From:	Kevin Cole
To:	_Regulatory Comments
Subject:	"Kevin Cole-Comments on Advance Notice of Proposed Rulemaking for Part 703, Financial Derivatives Transactions to Offset Interest Rate Risk"
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March 5, 2012

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

RE: Advanced Notice of Proposed Rulemaking for Part 703, Financial Derivatives Transactions to Offset Interest Rate Risk

Dear Ms. Rupp:

Question 1: should the Board require an FCU to demonstrate a material IRR exposure or another evident risk management need before it is granted independent derivatives authority?

It is reasonable for the Board to limit credit union use of derivatives to risk management activities. The Board should construct the rule broadly to allow credit unions to manage the timing between the risk generating activity and the corresponding risk mitigation activity. A narrow interpretation of "demonstrate a material IRR exposure" could require a credit union to have the risk on its balance sheet before hedging it, while the preferred approach would be to hedge the risk as it is being acquired.

Question 2: Is it appropriate to require minimum performance levels, as measured, for example, by CAMEL ratings and net worth classifications, when considering whether to grant or deny an FCU's application to independently engage in derivatives transactions? If so, what performance measures are appropriate and what should those levels be?

Approval to engage in derivatives transactions should be based on need and on ability to manage the activity. Requiring certain CAMEL ratings or net worth levels may prevent a qualified credit union with a need from obtaining approval, thereby leaving a higher level of risk in a troubled credit union. When the activity is limited to risk mitigation as discussed in the ANPR and with a requirement to demonstrate ability to manage the program, a requirement for certain CAMEL rating or net worth level seems excessively restrictive.

Question 3: What is the minimum kind and amount of derivatives experience and expertise that a FCU's staff should demonstrate before the FCU receives independent derivatives authority? For example, if an FCU has a less complex balance sheet, it is sufficient for that FCU's staff to demonstrate a minimum of 3 years transacting derivatives? Should NCUA require additional kinds and amounts of experience when there is more complexity in the FCU's balance sheet (e.g.

prepayments and call options)?

To have independent derivatives authority a credit union should be able to demonstrate that it has the ability to identify the risks it is attempting to mitigate, value the derivatives it intends to use, comply with accounting requirements for derivatives, and manage counterparty risks. I would encourage the Board to broadly define any experience requirement and to allow for certain types of education (Chartered Financial Analyst, etc.) to substitute for experience. As envisioned in the ANPR, approved credit union use of plain vanilla derivatives is no more complex than many of the investments or loans on credit union balance sheets, and should therefore be subject to similar standards for education and experience.

Question 4: Should FCU's be limited to using interest rate swaps and interest rate caps to offset and manage IRR? Should interest rate swaps be limited to pay-fixed/receive-floating instruments? What other limits should be established to ensure that a FCU does not transact interest rate derivatives in an amount greater than the level of its IRR exposure?

Credit unions should be allowed to use derivative instruments that are required to mitigate the risks identified in their balance sheets. Limiting it to a specific type of derivative or even one side of a transaction (pay-fixed/receive-floating) focuses too much on the current rate environment and would diminish the merits of the rule. Although no current market exists for it, a credit default swap might be an effective method for a credit union to increase or decrease its exposure to credit risk. Many credit unions may also find an instrument like a swaption or a cap to be a more cost effective tool for managing interest rate risk than a plain vanilla swap.

Because of the many key assumptions required in defining IRR exposure, it would be difficult to develop a regulatory definition of this concept. Therefore, it would be difficult to establish a regulatory threshold to determine compliance with this requirement. Because of the inherent difficulty in defining IRR exposure, it would be preferable to require credit unions to document their methodology and review it through the examination process.

A credit union's Board of Directors should establish the institution's risk tolerance, limits, and types of permissible instruments.

Question 5: Should NCUA establish exposure limits for FCU's or should it require a FCU's board of directors to establish exposure limits? Should there be limits on the aggregate amount of derivatives instruments in the portfolio or on the aggregate amount of derivatives transacted with any counterparty? Should limits be based on the notional amount of a derivatives instrument, its mark-to-market valuation, or both?

A credit union board of directors should establish its own exposure limits and such limits would be part of the risk management policies for the institution. Such limits should address concentrations of types of derivatives and counterparties. Most derivatives are properly measured at fair value and since fair value represents the current exposure to the credit union it would be preferable to require fair value as a standard for measurement.

Question 6: Are there ways to mitigate counterparty risk besides posting collateral? Are there additional or alternate collateralization conditions that NCUA should require beyond those described in the ANPR?

Collateral is an effective risk mitigation tool. The rule should be enhanced to allow the parties to waive the collateral requirement when the net exposure is below a minimum threshold. It should also allow a qualifying letter of credit as an acceptable form of collateral. For example, many state public funds laws allow for the use of a letter of credit from the Federal Home Loan Bank to serve as collateral for public funds. This option would provide a more cost and time effective means of posting collateral for credit unions who may lack qualifying Treasury or Agency bonds, or who may need to tap the liquidity of a letter of credit, or who may need to deposit only a small amount of collateral.

In general, I would like to express my support for expanded derivative authority for credit unions. Rarely has the need for balance sheet management strategy been greater. Derivatives are a tool that could help credit unions better serve members in a safe and prudent manner and are a logical extension of the Agency's focus on interest rate risk in the credit union system. While I advocate for the broadest authority possible for credit unions, some additional authority is preferable to none.

Respectfully Submitted,

Kevin Cole
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