April 3, 2012

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

Re: Advanced Notice of Proposed Rulemaking: Derivatives

Dear Ms. Rupp,

On behalf of SEFCU we would like to thank the National Credit Union Administration (NCUA) Board for inviting us to comment on the NCUA's proposal on Derivatives.

SEFCU is committed to complying with all provisions governing derivatives under NCUA regulation Part 703. Our comments are outlined below.

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?

RESPONSE:
Yes, because of our cooperative environment and the potential risk associated with this type of financial instrument it would be prudent for the NCUA to require a demonstrated need before an institution enters into a derivative contract. The IRR of any credit union should be assessed through prudent asset liability management practices which would include measurements of financial factors that present risk. Those factors/metrics should have guidelines which correlate to the prudent risk tolerance of the credit union as prescribed by Senior Management and approved through policy by the Board of Directors. If those measurements should indicate that the credit union balance is extending, facing liquidity concerns or earnings pressure in the current rate environment it would potentially warrant action through the use of other financial tools such as derivatives.

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?

RESPONSE:
Yes, if a credit union has a low CAMEL (3 or lower) rating or is under-capitalized based on the current NCUA measurements it would indicate that the financial condition or management of the credit union may not be well stabilized and likely have a diminishing tolerance for risk. While derivative contracts are designed to mitigate interest rate risk, they have other inherent risks which may be a deterrent if an institution has not demonstrated financial stability. Under-capitalization, with a less than 6% Net Worth Ratio, would allow for a base minimum capital requirement.

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?

RESPONSE:

There should not be a minimum experience requirement based on direct experience. Demonstrating the ability to perform prudent asset liability management absent of entering into derivative contracts should be required and training for those responsible for the execution and analysis of derivatives. Direct experience under a set number of years would limit institutions and not necessarily be the best indicator of effective understanding. As with any financial instrument there are many levels of expertise required depending on each individual's involvement with the transaction; board/senior management oversight responsibilities will likely differ from the operational working knowledge required for trade execution and accounting. Outside parties could be used in conjunction with Management expertise, but should not be wholly relied on in place of Management expertise.

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?

RESPONSE:

The majority of credit unions likely have asset exposure to real estate collateral products, whether loans or investments and liability exposure through liquid deposit accounts. However, all institutions are different and carry various exposures based on the cash flows of their specific membership base. Allowing only two types of derivatives will limit some institutions in effectively using this interest risk tool and compromise their ability to manage their exposure. Credit union management should determine what type of derivative is the best fit for mitigating their balance sheet risk and demonstrate the specific need. Limiting the type of derivative may not anticipate future needs of the credit union. Management should establish Asset/Liability Management policies surrounding the transactions of derivatives, approved by the Board of Directors.

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?

RESPONSE:
The FCU Board of Director's should establish limits based on the specific needs and risk tolerance of the institution. Specific guidelines that reference counterparty concentration risk and mark-to-market exposure should be documented in the institutions asset/liability policy. Counterparty risk is a material risk of entering into the derivative contract and it is important to limit the aggregate exposure with any one faction which reflects sensible oversight. Counterparties should be evaluated by the credit union before and during the term of the derivative contract. Limiting the exposure to a single counterparty will serve in reducing the overall risk of the institution.

There is no one size fits all answer to effective financial management of a credit union. If the credit union has established and demonstrated prudent financial management and asset liability management then derivative exposure should be monitored with board established limits in concert with all other financial metrics of the organization. For example, limits established on the duration of the instrument should be considered when the credit union enters into any contract because the size or notional amount cannot be considered in isolation. The duration on the notional amount is just as important in keeping exposure in check; as long durations possess more 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?

RESPONSE:
Collateral management standards would mitigate the counterparty risk and add an extra layer of balance sheet protection if the counterparty is willing to enter into a contract with pledged collateral. This should be an option at Management's discretion based on the risk parameters and other financial metrics of the credit union. While mitigating counterparty risk it is important to recognize that pledging collateral introduces the potential for liquidity risk in relation to the encumberment of the securities.

Once again, we would like to thank the NCUA Board for the opportunity to comment. We would be happy to further discuss this matter, if you so desire.

Respectfully,
David J. Gosstola
CFO, SEFCU

cc: Michael J. Castellana, President and CEO, SEFCU