Affinity
Federal Credit Union

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

RE: 12 CFR Part 703. Financial Derivatives Transactions to Offset Interest Rate Risk; Investment and Deposit Activities

Thank you for the opportunity to comment on this ANPR. The Board's continuing effort to help credit unions access these simple tools is timely and important. Interest rate derivatives reduce risk, preserve capital, and reduce the earnings volatility associated with interest rate risk. Reducing risk has continuing benefit for both the fund and credit unions. The NCUA recognizes that interest rate risk (IRR) is increasing given continued historic low rates and member preference to lock in these rates for longer periods of time. Adding another tool to manage IRR can alleviate concerns for both credit unions and the Board.

Interest rate derivatives have been used to manage interest rate risk since the early 1980's. The risk associated with plain vanilla derivatives is minimal, especially when compared to the risks that credit union's underwrite on a daily basis.

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?

We believe that this is already a requirement because of the rigorous application process implicit in 703.19. This application process coupled with the NCUA exam, 5300 reporting, credit union board reporting and annual external audit provide adequate oversight to ensure the use of derivatives for risk management purposes. In addition, candidates for independent derivatives authority are likely to employ independent reviews of models and assumptions. This is an additional layer of oversight.

It is difficult to define a "material IRR exposure". The point where IRR is "material" and should be hedged will vary with each credit union board's risk appetite. Credit unions that do not have "material IRR exposure" should be able to use this tool even if they want to hedge a "moderate" amount of IRR. If they demonstrate proficiency, they should be able to hedge independently.

Credit unions that have demonstrated the expertise and knowledge regarding derivatives should be able to use these tools on their own with a minimum of prescriptive rules imposed by regulation. Program limitations should continue to include transactions undertaken and documented purely for interest rate risk management. However, CUs with sufficient expertise should be afforded the opportunity to hedge their exposures whether these exposures are minimal, moderate or material.

Given the array of models and multitude of assumptions that go into these models, the ability to

compare one credit union's interest rate exposures to another credit union's exposures is difficult, adding more uncertainty in how to define material exposure.

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?

No. The purpose of these transactions is to minimize earnings volatility and **protect capital** from interest rate volatility. Institutions with earnings volatility, lower CAMEL ratings and inadequate capital ratios might be the exact institutions that need this tool to help protect capital and stabilize earnings. Performance criteria that limits access to credit unions that need hedging actually increases risk to the system.

Capital at risk associated with derivatives is minimal. Counterparty credit risk is managed through bilateral collateral arrangements. Effective hedge accounting minimizes risks to earnings/capital from adverse movements in rates. Therefore, criteria such as net worth ratio, CAMEL and positive stable earnings should not be a prerequisite to employ derivatives for risk management because earnings should be protected and stabilized in a well-managed program. NCUA should encourage the use of all tools that help credit unions hedge risk, minimize earnings volatility and protect/increase capital.

Lastly, the market is a good arbiter of risk. If a credit union is not strong enough to transact a derivative, they will not find a counterparty to transact with.

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?

Any credit union applying for independent authority should have experience and expertise to manage the program, irrespective of balance sheet complexity. Credit unions that apply for derivatives authority will most likely have experience with complex instruments such as mortgages or investments that require an understanding of interest rate risk, prepayment speeds and embedded options. Three years seems excessive given the requirements that these tools be used solely for risk management. I spent 10 years on Wall Street advising all types of institutions—corporates, supra-nationals, financial institutions, GSEs etc.-- on funding and use of derivatives to manage risk or access cheap funding. This experience suggested that plain vanilla derivatives are simple and generally can be mastered quickly. Relying on 3rd party expertise in selected areas such as accounting (resource intensive and complex) and ISDA documents (derivatives proficient legal counsel) is common practice. However, the credit union should have some level of expertise in these areas.

The credit union should demonstrate an understanding of derivatives, the appropriate use of these tools in interest rate risk management and the associated operational, legal, credit, accounting and management/measurement tools necessary to support a robust program. These elements are all part of the 703.19 application requirements.

Question 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?

Yes. Credit unions should be limited to using interest rate swaps to offset interest rate risk. As long as a credit union can prove to its ALCO Committee and Board that a particular interest rate derivative is improving the risk profile of the institution, it should be permitted.

The ANPR expertly describes the typical use of plain vanilla derivatives in IRR management where the institution has long term fixed rate assets funded with deposits. In addition to pay fixed swaps and caps, collars are a common technique used in IRR management. The collar can help reduce the cost of protection from rising rates. Pay fixed swaps, caps and collars should all be permissible structures.

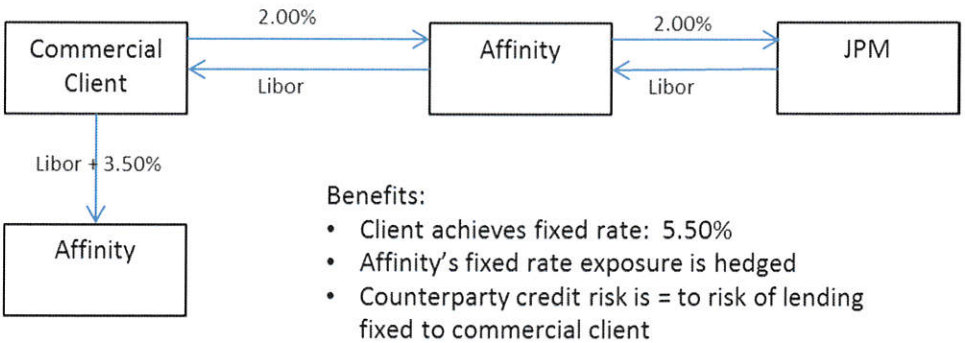
Hedge accounting rules limit the amount of hedging that can be done with derivatives. The most common structure to obtain hedge accounting for institutions with long term assets, funded with deposits is to hedge the rate on future CD issuances. Under this approach, the notional amount of swaps is limited to the $ amount of new/rollover CDs issued in a given time period. For Affinity, that means $70 million which is minimal given a $2 billion balance sheet with nearly $450 million in 30 year fixed rate mortgages. I often think what a big brouhaha we are making over a $70 million hedge opportunity. Over hedging in this paradigm is impossible. Over-hedging will also show up in the ALM metrics. Exposure from over-hedging would be reflected in NEV and NEV volatility in the declining rate scenarios.

Additional derivatives capacity may be obtained through the use of FAS 159: *"This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the Board's long-term measurement objectives for accounting for financial instruments."* [1] Affinity is currently studying the potential to use FAS 159 to expand derivative capacity.

An additional hedging option for credit union's whose commercial members prefer fixed rate is to lend floating, swap with the member and mirror swap to an approved counterparty. *The credit union would have the same exposure to the member as they would if they had lent fixed.* I mention this because we recently lost the opportunity to work with a commercial member because community banks advised that the member could obtain cheaper funding by borrowing floating and swapping to fixed. The community bank advised that this structure presents no more risk to the funding institution than a straight fixed rate funding.

[1] FASB Website. http://www.fasb.org

Creating Fixed Rate Borrowing for Commercial Client



Benefits:

- Client achieves fixed rate: 5.50%
- Affinity's fixed rate exposure is hedged
- Counterparty credit risk is = to risk of lending fixed to commercial client

Hedging interest rate risk is the basis for all 3 structures noted above.

Question 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 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?

Limits should be the responsibility of the credit union's board of directors; especially for credit union's proficient enough to manage their own derivatives program.

Exposure limits based on mark to market for counterparty credit risk are appropriate but should be left up to the CU's board and management team as part of its normal credit underwriting activities. Credit unions underwrite credit risk every day. Underwriting exposure to highly rated financial institutions given bilateral credit arrangements is quite manageable.

Other limits such as aggregate notional amount or mark to market of the derivatives portfolio are misguided because they do not take into account the mark to market of the hedged item. The point of hedging is to immunize the portfolio, i.e. to lock in a net interest margin. If the derivative has a negative mark, it is offset by a positive mark on the hedged item. If the derivative has a positive mark, the hedged item has a negative mark. In either case the net interest margin is "locked in". The following chart is a simplistic representation of the effects of an interest rate increase/decrease for a pay fixed swap on: mark to market of hedged item, mark to market of the derivative and net interest margin:

Pay Fixed Swap	Rates Increase	Rates Decrease
Mark to Market Hedged Item	Negative	Positive
Mark to Market Derivative	Positive	Negative
Net Mark to Market	Stable	Stable
Net Interest Margin	Stable	Stable
Opportunity costs	yes	no
Risk Protection	N/A	yes

Limits on notional amount of the derivatives portfolio or mark to market of the derivatives portfolio (for anything other than counterparty credit risk) must consider the offsetting hedged item. ALM metrics are the limits. The board should ensure that NII and NEV in the rising rate scenarios improve with the derivative in place and that NEV and NII are within ALM metrics for all rate scenarios.

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?**

I have taken letters of credit; however, high grade securities are more common.

Sincerely,

Denise B. McGlone
EVP, CFO