From: Brad Miller
To: _Regulatory Comments
Subject: Brad Miller - Comments on Advance Notice of Proposed Rulemaking for Part 703, Financial Derivatives Transactions to Offset Interest Rate Risk
Date: Monday, April 02, 2012 5:59:13 PM

Ms. Rupp,

Thank you for the opportunity to submit a response to the ANPR regarding derivatives transactions. Following are our responses:

ANPR: Financial Derivatives Transactions to Offset Interest Rate Risk; Investment & Deposit Activities

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?

The existence of a material IRR exposure or other risk management need prior to being able to request derivatives authority is not prudent. Instead, credit unions should be able to ask for and receive derivative authority if their business plans or reasonably likely economic scenarios could result in a risk exposure that lends itself to hedging with derivatives.

For example, a credit union may find itself with some degree of exposure to longer term fixed rate mortgages. Given their negative convexity, a credit union may experience increased risk exposure given a rise in interest rates even though its balance sheet structure hasn't changed. In such a case, having authority to enter into derivative transactions prior to the need would be prudent.

As the current economic situation has illustrated, consumer borrowing preferences are changing at the same time that their overall appetite for credit is diminishing. Concurrently, their demand for deposit products continues to grow. In order to continue to pay a return on their deposits, process their transactions, to be there for them in branches, online, via telephone and mobile devices, credit unions need to be able to earn a safe, reliable margin on their balance sheets.

As credit unions trying to meet our members' deposit and borrowing needs, we have had to adapt our balance sheets. Auto loans were once the bread and butter of credit union's Net Interest Margins. The relatively good credit quality, short average lives and rates resulted in balance sheets with enviable credit, interest rate, and liquidity risk profiles. Those days are gone as demand for autos has diminished due to the economy as well as increased quality of vehicles and competition from captive finance companies. Combine that with the potential for FNMA and FHLMC to cease to exist as buyers of our members' mortgages, and the need to be able to hedge risk utilizing derivatives ceases to be a rarely utilized tool and it may become a core competency for many FCUs.

To summarize, waiting for a risk exposure to become material before being able to seek permission to hedge it is not prudent. Instead, this is a competency and ability that many credit unions will want in place before the need arises in order to preserve their safety and soundness.

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?

A credit union should have a demonstrated ability to measure and manage its risks prior to being allowed to utilize derivatives. This authority should not be directly tied to Net Worth ratios or CAMEL ratings.

Utilizing simple Net Worth or CAMEL rating criteria may actually pose a threat to the insurance fund.

For example, a credit union may have managed its capital in line with regulatory expectations and legislative mandate while at the same time maximizing the returns that it offers to members through pricing, operational convenience and patronage dividends. In such a situation, a credit union may have the same risk on its balance sheet as a similar credit union that has instead opted to build capital to a higher level by offering lower member returns.

The more heavily capitalized credit union has more capital to absorb the risk on its balance sheet and may have no need for derivatives. The more thinly capitalized credit union would experience more financial strain given adverse economic conditions and would benefit more from derivatives authority. By extension, the insurance fund would also enjoy a greater cushion in such a situation.

When derivatives pose a threat to an institution and by extension to the insurance fund, it is typically because of operational shortfalls. For example, a position may be over hedged, the hedge may not be well correlated to the actual risk, or a derivative was used for speculation by a misguided credit union official. These all speak to a lack of ability to measure and manage risk.

We encourage the NCUA to lean more heavily on a credit union's ability to measure and manage risk than on a credit union's Net Worth ratio or CAMEL rating. In short, it comes back to the M in CAMEL, does management have the ability to prudently utilize derivatives to mitigate risk.

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?

The key element in this question is expertise. In all cases, expertise must be commensurate with the complexity of the risks being hedged as well as the instruments being utilized to hedge. Simply entering into derivatives transactions for a period of time provides no assurance that an individual has the necessary expertise. The prudent business requirement is an appropriate level of expertise and this should be the regulatory requirement.

There are a number of ways to obtain expertise. These include completion of graduate level course work in derivatives at an accredited university, successful completion of the Chartered Financial Analyst program, self study, and various methods of adult learning.

While experience in derivatives transactions may result in the expertise necessary to execute a transaction it does not guarantee that there is any expertise in determining if a transaction or series of transactions will appropriately hedge an actual risk. An experience requirement would likely only result in a false sense of security as experience is not the relevant measure.

Question 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/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?

The inherent assumption in this question is that all credit unions that may utilize derivatives only have adverse exposure to rapidly rising interest rates. While it is likely true that the majority of credit unions would experience adverse consequences from a rapid and dramatic increase in rates, it is also true that other rate environments would also cause harm.

An example of such a rate environment likely includes a protracted period of very low short-term interest rates. This risk could be mitigated with a pay floating/receive fixed swap or an interest rate floor. This environment is what we are experiencing as this letter is being written. It is resulting in Net Interest Margin compression for many credit unions and the hedges used to mitigate its effects would be prohibited by the limitations proposed within question four. For this reason, we encourage the NCUA to allow latitude in the types of derivatives and strategies that may be utilized and give credit unions the tools they may need to adapt to changing business conditions.

Each credit union should determine the types of derivatives that it would potentially utilize to hedge risk. These should be stated in policy and the credit union should be required to retain appropriate expertise to utilize any of the permissible derivative types contained within its policy. The policy and regulation should also prohibit the use of derivatives to speculate on changes in market conditions (i.e. over hedging).

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?

It would be prudent for the NCUA to establish umbrella limits for various derivatives exposures. A notional amount of more than 10 times Net Worth would almost certainly result in an over hedged position for a credit union with 10% Net Worth. On the other hand, a notional limitation of one times Net Worth may not provide ample lee way to hedge a sufficient amount of risk. The NCUA should allow for ample room to hedge risk and avoid imposing overly restrictive limitations.

Umbrella limits for credit risk exposures to counter parties would also be prudent. Credit union boards should review these limitations as part of their concentration risk policies (as already required by regulation), and establish their own limits either at the umbrella limits set by the NCUA or at lower limits that more closely match their own risk aversions.

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?

Utilizing exchange traded options would be a way to mitigate counterparty risk. However, this marketplace is not developed to the point where it is a useful tool in acquiring the derivatives typically needed to hedge balance sheet risks. Even if this were to occur, credit unions would still be exposed to the credit quality of their derivatives dealers. The potential harm from this has been illustrated by the recent failure of a large international derivatives firm. Consequently, it is our belief that posting collateral is currently the most expedient method of mitigating counterparty risk.

Regards,

Brad Miller
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Coastal FCU