SCHOOLSFIRST
FEDERAL CREDIT UNION

April 3, 2012

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

Re: ANPR for Part 703, Financial Derivatives Transactions to Offset IRR

Dear Ms. Rupp:

I am writing on behalf of SchoolsFirst Federal Credit Union, which serves school employees in Southern California. We have more than 500,000 Members and over $9 billion in assets. SchoolsFirst FCU appreciates the opportunity to comment on the NCUA Board's advanced notice of proposed rulemaking relating to whether and how the Board should modify its regulations to permit federal credit unions to engage in financial derivatives to hedge interest rate risk (IRR).

While SchoolsFirst FCU has not used derivatives to hedge IRR, the current interest rate environment is forcing all financial institutions to look to alternative methods to manage IRR. The ability to invest in derivatives may prove to be a critical tool for some FCUs in managing safety and soundness while meeting their Members' needs. Therefore, in general, we agree that natural person federal credit unions should be allowed to independently engage in derivatives to offset IRR.

However, we do not agree that an FCU should have to apply to NCUA for such authority. Instead, we recommend that derivative instruments be included under Part 703 as another financial transaction within the scope of the regulation, and when an FCU's board determines it is right thing for their credit union, and they have competent staff to manage it, the board may grant this authority through board policy.

As to the accounting and financial reporting for derivatives, FCUs should follow GAAP accounting for derivatives and NCUA should not impose additional or contradictory accounting standards.

<u>Question 1: Demonstrate a material IRR exposure or another evident risk management need before granted independent derivatives authority</u>

- We do not believe an FCU should have to demonstrate a material IRR exposure to NCUA or have to apply for independent derivatives authority. The decision of when hedging is appropriate should be made by a credit union's board as a normal course of managing risk and should be addressed in a board policy. To wait until a material IRR exposure exists and then seek NCUA approval is self-defeating.
- Independent derivatives authority should be no different than other investment authority under Part 703. The regulation lists investments that are permissible for FCUs and no additional authority is needed. This section should be amended to include permissible derivatives, such as the proposed interest rate swaps and interest rate caps, as well as mortgage-backed securities/TBA trades (MBS/TBA).

Question 2: Require minimum financial performance for FCUs to independently engage in derivatives

- We do not believe that an FCU should have to apply to NCUA for independent derivatives authority, and we do not believe that NCUA should set a minimum financial performance level for an FCU to engage in this activity. An FCU that does not have as strong a capital position as others, are the very ones who need this investment tool. A weak capital position could actually put more risk on the insurance fund than a properly executed derivatives strategy – which might actually preserve capital. We believe that restricting FCUs based on net worth, capital ratings, or other financial measures would be prohibitive to the actual FCUs that need the authority. Requiring such a numerical limit would be a disservice to those credit unions and to the insurance fund.

Question 3: Experience and expertise

- The ANPR proposes that an FCU transacting in plain vanilla derivatives demonstrate a minimum of three years of "effective experience with derivatives," and that additional experience would be required for FCUs with more complex IRR. NCUA should not regulate an experience requirement.
- First, we believe that should the NCUA limit permissible derivatives to interest rate swaps, interest rate caps, and MBS/TBA instruments, then the very nature of these plain vanilla investments removes the expertise risk. We note that FCUs already have the authority to buy more complex investments (e.g., CMOs) without any regulated expertise requirements.
- Second, we believe that it would be very difficult to define "effective experience." Instead, it should be up to each FCU board to understand the level of expertise they have in house and the need for an external evaluation before investing in derivatives.
- Lastly, the authority to invest in derivatives should come from the FCU board in a board approved derivatives policy (similar to the investments policy) that delegates authority to management, but includes restrictions or limits to manage the process and have sufficient board oversight.

Question 4: Limited to interest-rate swaps and interest-rate caps; limited to pay-fixed/receive-floating; other limits

- We agree with including interest-rate swaps and interest-rate caps as permissible derivatives, but would also add MBS/TBA trades. The MBS/TBA instruments would allow an FCU to hedge the risks associated with their fixed-rate mortgage activity.
- We agree with permitting pay-fixed/receive-floating instruments, but would also add that pay-floating/receive-fixed should be permissible for those FCUs whose balance sheets that are appropriate.
- We do not believe the NCUA should impose any other limits. Again, this activity should be approved by an FCU's board with sufficient oversight to ensure investments in derivatives are prudent and used for the purpose of IRR management and not speculation. One tool an FCU may choose to employ is to conduct pre-testing of NEV ratios prior to executing a transaction. This will help bring management perspective on the validity of a derivatives transaction as well as help demonstrate later why the transaction was appropriate for IRR management.

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Question 5: Exposure limits; aggregate by type or counterparty; basis of limits

- Again, we do not agree that NCUA should regulate exposure limits. Instead, an FCU's board should establish appropriate concentration limits, based on their own risk tolerance, for each type of derivatives instrument in the portfolio and for derivatives transacted with any counterparty.
- We recommend that the exposure limits established by board policy be based on the notional amount of a derivatives instrument. The notional method provides more stability, versus a particular point in time for mark-to-market.

Question 6: Market and counterparty risks

- The ANPR lists four collateral management standards that NCUA believes should be included in derivatives contracts. While we agree that these components should be considered in derivatives contracts, the collateral requirements and the posting of collateral should be subject to an FCU's negotiations with the counterparty, based on each party's financial and credit ratings. NCUA should not mandate the collateral requirements.
- In addition to collateralization, we recommend that an FCU's board policy include the requirement to annually review their counterparty risk. This includes assessing each counterparty's financial viability and obtaining board approval to continue doing business with the counterparty.

In summary, we recommend that derivatives be permissible investments under Part 703 and that an FCU's board should have the authority to allow their FCU to independently engage in derivatives transactions for the purpose of offsetting IRR. An FCU board should adopt a derivatives policy (similar to the investment policy) that delegates authority to management, but includes restrictions or limits to manage the process and have sufficient board oversight.

Thank you for the opportunity to comment on this ANPR and for considering our perspective on financial derivative transactions.

Sincerely,

Erin Mendez

Erin Mendez
Executive Vice President, Chief Operations Officer
SchoolsFirst Federal Credit Union

Cc: Credit Union National Association (CUNA)
California/Nevada Credit Union League (CCUL)