National Association
of Federal Credit Unions
3138 10th Street North
Arlington, VA 22201-2149
NAFCU | Your Direct Connection to Education, Advocacy & Advancement

August 23, 2011

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

RE: Advance Notice of Proposed Rulemaking - Derivatives

Dear Ms. Rupp:

On behalf of the National Association of Federal Credit Unions (NAFCU), the *only* trade association that exclusively represents federal credit unions, I am writing to you regarding the National Credit Union Administration's (NCUA) Advance Notice of Proposed Rulemaking (ANPR) regarding derivatives.

NAFCU is strongly supportive of easing regulatory limitations on credit unions' investment powers, including the current prohibition against engaging in derivatives activities. At the onset, it is important to dispel the notion that expanding investment powers for credit unions would, in and of itself, lead to losses to individual credit unions as well as the National Credit Union Share Insurance Fund (NCUSIF). While there are increased risks associated with expanded investment powers, if risk management tools are appropriately conceived and implemented, the benefits of particular powers can greatly outweigh the risks.

Further, as we indicated in our May 23, 2011 comment letter to the NCUA regarding the agency's proposed rule on interest rate risk (IRR), we recognize the challenges that interest rate risk pose both to individual credit unions and NCUSIF; as such, credit unions should have effective IRR policies in place. However, while IRR policies should play an important role in stemming losses associated with changing interest rate environments, we believe credit unions should also have particular tools and products that they can use to address IRR. Derivative transactions, used for protecting the credit union against IRR, offer an opportunity for credit unions to address IRR without having to shrink their loan portfolios or curtail products that their members demand. Accordingly, we strongly urge the NCUA to move forward with the next stage of the rulemaking and issue a proposed rule on derivatives as soon as possible.

Existing Pilot Programs

NCUA requests comments on whether existing pilot programs should continue and whether such programs should be permitted to continue by grandfathering previous approvals.

NAFCU strongly believes that the pilot programs should continue for the foreseeable future, allowing interested credit unions to participate in the programs while also permitting existing programs to be grandfathered. As NCUA is aware, credit unions' overall experience and expertise in derivatives activities is limited. While NAFCU believes that the pilot programs may prove to be unnecessary after credit unions' participation in the derivatives market becomes more common, the pilot programs should be maintained to offer interested credit unions the opportunity to gain experience, test the markets and determine whether to utilize derivatives to hedge against IRR. Participating in the pilot programs, however, should be an option for credit unions, not a mandatory step for engaging in derivatives either independently or through a third party.

Third Party Derivative Authorization

The ANPR contemplates that FCUs lacking prior experience with derivatives be required to spend a period of time within a third party pilot program.

NAFCU does not believe the agency should make participation in a third party pilot program a requirement for credit unions interested in engaging in derivatives activities. Rather than being a requirement, the choice of taking part of a pilot program should be available as a means of gaining experience in derivatives. While we understand that a credit union should garner as much knowledge and experience as possible, measuring the adequacy of the knowledge, capacity and experience should be conducted on a case-by-case basis. For example, an interested credit union may hire individuals with appropriate experience with derivatives. In such cases, the credit union may be just as ready to enter the market as a credit union that has participated in a pilot program.

Next, we are concerned about the agency's approach that a credit union seeking to engage in derivatives activities through a third party must have positive earnings for the preceding 12 (twelve) months. A credit union should not be precluded from being able to conduct derivatives transactions when it most needs to. While we understand that NCUA is attempting to create a baseline for "safe" participation, we believe this requirement should be more flexible. We recognize that a credit union may not have positive earnings in a particular year for myriad reasons. For example, a one-time event (ex: a loan charge-off; a sale of assets) could be attributed as the reason for negative earnings. On the other hand, the problem could be more systemic where, for example, a credit union has a low net interest margin, high expenses, and high loan charge-off. In cases where the negative earnings are due to a one-time event, a credit union should not be automatically precluded from engaging in derivatives. Where there is an apparent systemic problem, basic operating issues may first need to be resolved.

Further, we note that banks are not subject to a positive earnings requirement; thus, a credit union that has demonstrated its ability to responsibly engage in derivatives, has demonstrated its ability to withstand loss through stress testing and other appropriate measurements, and has adequate capital cushion, should not be subject to an earnings requirement.

We are also concerned about rigid counterparty credit quality requirements. Specifically, we do not believe that a transaction must be terminated if a counterparty's credit rating is downgraded to "BBB" or the equivalent. While we believe counterparty credit quality should be closely evaluated prior to entering and throughout the life of a derivatives transaction as part of a credit union's risk management tool, the agency, through a rigid regulatory scheme, should not force a credit union to engage, essentially, in a fire sale should a counterparty's credit quality deteriorates. Rather, the agency should allow a credit union to assess its risk and loss position and determine, independently, the best course of action.

Independent Derivatives Authorization

The NCUA also seeks comments on whether credit unions should be allowed to engage in derivatives activities independently.

We believe that qualified credit unions should be able to independently engage in derivatives activities. NAFCU does not advocate a size or asset threshold, as establishing such thresholds is both unnecessary and unfair.

Next, as we discussed above regarding a requirement for positive earnings for credit unions that seek to engage in derivatives through third parties, we are concerned that credit unions that engage in derivatives activities independently would unnecessarily be precluded from doing so when they most need it if a positive earnings requirement is imposed. Such credit unions could see volatility in their earnings as a result of applicable accounting rules. A credit union that has demonstrated its ability to responsibly engage in derivatives independently, has demonstrated its ability to withstand loss through stress testing, and has adequate capital cushion, should not be subject to an earnings requirement. Imposing such requirement can effectively shut down a credit union's derivatives program.

FCU Board Oversight of Program

The ANPR contemplates a significant oversight role of derivatives programs for credit union boards of directors. NAFCU believes that a FCU board should review and approve a derivatives program, including policy parameters, and be provided a report at least quarterly. However, we also believe that credit union management should be permitted to carryout the Board's policies in terms of executing individual transactions.

Approval to Engage in Derivatives

In the ANPR, the NCUA outlines a process for seeking approval to engage in derivatives, as well as particular items that a credit union should address in an application for approval to engage in derivatives.

Generally, both the outlined process and the specific items that a credit union should address in an application appear to be reasonable. We would, however, like to address one particular component - the agency's apparent intent to require a credit union's board of directors to specify limits on maximum exposure in terms of *both* notional principal amounts and mark-to-market values of individual and aggregate swaps. NAFCU believes that a prudent derivatives program limits the notional amount of individual and aggregate transactions as such limits would reduce the risk exposure to market value swings and volatility. However, NAFCU believes mark-to-market values are the more important and relevant measures of swaps' value. Thus, the agency should place more focus on swaps' fair value rather than their notional value in both its regulations and examinations of derivatives.

NAFCU appreciates the opportunity to provide comments on NCUA's ANPR on derivatives. Should you have any questions or would like to discuss these issues further, please contact me at (703) 842-2268 or by e-mail at tteferri@nafcu.org.

Sincerely,

Tessema Tefferi
Regulatory Affairs Counsel