

April 3, 2012

**BY ELECTRONIC SUBMISSION**  
**AT WWW.REGULATIONS.GOV**

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

**Re: Advance Notice of Proposed Rulemaking for 12 CFR Part 703, Financial  
Derivatives Transactions To Offset Interest Rate Risk**

Dear Ms. Rupp:

The undersigned Federal Home Loan Banks (“FHLBanks”) appreciate this opportunity to comment on the advance notice of proposed rulemaking (“ANPR”) published by the National Credit Union Administration (“NCUA”) in the Federal Register on February 3, 2012, which requests additional comments to identify conditions for federal credit unions (“FCUs”) to engage in certain derivatives transactions for the purpose of offsetting interest rate risk (“IRR”). The FHLBanks are supportive of the NCUA’s proposal to modify its rules regarding the conditions under which FCUs may engage in derivatives transactions. We believe that FCUs should have the authority to engage in derivatives transactions through their choice of a third party or, depending on their levels of experience and expertise in derivatives transactions, independently. Given that FCUs differ significantly in their sizes and portfolios, the FHLBanks do not believe the NCUA should adopt a one-size-fits-all approach when determining when or under what conditions FCUs should be allowed to engage in derivatives transactions. Instead, the FHLBanks urge the NCUA to evaluate FCU eligibility on a case-by-case basis and to establish a broad set of parameters when determining FCU qualifications to engage in derivatives activities independently and through third parties.

***The FHLBanks***

The twelve FHLBanks are government-sponsored enterprises of the United States, organized under the authority of the Federal Home Loan Bank Act of 1932, as amended, and structured as cooperatives. Each FHLBank is independently chartered and managed, but the FHLBanks collectively issue their consolidated debt obligations for which each is jointly and severally liable. The FHLBanks serve the general public interest by providing liquidity to approximately 7,800 member financial institutions, thereby increasing the availability of credit for residential mortgages, community investments, and other services for housing and

community development. The FHLBanks' member institutions, which include banks, savings institutions, credit unions, community development financial institutions, and insurance companies, are also their shareholders. The FHLBanks provide readily available, low-cost sources of funds to their member financial institutions through secured loans referred to as "advances."

The FHLBanks enter into swap transactions as end-users with swap dealers to facilitate their business objectives and to mitigate financial risk, including primarily IRR. As of December 31, 2011, the aggregate notional amount of over-the-counter interest rate swaps held by the twelve FHLBanks collectively was approximately \$706 billion. Certain of the FHLBanks also provide their member institutions, particularly smaller, community-based institutions, with access to the swap market by intermediating swap transactions between the member institutions and the large swap dealers, thus allowing such members to hedge IRR associated with their respective businesses.

#### ***Eligibility of Applicant FCUs for Independent Derivatives Authority***

As end-users who engage in derivatives transactions for purposes of managing their own IRR and who assist their member institutions in accessing the derivatives market when such access would not otherwise be available or available on reasonable terms to such institutions, the FHLBanks appreciate the benefits derivative instruments can provide when used as risk management tools. As such, the FHLBanks believe the NCUA's modified rules should be sufficiently flexible to permit FCUs to engage in derivatives transactions for risk management purposes so long as the FCUs do so responsibly and in a manner commensurate with their particular risk management needs, oversight structure and expertise.

*Question 1: The NCUA has asked whether it should require an FCU to demonstrate a material IRR exposure or another evident risk management need before it grants the FCU independent derivatives authority.* While the FHLBanks believe it is reasonable to restrict FCUs to utilize derivatives only for risk management purposes, we have concerns that restricting derivatives access to FCUs that can demonstrate a material IRR exposure *before* such authority is granted could prevent FCUs that are proactively managing their IRR from taking advantage of this useful risk management tool. For example, an FCU might benefit from utilizing derivatives instruments in order to prevent its IRR from becoming "material," yet such an FCU would not be able to take advantage of derivatives to achieve such results if it were required to demonstrate a "material" IRR exposure prior to having authority to engage in derivatives transactions.

The FHLBanks believe that an FCU's board of directors and management team are in the best position to determine if the use of derivatives instruments would be consistent with its risk management objectives. Therefore, instead of requiring FCUs to demonstrate a particular need in advance of obtaining derivatives authority, the FHLBanks propose that the NCUA simply permit FCUs to use interest rate derivatives only for hedging purposes and consider an approach similar to that imposed by the FHLBanks' own regulator, the Federal Housing Finance Agency ("FHFA"). Under the FHFA's regulations, the FHLBanks have authority to enter into

derivatives contracts. However, that authority is subject to limitations and prudential requirements outlined in the FHFA's regulations, including that derivatives instruments that do not qualify as hedging instruments be used only if the FHLBank can document that it is for non-speculative use.

*Question 3: The NCUA has asked for input regarding the minimum kind and amount of derivatives experience and expertise that an FCU's staff should demonstrate before the FCU receives independent derivatives authority and whether an FCU seeking independent derivatives authority should be allowed to rely on an outside party to fulfill an experience and expertise requirement.* The FHLBanks do not believe there should be a bright-line rule or formula for determining whether FCUs have sufficient experience or expertise to participate in derivatives transactions for the purpose of offsetting IRR. However, the FHLBanks believe it is important that an FCU have a clear understanding of the risks and benefits of derivatives transactions, be in satisfactory financial condition and have appropriate policies and procedures in place before engaging in derivatives activities, including governance processes to approve derivatives transactions, delegations of contracting and transactional authority, identification of advisors or intermediaries to be retained, access to pertinent software, segregation of responsibilities between transactional, accounting and risk management personnel and record-keeping and reporting policies. In addition, the FCU should perform or obtain pro-forma analyses of the effects of using the interest rate derivatives.

The determination as to whether derivatives instruments are an appropriate fit for an FCU's business needs and whether it can effectively execute such transactions as well as the level of expertise and experience that the NCUA requires should depend on the particular FCU's circumstances. Even small FCUs without extensive derivatives experience can responsibly engage in derivatives activity if they have appropriate internal policies in place and are able to take advantage of programs that third parties can offer to them. Consequently, the FHLBanks believe that an FCU seeking independent derivatives authority should be allowed to rely on an outside party to fulfill certain experience and expertise requirements.

When considering an application for independent derivatives authority, the NCUA should take into consideration a combination of factors such as: (i) volume of derivatives transactions the FCU has engaged in through a third party, pilot program or independently in the past, (ii) FCU's operational readiness to engage in derivatives transactions independently, (iii) FCU's risk management practices, internal controls and corporate governance, (iv) derivatives experience and expertise of the FCU's board of directors, management and staff, including experience such individuals acquired while at other institutions, (v) the board's and management's understanding of the risks associated with engaging in such transactions, and (vi) the complexity of the FCU's portfolio that it is seeking to hedge. The FHLBanks suggest looking at these and other key business functions collectively and on a case-by-case basis rather than instituting a single quantitative standard since the latter approach could eliminate a pool of FCUs that might otherwise be prime candidates for responsibly engaging in derivatives transactions for their risk management needs.

### ***Safety and Soundness Requirements***

The FHLBanks believe it is important for the NCUA to establish safety and soundness requirements relating to the types of derivatives activity in which FCUs may participate and understand the NCUA's desire to prevent speculative use of derivative instruments.

*Question: 4: With respect to the NCUA's question regarding whether FCUs should be limited to using interest rate swaps and interest rate caps, the FHLBanks encourage the NCUA to consider expanding the permissible derivatives to include other low risk derivatives, such as basis swaps, swaptions, interest-rate cap and floor agreements, options and forward starting swap contracts to assist FCUs in managing their interest-rate risks. These other types of derivatives would afford FCUs additional flexibility in protecting themselves against both current and future interest rate changes thereby enabling them to maximize their ability to achieve their risk management objectives. The FHLBanks believe that the FCUs are in the best position to determine the types of instruments that best assist them in meeting their risk management goals. Thus, if an FCU can demonstrate how a particular type of derivatives instrument serves its asset liability or risk management objectives, such instrument should be permitted.*

*Question 5: The NCUA has asked if it should establish exposure limits or if it should require an FCU's board to establish those limits, if there should be limits on the aggregate of amount of derivatives instruments in the portfolio and if limits should be based on notional amount or mark-to-market valuation. The FHLBanks believe the FCU's board should be allowed to establish the exposure limits for the FCU as well as the size of the derivatives portfolio. The FCU's board would be the most able to determine what best serves the FCU's business model and risk management needs. Thus, allocating responsibility for establishing limits to the board ensures that the derivatives portfolio can best be tailored to that entity's needs. In addition, because there is not a consensus within the industry regarding the best methods for assessing limits, the FHLBanks would not recommend incorporating a requirement to set exposure limits based on either notional or mark-to-market valuation into the NCUA's rules. Arguably, both notional and mark-to-market approaches have their limitations, and setting limits without the ability to use a methodology that works within the particular context could be problematic. Therefore, the FHLBanks would support leaving that determination to the FCU's board as well.*

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The FHLBanks appreciate this opportunity to provide comments on this important rulemaking process and appreciate your consideration of these comments.

Sincerely,

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Senior Vice President and General Counsel

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