March 28, 2012

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

Dear Ms. Rupp:

On behalf of the partners of ALM First Financial Advisors and its management staff, I am writing in response to the Advanced Notice of Proposed Rulemaking - Derivatives. I thank you for this opportunity.

Issues for Comment

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?**

Clearly, there are multiple ways to approach institutional hedging needs. Hedging can be conducted by protecting against high-probability events or by sheltering from more remote events with low probabilities. The NCUA should focus more on the experience of the credit union and their intent to manage risk rather than proving a current exposure or an evident risk management need.

If the Board requires a credit union to demonstrate material IRR exposure, hedging strategies would be constructed against current portfolios of assets to minimize the variance in the value of these portfolios against a target or set of liabilities. A mean-variance hedging strategy would then attempt to reduce the variability in portfolio value caused by factors to which the credit union wishes to reduce immediate exposure.

On the other hand, many credit unions have regulatory risk management reporting requirements that are centered on a sensitivity measure of the entire firm's net economic value to large, instantaneous changes in interest rates. These "NEV" sensitivities are measured against a very low probability of such large rate movements. Constructing low-cost hedging strategies for this type of event risk is, in most cases, fundamentally different than the hedging process described in the previous paragraph but might ensure against severe losses should these events occur. As an example, ABC Credit Union is comfortable with its interest rate risk measures in the

current environment. The rates up 5 percent NEV sensitivity or a twisted yield curve that has a remote possibility of occurring might alarm a conservative credit union and is the scenario that it wishes to address.

ABC Credit Union would benefit from a swap or option structure that wins big for rates up 4 or 5 percent, and it would be willing to sacrifice some hedge performance in the up 1 percent and 2 percent scenarios to keep costs down. The NCUA should be open to these hedging strategies as well as immediate interest rate reducing needs.

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?**

   Every credit union is different and circumstances vary when it pertains to the need to hedge. There are times when a credit union maintains longer-term mortgage loans due to the need to enhance income and build capital. There might be other times where the credit union is recovering from a Letter of Understanding situation or want to hedge against income fluctuations in the case of a large mortgage servicing rights portfolio. Although minimums will most likely be set by the markets when obtaining derivative lines, we recommend setting capital asset ratios low at 6.0% and CAMEL ratings as low as 2.

3. **What is the minimum kind and amount of derivatives experience and expertise that an FCU's staff should demonstrate before the FCU receives independent derivatives authority? For example, if an FCU has a less complex balance sheet, is it sufficient for that FCU's staff to demonstrate a minimum of three 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 what extent should an FCU seeking independent derivatives authority be allowed to rely on an outside party to fulfill an experience and expertise requirement?**

   Minimum requirements for derivative experience should not only include three years of derivative transactions, but experience within the staff of the credit union that would comprise the execution of trades within a financial institution, the knowledge of back office work, and derivative analytics.

   The guidelines for experience can be achieved by hiring experienced personnel or by obtaining guidance through third-party consultants. We believe that three years of experience through a third-party provider would suffice, but the Agency would have to make judgement on how much derivative activity was done during that period of time. This depends on what type of experience the credit union has had over the period of one year. We believe at least five separate trades should be conducted, as well as experience in setting up counterparty lines, such as negotiating ISDA agreements, and the development of the hedge process and back office operations. It is not unusual for the start-up process to take at least six months. Trading

experience should include at least one full year after the execution of the first trade. The credit union should attempt to meet all standards as outlined by the third-party provider. Most important are staff experience, board education, and analytical modeling.

The credit union should be capable of opening several counterparty lines in order to avoid dependence upon one broker and should also be able to price derivatives to ascertain mark ups.

The experience of the credit union should not be limited to employee experience, but should also include access to system capabilities. Infrastructure should include ALM modeling experience, as well as derivatives trading experience.

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/receiving-floating instruments? What other limits should be established to ensure that an FCU does not transact interest rate derivatives in an amount greater than the level of its IRR exposure.**

Derivative activity should not be limited to pay-fixed/receiving-floating instruments but should be open to other forms of interest rate swaps such as basis swaps.

Truly expanded hedging powers should allow institutions to not only hedge with over- the-counter swaps, caps, floors, and swaptions, but also exchange traded futures and options on these futures. Institutions managing their interest rate and convexity risks using derivatives would be better served having an expanded menu of derivatives to accomplish their risk management goals. Many benefits accrue to institutions using exchange traded instruments for hedging like Eurodollar futures, U.S. Treasury futures and call and put options on these instruments. Liquidity is generally higher, price discovery is generally clearer, and counterparty risk is generally lower. The Chicago Mercantile Exchange (CME), the Chicago Board of Trade (CBOT), and The Chicago Board Options Exchange (CBOE) are all well established, CFTC regulated exchanges used by bona fide hedging institutions daily to accomplish their risk management goals. Risk management programs within the U.S. credit union industry would be more complete if exchange traded futures and options were permissible items.

Each credit union's interest rate risk exposure varies and is dependent upon their risk tolerance, so it would be very difficult for the Agency to regulate a credit union to the extent that it does not transact derivatives in excess of its IRR exposure. In addition, focus on this issue might cause examiners to miss the point of the derivative trades. Because of this, no additional limits other than those outlined in question five should be imposed.

5. **Should NCUA establish exposure limits for FCUs or should it require an FCU's board of directors to establish exposure limits? Should there be limits on the aggregate amount of each type of derivatives instrument 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?**

   The board of directors should establish the exposure limits and the NCUA should **not** set specific limits for each credit union, due to the fact that derivative strategies will vary greatly from one institution to the next.

   Limits set solely based upon a notional amount will discourage out-of-the-money options, which would be the cheapest form of insurance and perhaps the more popular vehicle used to hedge regulatory risk or outlier event risk. In addition, should derivative powers be enhanced to include futures such as Eurodollar futures, the use of notional values would not seem sensible. As an example, building a $10 million two-year hedge with a strip of Eurodollar futures would require $80 million of notional contract values.

   As swaps or caps mature and decrease in duration, the hedge effect decreases and additional hedges are required, making a notional exposure amount again nonsensical. As far as how the mark-to-mark valuation is set, theoretically, if there is a loss on the derivative there should be a gain on the asset. Therefore, we suggest that the market valuation limit take into consideration the asset or liability being hedged. In this case, the maximum current unrealized loss should be low at 5% or 10% of net worth. Should the NCUA have a propensity to require limits set as a mark-to-mark valuation of just the hedge position, **ALM First strongly believes that this should not be in addition to a notional amount limit**. In this case, the maximum current unrealized loss should be at 150% to 200% of net worth. We would most likely encourage credit unions to be within both mark-to-market guidelines.

   The NCUA should also consider that a mandatory termination given a market value loss could present an economic disadvantage and should therefore add verbiage requiring that a suggested plan of action be presented to the NCUA should limits be pierced.

   If trades were cleared through a central counterparty (CCP), **limits should not be set** for each counterparty line due to the fact that there will be no exposure to the dealer. A clearing and settlement infrastructure provider is a third-party entity that plays a purely operational role in the clearing and settlement process. Derivatives will most likely continue to be traded over-the-counter with an individual dealer (OTC), but cleared through a central counterparty.

   In the event that trades are not cleared through a CCP, limits should be set for each counterparty line as a pro rata exposure to the aggregate mark-to-market limit.

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?**

In lieu of collateralization, the NCUA should consider allowing cash settle on derivative trades. In other words, the CSA agreement should be negotiated so that only cash is allowed as collateralization. This method provides a full mark-to-market payout either after a certain threshold is met, or periodically, or both similar to that of futures transactions. Cash settling positions do introduce the convexity bias issue that is always in the favor of the entity in the short position (in this case, the credit union) and the trade would most likely be affected by such cost. The convexity bias is higher when rates are more volatile (like an option), and tends to increase the all-in rate the short side pays because they "earn" a return on the float in the margin account. When rates are high and the trade has market gains, the credit union would earn the cash return. Obviously, if the CSA is negotiated in such fashion, the tri-party method is irrelevant.

Again, thank you for the opportunity to respond to this request. We hope the NCUA finds these suggestions useful and welcome any future dialogue.

Sincerely,

Emily Moré Hollis, CFA
Founding Partner