ESL

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August 23, 2011

National Credit Union Administration
Attn: Mary Rupp, Secretary of the Board
1775 Duke Street
Alexandria, VA 22317-3428

Dear Ms. Rupp:

ESL Federal Credit Union, located in Rochester, NY and serving over 300,000 members, appreciates this opportunity to comment on the National Credit Union Administration Board's Advance Notice of Proposed Rulemaking on Financial Derivatives Transactions to Offset Interest Rate Risk (the "ANPR").

In 2000, ESL was approved to participate in the NCUA's Part 703 pilot program for investing in derivatives as hedges to mitigate interest rate risk ("IRR"). The approval allows us to invest in interest rate swaps, caps and floors. The maturity for each derivative could not exceed 5 years. The approval also capped the total notional amount for all derivative investments. In 2008, ESL requested an increase in the cap on the notional value of derivatives in the original approval. This request was never approved or declined in writing.

The approval limited our counterparties to the members of the Federal Home Loan Bank Board ("FHLB"). The NCUA Regional Director was authorized to evaluate and approve other counterparties on a case-by-case basis upon a request from ESL. The standard for the approval required that (1) the counterparty be AAA rated and (2) ESL provide NCUA satisfactory proof of our evaluation of the counterparty's creditworthiness.

ESL has effectively used its authority to ameliorate the IRR resulting from longer term mortgage and investment holdings. We generally use interest rate swap derivatives to meet our needs, though we have successfully used swaps, caps and floors. We have recently approached our permitted maximum notional value. As will be discussed below, there are currently no counterparties available to ESL to obtain new derivatives. Because of this, we are not sure when we will again be able to use our current powers under the pilot program.

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Advantages of the Pilot Program

We have found that our use of derivatives as a hedge against IRR has been powerful and financially advantageous to ESL. Other tools we could have used to mitigate IRR (such as selling assets, purchasing lower duration assets or obtaining long-term borrowings) would have significantly altered the size of our balance sheet. Due to the off-balance sheet nature of the derivatives transactions, IRR mitigation programs can be used without significantly effecting balance sheet size and capital ratios.

The collateral requirements for derivative instruments are substantially lower than like-term wholesale borrowings. The flexibility to alter our IRR without deploying capital allows ESL to reserve balance sheet capacity for member-focused and earnings-focused activities.

Finally, we found that using derivative instruments had relative cost benefits. When compared to FHLB term borrowings, our other liability-based hedging alternative, the derivatives option allowed annual cost savings of about 35 bps. The cost advantages of derivatives over term borrowings rose to as much as 110 bps immediately following the recent financial crisis.

Weaknesses of the Pilot Program

Having participated in the pilot program for over 11 years, we have experienced some drawbacks that limited the program's usefulness.

1. *Limitation on counterparties*: ESL has been hamstrung by the limitation to use only FHLBs or other "approved" AAA counterparties. We encountered problems finding AAA counterparties willing to be a counterparty to ESL. Despite an approval process that appeared broad enough to all involved, ESL was in reality severely limited by the entities we could use as counterparties. This unexpectedly limited the market and raised our derivatives transaction costs. Based on our experience, we estimate that a cost of 6-8 bps per transaction that could be eliminated with a truly effective competitive selection of counterparties in a well operating derivatives market.

The limitation on counterparties has more recently had another unfortunate impact. The FHLB of New York recently informed us that it is no longer willing to act as an intermediary for end-user transactions. It took this action because of the regulatory uncertainty surrounding the derivatives market following the passage of Dodd-Frank. So, in today's market where there are no known or willing AAA-rated counterparties, the only other entity we are approved to transact with in the pilot program refuses to provide us the approved services. Clearly, any final regulation on derivatives cannot so limit a financially sound credit union's ability to find and use counterparties so that it is shut out of the market.

2. *Maximum term for the derivative contract*: The pilot program limited the derivatives we were permitted to acquire to ones with a term of five years or less. In our experience in the derivatives market, we found that at times it would have been advantageous to us from an IRR hedging perspective and from a financial perspective to be able to obtain derivatives with a ten-year maturity. Longer term contracts effectively meet duration hedging targets with lower notional amounts. Limiting the term of the hedge authority reduces the effectiveness of the hedge and ultimately increases the cost to the credit union.

Additionally, there are other derivatives instruments available that would be appropriate for credit unions. Several of them have terms longer than the permitted five-year timeframe. For example, some derivatives have a five-year payment stream, but the payments do not begin for two years (making a total term for that instrument of seven-years). This instrument would help a credit union that foresees future IRR it wants to mitigate, but the interest rate mismatch will not occur until two years in the future. These products were also unavailable to us under the pilot program because their terms exceeded the five-year limit.

Our experience suggests that the definition of permissible derivatives should not be so limited that credit unions are regularly leaving money on the table or spending more money than other financial institutions to obtain the same IRR hedging protection. We agree that credit unions should not be able to invest in any and all structures currently available in the derivatives market. We believe that language restricting the use of derivatives outside of hedging vehicles in combination with Generally Accepted Accounting Principles (GAAP) rules will effectively limit the usage of the more esoteric structures. However, the alternative of a list of acceptable derivatives that is too limited would render the tool ineffective at a time when IRR is becoming a greater concern to every credit union.

3. *Static notional value authority*: As discussed above, the 2000 NCUA approval allowed ESL to obtain derivatives up to a certain total notional value. In the 11 years since the approval, our asset size has grown, as has our potential IRR exposure. However, our total notional value limit has not changed. The inability to obtain approval for an increase in our limit (or the term structure of the instruments) limited the usefulness of the pilot program.

In order for a credit union to properly hedge its IRR using derivatives, the regulations will need to allow dynamic changes that track the credit union's current financial situation. The regulation should use one or two statistics about the FCU that will set a moving limit on the permitted notional value. We suggest basing the maximum derivatives market value a credit union can manage in relation to its capital. A focus on core capital is warranted as all non-credit-related market exposure reverts to par over the holding period.

The following are our responses to several of the questions contained in the ANPR:

Existing Pilot Programs

1. The existing pilot program should continue if Part 703 is not amended to allow credit unions the general power to use derivatives. With the prolonged low interest rate environment credit unions have been operating in and the resulting concentration of low yielding long-term assets accumulated over this period combined with a high probability of a rapidly rising interest rate environment, credit unions need as many tools as are reasonably available to mitigate IRR. Our experience in the pilot program shows that interest rate swaps, caps and floors can be effective mitigation tools.

If the final regulation has a different process by which a credit union can apply for approval to invest in derivatives (independently or through third parties), then the pilot program would not appear to be required. Any credit union involved in the pilot program would need to have a conversion plan, which may require grandfathering of the pilot program, until the credit union can be converted from the pilot program to the new final program.

2. See the prior response.

3. NCUA should not set any regulatory limitation on credit unions providing information to qualify for the exemption from mandatory clearing under CFTC regulation. If permitted to invest in derivatives, a credit union should have all the powers necessary to participate in that market. We would suggest that in the same way NCUA does not set standards for the information credit unions provide to FHA or SBA to become qualified lenders with those federal regulators, neither should NCUA set any special requirements for credit unions to meet the regulatory requirements of the CFTC.

Independent Derivatives Authorization

1. Yes, credit unions should be able to be independently able to invest in derivatives to hedge IRR. Approved credit unions should either have direct credit union experience in such credit function/hedging activities or have management and/or directors who have obtained experience at other financial institutions in such credit function/hedging activities. Our experience with the pilot program shows that credit unions with the proper management, informed directors and proper oversight can use derivatives to successfully hedge IRR. Allowing a credit union to independently invest in derivatives *and* to use third parties would provide additional flexibility needed to operate in the derivatives market.

We note that the ANPR does not explicitly mention "floor" derivatives as a tool to hedge against the prepayment risk of IRR. Given a credit union's legal inability to charge prepayment penalties, it is particularly important that a credit union's authority under any regulations include using floors as well as caps and swaps to mitigate IRR.

Approval to Engage Independently

2 & 3. While we agree that FCUs must have staff that can demonstrate understanding of the derivatives markets and various derivative instruments, we are unsure about the meaning and standards behind "enhanced" experience. That standard would be very subjective. As such, a FCU would be unable to prepare itself for the application process and know whether the staffing plans would be "enhanced" enough for an examiner, regional director or NCUA board members. We counsel that the staffing requirement should be as clear and objective as possible, similar to the requirements of experience contained in the NCUA's member business lending regulations.

4. One-year timeframe referenced in the question does not appear to be related to the needs of an application process for an approval. There should be no artificial timeframe for a credit union to take the steps necessary to prepare an application/self-assessment. Based on our experience, it should not take one year for a credit union that is ready to invest in derivatives to prepare its application based on a clearly written regulation containing objective requirements. Having a regulation with clear objective standards will also allow the regulator to approve or deny an application for approval (or amendment of the terms of the approval) in well under one year.

If you have any questions about the contents of these comments, please contact either James Darcy at 585.336.1054 or jdarcy@esl.org or me at 585.336.1171 or pwoods@esl.org.

Thank you very much for your consideration of this matter.

Very truly yours,

Peter R. Woods
Associate General Counsel
ESL Federal Credit Union