KINECTA
FEDERAL CREDIT UNION

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April 3, 2012

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

Re: Advanced Notice of Proposed Rulemaking for Part 703, Financial Derivatives Transactions to Offset Interest Rate Risk

Dear Ms Rupp:

On behalf of Kinecta Federal Credit Union, I appreciate the opportunity to comment on the Advanced Notice of Proposed Rulemaking related to the use of 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?

Credit unions should demonstrate that derivatives activity is being conducted to mitigate a specific and identifiable interest rate risk but they should be able to use derivatives to mitigate that risk without having to "demonstrate a material IRR exposure" prior to hedging it. Limiting authority to those institutions with material exposures could require a credit union to accumulate IRR exposure prior to hedging it rather than hedging as the risk generating activity takes place. The NCUA should focus more on the credit union's demonstrated experience, expertise and the plan for managing risk rather than on establishing a required minimum level of risk exposure.

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?

The need and ability to manage the hedge should be the determining factors for approval to engage in derivative transactions rather than minimum performance levels. Every credit union is different and the reasons for hedging vary as well. Limiting hedging authority to credit unions with a minimum CAMEL or other performance rating may prohibit credit unions which have the demonstrated need and ability to hedge from doing so. Limitations may actually inhibit safe and sound practices which could and should be employed. Performance levels will come into play and serve as a limiting factor for credit unions that seek to engage in derivatives activity through the credit review process that is conducted by counterparties in establishing derivatives lines. These counterparties will apply risk mitigation measures up to and including prohibition from authorizing transaction authority based on their objective view of the credit union's overall financial condition.

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?

The ability to attain a safe and sound level of derivatives understanding is a function of many factors but not necessarily a set timeframe. Credit unions should be able to demonstrate the ability to engage in independent derivatives authority through the use of an outside third party as well as internal knowledge and expertise. Third party providers allow credits unions to leverage off of the providers' industry expertise. However, in utilizing third party providers, it is critical that the credit union conduct and document appropriate and robust due diligence to confirm the qualifications and expertise of the provider. Whether through use of a third party, or in-house expertise, a credit union must establish that it has the ability to identify and measure the risks it is trying to mitigate, value the derivatives it is using to mitigate the risk,, properly account for the transactions, including identification and evaluation of the effectiveness of the hedge strategy, , and manage counterparty risk. Required infrastructure should include ALM modeling capabilities and experience, derivatives trading and accounting experience as well as access to pricing and market monitoring systems such as Bloomberg. The NCUA should define required experience requirement to allow for certain types of education such as a Chartered Financial Analyst (CFA) or Financial Risk Manager (FRM) in lieu of some amount of experience. Board education and understanding should also be a part of the independent authority approval process.

4. Should FCU's 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/receiving-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.

Credit unions should be allowed to use the derivative instruments that are most effective for hedging risks and not be limited as to instrument types. Institutions benefit by having a variety of derivatives types to accomplish their risk management goals. Each credit union's interest rate risk exposure varies and is dependent upon their risk tolerance, so it would be very difficult for the NCUA to regulate the type of derivative instruments that can be used. However, a credit union should be required to document the types of permissible instruments and the rationale for their use in the interest rate risk mitigating hedging program.

Because of the variety of interest rate risk exposures and methods to mitigate exposure, it would not be effective to establish a common regulatory threshold. Credit unions who demonstrate the requisite experience qualifications discussed above should be permitted to set their own limits and permissible instrument types, with the rationale documented and approved by their board of directors.

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?

A credit union's board of directors should establish its own exposure limits and those limits should be part of the institution's risk management policies. The NCUA should not set specific limits for each credit union because derivative strategies will vary greatly from one institution to another. Limits should address concentrations, derivative instrument types, and counterparty exposures. Credit union limits should be based on both notional amounts and mark-to-market valuation exposure of the derivative instruments being used

Counterparty limits are a critical aspect of any derivatives program. The limits should take into account both of the factors noted in the preceding paragraph.

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 the ANPR?

While collateral is a common and effective risk management tool that protects the "at-risk" party from exposure of non-performance by the other party, it is not a substitute for appropriate initial and frequent due-diligence on the counterparty. In addition to qualifying Treasury or U.S. Agency instruments, eligible collateral should include cash as well as letters of credit from institutions with minimum required credit ratings (e.g. the Federal Home Loan Banks).

Sincerely,

Gregory C. Talbott
Senior Vice President
Chief Financial Officer
Kinecta Federal Credit Union