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CREATING OWNERSHIP AND ECONOMIC OPPORTUNITY

April 3, 2012

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

RE: Self-Help Federal Credit Union Comments on Advance Notice of Proposed Rulemaking for Part 703, Financial Derivatives Transactions to Offset Interest Rate Risk

Via e-mail: regcomments@ncua.gov

Dear Ms. Rupp,

Thank you for providing Self-Help Federal Credit Union with the opportunity to comment on NCUA's Advanced Notice of Proposed Rulemaking on Financial Derivatives Transactions to Offset Interest Rate Risk. As we noted in our response to last year's ANPR ("ANPR I") on this subject, we believe that one of the greatest threats facing credit unions over the next decade is the interest rate risk associated with serving members' needs through long-term real estate lending – the most viable lending product that credit unions can produce at sufficient scale to both serve their members' needs and sustain themselves financially. For that reason, Self-Help FCU supports expanding the number of FCUs using derivatives to effectively manage their interest rate risk. We support granting independent authority to credit unions that have the knowledge and operational tools to implement a derivatives program. We applaud NCUA's interest in granting reasonable authority – both via third party pilots and independent authority – to engage in derivatives to offset interest rate risk ("IRR").

As noted in ANPR I, Self-Help Federal Credit Union is authorized to use derivatives via the ALM First Pilot Program, though it has yet to enter into any derivatives under the program. Self-Help Credit Union, our affiliated federally-insured state-chartered credit union, and Self-Help Ventures Fund, our affiliated non-depository community development loan fund, have almost ten years of experience using interest rate swaps. Our comments are based on the substantial experience of these institutions in utilizing and managing a portfolio of interest rate swaps to manage interest rate risk.

We believe that NCUA is moving in the proper direction by describing a proposal to allow FCUs with adequate capital, reasonable levels of staff experience and strong systems and controls to engage in independent authority. As we described in our comments on ANPR I, we strongly believe that derivatives authority should not be artificially limited, by either the notional amount outstanding or mark-to-market value of derivatives. Neither of these is a measure of IRR, and as such, provide little value in mitigating IRR. At the same time, such limits do not describe any

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other material risk to a credit union, such as accounting or compliance risk. In our experience, back off ice accounting, legal and valuation systems are almost as important an indicator of an institution's capacity to independently manage a derivatives portfolio as the specific experience of the credit union's staff.

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. A credit union needs to be prepared to mitigate risk before the risk occurs. If a credit union plans to increase its long-term real estate loan portfolio, it must have the tools in place to off-set the interest rate risk created by such lending <u>prior</u> to making the loans. Only credit unions with a known – existing or foreseeable – exposure to interest rate risk that justifies it seeking independent derivatives authority are going to seek such authority. Waiting until risk exists before NCUA grants independent authority neither reduces risk to the credit union nor the insurance fund.

Waiting until a credit union has a material IRR exposure provides credit union's with a false incentive to establish risk and then seek to put in the controls to mitigate those risks. In our experience, it take a substantial investment in staff and operations to establish a derivatives program – negotiating swaps contracts with prospective counterparties, establishing measurement controls and accounting procedures, etc. A credit union is unlikely to begin making such an investment until it is confident that NCUA will grant it independent authority. As such, waiting until after the risks exists to even request authority exacerbates the risk by increasing the amount of time before the credit union can put the mitigant in place and thereby address any risk.

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?

We believe NCUA should require an FCU to be well-capitalized prior to engaging in independent transactions. While a credit union that is less than well-capitalized may need derivatives to help improve its financial condition, it is reasonable that NCUA guide such a credit union to an approved third-party vendor to assist that credit union, given the capital at risk.

We do not believe that CAMEL rating should be a precondition to independent authority. CAMEL composite ratings are broad measures of performance, whereas derivatives are used to mitigate a narrow risk.

CAMEL ratings do not adequately identify the potential IRR and mitigation that an FCU can undertake. For example, a credit union with strong capital, good management controls and adequate training and systems for managing derivatives could be a CAMEL 3 or even a CAMEL 4 solely because of a troubled loan portfolio. That credit union might need to enter into derivatives in order to off-set its increasing IRR. A derivative trade would reduce its IRR and might even improve its CAMEL composite rating. If the credit union can demonstrate it meets the minimum standards described in question 3 and can reduce risk through derivatives, NCUA should encourage, not discourage, the credit union from using appropriate tools to manage its risk.

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., prepayment and call options)? To what extent should and FCU seeking independent derivatives authority be allowed to rely on an outside party to fulfill an experience and expertise requirement?

We agree that some reasonable minimum experience level that can be documented is appropriate before an FCU can enter into independent authority. In our response to ANPR I, we proposed that such limits be evaluated on a case-by-case basis. Some FCUs might be in a pilot for three years with little or no transaction activity, and thus, may be unprepared for independent authority. Others might only be engaged in a pilot for a year, execute many transactions, and have staff with prior experience, and therefore, be able to demonstrate adequate expertise and experience more quickly than three years.

As we also noted in our ANPR I response, qualified staff also need good systems. We highlighted some of the actions we believe an FCU should demonstrate, which we repeat below:

It is absolutely critical for an FCU to have robust derivatives back-office infrastructure in accounting, reporting and valuation. An FCU has to be able to value all of its positions daily and make margin calls of each counterparty. While third-party technology, such as Bloomberg, should be used to value derivatives, such systems have to be operated by qualified personnel that are equipped to engage with their counterparties on a daily basis.

- Demonstrate the capacity to adequately measure and monitor interest rate risk, by the use of a qualified third-party asset-liability management ("ALM") analysis vendor or third-party software operated by qualified in-house personnel. The rigor of third-party analysis and/or software ensures that a credit union is using a widely-accepted model for measuring and monitoring IRR rather than using in-house developed tools that have not been reviewed and tested by others. If an FCU runs its own ALM model in-house using outside software, NCUA may want to consider requiring the FCU to have its ALM model validated by a qualified third-party from time-to-time – perhaps biennially. A third party validation ensures that the modeling that drives the decision to use derivatives is sound.
- Establish a derivatives policy that describes the objectives and parameters under which derivatives will be used, including established limits for counterparty exposure.
- Develop GAAP compliant accounting procedures for derivatives.
- Install information systems that can accurately value the FCU's derivatives positions daily.

- Provide adequate personnel to make and respond to daily margin calls.

We do not believe NCUA should attempt to delineate between "complex" and "less complex" balance sheets. Any credit union that seeks independent authority is going to have to be able to model prepayments and options, which are the primary drivers of interest rate risk, particularly in a long-term residential mortgage portfolio. To the extent that a credit union explicitly owns investments with embedded options in them, such instruments may be easier to measure than a mortgage portfolio, which has a free, one-way, lifetime option to the member-borrowers. As such, we do not believe there is a material difference between a "complex" and "less complex" balance sheet for credit unions that will seek derivatives authority – independent or otherwise.

We do not believe that a credit union should be allowed to rely on an outside party to fulfill an experience and expertise requirement prior to entering into independent derivatives authority. The training a credit union's employees receive from a third party should help it meet the minimum qualifications standard and a credit union should be able to work with a third party to document systems. For example, a third party valuation system could be part of the controls an FCU puts in place. However, the FCU should be able to demonstrate its independent understanding of such a system, rather than simply relying on the outside party.

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?

FCUs should be limited to using derivatives that offset and manager IRR. We do not believe NCUA should proscribe the types of derivatives beyond that mandate. While our sister credit union, Self-Help Credit Union, has only used pay-fixed/receive-floating interest rate swaps, it has considered using swaptions to offset IRR. Floors and other derivatives that offset interest rate risk could also be useful tools for a given FCU, provided the FCU has adequate accounting, valuation and margin management tools to monitor, record and report risk.

The limits on derivatives should be based on their effectiveness in mitigating interest rate risk. An FCU should clearly state its objectives for managing IRR in board-approved policies. Objectives should both be programmatic and measurable, e.g., to reduce the interest rate risk created by funding long-term fixed rate loans to members with short-term deposits from members, and quantitative. For example, after a +/- 300 basis point instantaneous interest rate shock, Self-Help FCU's ALM policy requires net economic value ("NEV") to remain above 6 percent and the change in NEV to not exceed 35 percent of base NEV.

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?

NCUA should require and FCU's board of directors to establish exposure limits, such as those described above. Those exposure limits should not be based on artificial measures such as notional amount and/or mark-to-market valuation. Instead, limits should be based on the amount of risk being offset by the derivatives.

Specifically, the existing maximum limit of 250 percent of net worth for the notional amount of swaps outstanding plus the value of underlying securities in option transactions, or any other such limit based on notional or mark-to-market valuation does little to actually curb risk. We propose that NCUA limit the net notional swaps outstanding to 100 percent of long-term real estate assets.

Swaps positions should be matched to the interest rate risk created by holding long-term real estate loans funded by shorter-term liabilities, primarily member shares, rather than tied to net worth. Interest rate swaps, for example, can be structured in a maturity ladder, to hedge both the likely cash flows coming from the long-term loans and the borrowing members' option to prepay. An FCU that has 50 percent of assets invested in long-term real estate loans should generally have hedges in place with a net notional amount equal to 80-100 percent of those loans, with swaps laddered out over a 2-to-10 year period to mimic the likely cash flows generated by the hedged loan portfolio.

An artificial notional or mark-to-market limit provides an undue incentive for FCUs to enter into longer duration swaps with lower notional amounts. Longer-term swaps appear to limit NEV at risk in a shocked interest rate scenario. However, long duration swaps are ineffective at matching potential changes in interest rates in the short-to-mid term and give the FCU less flexibility to dynamically re-balance its balance sheet as its asset mix changes and/or prepayment speeds change.

We do not support using a mark-to-market valuation limit because it is a poor measure of IRR management. A market loss in a derivatives portfolio is recognized under GAAP as unrealized losses in net worth. However, such an unrealized loss is often more than offset by a commensurate gain in the value of long-term fixed rate loans, which GAAP all but precludes from being recognized anywhere on a credit union's financial statement. As such, a credit union's balance sheet may continue to be well-hedged with very little, if any, NEV volatility even when it is carrying a large net unrealized loss on cash flow hedges in its GAAP net worth.

The most economical trade for an FCU might be an out-of-the-money derivative trade that, by definition, has a fair value other than zero. This trade creates no financial or compliance damage, and as such, should not be discouraged solely because of its carrying value. Our sister credit union, Self-Help Credit Union, has acquired out-of-the-money swaps rather than buying new swaps in the past without any harm to the institution.

We use the term "net notional" in our recommended derivatives limit because one way to offset the IRR protection of a swap that is no longer needed is to enter into an offsetting swap of like term, amount and structure. For example, if a credit union decides to sell a portion of its long-term real estate portfolio, the credit union may need to cancel the swap it entered into to hedge that portfolio. Rather than recognizing an immediate gain or loss by terminating the swap prematurely, the credit union could enter into an offsetting swap that effectively cancels the hedge. While the total notional amount outstanding has doubled, the two positions effectively cancel each other out. NCUA should not artificially preclude such an action.

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?

We strongly support NCUA's recommendation to use bilateral collateral agreements, tri-party custodians and/or zero thresholds, coupled with strong collateral eligibility standards, to mitigate counterparty risk. As we noted in our response to ANPR I, such systems are vastly superior to credit ratings inasmuch as they actually mitigate counterparty risk.

We encourage NCUA to be specific, in its proposed regulations, as to the definition of thresholds. For example, we have seen swaps contracts where the threshold is zero but the minimum transfer amount is $1,000,000 and swap contracts where the threshold is $500,000 and the minimum transfer amount is $250,000. The latter situation has less risk than the former, because the actual counterparty exposure is never more than $749,999, whereas the former could be as high as $999,999, even though the former has a "zero threshold". We encourage NCUA to provide reasonable leeway for a credit union to use thresholds and minimum transfer amounts to effectively limit risk without prescribing specifics for each. As we noted in our response to ANPR I, we recommend that NCUA establish a 5 percent of net worth at-risk limit for any single counterparty and a 20 percent of net worth aggregate limit for all active counterparties, using a combination of thresholds and minimum transfer amounts. FCUs may negotiate lower limits with counterparties, but should not be permitted to exceed these limits.

Thank you again for your attention to this important matter. Helping credit unions access the tools to prudently manage the interest rate risk associated with serving their members' needs and strengthening the institution's financial stability through long-term real estate lending is a crucial step forward for credit unions and NCUA.

Sincerely,

Randy Chambers
Chief Financial Officer