From: Hewedak, Reham
To: Regulatory Comment
Subject: Comments on Part 703 ANPR, Financial Derivatives Transactions to Offset Interest Rate Risk; Investment and Deposit Activities
Date: March 31, 2012

To whom it may concern,

Thank you for the opportunity to comment on whether and how the National Credit Union Administration (NCUA) should modify its rule on investment and deposit activities to permit natural person credit unions to engage in the purchase and sale of financial derivatives for the purpose of offsetting interest rate risk (IRR).

While currently the NCUA allows a limited number of Federal Credit Unions (FCUs) on a case by case basis to engage in some derivatives transactions to hedge IRR through an investment pilot program, this Advance Notice of Proposed Rulemaking ("ANPR") granting independent derivatives authority to FCUs needs to protect the credit union industry from undue risk. First, an FCU needs to demonstrate that it has an IRR or risk management need that would be met through the use of derivatives. Moreover, the only permissible derivatives to hedge IRR should be: (1) interest rate swaps, and (2) interest rate caps because both types of derivatives will eliminate some of the unforeseen risks associated with transacting for speculation purposes. Financial derivatives are a valuable risk management tool and should be an option for credit unions but only in the presence of a controlled and managed environment in which FCUs could engage in derivative activities in a safe and sound manner.

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 derivative authority?

Yes, the NCUA goal is to safely allow more credit unions to use derivatives responsibly as a hedge against interest rate risks.[1] The rule is needed because while "banks have steadily reduced their interest rate risk exposure since 1995, credit unions have increased their exposure by more than 50%."[2] In fact, credit unions hold nearly 31% of their assets in long-term fixed-rate

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[1] Marx, Claude, "NCUA Approves Interest Rate Risk Rule" Credit Union Times, February 1,2012 http://www.cutimes.com/2012/01/31/ncua-approves-interest-rate-risk-rule
[2] *Id.*

mortgages, compared to only 18% at banks.[3] Therefore, by requiring FCUs to demonstrate material IRR exposure before they are granted independent derivative authority, the agency will be effectively using its rulemaking authority to target FCUs with such large holdings of long-term assets, which would be exposed by a rapid rise to pre-recession rates, and therefore could significantly reduce their net worth.[4]

The Board should consider the FCUs eligibility requirements to include *need* as one factor in their decision because expanded derivatives authority should be aimed at reducing potentially excessive interest rate risks. Furthermore, by requiring FCUs to demonstrate their "risk management need" before they are granted independent derivative authority, the agency can better make an informed decision on its ability to mitigate the risk to FCUs through granting them the authority to engage in certain derivatives transactions. A rule granting FCUs independent derivatives authority would be both manageable for both participating FCUs and NCUA because it sets specific criteria for FCUs to both qualify and cure any excessive interest rate risk.

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

Yes, an FCU should be required to demonstrate a requisite level of financial performance measured in part by its net worth classifications and CAMELS ratings which evaluate six components: (1) Capital adequacy; (2) Assets quality (3) Management; (4) Earnings; (5) Liquidity; and (6) Sensitivity to market risk. In addition to the first five components (which are measured in the same manner by the CAMEL ratings), the CAMELS ratings also measure an FCU's financial performance which is related to its ability to identify, measure, and control the market risks. Measuring an FCUs sensitivity to market risks will prove valuable in evaluating factors such as sensitivity to adverse changes in interest rates, commodity prices, and fixed assets. Also, by measuring an FCU's sensitivity to the market, the agency can better evaluate the nature of an FCU's operations and changes in the value of its fixed assets.

[3] *Id.*
[4] *Id.*

A well-capitalized FCU with a net worth ratio of seven percent (7%) or greater or an adequately capitalized FCU with a net worth ratio of six percent (6%) should be able to independently engage in certain derivative transaction for the purpose of offsetting IRR. This does not result in any undue burden on FCUs which are already required under the current federal regulation to determine their net worth category classification at the end of each calendar quarter. 12 CFR 702.101(a). Furthermore, the agency should generally accept an FCU with CAMELS ratings of 1 or 2 because those exhibit the strongest performance and risk-management practices relative to their size, complexity, and risk profile and give no cause for supervisory concern. A rating of 2 indicates a fundamentally sound and stable FCU which is in substantial compliance with laws and regulations with no material supervisory concerns at issue. There are numerous risks inherent in any derivative activity, and therefore by requiring an FCU to demonstrate strong risk-management practices, an FCU stands a better chance in being able to independently limit its exposure to market risks.

Question 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? 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?

Credit unions' staffs need to demonstrate sufficient experience to be able to manage derivatives to hedge IRR risk. For an FCU with a less complex balance sheet, it is sufficient for the FCU's staff to demonstrate a minimum of three years of experience transacting in derivatives transactions. However, where an FCU has a more complex balance sheet, it should be required that the FCU demonstrate a minimum of five years of experience transacting in derivatives. FCUs generally have limited experience with derivatives and only eight FCUs participated so far in existing derivatives pilot programs as of June 2011. Of these, six participated in third-party programs and only two FCUs were authorized to independently engage in derivative transactions. Therefore, given the complexity of even the most straight forward derivatives, an FCU should independently engage in derivate transactions only if FCU management and staff can demonstrate adequate derivative experience.

What constitutes adequate derivatives experience will vary depending on the nature and complexity of an FCU's balance sheet. For example, if an FCU is limited to a relatively simple, "plain vanilla" derivatives instruments such as interest swaps and interest rate caps, an FCU's staff should demonstrate at least three years of effective experience with derivatives, including the ability to evaluate key risk factors. However, an FCU whose assets or liabilities exhibit more complex characteristics should be required to demonstrate five years of experience through an approved third party provider because of the additional level of experience and competence needed to handle derivatives. Such a measure will ensure that FCUs would engage in derivate activities in a safe and sound manner while allowing FCUs that lacked experience in derivatives to gain this experience.

If an FCU is seeking independent derivative authority, the NCUA Board should not rely exclusively on the derivatives experience of an outsider party. FCUs should be required to demonstrate sufficient internal knowledge of derivatives in an onsite review prior to receiving independent derivatives authority to ensure that FCUs will be operating in a controlled and managed environment. The current pilot program, for example, requires the management of an FCU engaged in third party derivatives to demonstrate they had adequate knowledge to understand and monitor derivative instruments. An onsite review of FCUs seeking independent derivatives authority will ensure an assessment of the FCUs knowledge, expertise and infrastructure. The NCUA board should require an FCU which have previously participated in derivative activities only through a third party provider to have enhanced its experience to determine if the FCU is able to perform all aspects of derivatives activity independently for which an FCU may have previously relied on the third party provider.

Question 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?

Yes, FCUs should be limited to using interest rate swaps and interest rate caps to offset and manage IRR. Derivatives in general can help credit unions become less interest-rate sensitive, and therefore continue to meet their members' loan needs. [5] Instead of having to borrow money to reduce the interest-rate risk of their portfolio, credit unions can use derivatives to do interest-rate swapping by converting fixed-rate loans into floating-rate loans to try and

[5] "WesCorp can now offer CUs access to derivatives market to help hedge interest rate risk" Credit Union Times February 23, 2000 http://www.cutimes.com/2000/02/23/wescorp-can-now-offer-cus-access-to-derivatives-market-to-help-hedge-interest-rate-risk

offset potential interest-risk.[6] By allowing FCUs the authority to independently engage in certain derivative transactions, credit unions will not have to turn business away because of their inability to take on calculated interest-rate risk.[7] The big advantage of the proposed rule is that hedging becomes a natural part of the business process, whether rates are going up or down and more importantly it takes credit unions away from trying to speculate of where rates are going at all times.[8]

The purchase and sale of financial derivatives provided it is for the purpose of offsetting interest rate risk is recognized as an "incidental power" granted by the Federal Credit Union Act ("the Act") to enable a federally-chartered credit union to carry on the business for which it was incorporated. 12 U.S.C. 1757(17); NCUA General Council Opinion No. 99-0229 (Feb. 23, 1999). To implement the investment authorities of the Act, the NCUA should continue to prohibit FCUs from transacting in certain investments for safety and soundness reasons. However, interest rate swaps, particularly "pay-fixed/receiving floating swaps" in which one party pays a fixed rate of interest and receives a floating rate, can offset credit union's IRR resulting from cash flows received on fixed, long term assets such as fixed-rate mortgage loans. Moreover, interest rate caps can offset IRR resulting from cash flows paid on liabilities which are either short term or related with nonmaturity shares on which interest may vary by fixing the cost of funds at a pre-agreed ceiling. The counterparty thus absorbs the risk of significant interest rate increases above the contractual ceiling rate. Other derivatives instruments such as credit default swaps provide limited IRR mitigation and potentially could be used for the unauthorized purpose of speculation. Therefore, given the FCUs limited experience with derivatives, interest rate swaps specifically "pay-fixed/receiving floating swaps" and interest rate caps can prove helpful in offsetting the credit unions' IRR without the increased risk associated with other derivatives instruments.

Another possibility (which has been previously required under the pilot program for an FCU engaging in third party derivatives) would be to limit derivatives transactions to which an FCU is allowed to engage independently to a percent of an FCU's net worth. The maximum notional limit for swaps plus the value of the underlying securities in option transactions must

[6] *Id.*
[7] *Id.*
[8] *Id.*

not exceed 250 percent of net worth. Such a measure would safely allow credit unions to use derivatives responsibly as a hedge against interest rate risks.[9]

Question 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 NCUA should establish limits for FCUs to guard against volatility in the value of derivatives portfolio. The current NCUA's Third Party Pilot program includes exposure limits that are based on the notional amount of the derivatives portfolio, expressed as a percentage of the credit union's net worth. It is important to note that this ANPR is not a result of a problem or issue relating to the use of derivatives in the current NCUA's Third Party Derivative Program which is a fundamentally sound process in giving credit unions access to the derivatives market. Therefore, the NCUA should continue in setting the same limits on the notional amounts of derivatives instrument for FCUs which it has previously utilized to effectively regulate FCUs derivative transactions.

If for example the NCUA was to use the mark-to- market valuation to establish exposure limits as a way to guard against losses in excess of a specified threshold, the NCUA would need to interfere after the fact of a loss to limit an FCU's authority to transact in derivatives. The NCUA should continue to set the limits on the initial eligibility of an FCU to responsibly engage in derivatives transactions to guard against significant losses which is a more manageable and cost effective rule for the agency than in the alternative.

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 this ANPR?

To manage an FCU counterparty risk, an approved third party provider can on an ongoing basis monitor counterparties to establish their credit worthiness as well as the credit risk mitigation feature inherent in the derivatives transactions. Counterparty risk can be mitigated by effective collateral management. However, an alternative would be for an approved third party

[9] Marx, Claude "NCUA Requests More Input on Derivative Rule: Onsite Coverage" Credit Union Times, March 15 2012 http://www.cutimes.com/2012/01/26/ncua-requests-more-input-on-derivatives-rule-onsit

providers to be continually involved in the process which is consistent with the agency's need to carefully monitor FCUs credit features and mitigate counterparty risks. The final proposed rule should ameliorate all possible risks for FCUs inside the framework of industry standard practices and operational procedures.[10]

If the final amendment contains restrictions or operational procedures beyond what the marketplace participants are accustomed to, FCUs will not find any counterparties to transact with. [11] One issue which substantially reduce or eliminate availability of derivatives to credit unions is the requirement that all derivatives be bilateral and zero margin.[12] This means that the credit union's counterparty will have to post $1 of collateral for every $1 of market risk, thus greatly reducing any counterparty risk to the credit union.[13] Those terms are difficult to obtain with a zero threshold and when possible could make pricing so unattractive that the whole exercise becomes moot.[14] Instead, an FCU should continually rely on the expertise of an approved third party to assess the credit quality of derivative counterparties. Selection criteria for eligible counterparties that address the process of identification, posting of collateral, credit monitoring, and process for maintenance of available collateral requires the enhanced supervision of an approved third party. The presence of an approved third party for example would better guarantee for the termination of transactions once a counterparty is down-graded to a "BBB" rating. A significant risk in derivative activity is counterparty risk and therefore by requiring the continued involvement of an approved third party, the NCUA will be better able to manage the risks that generally are not familiar to FCUs.

Thank you for time and consideration in this matter. If you have any questions or comments, please do not hesitate to contact me.

Sincerely,

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[10] Cooke, Sarah "Commenters Call Mortgage Note Repurchases Helpful But Redundancies Should be Eliminated in Reg; Maturity Should be Longer" Credit Union Times, March 15, 2012 http://www.cutimes.com/2006/10/04/commenters-call-mortgage-note-repurchases-helpful-but-redundancies-should-be-eliminated-in-reg-maturity-should-be-longer

[11] Anderson, Jeff "Derivatives to Offset Interest Rate Risk-Comment Call" The Works, March 6, 2012 http://www.theworksblog.com/index.php/2012/03/06/derivatives-to-offset-interest-rate-risk-comment-call/

[12] *Id.*

[13] *Id.*

[14] *Id.*