CommunityAmerica®
CREDIT UNION

August 23, 2011

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

Dear Ms. Rupp:

Thank you for the opportunity to respond to the Advanced Notice of Part 703 – Financial Derivatives Transactions To Offset Interest Rate Risk; Investment and Deposit Activities.

Issues for Comment

A. ***Whether to discontinue allowing Pilot Programs for FCUs and third parties to engage in derivatives activities to offset IRR and, if so, whether to terminate such 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.*

   We are indifferent as to the terminology around permissible derivatives activity. Credit unions should have at minimum one to two individuals on staff that have some direct or like experience and understanding of derivatives prior to execution of transactions. The degree to which a credit union wishes to employ outside expertise should be a decision left to senior management and the board of directors. NCUA should be responsible for creating rules and regulations that result in prudent policy and procedures at regulated institutions.

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

   The pilot program suggests that NCUA endorses specific vendors and implies oversight of pilot program providers. NCUA should provide some analysis as to the success or failure of such activities to date. Additionally, if NCUA is truly providing oversight, distribution of on-going derivatives activity statistics should be included in regularly scheduled correspondence. Statistics to consider: types of hedges implemented, such as liability hedges which fix money market yields for a specified term; dollar amount of

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hedges; instruments used; counter-parties; outside providers engaged by credit unions, such as ALM First and HedgeTrackers.

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.*

   With regard to over-the-counter (OTC) derivatives transactions, exchanges will facilitate price discovery and lead to greater transparency. The facilitation of converting OTC trades into exchange-traded instruments is currently functioning in the crude oil and grain markets. Additionally, from a credit risk perspective, credit unions should feel more comfortable facing a regulated exchange as opposed to a rated counter-party that is subject to downgrades. Price discovery would ultimately lead to a lower transaction cost and more originators entering the marketplace. Ratings of counter-parties would become less relevant.

   The actions of those resisting the change imply that implementation of Dodd-Frank is the right thing to do. Bloomberg Magazine reported in its August 2011 edition that, "Wall Street has emerged as Gensler's (head of the CFTC pushing for implementation of Dodd-Frank provisions) biggest nemesis. JP Morgan Chase & Co., Bank of America Corp., Citigroup Inc., Goldman and Morgan Stanley controlled 96 percent of the $298 trillion derivatives contracts held by U.S. banks in the fourth quarter, the Office of the Comptroller of the Currency says. The $298 trillion notional amount represents the estimated value of the assets that underlie the derivatives. Goldman and the others make more than $30 billion in annual profit in financial derivatives trading, according to financial consultant Oliver Wyman, a unit of Marsh & McLennan Cos., the world's second-biggest insurance broker."

   One must also question how many credit unions have relationships with the derivative dealers listed above. While most regional dealers offer swaps, many do not meet current ratings criteria. As constructed today, most advisors act as a pass-through to Wall Street, adding a layer of transaction cost.

B. Whether to allow FCUs to engage in such derivatives activities through a third party on a case-by-case basis (i.e., by waiver) provided the FCUs meet prudential standards applicable to the third party and the FCU;

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.*

   Although approved for the pilot program, our credit union has not engaged in derivatives transactions and thus would defer judgment to those with greater experience whose opinion we trust such as ALM First.

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*

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

Experience does not guarantee success; conversely, lack of experience does not suggest failure is imminent. Speaking from my experience as a market-maker in the Kansas City Wheat option pit from 1999 to 2005, while trading my own account I experienced only one trading day in which Kansas City Wheat traded at a limit and it traded off the limit within 15 minutes. The entire price range traded for Kansas City Wheat during my tenure in the pit was $2.47. Since leaving the floor roughly six years ago, the front month of Kansas City Wheat has traded a range of $10.76 and has experienced countless limit moves. While I have 6 years of on-the-floor in-the-pit experience, it was not the same experience as someone in the same position over the past six years.

The mortgage hedge is a good example of experience that is not technically associated with derivatives but requires a similar thought process and should therefore qualify. For a credit union that originates, inventories, sells, and services, multiple risks are apparent. With the origination hedge, credit unions can use mandatory commitments but are subject to fallout or roll-downs in periods of rapidly falling rates, thus decreasing the profitability of secondary marketing activity. Short TBAs offer similar protection but suffer from similar hedge ratio concerns. Regarding the inventory hedge, for credit unions that choose to hold mortgages the FHLB advance is a popular hedging tool. However, when implemented during higher rate environments it subjects the credit union to the risk that sharp drops in interest rates could lead to heavy portfolio refinancing activity. Given the high cost of prepaying FHLB advances many credit unions simply roll the mortgage portfolio yield down while maintaining a high funding cost thus narrowing the margin. When the difficulty of hedging with advances is realized, hedge ratios are adjusted down, potentially leaving institutions under-hedged in the event of a sharp bounce in rates. Mortgage servicing rights, are positively convex but also subject to large swings in value. Lower of cost or market accounting treatment expose credit unions to year-end mark-to-market income hits.

With uncertainty about the future of Freddie Mac and Fannie Mae thrown into the mix, the mortgage play becomes more complicated. Diminished government involvement in secondary markets implies an increase in the one risk that is unhedgable - basis risk. If mortgage spreads widen dramatically due to unforeseen future events most hedges and existing NEV results would be adversely affected. While many credit unions have some degree of experience with the mortgage process, which as illustrated above is loaded with challenges, the unpredictable nature of current events suggests that an added element of risk exists in the market today. However, despite the risks illustrated above, it would imprudent for NCUA to restrict credit unions from what is integral to our business model, the consumer lending (mortgage) process.

Bottom Line: experience is great until you encounter a new situation. And in this age of "Black Swans," new situations are popping up with alarming frequency.

C. Whether to allow FCUs to independently engage in such derivatives activities by waiver provided they meet prudential standards

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

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Assuming NCUA has proper rules and regulations in place and the staff expertise to effectively examine credit unions engaging in derivative activity, it should prove no greater risk to the insurance fund than using a third party provider.

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.*

As noted in A(3), most credit unions do not have direct access to Wall Street dealers. Additionally, the customer credit standards at most dealers, Wall Street and regional alike, and FCMs are greater today than in years past. NCUA should perform an analysis to determine which credit unions could actually open an account with Wall Street, regional dealers, or registered FCMs. Credit unions not meeting the criteria will be filtered to third party providers by default. NCUA can wait for market knowledge of the process to develop, which could take years, or help facilitate the process.

For exchange traded futures and options markets to be successful, they must facilitate transactions for risk managers of all sizes. Market makers on exchanges are mostly indifferent as to the size of a transaction. Therefore, we feel size is less of a concern than access.

For large credit unions, the relationship between interest rate risk and capital is performed through the use of an economic capital model. Extensive use of derivatives should be supported by such analysis on a reasonably frequent basis.

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.*

At minimum, the requirements should be consistent with the standards outlined by third party providers. Primary considerations include: staff experience, board education, accounting procedures, and risk modeling.

(D) What approval standards should be established to govern the evaluation of an FCU's request for approval to engage in derivatives through a 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.*

At a minimum, expectations should be set around affecting income and safety and soundness metrics.

Income:

- Effect on margin in base and shocked cases, such as dynamic curve shifts (flattening, twists etc.)
- Potential impact on operating expenses

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Safety and Soundness:

- Impact on Economic Capital (if available)
  - Impact on credit risk – in the case of counter-parties
  - Impact on interest rate risk in various shocked scenarios
  - Impact on liquidity risk – potential for margin call (exchange traded) or collateral pledged
  - Operational risk assessment – risk of insufficient oversight – internal audit and compliance roles

2. *Is it useful for a 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.*

   I would be less worried about expertise and more focused on a clear understanding of the risk the credit union wishes to hedge. If the board and management can precisely communicate, either through writing or orally, the goals of the plan to a third party provider, and have a clear understanding of the resulting risk as stated in D(1), a trusted long-term relationship with a third party provider should meet with regulatory scrutiny.

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.*

   Hopefully this becomes irrelevant under Dodd-Frank. In the event an exchange is not involved, credit unions should be able to monitor credit risk internally.

E. What approval standards should be established to govern the evaluation of an FCUs request to engage in derivatives 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.*

   Approval under expanded authorities may be of benefit to the credit union and NCUA. It sends a message to the Board of Directors that the credit union is engaging in an activity that is not common among credit unions. It provides NCUA with information needed to facilitate an orderly and effective examination process.

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.*

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Not in the case of exchange traded derivatives. OTC derivatives require an ISDA agreement that governs the transaction. Bilateral agreements mitigate counter-party exposure. However, great care should be taken during the negotiation of the initial ISDA agreement.

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.*

   Hedging is a risk management process. Unfortunately, in cases of misuse it actually leads to increased risk. Credit unions should clearly understand the risk being hedged, and have staffing, tools, and processes in place to ensure that hedges are functioning properly, risk is being mitigated, and resulting impacts are properly reported to management and the Board.

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*

   For exchanged traded solutions the approval time should be shortened.

   Working with a third party doesn't necessarily decrease the monetary risk of an individual trade. As I noted in B(2) not all time-based experience is equal. Time restrictions should only apply to the infrastructure needed to safely facilitate the process.

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.*

We hope you find these suggestions useful and welcome any future dialogue.

Sincerely,

Tim Saracini

Tim Saracini
VP-Finance and Treasury

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