NAVY FEDERAL Credit Union

Office of the President

April 3, 2012

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

Re: Comments on 2nd Version of the Advanced Notice of Proposed Rulemaking - Derivatives

Dear Ms. Rupp:

Navy Federal Credit Union is pleased to provide comments on the National Credit Union Administration's (NCUA) 2nd Advanced Notice of Proposed Rulemaking (ANPR) governing the use of Derivatives for Federal Credit Unions (FCUs).

Overall, we believe the NCUA should provide FCUs the ability to use derivatives for the non-speculative management of interest rate risk. These instruments are a highly effective tool for managing risk; as such, we do not believe their use should be curtailed in any fashion, particularly for those FCUs who have already demonstrated an ability to use them effectively.

We agree FCUs need to conduct this activity in a prudent and well-controlled manner. To achieve these goals, we believe the NCUA should offer FCUs two alternatives for using these instruments: execute transactions under the guidance of a third-party program, or, for those FCUs that qualify, grant them the authority to execute these transactions independently.

For those FCUs that want the advice and assistance of a third-party advisor, we recommend the NCUA continue to use the framework that exists under the current pilot program. We believe this process will provide the majority of FCUs the ability to use these instruments without having to invest in the extensive resources necessary to support an independent derivatives program.

For those FCUs that wish to act independently, we support establishing additional requirements and layers of control to ensure they use these instruments in a safe and sound manner. For example, we agree the NCUA should require a minimum level of financial stability. We also agree the NCUA should consider the expertise and experience of a FCU's staff when considering the readiness of an institution to transact independently. However, we do not believe it is necessary for a well-managed institution to demonstrate a material level of risk before being granted authority to use these instruments. As the NCUA has recognized, when used properly, these instruments enable FCUs to better manage their risk. We see no reason to limit their use only to those institutions that have a higher degree of risk. If they are beneficial to high risk institutions, they are beneficial to all institutions that want to lower their exposure to interest rate risk. The decision to use these instruments should be based on an individual FCU's desire to mitigate their risk and their ability to do so in a safe and sound manner.

The ANPR raised several questions regarding limits for those FCUs who elect to act independently. We believe these limits should be established by a FCU's Board of Directors and not the NCUA. Historically, the process of establishing risk tolerances and limits has been, and should continue to be, the responsibility of a FCU's Board of Directors. We understand the NCUA's desire to monitor the amount of exposure a FCU has to this activity, but we believe the industry would be better served by having the regional examination staff oversee the level of risk taken by an individual FCU rather than an industry-wide limit.

Finally, we strongly recommend the NCUA authorize FCUs to execute interest rate swaps and purchased options including derivations thereof (e.g., swaptions and floors). We do not believe limiting interest rate swaps to the pay-fixed variety is consistent with the principles of effective risk management. In fact, this limitation may hinder a FCU's ability to effectively use these instruments to manage risk. Additionally, the NCUA should enhance the list of authorized instruments to include basis swaps and interest rate futures. Basis swaps will allow FCUs to manage the inherent basis risk between Prime-based lending products (e.g., credit cards) and LIBOR based funding sources (e.g., deposits and borrowings). This is a risk management tool available across the financial services industry and a limitation of the current pilot program. Futures will give FCUs access to a deep and liquid market for hedging interest rate risk.

In Attachment I we provide our detailed responses to the six questions raised in the ANPR: (1) whether to require a material amount of IRR; (2) whether to require minimum performance thresholds; (3) whether to establish minimum experience requirements; (4) whether to limit the types of instruments; (5) whether to establish exposure limits, and; (6) what ways should a FCU mitigate credit risk.

In summary, we believe it is important to provide FCUs with all of the tools necessary to manage their balance sheets. We also believe it is important for the NCUA to establish controls and minimum requirements such that FCUs who use these instruments do so in an effective and well-controlled manner. The resources required to use these instruments can be substantial, hence, the use of a third party advisor is appropriate for those FCUs who lack the ability to manage the risks internally. For those FCUs who have the capabilities, the NCUA should grant them the authority to manage their balance sheet with all of the available tools in the marketplace. Providing FCUs with the tools necessary to manage risk will enable them to better serve their members while enabling them to better manage the risk on their balance sheets.

If you have any questions, please contact our Chief Financial Officer, Lauren Lloyd at (703) 255-8720.

Sincerely,

Cutler Dawson

Cutler Dawson
President/CEO

CD/sm
Enclosure

Attachment I

This attachment is provided as a supplement to our response to the Proposed Rule. It is organized according to the specific questions raised by the NCUA in the ANPR. First, we address the NCUA's questions regarding the eligibility of FCU's to independently use derivatives. Second, we address the NCUA's questions regarding safety and soundness.

Eligibility of Applicant FCUs for Independent Derivatives Authority

Our responses to the NCUA's specific questions are below:

1. ***Should the Board require a FCU to demonstrate a material IRR exposure or another evident risk management need before it is granted independent derivatives authority?***

   Irrespective of whether a FCU pursues this activity independently or via a third-party program, we do not believe it is necessary for a FCU to demonstrate material IRR exposure before being granted authority to use these instruments. The purpose of these instruments, if used properly, is to reduce interest rate risk. The ability to lower a FCU's risk profile should not be limited only to those FCUs who have higher levels of risk. If a FCU's Board of Directors wants to lower their interest rate risk, they should be afforded all the tools necessary to achieve their risk management objectives; provided they execute these strategies in a safe and sound manner.

   Additionally, the term "material" is ambiguous. This approach puts the NCUA in a position to prescriptively define "material interest rate risk" such that it fits across the entire industry. Unfortunately, what may be material to one FCU may be acceptable to another. For example, a thinly capitalized FCU may not be willing to accept any interest rate risk because it cannot afford the risk. Conversely, a very well capitalized FCU may be more comfortable with a higher level of interest rate risk because it has the financial strength to absorb potential losses. Historically, the discussion of what constitutes a material level of risk has been between a FCU's Board of Directors and the NCUA's regional examination staff. We believe creating a definition of "material" will inadvertently create an industry-wide barometer by which all FCUs will be judged. We believe the determination of acceptable levels of risk should remain the purview of an individual FCU's Board of Directors; subject to regulatory oversight by the regional examination staff.

2. ***Is it appropriate to require minimum performance levels, as measures, for example by CAMEL ratings and net worth classifications, when considering whether to grant or deny a FCU's application to independently engage in derivatives transactions?***

   We believe it is appropriate for the NCUA to consider the financial strength of a FCU when granting *independent* authority to a FCU. As noted above, we support industry-wide access to derivatives; however, the ability to execute these transactions without third-party assistance should require an additional level of preparedness and financial stability.

While we support the concept of performance measures, we do not believe the aggregate CAMEL rating should be used as a barometer. The CAMEL rating includes many other factors that go beyond a FCU's ability to use these instruments independently. If the NCUA were to use the CAMEL rating, we believe it should be limited to the ALM component of the rating, not the entire rating. In this case, we believe a rating of 2 or higher for the ALM component would be appropriate.

We also support a minimum net worth classification. We believe all FCUs that seek independent authority should maintain a "well-capitalized" status. This level of capital ensures the FCU can better absorb losses from any missteps executing these transactions.

Additionally, we recommend the NCUA remove the pilot program's limitation of 250% of net worth. The current limit reduces the effectiveness of these instruments as a risk management tool. For example; if a FCU has $100mm in assets and is well-capitalized (e.g., 7% net worth), it can only use $17.5mm of derivatives against a $100mm balance sheet. If this FCU wanted to reduce the risk on a larger percentage of its balance sheet, it could not do so with derivatives because the current 250% limit restricts them to ~17% of their balance sheet. We recommend the NCUA remove this limit and allow FCUs to use these instruments to manage risk on their entire balance sheet; subject to controls and safety & soundness considerations.

3. ***What is the minimum kind and amount of derivatives experience and expertise that a FCU's staff should demonstrate before the FCU receives independent derivatives authority? To what extent should a FCU seeking independent derivatives authority be allowed to rely on an outside party to fulfill an experience and expertise requirement?***

We believe it is appropriate for the NCUA to consider the expertise of the FCU's staff before granting *independent* derivatives authority. We also agree what constitutes "adequate derivatives experience" will vary depending on the nature and complexity of a FCU's balance sheet; however, we recommend the NCUA clarify what constitutes derivatives experience. We believe there are two elements of experience related to derivatives: analysis and execution. With respect to analysis, we believe the NCUA should clarify its experience requirements to focus on Asset/Liability Management expertise. FCUs who seek independent derivatives authority should have sufficient risk management systems and in-house experience to properly identify the risks on the balance sheet and independently construct risk mitigation strategies. FCUs should also have the ability to model how these risk mitigation strategies will perform under a variety of future interest rate environments. It is crucial for a FCU to have the requisite systems and expertise in-house before executing any hedging strategy. We believe the

NCUA's 3 year requirement is appropriate for ALM expertise.

The NCUA should also require FCUs to have the ability to effectively trade, process and monitor these transactions. A FCU seeking *independent* authority should be required to demonstrate the requisite trading, middle and back office operations and controls necessary to ensure timely processing and servicing of these transactions on an on-going basis. Since many of these transactions are long-term in nature, the FCU should also demonstrate an ability to maintain the necessary industry standards over time.

We do not believe a FCU that wishes to act independently should rely on outside parties to fulfill their experience requirement. We believe many FCUs will benefit from a third-party program, but for those FCUs' seeking authority to act on their own, they should be in a position to make the necessary investments to bring the expertise in-house.

Safety and Soundness Requirements

Our responses to the NCUA's specific questions are below:

4. ***Should FCUs be limited to using interest rate swaps and 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 a FCU does not transact interest rate derivatives in an amount greater than the level of its IRR exposure?***

The current derivatives pilot program allows FCUs to execute interest rate swaps and options. By extension, this allows FCUs to execute combinations of these products (e.g., swaptions). We strongly recommend the NCUA not limit the scope of authorized products; in fact, we recommend the NCUA add basis swaps and interest rate futures to its list of authorized investments.

Interest Rate Swaps

FCUs should be allowed to execute all forms of interest rate swaps; not just pay-fixed swaps. Limiting a FCU's ability to pay-fixed swaps reduces their ability to execute effective hedge transactions. For example; FAS133 has specific identification requirements which limit a FCU's ability to use swaps and still achieve deferral accounting. Given the requirements of FAS133, limiting a FCU to only pay-fixed swaps will significantly reduce the specific assets or liabilities that can be designated for hedge accounting purposes. This limits the value of the derivatives program which we do not believe is consistent with the NCUA's intent.

We understand the perspective in the ANPR that most FCUs are exposed to rising rates, however, our recommendation is the NCUA create a derivatives program that is robust in all rate environments. There are cases where a FCU may need to use receive-fixed swaps to mitigate risk on its balance sheet and simultaneously meet the requirements of FAS133. For example; assume a FCU has made shorterterm car loans and funded them with longer-term CDs. In this example the FCU is exposed to falling rates and given the requirements of FAS133, it is preferable to hedge the CD portfolio rather than the auto loan portfolio. In this case, the FCU would execute a received fixed swap to shorten the duration of its liabilities to match the cash flows from its assets. If the NCUA were to limit the use of interest rate swaps to pay-fixed, this FCU would have its risk management alternatives limited. Effective hedging is about matching cash flows; limiting the tools FCU's can use will reduce the benefits to the industry.

Options

The current pilot program allows FCUs to use purchased options. We recommend the NCUA continue to allow FCUs to use purchased options. We do not believe the NCUA should limit the use of options to "caps". Similar to the concerns highlighted above regarding the use of only pay-fixed swaps, there are situations and interest rate environments where a "floor" may be beneficial to the FCU. For example; a FCU may issue deposit products where the interest rate floats but maintains a minimum level (e.g., a floor). The ability to use a floor as an offset allows FCUs to mitigate the risk of falling rates. As noted above, the derivatives program should be structured so it enables effective risk management in all rate environments rather than focusing on those instruments that primarily benefit FCUs in rising rate environments.

Additionally, we encourage the NCUA to ensure the final language does not prohibit the use of swaptions (i.e., options on swaps). For holders of convex assets (e.g., mortgages and MBS), the ability to manage the optionality is extremely important. A key tool for managing convexity risk is the ability to use options and swaptions. Given the NCUA's concern about FCUs holding mortgages on the balance sheet, the ability to use swaptions is paramount. We encourage the NCUA to mirror the language in the existing pilot program which gives FCUs the ability to execute both swaps and options, and by extension, swaptions.

Basis Swaps

The current pilot program does not allow FCUs to execute basis swaps (i.e., Prime vs. LIBOR swaps). With the introduction of the Card Act, many credit card issuers switched their fixed rate credit cards to floating rate cards. The rate on these products is almost invariably tied to the Prime rate. Unfortunately, most funding is tied to LIBOR. The deposit market and the capital markets are tied to the overall level of interest rates which is driven by the LIBOR/Swap curve. This exposes a FCU to Prime / LIBOR basis risk. This is the risk that LIBOR will move differently than the Prime rate. For example; LIBOR may increase while the Prime rate remains constant. This will cause margin compression for FCUs. In order to manage this risk, FCUs should be authorized to execute a Prime / LIBOR basis swap. For example; the FCU could convert its Prime-based credit card receivables to a LIBOR-based receivable thereby eliminating the risk that Prime and LIBOR do not move in tandem. This is a tool readily available to other financial institutions and a mainstay of sound risk management. We recommend the NCUA authorize FCU's to use this type of swap; irrespective of whether they are acting independently or through a third-party program.

Interest Rate Futures

FCUs should be allowed to use exchange traded futures, such as Eurodollar and Treasury futures, and options on these futures. Eurodollar futures and options on Eurodollar futures provide interest rate risk management benefits identical to those provided by swaps, caps and floors while Treasury futures and options on Treasury futures are a natural means of hedging the interest rate risk associated with holding Treasury securities. Exchange traded instruments also provide additional benefits vis-à-vis the over-the-counter market including; greater price transparency, improved liquidity, reduced counterparty credit risk, greater operational efficiency and potentially reduced operational risk due to contract standardization. We recommend the NCUA add these instruments to their list of authorized derivatives.

5. ***Should NCUA establish exposure limits for FCUs or should it require a FCU's board of directors to establish exposure limits? Should there be limits on the aggregate amount of each type of derivative 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 derivative, its market value, or both?***

The NCUA should not prescribe exposure limits as part of this rule. The process of establishing risk tolerances and limits has been, and should continue to be, the responsibility of a FCU's board of directors. We understand the NCUA's desire to monitor the exposure a FCU may have to this activity, but we believe the industry would be better served by having the regional examination staff oversee the level of risk taken by an individual FCU.

We do not believe there should be limits on the aggregate amount of derivatives in the portfolio. As long as the FCU can demonstrate its hedging strategies have reduced risk (i.e., are not being used for speculative purposes), we do not see the value of establishing limits on the amount that can be used. Assuming they are being used properly, why would the FCU want to limit their use? We support establishing "triggers" at which point the FCU must review the effectiveness of the program with their board of directors, but we do not support an arbitrary line in the sand which could potentially limit a FCU's ability to use an instrument that adds value.

We do support limits on counterparty exposure and these limits should be part of a FCU's regular wholesale credit risk management processes. We do not believe the NCUA should prescribe these limits but rather require a FCU to have a robust wholesale counterparty credit risk management program that; measures the amount of exposure to each counterparty, evaluates the financial risks of the counterparties, and monitors their health over time.

As noted above, one of the basic principles of credit risk management is diversification. Under the current pilot program, the ability to establish a diversified set of derivatives counterparties is hindered by the minimum credit rating criteria. We request the NCUA relax, or eliminate, the minimum credit rating criteria (elimination would be consistent with the proposed changes under the Dodd-Frank Act). We understand the current standard was established at a time when the credit ratings of several financial counterparties were much higher, however, given the events of the past few years, there are only a few counterparties that are eligible trading partners. This hinders a FCU's ability to diversify counterparty risk. We further request the NCUA consider allowing the Federal Home Loan Banks to stand as counterparties given their financial stability and close ties to the U.S. Government.

Finally, any limits established should be based on the market value of the derivative. When examining the risk of derivatives, the concept of notional value is far less meaningful than market value. The notional value is merely the basis on which cash flows are valued and exchanged; the economic risk of the transaction is based on the market value. We do not support limits based on notional value.

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?***

The derivatives market is evolving to address the systemic risks caused by the failure of Lehman Brothers. One area not addressed by the ANPR is the planned creation of a derivatives exchange. We recommend the NCUA authorize FCUs to participate in this exchange, or any other type of clearinghouse arrangement, to reduce the risk of bi-lateral agreements. To the extent FCUs can participate in an exchange, or at a minimum clear their transactions through an exchange, they will have materially reduced their counterparty credit risk. We believe the ability to use these types of exchanges should be explicitly authorized as part of the final rule. This authority should extend to FCUs that elect to act independently as well as FCUs that transact under the auspices of a third-party program.

Under the current pilot program, the NCUA requires FCUs to use a tri-party custodial agreement. While on the surface this may appear to be beneficial, it will significantly reduce the ability of FCUs to execute transactions. The use of a tri-party custodial relationship is ***not*** industry standard. The tri-party relationship adds cost and operational burdens to the program which makes it difficult to finds counterparties who are willing to enter into ISDA agreements that mandate the use of a third-party custodian. This effectively limits the universe of trading partners which increases credit risk because a FCU will likely need to concentrate its transactions with the few counterparties who are willing to utilize this type of structure. Additionally, we believe effective margin and collateral requirements will enable FCUs to achieve effective credit risk management even if they are using bi-lateral arrangements. As noted above, FCU must have robust middle and back office operational capabilities to execute these types of transactions. Given these capabilities, FCUs can effectively monitor their collateral positions and manage the risk of counterparty failure without having to rely on, or pay for, a tri-party custodian. We recommend the NCUA remove the requirement to use a tri-party custodian.