From:	Smith, Steve
To:	_Regulatory Comments
Cc:	Senior Support Team
Subject:	Comments on Part 703 ANPR, Financial Derivatives Transactions to Offset Interest Rate Risk - Sharonview Federal Credit Union - Steve Smith
Date:	Monday, August 22, 2011 3:24:17 PM

Thank you for the opportunity to comment on the Financial Derivatives Transactions to Offset Interest Rate Risk; Investment and Deposit Activities Advance Notice of Proposed Rulemaking. Sharonview Federal Credit Union is a $965 million credit union serving about 62,000 members, primarily in the Carolinas and New Jersey. We have $20 million in interest rate swaps working through ALM First as our third party to participate in the existing pilot program. We entered into these swaps in 2008 and they will mature in 2014. As a heavy mortgage lender, we rely on various tools to help manage interest rate risk (IRR). The primary tool in the past has been utilizing long-term borrowings with the Federal Home Loan Bank. This has served us well over the years, but we realized several years ago that we needed more tools to manage IRR. After extensive board education and staff training, we executed our first derivative transactions in 2008 to "test the waters", so to speak. We have been pleased with the results and wish to execute more derivative transactions in the future to help manage the IRR associated with our growing fixed rate mortgage portfolio. Derivatives become a valuable tool when long-term borrowings are not needed due to excess liquidity and/or asset growth concerns. We believe derivatives, in the form of interest rate swaps and caps, are a key ingredient for us in increasing member value and helping drive future growth of our credit union.

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

The important point is that credit unions should continue to be allowed to do derivative transactions, either through a pilot program or written within NCUA rules as permissible investments. Banks routinely use derivatives to mitigate IRR. Credit unions that originate and hold first mortgage loans will be at a significant competitive disadvantage if not allowed to use derivatives to help manage IRR.

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

Yes, we have spent considerable time and effort in obtaining approval to participate in and complying with the various requirements of the existing pilot program. We have demonstrated we have the expertise needed to do additional derivative transactions.

- *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.*

It appears to us, based on our limited understanding of the clearing requirements resulting from

the CFTC's proposed rule, that FCUs should be permitted to seek an end-user exception.

- *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.*

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.

Board of Directors

We believe that the board of directors must understand the fundamental risks and benefits of hedging; however, it is difficult for the board of directors to determine hedge objectives and parameters and designate what correlation measures will be utilized. It is also difficult for the board to approve correlation targets and tolerance limits *prior* to execution of each individual transaction. We would suggest that this be delegated to a special committee or to a team of senior staff members.

Accounting Standards

Eliminate the requirement to have external auditors review its accounting policies and procedures prior to the first transaction and opine that the policies are suitable for these transactions. If it must be done at all, third party providers can opine on these documents prior to the first transaction.

Counter-party 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 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.

Legal issues

We believe that FCU's should not be required to obtain an opinion from legal counsel that the proposed transactions are legal. This is simply an unneeded expense.

We believe that a third party custodial should be suggested, but not a requirement. The reasons are cited below:

- When the credit union's trade is "in-the-money", the dealer delivers collateral to the credit union's choice custodian as long as the custodian's credit standards comply with the ISDA documents; therefore, the collateral is held tri-party.
- When the credit union's trade is "out-of-the-money", the credit union delivers collateral to the dealer under a bilateral Credit Support Annex (CSA). Collateral is held in the credit union's name in an omnibus account with a sub account for each counterparty. The market value loss of the trade should equal the collateral minus the threshold variance and daily market movement.
- Throughout the industry's experience with billions of dollars of derivative trades, mainly being executed by the corporate credit unions, bilateral agreements have always been the practice and is the market norm.
- The AA rating requirement for counterparties is higher than most custodians.
- The delivery of collateral to a third party custodian will generate operating expenses and other punitive costs by the dealer that will be passed onto the credit union.
- There are currently only four dealers that meet the strict NCUA requirements as an approved counterparty and are willing to supplement the ISDA agreements with bilateral agreements. As a side note, the current restrictions are so conservative that we cannot use the Federal Home Loan Banks as counterparties for they only offer unilateral agreements and will therefore not post collateral bilaterally, much less on a tri-party arrangement.
- These four large banks will be disinclined to deal with smaller credit unions if tri-party agreements are required. This might prevent credit unions from entering into the program or have lines open to only one dealer. Only one line will prevent a request for multiple offerings for optimal price execution.

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.

- *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.*

We believe 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.

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

We believe 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.

- *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.*

The critical attendant criterion is the experience of staff. We don't believe that asset size should be a factor as long as all requirements are met. We also don't believe that the credit union should be in a high risk position in order to receive powers. Sophisticated credit unions acknowledge that risk might be within guidelines currently but might not stay within acceptable limits should rates

rise rapidly. In addition, risk tolerance is vastly different between different credit unions. For this reason, we do not believe that criteria should be set upon a current "high risk" valuation of the ALM reports, but that NCUA should evaluate on a case by case basis if the credit union can use these tools in a safe and sound manner to manage interest rate risk.

We would suggest the following as criteria:

- Derivative experience within the staff of the credit union which would comprise the execution of trades within a financial institution, the knowledge of back office work, and derivative analytics.
- Comfort with the staff that derivatives will not be used to speculate on the markets.
- Capital adequacy of at least 6%.
- Guidelines that experience can be achieved with the hiring of experienced personnel or by obtaining guidance through third party consultants.

- *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.*

The credit union should attempt to meet all standards as outlined by the third party provider. Most importantly are staff experience, board education, and analytical modeling. We also believe that the credit union should be required to execute through the Exchange or be capable of opening several lines to the dealers (in the case of derivatives not offered through the Exchange). The credit union should be able to price derivatives to ascertain dealer mark ups.

- *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.*

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.

- *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.*

It is 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 as long as the third party is not the counterparty of the trade. Having said that, the credit union must have the knowledge in house to adequately review its ALM reports and assess the need to hedge. In other words, the credit union must have the expertise in house to ensure that hedging activity is truly within its strategic plan. If the credit union has a sufficient amount of expertise internally, it should be allowed to deal directly with counterparties unless oversight is needed or if it believes it will be unsuccessful in obtaining lines on its own.

- *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.*

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.

- *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 and no. The appendix is based upon various levels of additional powers and subsequent levels of risk that can be taken (as measured by the NEV). Hedging powers is one activity and should either be approved or not. Additionally, having hedging authority should not allow the credit union to take additional interest rate risk, for it is with the use of these powers that the credit union is attempting to contain risk. However, we believe that the NCUA should outline guidance for an FCU to apply, similar to the form of the "Guidelines for Submission of Requests for Expanded Authority".

- *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.*

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.

- *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.*

Yes. Credit unions wishing to engage in derivative activity independently will need to have additional expertise and infrastructure not required in a third party system. In a third party system, trade execution is largely handled by the third party. Direct trade execution at the credit union level may require more technical expertise than currently exists in a third party setup. 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 the accuracy or fairness of indicated prices. 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.

- *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.*

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 currently possess the requisite skills and infrastructure to operate independently, while others may not. This is not a function of time. It is instead a function of the skill level and experience of staff, management and senior management as well as the capability of existing infrastructure. Arbitrary time guidelines are not the best measure of ability, knowledge, expertise, and infrastructure.

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