Chevron Federal Credit Union

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James E. Mooney
President & CEO

March 29, 2012

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

Re: Advance Notice of Proposed Rulemaking for Part 703, Financial Derivatives Transactions to Offset Interest Rate Risk (ANPR)

Dear Ms. Rupp:

As the first credit union to be approved under NCUA's Reg 703 Pilot Program to mitigate interest rate risk using financial derivatives, Chevron Federal Credit Union appreciates the opportunity to respond to this ANPR.

(1) Should the Board require a Federal Credit Union (FCU) to demonstrate a material interest rate risk (IRR) exposure or another evident risk management need before it is granted independent derivatives authority?

We believe that, before it is granted independent derivatives authority, an FCU should demonstrate a material IRR exposure (a) already in existence on its balance sheet or (b) on pro forma financial statements due to planned growth. We suggest NCUA allow the FCU to define materiality and show evidence of impact on its operating results with and without hedging tools. To preserve the safety and soundness of the credit union industry, we believe it is very important for the FCU to use a rigorous asset liability management (ALM) model to produce results supporting IRR exposure.

(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?

The FCU should be well managed and well capitalized in order to receive independent derivatives transaction authority. CAMEL rating and net capital ratios are good indicators. We suggest a minimum CAMEL rating of 2 be required as evidence that the FCU has adequate capital, asset liability management, management capabilities, earnings and liquidity. In an interest rate shock of +/-300 bps, the net capital ratio should remain at no less than the level NCUA considers "adequate."

For purposes of determining regulatory capital, an FCU should be allowed to exclude the impact of mark-to-market adjustments on its interest rate derivatives portfolio to the extent the derivatives are effective economic hedges.

(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? If an FCU has a less complex balance sheet, is it sufficient for the 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 derivative authority be allowed to rely on an outside party to fulfill an experience and expertise requirement?*

An FCU employing derivatives to hedge its interest rate risk should have in-house expertise in asset liability management and in using derivatives. This should apply to staff, management and board volunteers. It is up to the FCU to demonstrate that these parties have the expertise through practical financial market experience and relevant education. FCUs may engage an outside party but should also possess expertise in-house at the staff, management and board levels in order to make safe and sound decisions.

(4) *Should FCUs 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 an FCU does not transact interest rate derivatives in an amount greater than the level of its IRR exposure?*

Financial derivatives in the form of interest rate swaps and interest rate caps are generally sufficient for mitigation of interest rate risk. NCUA regulation should allow a credit union to request additional or alternative derivative products that can be demonstrated to mitigate interest rate risk.

In deploying interest rate swaps and interest rate caps, FCUs should have the ability to sell/offset existing contracts and select forward start dates.

a) FCUs should be allowed to sell/offset a financial derivative before contract expiration date. This option is useful when an FCU wants to restructure its hedge portfolio.
b) FCUs should be allowed to select start dates on interest rate derivative contracts. This option is useful for extension of derivatives contracts, when current rates are not expected to change for a period of time or if the FCU does not need to hedge current periods based on results of its ALM modeling.

We do not recommend imposing any specifics as to pay fixed/receive floating for interest rate swaps as each FCU's needs may differ.

To minimize the risk of hedging more than the level of IRR exposure, FCUs should have established ALM metrics to measure IRR, such as net economic value (NEV) levels, NEV change in interest rate shocks, net interest margin (NII) levels and NII change in interest rate shocks. The FCU should have policy limits on maximum and minimum volatility levels under interest rate shocks and thresholds for hedge considerations based on its tolerance for IRR.

(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?

We recommend that exposure limits be set by the individual FCU board of directors, which should have comprehensive knowledge and management experience of interest rate risk exposure, as each balance sheet has its own uniqueness.

We do not believe it necessary to set limits on the aggregate amount of each type of derivative instrument or on the aggregate amount with any counterparty. Each FCU should analyze and document which derivative instrument is best for its own particular balance sheet issues. A limit on the aggregate amount with each counterparty is neither necessary nor practical as long as counterparty risk is analyzed and mitigated through collateralization. There are very few qualifying entities meeting the current Pilot Program credit criteria.

Notional amounts of derivative instruments are not reflective of hedge effectiveness as they do not account for tenor and rate. If the purpose is to prevent an FCU from over-hedging, then the focus should be on ALM metrics and those limits.

(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 this ANPR?*

We believe the best way to mitigate counterparty risk is to impose a collateral requirement. We recommend requiring counterparties to post collateral when their credit ratings fall below AA- as required under the current Pilot Program rules. However, a non-zero threshold for collateral posting by the counterparty should be permitted based on the capital strength of the FCU. A counterparty is only required to post collateral when the market value of derivatives exceeds a certain dollar threshold. With some FHLBs no longer serving as derivatives counterparties, other potential counterparties meeting the credit criteria and willing to offer a zero threshold for collateral posting are limited.

Additionally, given how few counterparties have credit ratings of AA- or better, NCUA should consider allowing FCUs to enter into derivatives contract with counterparties with a minimum credit rating of A- or better, but require collateralization at the outset if the counterparty's credit rating is below AA-, taking into consideration the threshold recommendation above.

Once again, we wish to commend NCUA for considering expansion of derivatives authority to credit unions. We believe that the use of derivatives will be increasingly important in managing and mitigating interest rate risk.

Sincerely,