BCU

April 3, 2012

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

Subject: Comments on Part 703 ANPR, Financial Derivatives Transactions – Part 2

Dear Ms. Rupp:

We appreciate the opportunity to comment on the ANPR for Financial Derivatives Transactions – Part 2. In general, as we stated in our response to the initial ANPR on this topic, we believe that credit unions should have access to appropriate tools that are necessary to effectively offset interest rate risk and pro-actively manage the balance sheet in a cost efficient and capital friendly manner. Interest rate derivatives, which have been a critical part of risk management practices for most financial institutions for the past 30 years, would help credit unions to accomplish this goal.

We believe that appropriate attention should be focused on education, experience and controls regarding the use of derivatives to further ensure this tool is properly utilized to offset interest rate risk in a safe and efficient manner. We feel that credit unions should be allowed to engage independently in derivatives transactions with appropriate counterparties, given sufficient infrastructure, skill level and experience of staff and management. Counterparties should also have a bilateral collateral agreement in place that collateralizes 100% of market exposure.

Following are responses to the specific questions that were posed in the ANPR.

Question 1:
A credit union should not be required to demonstrate a material Interest Rate Risk (IRR) exposure in order to be granted derivatives authority. At the time that a material IRR exposure exists, it most likely would be too late to start implementing a hedge position in a cost effective and efficient manner. The derivatives authority would be needed to proactively develop a strategy to address interest rate scenarios that present potential risks for credit unions before they become a threat. It is important to anticipate potential future risk in various interest rate environments, rather than reacting to just the current exposure. As we also stated in our previous ANPR response, derivatives should be used for risk mitigation and not for speculation.

Question 2:
Limiting derivative authority to credit unions with a restrictive set of performance criteria may prohibit credit unions from hedging when they may need it most. Banks and other financial entities are not prohibited from hedging based on earnings, capital levels and balance sheet composition and neither should credit unions. The adequately capitalized level of 6 percent should be sufficient criteria. Temporary earnings fluctuations should not prohibit the implementation of an effective risk management strategy. It is also possible that earnings issues could actually be related to interest rate risk and the responsible use of derivatives would lessen those earnings challenges. Effective risk management tools should not be limited based purely on financial condition as long as both parties to the contract have the ability to fulfill their obligations under the respective contract.

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Question 3:
Credit unions should be allowed to rely on qualified third parties to fulfill the expertise and experience requirements and not be restricted to use certain service providers. We believe that most credit unions would begin with small and limited derivatives trades. If so, then it may be operationally burdensome and cost prohibitive to require in-house derivatives transaction experience. It may not be financially prudent to hire new staff just to manage a small and limited derivatives exposure. Also, derivatives experience can be acquired in a variety of ways besides trading, which would include education, modeling, and analytical experience and expertise. Other types of balance sheet instruments, including certain investments and loans, incorporate the same types of features and cash flows as derivatives, but do not have a requirement for trading experience.

Question 4:
Credit unions should not be limited to using caps and pay-fixed/receive-floating instruments. This may incorrectly assume that all credit unions have exposure to risk in only a rising interest rate environment, although this may be a common scenario. If derivatives are used to hedge risk, why should they be limited to hedging risk in only one direction? As stated in our response to the initial ANPR, if BCU had derivatives authority, we would deploy interest rate swaps and/or floors to hedge down-rate earnings volatility risk on our mortgage servicing rights (MSR) asset, which is carried at fair value on the balance sheet.

Question 5:
The credit union's Board should establish exposure limits based on a mark-to-market valuation or some measure of market value or earnings volatility, but not based on notional amount. A $10 million notional amount for a 1-year derivative could have the same impact as $1 million notional amount for a 10-year derivative, so the notional amount is less important than limits based on a measure of earnings and/or capital impact.

Question 6:
Bilateral collateral agreements should be required in order to contain the credit exposure.

In summary, we feel strongly that credit unions should have the ability to use derivatives for the efficient management of interest rate risk. Furthermore, we also believe it is imperative that the NCUA develop an effective regulatory framework that is not overly burdensome. It should also allow credit union management, with the appropriate expertise, the ability to execute derivatives transactions through a number of acceptable financial intermediaries and not be restricted to a particular counterparty. A committed focus on effective and responsible risk management will be critical for credit unions in the future. In this regard, we believe interest rate derivatives should be available to credit unions. Thank you for the opportunity to comment on this subject matter.

Please feel free to contact myself or my staff with any questions or comments with regard to this response. We would be happy to work together with the NCUA staff to design an effective solution.

Best regards,

Todd A. Gustafson, CPA
Senior Vice President & Chief Financial Officer
Baxter Credit Union