Balance Sheet Solutions, LLC

Member FINRA/SIPC

April 2, 2012

Mary Rupp
Secretary of the Board
National Credit Union Administration

Subject: PART 2, Comments on 12 CFR Part 703 ANPR, Financial Derivatives Transactions to Offset Interest Rate Risk; Investment and Deposit Activities.

Interest rate derivatives are a valuable risk management tool and should be an option for credit unions in a managed environment. Interest rate swaps are still one of the cheapest and most capital efficient ways for a credit union to extend liability duration to hedge interest rate risk. Credit unions possessing the expertise and knowledge to engage in independent activity should be allowed to do so under the explicit constraint that derivatives be used for risk mitigation purposes. This right should be limited to credit unions that can demonstrate a strong fundamental knowledge of how derivatives are valued, the expertise required to properly use account for them. It is important to keep in mind that interest rate derivatives are most effective when thought of as a macro hedge for balance sheet risk and not as a means to hedge a specific risk such as a mortgage loan portfolio. Swaps are used to mitigate interest rate risk, while mortgage loans possess more than just interest rate risk.

We believe that it is important to give knowledgeable and experienced credit unions the ability to hedge IRR with as many tools as possible. As such, Balance Sheet Solutions would like to offer the following in response to NCUA's Derivative ANPR Part 2.

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

Answer: No. Allowing a credit union to seek independent derivative authority should not be tied to a material level of IRR exposure. The use of interest derivatives should only be allowed to HEDGE interest rate risk on the balance sheet. The application and approval for transacting in derivatives (including the proper safeguards) should be sought and obtained well in advance of the ACTUAL need to transact. Waiting until material IRR exposure is present could create a situation in which the process is rushed and proper education and experience are not developed, or the process is delayed and an opportunity to mitigate risk in an efficient and effective manner is missed, potentially resulting in a material impact to the credit union. A risk management tool should be in a credit union's toolbox long before the need to

use it arises. It is important to point out that under the previous Pilot Program the timeframe to apply and be accepted (start to finish) for derivative authority was usually in excess of 12 to 15 months.

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 derivatives transaction? If so, what performance measures are appropriate and what should those levels be?

Answer: Yes. Minimum performance levels should be designed to protect credit unions, not to preclude potential access to interest rate derivatives. We support using a minimum requirement of 6% net worth (to ensure the ability to perform the responsibilities of the contracts entered into and to post collateral where applicable, as well as to be able to withstand the changes in mark-to-market) as long as exceptions are allowed on a case by case basis. Situations will arise where credit unions, with a less than favorable financial position, will need to hedge potentially dangerous interest rate risk and these credit unions should be able to do so, subject to special approval. Credit unions that need an exception to qualify should be subject to additional scrutiny regarding their ability to fulfill the underlying derivative contract, post collateral to mitigate credit risk, as well as how to properly use derivatives. Minimum requirements without exceptions defeats the purpose of the credit union industry having access to a cost effective, capital efficient means of hedging and may penalize credit unions that may have the greatest need to use these tools.

Question3: What is the minimum kind and amount of derivatives experience and expertise that an FCU's staff should demonstrate before the FCU receives independent 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?

Answer: It is difficult to attach a "one-size-fits-all" measurement approach to the appropriate amount of experience needed to possess independent authority. How well derivatives are understood is much more important than how long someone may have been using them. As such, we believe that NCUA should institute a formal process requiring credit unions seeking independent authority to demonstrate an advanced level of skill prior to being approved for derivative authority. This process should focus heavily on:

- Strong understanding of the risks associated in using derivatives.
- Proficiency in understanding and valuing each derivative contract, and a strong understanding of how and why the values change (what drives the swap's mark-to-market (MTM) volatility?)
- The ability to understand and accurately measure the volatility of each interest rate hedge.

- How swap MTM changes impact the income statement, credit union ratios, and risk parameters.
- The ability to understand how to account for the derivatives contracts and effectively apply it under all scenarios (including both hedge and mark-to-market accounting).
- Trade execution skill and knowledge.
- Quick and accurate portfolio valuation for on-time collateral calls when necessary (the inability to do this could create significant credit risk).

To the best of our knowledge, the process by which existing credit unions received independent authority seems to have worked, and if this is the case, the prior program should serve as a basis for the new one. We would suggest adding additional requirements on understanding the effects of pure MTM accounting on the balance sheet, even if the intent is to use effective hedge accounting.

Requiring 3yrs of experience would in many cases force credit unions to either not participate, or hire specific, qualified personnel for what may amount to a small fraction of their risk management activities. This may prove to be cost prohibitive for some and non-practical for most. One of the benefits of the previous Pilot Program was the ability for credit unions to leverage industry experts outside of their own staff at minimal expense. We believe that the best approach in the independent model is to require a strong level of understanding of all aspects of the derivative process and to require credit unions to comply with pre-determined process for achieving approval, thereby letting credit unions decide how to best fulfill the "skill" requirement (hire or develop it). Having a specific requirement for the number of years of experience necessary becomes circular in a sense, since credit union personnel couldn't gain the necessary experience without participating, especially in the absence of a third party program, and can't participate without gaining the experience. It would basically amount to requiring a credit union to hire outside professionals to fulfill the requirements, in most cases.

A complex balance sheet does not add additional need for understanding derivatives if one accepts the premise that an interest rate swap and/or and interest rate cap are almost always used in the same manner to reduce risk. A complex balance sheet requires greater understanding of the balance sheet itself. Swaps are applied in the same manner to both simple and complex balance sheets and the risks (for the swaps themselves) don't change. Swaps are simply a series of discounted cash flows and their mark-to-market and/or risk attributes don't change regardless of the size and complexity of the balance sheet. However, if swaptions would be allowable under the independent program model, then our answer would be different.

A credit union relying on an outside provider while having independent authority defeats the true purpose of awarding independent authority. Credit unions should certainly have the right to seek assistance, but if they have to rely on outside help, they should not be awarded independent authority. Instead, they should apply for derivative powers through an NCUA approved third-party program and work with the provider to manage risk.

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 an FCU does not transact interest rate derivatives in an amount greater than the level of its IRR exposure?

Answer: Yes, we believe that the current list of products should initially be limited to the following plain-vanilla, US dollar interest rate derivatives and their use should be limited to hedging and managing interest rate risk:

- Pay fixed – Receive floating swap (the most common form of swap hedge).
- Receive fixed – Pay floating swap (where and when it makes sense).
- Pay floating – Receive floating swap (most commonly referred to as a basis swap, where and when it makes sense).
- Caps and floors.

The inclusion of interest rate swaptions may be reviewed and possibly included at a later date, or granted through a special exception (with a much higher standard for knowledge and expertise), but we believe that due to their higher complexity and potential for higher price volatility, they should be excluded from the initial structure of the independent program.

Limiting credit unions to hedge transactions that reduce NEV risk (above a certain predetermined level, perhaps 10%) may be the best approach to prevent the use of derivatives in an amount greater than their IRR exposure. To be clear, we propose limiting the execution of a derivative when a sufficient enough risk is not present, not preventing the application for derivative powers. For example, a credit union with a +300 NEV change of -2% should not look to hedge this relatively low amount of risk. The minimum NEV threshold is one way to ensure that credit unions are not attempting to "lock up" an alternate form of cheap synthetic funding in the absence of any material risk, instead of focusing on reducing existing IRR exposure on the balance sheet.

Finally, credit unions must be required to understand what amount (or magnitude) of changes in the value of the hedging portfolio (through the use of scenario testing) would be materially significant for the credit union. This understanding could then be addressed and policy instituted in board policy.

Question 5: Should NCUA establish exposure limits for FCU's 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?

Answer: First and foremost, if limits are to be put in place, they should be based on mark-to-market (MTM) value and <u>not</u> on notional amounts. A "+300 shock scenario" MTM is an infinitely better

representation of exposure than notional amount. Risk, collateral posting, accounting gain/loss are all driven by the MTM not the notional.

While limits may be seen as an effective way to prevent over-use of derivatives, they come with unintended negative side effects. An unintended consequence of having a dollar-based limit, for example: total swap MTM cannot exceed $20MM, may require action to comply with policy that is not in the best interest of hedging and/or the credit union (duration extension to the liabilities versus hedging partial duration exposures). A credit union that purchased caps in a low rate environment might be forced to unwind them prematurely when rates increase enough such that the MTM value hits a predefined limit. Another more telling example would be paying fixed in a swap transaction to reduce balance sheet risk and having rates fall enough that the credit union would be forced to unwind at the worst possible time. If the hedge is still effective and still makes sense, then a forced unwind due to pre-defined limits would be a very bad and expensive event.

If interest rate derivatives are ONLY used to hedge existing interest rate risk and are collateralized with cash or securities to eliminate credit risk, then an implied limit on the use of these tools already exists. Adding a macro-based limit tied to net worth, similar to those in place for borrowing, may make some sense and should be examined. The board of directors for a credit union should certainly have the ability to establish limits and should consider limits in tiered phases. It is important to remember that this is being considered in an "Independent Authority" environment which carries a much greater requirement for understanding and expertise than that of a third party program. As such, we believe that a credit union's board of directors would be best suited to define the appropriate MTM limits for the use of derivatives for hedging for their respective credit union.

Limits should not be placed on the number of a particular type of hedge (swap or cap) to use within the portfolio. The proper tool should be the one that best fits the credit union's objective and means.

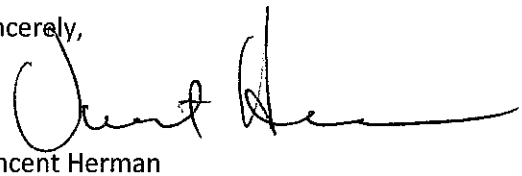
As long as the derivative hedging positions are fully collateralized with both an initial maintenance margin and their current MTM, there would be no reason to limit the number of trades executed with an individual counterparty. If the program were to not require all trades to be fully collateralized, then it would certainly make sense to establish limits to the amount of contracts with any one dealer in an attempt to reduce and diversify credit risk.

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?

Answer: In the absence of all trades moving to a universal exchange or clearing house that guarantees fulfillment of all transactions, the best way to mitigate credit risk is the full collateralization (maintenance and MTM) and dynamic monitoring of the hedge positions.

Thank you for allowing us to express our opinions related to this matter. Balance Sheet Solutions would be glad to assist NCUA in further developing this process. If you have any questions or comments, please do not hesitate to contact us. Thank you again.

Sincerely,



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