EAGLE COMMUNITY CREDIT UNION

April 3, 2012

Mary Rupp
Secretary of the Board
National Credit Union Administration

RE: Comments on 12 CFR Part 703 ANPR, Financial Derivatives Transactions to Offset Interest rate Risk

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?**

   Response: No. I feel that in part the number of credit unions that did not apply for Derivative Transaction approval under past guidelines was due to the time and constraints placed on the credit unions under prior rules. The time and effort expended to obtain approval for participation in a derivative transaction can take over 12 months if managed properly. Internal training and development, Board and volunteer education as well as the application and approval by the NCUA all take a considerable amount of time and effort.

   To wait until a definitive need arises will do little to assist credit unions in reducing interest rate risk. A credit union that must wait until a level of interest rate risk exist will likely not receive the benefit that it needs to mitigate that level of risk if it requires another 12 months to gain approval. The cost of obtaining even a simple interest rate swap could become extraordinarily expenses and of little benefit once a change in interest rate trends begins.

   The use of derivative transactions should be planned for an executed as a significant part of a credit unions interest rate risk strategy and not as an afterthought or last minute decision to be made in a vain attempt to reduce risk after the fact. Hedge transactions should not be utilized to mitigate the interest rate risk of a single product but should be considered as a larger portion of a credit unions overall interest rate risk strategy.

   In short, requiring a credit union to demonstrate a material IRR exposure before consideration of granting approval to enter into a derivative transaction is tantamount to "closing the barn door after the horses are out". The use of derivative transactions should be well thought out, included in the overall risk management strategy and staff and volunteers should be adequately educated and trained well in advance of the need to execute a hedge transaction.

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 measures be?**

   Response: Generally speaking yes. Minimum performance levels should be established when considering approval to engage in derivative transactions. Financial performance, however, should not be the only factor in the approval process. Management deduction and experience should also be a determining factor. Derivatives transactions are somewhat market driven in that they require the parties to maintain minimum capital levels and assure that both parties have the ability to perform under the contract. The accounting effects of the mark to market nature of a derivative transaction will also affect the credit union net worth. The minimum capital level required should be set near 6% to 6.5% to gain approval to engage in a derivative transaction, however, there should be allowances for exceptions if the credit union requesting approval can demonstrate the:

   - Positive effects a derivative transaction will have on the level of interest rate risk at the time of the request.
   - Experience to manage the transaction.
   - Financial ability to meet the conditions of the derivative contract.

   I believe exceptions are warranted and needed in the approval process. Any credit union can find itself in a poor financial situation due to a myriad of reasons unrelated to interest rate risk. Over the past five years credit quality and other economic factors have had the most significant impact on credit union performance. To deny a credit union the ability to participate in a program that will improve their overall performance and reduce risk is counterproductive to say the least. Exceptions should be fully justified and documented as to the actual value of the proposed transaction, reduction in risk to be achieved and the ability to manage the transaction.

   Once again, derivative/hedge transactions can be a very good tool for reducing interest rate risk, limiting the negative effects on capital produced by an on balance sheet transaction and the most cost effective method of mitigating risk. To mandate that credit unions that don't meet minimum thresholds without an exception process in place is effectively eliminating one of the most efficient risk mitigation tools available.

3. **What is the minimum kind and amount of derivatives experience and expertise that an FUC's staff should demonstrate before the FCU receives independent authority? For example, if a credit union has a less complex balance sheet, is it sufficient for that FCU's staff to demonstrate a minimum of three years of transacting derivatives? Should the NCUA require additional kinds and amounts of experience where there is more complexity in the FCU's balance sheet (e.g. prepayments and call options)? To what extent should an FCU seeking independent derivative authority be allowed to rely on an outside party to fulfill an experience and expertise requirement?**

   Response: The on staff derivatives experience should be weighed based on the complexity of the credit unions balance sheet as well as the types of derivatives or hedges to be utilized to reduce risk. To enact a requirement that a minimum experience level is required for all credit unions regardless of size or complexity would virtually eliminate many but the largest credit unions from gaining approval. To bring on a staff member with 3 years of experience in derivative transactions would not necessarily ensure the program was working as designed. The cost of retaining a staff member with these qualifications would be prohibitive to many credit unions, particularly for the amount and number of derivative transactions entered into.

For many credit unions in the under $500 million asset range the number of derivative transactions required to reduce interest rate risk may be limited to a single transaction or one every two to three years depending on balance sheet changes and terms. To require that they hire and retain staff with three years of experience actually completing derivative transactions is not feasible or warranted.

Previously, under the pilot program, a credit union could qualify for approval after demonstrating a high degree of understanding related to derivative transactions. Actual experience completing the transactions and accounting for the hedge on an ongoing basis was allowed to be outsourced to a third party. The NCUA had required approval of third parties to engage in derivative transactions on behalf of credit unions. Prior to approval the third parties had demonstrated:

- Skill and experience required to safely enter into derivative transactions.
- Experience in understanding the effects of both mark to market and hedge accounting on the credit union client financial position.
- The ability of the credit union to meet any derivative related collateral commitments and meet the contract requirements.
- Demonstrate and quantify the effects of the transaction on a credit unions interest rate risk profile and the related reduction in risk.

Approval for participation in the derivative program should be more heavily weighted to the amount of understanding that management can demonstrate rather than actual experience. The fact that someone executed derivative transactions does not necessarily understand the full effects of a hedge transaction on any credit unions interest rate risk position or the complexities of actually accounting for the transaction on an ongoing basis or potential for valuation changes that may occur in future periods.

The use of third parties in the derivative program enables a credit union to avail itself of a wide breadth of knowledge available to determine the best type of derivative, potential short and long term financial issues and proper accounting treatment. Even the hiring of an individual with three years experience does not guarantee that the same level of knowledge and understanding across the entire transaction will be obtained.

Management should be able to show a high degree of understanding of the derivative fundamentals and how the transaction will affect the credit unions overall risk and financial performance.

Generally speaking I would rather see a tiered approval in which a credit union may apply for truly independent authority and one in which there is a NCUA approved third party program in which participants are required to meet specific standards prior to being included as an approved third party provider.

The number of credit unions that have the resources, financial need and expertise to be approved for actual independent approval derivative authority are far fewer than the number of credit unions that would benefit from the ability to manage interest rate risk though a qualified third party and benefit. The prior program seemed to address this requirement adequately.

4. **Should credit unions 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 an FCU does not transact interest rate derivatives in an amount greater than the level of its IRR exposure?**

   Response: yes. Not fully understanding the complexity of the balance sheets of other respondents to this ANPR I would venture to guess that in most cases simple derivatives would suffice to reduce interest rate risk to acceptable levels. My past experience has included working for an audit firm specializing in credit unions and stints as a CFO in three different credit unions of differing asset sizes ranging from $200 to $700 million. With rare exception have I come across a credit union would even need to consider something other than some simple type of interest rate swap, cap or floor that would adequately address their IRR exposure.

   Before entering into any derivative transaction a credit union should perform both pre and post IRR scenarios to assess the current risk exposure, address the amount of exposure to be mitigated and the actual need to mitigate IRR. There is a distinct difference between credit unions that have similar exposure in any interest rate shock scenario depending upon the current net worth of each. The amount of risk to be mitigated in any transaction depends on the credit unions current net worth position, embedded risk and ability to absorb the current risk.

   Fully documenting each transaction, including IRR modeling under several scenarios, along with the change in risk profile should be required prior to execution. Derivative transactions and risk tolerances should be established by the credit union Board and included in policy. Policy should clearly define when and to what extent a derivative/hedge can be executed based upon the credit unions current risk profile and the amount of acceptable risk.

5. **Should the NCUA establish limits for FCU's or should it require an FCU's board of directors to establish limits? Should there be limits on the aggregate amount of each type of derivative instrument in the portfolio or on the aggregate amount of derivatives transacted with any counterparty? Should limits be based on the notational amount of a derivative instrument, its mark to market valuation, or both?**

   Response: I feel that if limits are to be established they should be based upon the aggregate amount of derivative transactions. Limits should be based on the market valuations as they more accurately reflect the true exposure. Application of predetermined limits as measured over the life of the transaction is a different matter. Derivative transactions should be entered into with care and planning from the outset. The imposition of a limit during the life of the derivative that would create a situation in which the credit union is required to unwind the transaction at an inappropriate time may result in a significant expense. It would be more accurate to require the value of a hedge be evaluated at the time a predetermined limit is exceeded than to require the transaction be unwound. The overriding question would be "Is the transaction still of value and reducing IRR as expected?"

The limit should require additional review and assessment of the transactions and the original assumptions made. Only after the assessment is made can it be determined if it is in the best interest of the credit union to unwind the transaction or determine that it still has the value originally intended.

Limitation by transaction type may be too restrictive for many credit unions. Depending upon the actual makeup of the credit union and IRR position there may only be one type of derivative transaction needed to reduce IRR.

Counterparty risk should be measured as part of the initial due diligence process. As long as the derivative transaction requires full collateralization by both parties, and underlying requirements are met at the time of execution there would be no reason to limit transactions with any particular counterparty. For many midsize credit unions the imposition of limits on derivatives per a single counterparty would only increase the transaction cost and ongoing monitoring requirements without realizing any additional benefit or risk reduction.

6. **Are there ways to mitigate counterparty risk besides posting collateral? Are there additional or alternate collateralization conditions that the NCUA should require beyond those described in this ANPR?**

   Response: The simple derivatives described in the ANPR are common and ordinary transactions used by financial institutions to mitigate IRR. Each transaction should clearly define the collaterization required to protect both parties in the transaction, including the addition of collateral to address changes in the market value of the derivative and maintain the interest margins required by the transaction. If properly executed at the onset there is no additional collateral that should be required by the NCUA through regulation. The transaction should stand on its own merits.

   The due diligence and transaction evaluation process conducted prior to execution should accurately address the potential need for additional collateral that may be required to support the transaction and ensure the credit union has the capacity to meet its contractual obligation. This should also be true of the counterparty to the transaction; ongoing monitoring and valuation of the derivative should be sufficient measure the ongoing value of the transaction and ensure that it is meeting its original objectives. Requiring additional or alternate collateral would seem to be outside the scope of the transaction itself and would satisfy no real financial purpose.

Thank you for providing us the opportunity to present our views on the proposed regulation. If I can add any clarification on the opinions expressed in this response please do not hesitate to contact me.

Regards,

Scott Rains
Chief Financial Officer
Eagle Community Credit Union
1(949) 639-7834
srains@eaglecu.org