Via Email to regcomments@ncua.gov

ALM Risk Management Consulting LLC

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

April 2, 2012

Re: ANPR 2 - Financial Derivatives Transactions to Offset Interest Rate Risk (2/12/2012)

Dear Ms. Rupp:

ALM Risk Management Consulting is pleased to offer comments on the NCUA *Advanced Notice of Proposed Rulemaking 2 - Financial Derivatives Transactions to Offset Interest Rate Risk* issued 2/12/2012. Thank you for the opportunity.

The ANPR mentions how few credit unions participate in the pilot program, and suggests that the falling interest rate environment may be a reason. While I would agree that falling rates could be a factor, I think the main reason for the lack of participation is due to the difficulty, perceived or real, of qualifying for the program. Derivatives have gotten a bad reputation for being exceedingly dangerous and too complex to understand, to the point where most credit unions don't even consider the possibility of using them to reduce interest rate risk.

While I applaud the NCUA for seeking comments for revising regulations in this arena, I feel that the current ANPR perpetuates the notion that derivatives are bad or too complex for most credit unions. For example, requiring credit unions to demonstrate three years of experience with derivatives through use of the third party program before they can manage derivatives independently sends the message that only a select few credit unions are capable of managing a derivative program on their own.

There is no question that the wrong derivatives can bring down an institution quickly. However, poor underwriting standards and inadequate internal controls can do the same. Credit Unions are entrusted to manage credit risk, liquidity risk, operational risk, and a host of other risks. They should be entrusted to independently manage its interest rate risks with derivatives. Accordingly, our position is that credit unions should be given the authority to independently transact in derivatives without meeting stringent experience requirements, and without needing to obtain prior NCUA approval in order to do so.

We recognize the complexities of derivative instruments and that certain restrictions are necessary. Some future credit union failures my well be attributed to its derivative transactions. However, I feel that there is a greater risk of credit union failures due to the lack of an effective hedging program using derivatives.

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?

No. The determination of "material IRR exposure" is subjective and may not be applied consistently.

Credit Unions should be allowed to take proactive steps to mitigate interest rate risk regardless of their present IRR exposure. The decision of how much IRR is acceptable will vary from credit union to credit union.

- A materiality requirement could result in a credit union assuming a level of interest rate risk that it considers unacceptable, but cannot engage in derivative activity to mitigate this risk because the NCUA considers the credit union's overall IRR exposure immaterial.
- A credit union wants to invoke a new pricing strategy, portfolio strategy, or offer a new product, and head off the potential IRR exposure from the beginning, even though its current IRR exposure is considered immaterial.
  - For example, a credit union decides to start keeping 30-year fixed rate mortgages in its loan portfolio, rather than getting paid a finder's fee for having someone else finance the loan. Keeping the loan in the credit union's portfolio is beneficial because it preserves the relationship between the credit union and its member.
- A credit union may wish to finance a long-term fixed rate loan for a small business member and offset the interest rate risk with an interest rate swap tied directly to the loan. Without the ability to purchase an interest rate swap independently, the credit union may have to turn down the opportunity to serve that member's lending needs.

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?

CAMEL ratings are subjective in nature, and therefore should not be a determining factor. For example, a credit union that is a CAMEL 3 primarily due to loan quality issues may still be qualified to manage its own derivatives transactions. Restricting certain credit unions from independently engaging in derivative transactions via a letter of understanding would be a better mechanism than using CAMEL ratings as a qualification criteria. However, credit unions with low net worth have less margin for error, so a minimum capital requirement such as six percent or higher would be appropriate.

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? 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?

A minimum experience threshold by credit union staff should not be a requirement, because each individual credit union's circumstances are different. Such a requirement is highly subjective, because measuring a credit union's in-house expertise is difficult at best.

- Is a credit union that purchased one interest rate swap three years ago better qualified to make sound derivative decisions than, for example, a credit union with one year's experience, but which has performed multiple derivative transactions?
- What if personnel with the most experience and deepest understanding of the hedging program leave the credit union?
- What if a credit union with no past derivative transactions hires personnel with extensive derivative experience or engages the service of a qualified third party?

Credit unions should be allowed to substitute an outside party in order to fulfill experience requirements. A qualified consultant can structure an interest rate reduction program and explain it to credit union management and the board so that they can make an informed and prudent decision regarding the adoption of such a program -- regardless of the credit unions' past experience with derivatives. In other words, credit unions can perform their due diligence in initiating an IRR reduction program using derivative, without the knowledge and experience necessary to structure a program internally, by using qualified third party consultants.

If an experience requirement, whether internal or through a third party, is included in the final regulation, relevant education and/or certification should be allowed as a substitute. For example, an individual with an MBA in Finance or a Chartered Financial Analyst (CFA) would have the requisite skills necessary to set up and maintain an IRR program using derivative instruments.

There should be restrictions on the type of derivatives a credit union can transact independently. Credit unions should be allowed to acquire interest rate swaps, caps, floors, and collars, regardless of their level of in-house experience. Restricting derivatives to those considered "vanilla" would reduce the experience requirement, because of the ease in which they can be understood and explained. More complex instruments would be individually evaluated and approved by the NCUA on a case by case basis.

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?

As stated under question 3, there should be restrictions on the type of derivatives that a credit union can transact independently. Interest rate swaps and the purchase of options that include interest rate caps, floors, or collars should sufficiently cover most credit unions' interest rate risk exposure. These instruments are fairly straightforward in how they will perform in various interest rate environments. Anything more complex could result in unintended outcomes.

Interest rate swaps should not be limited to pay-fixed / receive floating instruments. A credit union that is asset-sensitive has IRR exposure to falling rates, and should be allowed to purchase pay variable/ receive fixed instruments, if doing so reduces their interest rate risk.

Credit unions should only be allowed to *purchase* (as opposed to sell) options as part of an interest rate program in order to limit their losses to the amount of premium paid for the options. Credit Unions should not be allowed to sell (as opposed to purchase) options without prior regulatory approval. The potential liability of selling options could be unlimited. A credit union wanting to sell options to reduce IRR should be individually evaluated and approved by the NCUA on a case-by-case basis.

Restriction on the maximum notional amount outstanding at any given time may be necessary to avoid transacting derivatives in excess of the level of IRR exposure. This could be accomplished by limiting the notional amount to some fraction of assets or multiple of net worth, provided that such limits still provide most credit unions the flexibility to set up IRR reduction programs unique to their individual circumstances.

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?

Because each credit union is unique, it would be impractical for the NCUA to establish viable exposure limits; therefore, the credit unions' board of directors should have the freedom to establish exposure limits appropriate to their own credit union.

The NCUA could establish upper limits based on a credit union's assets and/or net worth. Possible limits on the notional amount could be 1/3 of total assets and/or 2x net worth. However, the credit unions' board of directors should also establish limits within the upper boundaries set by the NCUA on the aggregate amount of each type of derivative instruments and exposure limits on counterparties. It would be up to the credit union board to determine the basis (notional or market value) of limits on derivative instruments.

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?

If a nationally recognized exchange such as the CBOE is involved, counterparty risk is substantially reduced, and each party would be required to follow collateralization rules of the exchange. In a private party transaction, collateralization should be required as suggested by ANPR 2 (i.e.: only permissible investments may be used for collateral). A letter of credit may be a viable substitute for collateral depending on the strength of the issuer. However, due to the risk of systemic failure within the banking sector, a letter of credit may not necessarily provide protection when it is needed the most.

In conclusion we feel the following restrictions for a credit union to perform derivative transactions independently are appropriate:

- Minimum net worth of 6%.
- Permissible derivative instruments restricted to interest rate swaps and interest rate caps, floors, and collars.
- Options may only be purchased. Selling options should be prohibited unless prior regulatory approval is obtained.
- Restrict the total notional amount of derivatives outstanding at any given time to 200% of net worth and/or 1/3 of total assets.

Please contact me should you have any questions or concerns. My phone number is 317-200-3150.

Sincerely,

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President
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