



OHIO CREDIT
UNION LEAGUE

April 3, 2012

VIA E-mail: regcomments@ncua.org

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

RE: Comments on Advance Notice of Proposed Rulemaking for Part 703, Financial Derivatives Transactions to Offset Interest Rate Risk

Dear Ms. Rupp:

The Ohio Credit Union League (OCUL) appreciates the opportunity to comment on the National Credit Union Administration's (NCUA) Advance Notice of Proposed Rulemaking for Part 703 (Financial Derivatives Transactions to Offset Interest Rate Risk).

OCUL is the trade association for credit unions in Ohio and advocates on behalf of Ohio's 379 federal-and state-chartered credit unions, serving their 2.7 million members. The comments reflected in this letter represent the recommendations and suggestions that OCUL believes would be in the best interest of Ohio credit unions.

Background

NCUA requests public comment on whether and how to modify its rule on investment and deposit activities to permit federal credit unions (FCUs) to enter derivatives transactions for the purpose of offsetting Interest Rate Risk (IRR). The agency seeks additional information to assist in drafting a proposed rule for FCUs to independently engage in derivatives transactions (*i.e.*, without program oversight by a third-party provider).

Analysis

Specifically, NCUA asks the following questions:

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



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 the FCU's staff to demonstrate a minimum of three years 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?
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?
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 derivatives transacted with any counterparty? Should limits be based on the notional amounts of a derivatives instrument, its mark-to-market valuation, or both?
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?

OCUL notes that prudent management of IRR and other risk may dictate engaging in derivatives transactions as such risk is still developing, rather than waiting for it to develop fully enough to be reflected on the FCU's balance sheet.

Requirement of Demonstrated IRR Exposure or Other Risk Management Need

OCUL concurs that safety and soundness concerns require that limitations be placed on NCUA grants of independent derivative authority. However, OCUL urges NCUA to be mindful that prudent risk management may indicate the advisability of engaging in derivatives transactions as IRR or other risk develops, rather than waiting for to appear on an FCU's balance sheet. Accordingly, requirement of a need to manage IRR or other risk should be crafted broadly enough to allow an FCU to demonstrate a future or developing need, as well as actual balance sheet considerations.

Minimum FCU Performance Levels

OCUL believes that the approval to engage in derivatives transactions should be based on need and the ability to manage the activity rather than on an artificial requirement based on net worth. Such a limitation might prevent a troubled credit union from the use of a beneficial tool that might mitigate its risk. Requirement of a demonstrated need for such a risk management tool, coupled with demonstrated ability on the part of the FCU to manage a derivatives program, would be sufficient to meet safety and soundness concerns. If NCUA finds that an artificial net worth requirement is necessary, NCUA should permit a waiver through the application process.

Requirement of Minimum Derivatives Expertise

OCUL applauds NCUA's recognition that there is no "one size fits all" template to evaluate an FCU's expertise to engage in derivatives transactions. OCUL concurs that the expertise required of an FCU's staff should be commensurate with the complexity of the contemplated transactions. It should also be flexible enough to include education or certification (such as Chartered Financial Analyst) to supplement experience in derivatives.

Limitation to Use of Interest Rate Swaps and Caps

OCUL observes that limiting derivative instruments to a specific type or even further limiting them to one side of a transaction (pay-fixed/receive-floating) limits the ability to use derivatives to respond to risk environments other than the current IRR environment of low interest rates. An FCU that demonstrates its ability to appropriately manage a derivatives program should be able to demonstrate to NCUA its ability to manage the variety of derivatives transactions necessary to respond to the IRR or other investment risk experienced by the FCU.

Setting Exposure Limits

OCUL observes that exposure limits in derivatives transactions are a part of the risk management policies for the FCU. Establishment of risk management policies is properly a part of the fiduciary oversight and governance of the credit union by the FCU's board of directors. Consideration of the underlying risk should be a part of determining the appropriate exposure limits for a specific FCU.

Mitigation of Counterparty Risk

OCUL notes that use of collateral is an effective risk management tool. However, there are other forms of collateral other than posting collateral that may be acceptable, such as, the use of a letter of credit from a Federal Home Loan Bank. Allowing use of such alternatives may provide a more cost and time effective means of establishing collateral while answering concerns about risk management. Effective due diligence in evaluating counterparties should be an integral part in determining appropriate collateral requirements.

Conclusion

The proposed changes to NCUA regulations allowing FCUs to use derivatives transactions as a means of managing interest rate or other risk (such as credit risk) are a welcome addition to the tools FCUs are allowed under regulations. NCUA should establish flexible standards, recognizing that each federal credit union's need for such programs must be tailored to fit that credit union. Decisions regarding the risk tolerance of the FCU should be left to those tasked with fiduciary oversight and governance of the FCU, and its own board of directors, once the FCU has demonstrated: a) the need for such a program; and b) the expertise to manage the program.

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OCUL further urges NCUA to include a policy statement in its formal rulemaking signaling that financial derivatives transactions for the purpose of IRR management constitutes appropriate investment authority for federally insured state-chartered credit unions if established in a manner that is substantially similar to 12 CFR Part 703, and with adequate supervision by the state regulator.

The Ohio Credit Union League appreciates the opportunity to provide comments on the NCUA's proposed rule allowing for the use of derivatives transactions to offset interest rate risk, and is available to provide additional comments or information on this proposal if so requested. If you have any questions, please do not hesitate to contact me at (800) 486-2917, ext. 266, or jkozlowski@ohiocul.org.

Respectfully submitted,



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General Counsel



David J. Shoup
Director, Compliance & Information



Carole McCallister,
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cc: Mary Dunn, Credit Union National Association General Counsel
Tim Boellner, OCUL Chair
Paul Mercer, OCUL President
Jennifer Ferguson, Government Affairs Committee Chair