National Credit Union Administration 8/22/2011

RE: Financial Derivatives Transactions to Offset Interest Rate Risk (ANPR Part 703)

The ability of credit unions to enter into derivative transactions for the purpose of mitigating interest rate risk should be a viable option. The effective use of interest rate swaps, caps and floors are simple and effective methods to mitigate interest rate risk when utilized properly. Without an effective derivative alternative many credit unions are forced to attempt to mitigate risk though term borrowings which has the impact of negatively effecting capital ratios and can give rise to an increase in risk in many cases if structured improperly. The use of an interest rate swap can achieve the same results as term fixed rate borrowing while minimally impacting the credit unions capital ratio as well as reducing interest rate risk and extending liability duration on variable rate share deposits.

While the use of financial derivative instruments may not be appropriate for many credit unions it is useful for those maintaining more complex balance sheets relying of fixed rate products. While I realize that derivatives do not solve all risk management problems for every credit union, they can play a vital role for American First Credit Union and would have significantly reduced interest rate risk at my previous credit union, both of which carry very different balance sheet structures but would have benefitted from an effective derivative program. Many credit unions do not have the expertise to enter into or manage derivatives and in this respect the NUCA's Third Party Derivative Program provides a sound basis for entering into derivative transactions. Relying on the expertise of professional providers while at the same time gaining the necessary knowledge to enhance internal operations and reduce risk. There are several industry resources for both evaluating the benefits of entering into a derivative transaction and reviewing transactions prior to implementation for verification purposes to ensure the transaction is appropriate, a second look if you will.

I support the use of derivatives and feel that they should be considered as part of the larger risk mitigation best practices for most complex credit unions in the normal course of business. Simple derivatives could have substantially reduced the negative impact on earnings and capital for many credit unions during the past several years as the economy deteriorated and interest rates neared record lows. Conversely proper implementation of derivative transactions in the current economic environment will enable credit unions to reduce interest rate risk as the economy moves forward while at the same time allowing us to provide much needed services to the credit union members. Please consider converting the current NCUA Investment Pilot Program into a permanent program. I firmly believe that with appropriate oversight, either internal or externally provided, a simple derivative hedging tool will enhance our ability to more effectively manage interest rate risk and minimize the negative effects on capital associated with term borrowing structures or other balance sheet risk mitigation strategies that may be employed in lieu of a derivative alternative.

A. Existing Pilot Program

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

Response: We believe that 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. Any program that has operated effectively, safely and proven itself to be of value should be allowed to continue. Further, any credit union that demonstrates the need for and ability to manage derivatives internally or through an approved third party provider should be considered for inclusion in the program.

It is our belief that 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.

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

Response: Yes. If a credit union has already invested the time, effort and cost associated with the Pilot Program and been accepted they should be allowed to continue without having to incur the cost a second time. These credit unions have already demonstrated the ability to effectively manage the programs in a responsible manner and met the regulatory requirements.

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.

Response: While this is a difficult question to answer without having been involved in the clearinghouse process or knowledge of the proposed guidelines detailing the issues, we believe that there should be an option to seek and end user exception if possible. While we feel that credit unions should have a derivative option available to reduce interest rate risk that the demand for these derivative transactions in most cases would not be of sufficient quantity or magnitude to warrant the cost associated with meeting the reporting requirements of a registered swap repository.

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.

Response: As a result of changes in the economic environment, years of recessionary trends and the effects on credit union capital, particularly as a result of the deterioration of credit quality we believe that it is in the best interest of the credit union industry to request adjustments to the third party

standards. Over the past two years many credit unions have borne losses related to declines in credit quality. These losses have also been increased as a result of the inability to make use of derivatives to mitigate interest rate risk. As such these credit unions will also be negatively impacted in a rising interest rate environment as their current capital and earnings positions exclude them for consideration in the program at a time when it is most needed.

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 management tool. 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. Our rationale for each is as follows: 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 – we believe the existing guidelines surrounding hedge transactions to be sufficient and continued enforcement of existing guidelines is all that is necessary.

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

e) Internal Controls – we believe 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 – we believe existing third party provider guidelines relating to legality are sufficient and continued enforcement of existing guidelines is all that is necessary.

g) Transaction Termination – we suggest changing the guidelines 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, have the option to choose to continue to 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, and as such we believe the concept of mandatory termination is not in the best interest of risk management. A process should be established 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.

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.

Response: We believe that to obtain a level of understanding to manage a derivative program and engage in transactions is more a function of credit union size and staff expertise. In many cases we believe that there are credit unions that can benefit from a derivatives program that may not be of sufficient size to retain qualified staff capable of fully managing a program. For smaller, less complex credit unions the volume of derivative transactions may be so minimal as to make extensive training or the retention of staff with industry specific knowledge prohibitive. This is the basis for using a third party Pilot Program. 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.

For those credit unions that are seeking independent status and wish to manage programs internally the level of understanding and expertise of derivative hedge transactions, strategies and regulatory requirements should be demonstrated to a far greater degree. However neither time nor transaction counts can adequately determine the level of expertise and understanding required. It would be beneficial to develop some form of certification program for those credit unions wishing to administer hedging programs independently.

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

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

Response: Yes, we believe that credit unions that have staff with sufficient knowledge and expertise in derivative transactions should be allowed to engage in independent activity within the regulatory guidelines established. It should be fully understood that for credit unions derivative transactions are meant solely as a means of mitigating interest rate risk and not to be entered into for speculative investment purposes.

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.

A credit union seeking independent derivative authorization should not only have to demonstrate that the staff has the expertise and knowledge to safely engage in derivative transactions but should also possess the expertise to demonstrate a more in depth awareness of market understanding, trade execution and hedge pricing than those using the third party provider option.

The approval of independent derivative status should not be based upon a given asset or capital constraint but rather the expertise of the staff and the need for an effective hedge strategy. The cost of staffing and infrastructure to a department capable of independently managing a derivative function would provide a natural constraint for those seeking independent derivative authority. For most credit unions the limited transaction volume alone would negate the cost benefit of adding staff with the expertise to execute and monitor derivative transactions independently.

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.

Response: Yes. We believe that any credit union seeking independent derivative authority should have to satisfy any and all guidelines established for independent operation. We believe this process should look and function similar to the 3rd party provider program with some additional qualifications to ensure a higher standard than a 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 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>

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.

Response: No. The existing third party provider guidelines require credit unions to both the current risk position and the potential impact of any contemplated hedge prior to execution. The requirement to submit a balance sheet management plan as a condition of approval just appears to create an additional requirement that appears to be redundant. It should also be noted that once approved the requirement that each subsequent transaction contemplated should undergo the same stringent risk review process prior to execution. Would it also be required that a revised balance sheet management plan be provided for each transaction? The purpose of entering into derivative hedge transaction often does not require/trigger changes that need to be made to the balance sheet. The overriding purpose is to mitigate the interest rate risk in an existing balance structure in a cost effective and safe manner.

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.

Yes. The reasoning is much the same as that applicable to the ability of a credit union to independently manage and engage in derivative transactions. The resources necessary to manage and evaluate derivative transactions on a live or ongoing basis are very costly. The majority of the ALM systems currently used by most mid-asset range credit unions are not capable of evaluating the ongoing effectiveness of a hedge transaction within the scope required. The requirement that an internal staff assess the ongoing risk on a dynamic basis would effectively eliminate the hedge option for many credit unions; lead to safety and soundness issues for those credit unions that experience turnover among key staff.

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.

Response: Yes. In a system where the third party is the counterparty, and uniform bilateral collateral agreements and maintenance margins (which is what 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, then the 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 conducive to 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.

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

> ***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.***

Response: 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. Holding credit unions to lower standards for independently engaging in hedging activities is counterintuitive. If anything the standards to independently engage in derivative transactions should be the same as those required of third party providers but also include a review of the current staffing and expertise levels by position and an adequate succession plan be established to address ongoing operational concerns. One of the primary benefits of utilizing third party providers is the expertise, continuity and depth of knowledge available through the provider. The ability to duplicate the depth of experience and expertise provided by a qualified third party provider internally is cost prohibitive in most cases and should be considered as one of the risk factors in evaluated when deciding to request authorization to operate independently.

> ***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.***

Response: It depends. 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. We believe this applies to both independent and the third party provider systems alike. We feel strongly that 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.

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.

Response: Yes. The purpose of utilizing a third party derivative provider is to leverage the expertise, knowledge and infrastructure required to safely evaluate and execute derivative transactions as well as monitor the effectiveness on an ongoing basis. Credit unions that independently engage in derivative activity should also be required that they can also provide the same level of knowledge and expertise that would be expected of a third party provider. The complexity of live pricing and ongoing valuation requirements would be beyond the resources of most credit unions but in any circumstance these requirements should be no less for credit unions seeking independent authority as it is for those services provided by a third party provider for credit unions opting for the outsource solution. In the end it would seem the purpose of any derivative hedging program should be to reduce risk not only within the given credit union but in the credit union system as a whole. A difference in approval standards between the expectations of a third party provider and internally managed programs would invariably lead to lack of continuity and expectations between programs and invariably increase system wide risk.

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.

Response: The length of time any credit union has engaged in derivative transactions is not an accurate measure of their ability to operate independently. A better measure would be the number or complexity of the transactions executed, however, there is also no guarantee that transaction volume is an effective measure of a credit unions ability to independently engage in derivative transactions.

The approval to operate independently should be based upon the infrastructure of the credit union, management expertise and ability to meet all the regulatory monitoring requirements for hedge transactions. Granting approval based upon a specific length of time does not guarantee the actual ability to effectively engage in and monitor derivative transactions. Conversely those credit unions with sufficient resources to hire qualified personnel , demonstrate the ability to appropriately value, monitor the ongoing effectiveness of derivative transactions and effectively execute transactions may be qualified to act independently in a much shorter time frame.

I have had the privilege to have been involved in the credit union industry for over 23 years as a Certified Public Accountant conducting audits and providing consulting services as well as the Chief Financial Officer at two different credit unions. Both credit unions that I have served at in a CFO capacity could have and would benefit from the ability to engage in derivative transactions for the purpose of reducing interest rate risk. I firmly believe that derivative investments are an effective option for credit unions to mitigate interest rate risk in a cost effective manner. The Pilot Program should be opened to more credit unions based on the demonstrated improvement in interest rate risk that can be provided by an effective hedge transaction rather than asset size or capital limitations. The benefit of an interest rate risk derivative is based more upon the complexity of the balance sheet and impact on the credit unions risk position than size alone. I feel that it will be a significant minority of credit unions that could or should qualify for independent derivative status due to the internal cost of effectively and safely

managing a derivative investment program. For those credit unions that can operate independently the regulatory requirements should be no less than those expected of a third party provider if for no other reason than to guarantee a uniformity in program expectations among all credit unions engaging in derivative transactions.

Thank you for your time and attention to this matter. If I can provide any additional information or you would like clarification on any responses provided please do not hesitate to contact me.

Regards,

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