial strength. It is not logical that a credit union that may happen to experience 1 quarter of negative earnings be prohibited from using a risk mitigation tool. In fact such limitations actually prohibit safe and sound practices which could and should be employed. Effective risk management tools should not be limited based on financial condition as long as both parties to the contract have the ability to fulfill their obligations under the respective contract.

b) Counterparty Credit Quality - we believe that the credit quality requirement of third party providers should be changed to language that requires EITHER; a public rating of AA- or better, AND/OR a bilateral collateral agreement as well as a maintenance margin designed to eliminate credit exposure. We would suggest the following: (1) FHLB counterparties should be allowed as long as their ratings are AA- or better without a bilateral collateral agreement in place. (2) All bank counterparties (regardless of rating) must have a bilateral collateral agreement in place that 100% collateralizes market exposure when their public rating falls below AA-. (3) Non-rated entities such as Balance Sheet Solutions and/or any Corporate Credit Union or CUSO should be required to post collateral and maintenance margins that protect credit unions from the outset of the trades. Historically, FHLB's have not agreed to the use of bilateral collateral agreements with credit unions and will likely continue to do so. FHLB's are sometimes an important resource for credit unions and while it is likely that many (or all of them) will not offer hedging services in the future, the rules should be designed to easily allow their use. Banks should be required to uniformly post collateral to mitigate exposure and maintenance margins (designed to protect against rapid and/or large short-term adverse changes in the value of the hedge positions) should be mandatory if a bank were to fall below an A+ rating. It is highly unlikely that any existing or future corporate credit union entity or credit union CUSO would be able to obtain a public credit rating from the rating agencies. These participants should be required to post collateral and maintenance margins at all times to eliminate any/all counterparty credit exposure.

c) Hedge Transactions – The existing guidelines surrounding hedge transactions are sufficient and continued enforcement of existing guidelines is all that is necessary.

d) Modeling – Existing third party provider guidelines relating to modeling are sufficient and continued enforcement of existing guidelines is all that is necessary.

e) Internal Controls – Existing third party provider guidelines relating to internal controls are sufficient and continued enforcement of existing guidelines is all that is necessary.

f) Legal Issues – Eexisting third party provider guidelines relating to legality are sufficient and continued enforcement of existing guidelines is all that is necessary.

g) Transaction Termination – The guidelines should be adjusted to read that in the event the hedge fails the limits of effectiveness testing the credit union will seek to restore the effectiveness relationship through the de-designation/re-designation process within a timely basis, not to exceed three months, have the option to choose to continue carry the hedge if the credit union can prove the value of the hedge as a risk management tool on the balance sheet, or terminate the trade when it is practical to do so. A hedge position that fails an effectiveness test may still be a valuable risk mitigation tool on the balance sheet. Mandatory termination may not be in the best interest of risk management. Credit unions should establish a process to review this type of scenario. Also, language specifying mandatory termination based on a ratings downgrade should be removed and replaced with language that states that a termination is not necessary as long as the counterparty complies with the proposed bilateral collateral and maintenance margin agreement guidelines designed to eliminate counterparty risk.

Question 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 safe and sound understanding of derivatives? In your answer, explain why this is sufficient minimum time or number of transactions.

Answer: The ability to attain a safe and sound level of derivative understanding is a function of many factors and should not necessarily be governed by arbitrary time and volume guidelines. Credit unions using a third party Pilot Program to gain expertise should have to demonstrate the ability to comply with all regulations and guidelines completely independent of such a provider prior to seeking independent status. Third party Pilot Programs were designed to provide an expert partner for credit unions in order to provide safe and effective use of derivatives as a risk management tool. Guidelines to judge expertise and understanding should be a function of expertise and understanding, and not numeric targets. Credit unions should be required to operate within a third party Pilot Program until they can fulfill the requirements met by the third party provider in compliance with regulation.

C. <u>Independent Derivatives Authorization</u>

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

Answer: Yes. Credit unions possessing the expertise and knowledge to engage in independent activity should be allowed to do so under the explicit constraint that derivatives be used for risk mitigation purposes. This should be limited to credit unions that have demonstrated the ability and expertise through the use of an existing third party provider over time and/or by demonstrating the knowledge and expertise independent of any outside provider. Not all third party users may qualify for independent activity, but should have the chance to demonstrate the ability to operate independently.

Question2: 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.

Answer: Credit union participation should be a function of strong knowledge, understanding and depth of expertise rather than be based on a numerical attribute of the balance sheet. Factors such as size, balance sheet composition, and risk-exposure should not be the determining basis of those allowed to have independent powers. The cost of added infrastructure, expertise and organizational depth will already place a natural constraint. A credit union seeking independent powers should have to demonstrate not only the expertise required under the third party provider model, but additional skills such as trade execution and contract pricing using current market data to ensure cost effective execution.

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

Answer: Yes. Credit unions seeking independent derivative authority should have to satisfy any and all guidelines established for independent operation. This process should look and function similar to the 3rd party provider program to ensure compliance with equivalent standards as 3rd party provider operation. This includes being able to independently value and risk shock trades on the "in-house" ALM model, demonstrate why/how the hedge benefits the risk position, calculate mark to market values for valuation and recording purposes, calculate payments to be made and received under any executed transaction, and understand and comply with appropriate accounting rules related to any transaction. In addition, credit unions seeking independent authorization should be required to demonstrate the ability to "live price" contemplated trades independently using live market data (using an "in-house" system, Bloomberg, or relationship resource) in order to prevent excessive dealer spreads. In addition, credit unions should have to demonstrate the ability to consistently value executed trades on a daily basis using "in-house" systems (or comparable such as Bloomberg) for collateral purposes. Inability to do so may put a credit union at risk of being over-collateralized. It is not advisable to leave the collateral "call process" to a dealer, as a dealer is quick to ask for additional collateral but slow to return it unless prompted to do so. (Bilateral collateral agreements don't force dealers to send collateral when applicable, they require them to when prompted).

D. <u>Approval Standards for Derivative Activities Through an Approved Third Party.</u>

Question 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.

Answer: No. The existing guidelines for third party providers require credit unions to examine both their current risk situation and the overall effects of any contemplated hedge prior to execution. Requiring credit unions to submit balance sheet management plans as condition of approval adds a redundant, unnecessary step that is already addressed in current 3rd party guidelines.

Question 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.

Answer: An FCU should be allowed to rely on the expertise of an NCUA approved third party provider. Third party programs successfully allow credit unions to lever industry skills and resources in order to gain access to the knowledge and expertise that allows them to safely use derivatives as a hedging tool. The continued safe and managed use of derivatives is a benefit for the industry as a whole in that it helps mitigate interest rate risk and exposure in the system. Only the largest of institutions could potentially add the individual resources necessary to begin the use derivatives outside of a third party system. Providing permanent or initial access in safe and managed format is a good thing.

Question 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.

Answer: In a system where the third party is the counterparty, and uniform bilateral collateral agreements and maintenance margins (which is what we believe the standard should be) are in place in order to eliminate credit exposure, the question becomes irrelevant. If the credit union were to rely on the third party without these agreements in place, then the answer is no, as there may be a conflict of interest. In a system where the third party provider merely brokers the transaction, we would argue that those same uniform bilateral collateral and maintenance margin agreements would have to be in place, or the provider would have to be held to an extremely high standard in its fiduciary role as an agent of the credit union. Providing the credit union with a counterparty that the third party feels is sufficient is not, in our view, meeting the proper standard of protecting the credit union against credit exposure. A level playing field arrived at by requiring uniform bilateral collateral and maintenance margin agreements is the proper way to remove the credit component from the equation. Pledging of collateral is normally based on the credit quality of the counterparty as measured by rating agencies grades rather than a third party which could be counterparty to the deal as a broker.

E. <u>Approval to Engage Independently.</u>

Question 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.

Answer: Yes. Credit unions wishing to engage in derivative activity independently should have the ability to do so and at a minimum, should be held to a similar requisite standard as a third party provider with respect to hedging activities. Since the third party standards were not intended to specifically govern a credit union's hedging needs, these standards would need to be modified to specifically address this issue

Question 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.

Answer: If credit unions and providers adopt a risk mitigation system that fully collateralizes exposure with additional margins to guard against large/fast adverse changes in value until such a time that collateral can be replenished, then there would be no need for enhanced credit functionality. In a system where a swap provider is only willing to post collateral on a sliding scale to an independent (for example AA- rating allows $500K unsecured but a downgrade to A+ requires 100% collateral), enhanced functionalities may be necessary in order to track and quantify potential risk of loss to a single or multitude of counterparties. In addition, in a system in which a swap provider is willing to provide collateral to cover current mark to market exposure, but no additional margins to guard against rapid changes in the mark to market, the same would answer would apply. This applies to both independent and the third party provider systems alike. A fully collateralized exposure with additional maintenance margins is the best way to guard against loss and eliminate the need for any expanded credit functionality.

Question 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.

Answer: Yes. Credit unions wishing to engage in derivative activity independently will need to have additional expertise and infrastructure to support hedging strategies and ongoing reporting. In a third party system, trade execution is largely handled by the third party. In addition, a credit union would have to demonstrate access to a "live" pricing system or resource (internal system, Bloomberg, outside relationship) that would allow it to check that prices are accurate and fair. Additionally a credit union would have to independently be able to calculate the risk attributes and balance sheet effects of any contemplated or executed positions.

Question 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.

Answer: Time should not be the independent variable by which ability should be measured. Credit unions that have participated in a previously existing third party program for a number of years may currently possess the requisite skills and infrastructure to operate independently, while others may not. Arbitrary time guidelines are not the best measure of ability, knowledge, expertise, and infrastructure.

Thank you for time and consideration in this matter.

Sincerely

Nicolette MA

Nicolette Harms

VP/ CFO, America's Christian Credit Union