LSCU
League of Southeastern Credit Unions

April 3, 2012

Ms. Mary Rupp
Secretary of the Board
National Credit Union Administration Board
1775 Duke Street
Alexandria, VA 22314-3486

Re: Comments on ANPR, Financial Derivatives Transactions to Offset Interest Rate Risk

Dear Ms. Rupp:

Thank you for the opportunity to comment on the NCUA's advance notice of proposed rulemaking (ANPR) on financial derivatives to offset interest rate risk (IRR). By way of background, the League of Southeastern Credit Unions is one of the largest credit union advocacy organizations in the country, representing approximately 300 state and federal credit unions, which serve approximately 6 million members.

We commend the Board for initiating a rule making process on the possible use of derivatives to assist credit unions in managing risks associated with changing interest rates. We support the Board's efforts to ensure that credit unions have tools available to them to better manage their operations, tools such as financial derivatives to hedge interest rate risk (IRR). We believe the use by credit unions of an effective and consistent risk management process along with the application of reasonable oversight and supervision from regulators; creates an environment for success. We support this proposal and offer some suggestions concerning issues we would like to see addressed.

Participation

We agree the NCUA's proposed rule allowing credit unions to use derivatives products will help mitigate their IRR. Products or methods that permit credit unions to maintain healthy margins on their loan portfolios serve to increase the availability of credit to qualified credit union members. The proposed approach of allowing the use of financial derivatives to hedge IRR is an acceptable investment activity in our view. We would, however; like to see the eligibility expanded to include all eligible credit unions.

ALABAMA OFFICE: 22 Inverness Center Parkway, Suite 200, Birmingham AL 35242 | PO Box 380428, Birmingham AL 35238 | 205.991.9710
FLORIDA OFFICE: 3773 Commonwealth Boulevard, Tallahassee FL 32303 | PO Box 3108, Tallahassee FL 32315 | 850.576.8171
866.231.0545
www.lscu.coop

In our view, credit unions of all sizes, including small asset sized credit unions, should be eligible to voluntarily access derivatives to hedge IRR as part of an effective risk management program. To exclude small credit unions from access to financial derivatives can only be viewed as detrimental to their operations and should be avoided. In today's economic environment, access to third-parties and aggregation of smaller contracts can have a positive impact on small credit union operations when managed properly along with strong safety and soundness procedures.

Across the country, state-chartered credit unions (SCUs) may legally possess the authority to access derivatives based on individual state laws and statutes. We do not support NCUA regulations that seek to override state authority without verifiable safety and soundness issues. In the absence of clearly defined state guidelines, we agree that state chartered credit unions should be obligated to conduct all derivatives activities consistent with NCUA regulation.

Internal Expertise

LSCU strongly supports the concept that credit unions seeking independent authority for derivatives should not be permitted to rely solely on the stated experience of an outside party. We agree that demonstrated knowledge and sufficient derivative experience should be required prior to an institution receiving derivatives authority. If the proposed rule is adopted, while maintaining the requirement that adequate credit union experience and knowledge be verified, LSCU would urge NCUA to consider including a limited basis exemption or waiver process to assist credit unions, especially small asset sized credit unions, in mitigating other compliance issues related to the use of derivatives to offset IRRs.

Eligibility Requirements

We agree that a regulation on the use of derivatives for IRR risk management should, in our view, meet eligibility requirements based on a minimum of three factors: (1) a demonstrated need and verifiable IRR risk or exposure; (2) Institutional CAMEL ratings strong enough to support entry into the derivatives market; and (3) proven ability to manage the analysis, strategic planning, and ongoing monitoring necessary to carry on such a risk management program. We support allowing credit unions meeting these requirements, barring other issues that would serve to disqualify an institution, to seek to engage in derivatives activities to mitigate IRR.

Exposure Limits

The consideration of established exposure limits to reduce volatility in the value of a derivatives portfolio is a prudent and reasonable step. We agree with the goal but we would like to see a revision to the proposed process. Current maximum limits on derivatives exposure are not to exceed 250% of net worth. If a maximum limit is adopted, we believe a credit union's maximum limit should be based on 100% of its fixed rate loan portfolio. This approach to limiting exposure is more appropriate because it better serves credit unions of varying sizes and provides a more stable platform when adjustments necessary. Basing exposure limits on a credit union's net-worth does not provide the same stability due to fluctuations in that total.

Collateral Requirements

LSCU believes sound and effective collateral management will serve to mitigate counterparty risk. LSCU supports including the following collateral management performance standards in credit union derivative contracts: (1) Bilateral collateral – each party agrees to assign collateral in amounts that cover mark-to-market gains and losses; (2) Tri-party custody – all posted collateral is delivered to a third party, who by agreement, serves as custodian for the collateral. This step eliminates decisions based on "self-interest" circumstances; (3) Zero thresholds - parties are contractually obligated to post collateral at any loss level past a minimum agreed upon amount; and (4) Restrictions on the type of assets used as posted collateral to instruments permitted for investment by a FCU. This will serve to maintain a level of collateral quality guaranteed by contractual agreement between parties.

Market and Counterparty Risks

There are many risks associated with a derivatives transaction, including market risk and counterparty risk. The two, market risk, the fluctuation of the mark-to-market value of a derivatives position and counterparty risk or "default or credit risk", the most likely loss faced by a credit union due to a counterparty default in fulfilling its obligations occur most often in derivatives transactions. LSCU supports the application of guidelines directing a credit union to, as part of an ongoing basis, monitor counterparties and their creditworthiness, as well as credit risk mitigation features with its derivatives (e.g., margin requirements, daily valuations of collateral, and performance of third parties). We support these steps as they contribute to a sound credit union program.

Thank you for the opportunity to express our views on this proposed rule. We support the agency's course of action and believe this concept has the potential to aid credit unions of all sizes in managing their interest rate risks. If you have any questions concerning our comments, please do not hesitate to contact me.

Sincerely,

Patrick La Pine
President and CEO