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July 22, 2013

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

Re: 12 CFR Parts 703, 715 and 741 Derivatives

Dear Ms. Rupp:

On behalf of Affinity Federal Credit Union, thank you for the opportunity to comment on the proposed rule for Derivatives.

We applaud the NCUA for taking the time to expand the use of a very valuable capital markets tool that can be used to mitigate interest rate risk. While the use of derivatives may be new to credit unions outside the pilot program, it is one of the standard tools in Affinity's risk mitigation toolbox. As such, we had expected the new derivative rule to be an improvement over the current program, but were disappointed.

While the new rule appears to increase the amount of counterparties that are available and does not require that we employ an External Service Provider for routine functions, the new rule falls short in several key places.

Before addressing specific concerns, we would like to explain that the amount of notional that can be swapped is limited if the CU employs derivatives to hedge IRR without raising new funds and wants to ensure hedge effectiveness.

#### **Hedge Accounting Limits Notional Amount**

One of the most attractive features of derivatives is that they enable a credit union **to separate the risk management decision from the liquidity decision**. This tool enables institutions to manage risk without increasing pressure on net worth ratios. Prior to obtaining derivatives authority, Affinity managed IRR with two tools—loan sales and fixed rate borrowings. While the borrowings enabled us to manage IRR, they increased the denominator in the net worth ratio during a time when shares were flowing in and liquidity was not needed. Once we obtained authority we employed derivatives to hedge future costs of **existing** liabilities and thus were able to reduce IRR without pressure on the net worth ratio.

As NCUA correctly points out, interest rate is introduced as many financial institutions fund long term assets such as mortgages with short term liabilities such as non-maturity shares and CDs. Our goal was to use these tools to mitigate precisely this mismatch and to ensure hedge accounting under FASB rules. If you separate the risk management decision from the liquidity decision, i.e. transform existing liabilities—the only mechanism that ensures hedge accounting is synthetic swaps against CDs. Thus, we could only swap notional approximating new and rollover CDs. For us it was not a large amount relative to the balance sheet.

Affinity's balance sheet is nearly \$2.5 billion and we determined that, under the paradigm described above, we could only hedge \$100 million with derivatives. This assumes we employ swaps against 1, 3, and 6 month CDs (the most liquid sector of the market). For example, new + rollover CDs are routinely \$10,000,000 in one month, \$20,000,000 in 3 months and \$5,000,000 in 6 month CDs—the maximum amount we can execute and ensure hedge accounting is as follows:

<b>Hedge Accounting Example</b>		
<b>Index</b>	<b>New + Rollover CDs</b>	<b>Roll Cycle</b>
1 month CDs	\$ 10,000,000	Monthly
3 month CDs	\$ 20,000,000	January, April, July & October
	\$ 20,000,000	February, May, August & November
	\$ 20,000,000	March, June, September & December
6 Month CDs	\$ 5,000,000	January & July
	\$ 5,000,000	February & August
	\$ 5,000,000	March & September
	\$ 5,000,000	April & November
	\$ 5,000,000	May & November
	\$ 5,000,000	June & December
	\$ 100,000,000	

The other primary use has been to borrow floating from FHLB and swap into fixed. This combined the liquidity and risk management decisions and enabled the credit union to secure funding below the FHLB fixed rate. Any transactions coupled with new funding would be in addition to notional in the above example. However, the primary use of this tool for Affinity has been to hedge future cost of shares to better align liability costs with income from fixed rate mortgages. To date, we have not found a mechanism that would ensure hedge accounting for non-maturity shares. Thus, notional amounts are limited to new + rollover CDs given our hedge accounting requirement. This brings us to the fee discussion.

### **Fees**

Given the implicit limitations on notional amount, the fees add quite a bit to the cost of a derivatives program, even for a large credit union. The fees are not necessary and serve as a disincentive. The training of regulatory personnel is not that difficult, especially since the proposal is limiting the type of derivatives to “plain vanilla” structures. In addition, the NCUA examiners that we have encountered for our current program have been very capable in auditing this area.

The following chart illustrates the per annum cost of this fee across varying notional amounts

The Fee	
Fee	\$125,000
Term	5
Per Annum	\$26,520

  

Program Size	Per annum BPS Cost
\$20,000,000	0.13%
\$30,000,000	0.09%
\$40,000,000	0.07%
\$50,000,000	0.05%

This does not include any annual costs that NCUA might impose for program maintenance. Nor, does it include the costs associated with daily mark to market and frequent exchanges of collateral. Charging CUs to reduce risk is not intuitive. I do not recollect any other regulator that does this.

### Types of Derivatives

Forward starting swaps, varying notional swaps, swaptions, basis swaps and floors are all “plain vanilla” instruments that need to be in a financial institution’s toolbox. For example, loans are normally amortizing assets and it would be more effective to have a hedge that has notional amounts that also amortize.

Forward starting swaps and swaptions are also an effective hedging vehicle. We all believe interest rates will rise in the future, however why incur the interest expense and start the hedge today when you have a view that interest rates will not rise in the short term. **Note: This is not speculating.** Additionally, if a credit union knew it had a funding need in the future, the forward starting swap or swaption would give them the ability to lock the rate in today and avoid taking interest rate risk.

Affinity is a good example of how useful forward swaps can be. Early on in our program we executed swaps that had maturities of 2 and 3 years. Rates plummeted and we were able to do a forward swap that started when the initial swap matured and thus lock in a cost of funds well beyond the maturity date of the initial transaction. Given the limited \$ amount of notional we could have against CDs, an entirely new swap was not necessary. We did not have to use up capacity and increase costs in the short term but were able to take advantage of a significant decline in rates and lengthen liabilities.

Also, given that most loans are tied to prime and fundings are normally tied to libor, basis swaps would give a credit union the ability to manage this basis risk.

These are not exotic nor are they speculative, just good interest rate risk management. The extensive auditing, monitoring, modeling, and reporting that govern the program are more than sufficient to curtail the misuse of any derivative.

## **Collateral**

Acceptable securities for collateral purposes should be expanded to include Agency callables and Agency pass throughs. All are very liquid, backed by the government and can be readily priced by all counterparties. There should be no issue in pricing, because these securities will be kept and priced by an independent third party. In addition, the “haircuts” that are imposed on these securities will also serve to decrease the risk involved. This would open up the universe of assets that credit unions can pledge or accept as collateral.

## **Counterparties & Risk**

We agree that counterparties should be limited to swap dealers and major swap participants as defined by CFTC. However, thresholds for collateral transfer and initial threshold amounts should be up to the credit union’s credit team and its board. The mandate of daily mark to market and a \$250,000 transfer amount is costly and too conservative.

## **Limits: Notional Amount, Maturity & Aggregate Fair Value Loss**

We believe that in order to have an effective risk mitigation program, credit unions need to have the flexibility to determine the notional amount and the maturity of the derivative. Attempting to impose limits around these parameters is counter productive. In entering into a derivative, one is hedging an underlying asset or liability. It is the underlying asset or liability that should drive the notional and maturity of the derivative. However, if limits need to be imposed, they should be based on the market value changes of the derivative, which measures the true economic exposure of the credit union. The change in the market value of the underlying asset or liability being hedged would also have to be taken into consideration.

Early on in derivatives, notional limits were used but financial institutions the concept of notional limits decades ago. Simply put—how could a swap with 2 years remaining be risked in the same way as a swap with 7 years to go. However, if NCUA deems notional amounts a necessity, the notional amounts that NCUA has suggested should provide program participants with adequate flexibility.

Another concern is the requirement that the aggregate fair value loss of all swap positions into which the credit union has entered cannot exceed a certain percentage of net worth. Limits on mark-to-market changes independent of the asset or liability being hedged are inappropriate and could negatively impact effective hedging strategies. Theoretically, if there is a loss on the derivative there should be a gain on the asset. Therefore, the market valuation limit should take into consideration the asset or liability being hedged. A corrective action plan addressing the hedge, exclusive of the hedged item could force sub-optimal decisions. If action is forced just because a position has a mark to market loss, the NCUA will force the CU to lock in losses. More often than not, the best course would be to let the hedge stay in place until maturity.

## **Internal Controls Review**

An external review of internal controls is an additional deterrent to utilizing these tools. Internal control audits are different from financial statement audits and add additional cost. Derivative activities are much less complicated than other credit union activities, for which this provision is not required. The

credit union should have the option to have an internal auditor and/or their Enterprise Risk Management teams review the internal controls, modeling methodologies, and oversight process.

### **Legal Review**

The main body of the ISDA Master is boiler plate. The other parts include the Schedule and Credit Support Annex (CSA). The CSA specifies that collateral is to be provided by a party if the exposure of the other to it exceeds an agreed amount. The CSA contains provisions concerning the posting and return of collateral, the types of collateral that may be used, and the treatment of collateral by the secured party. Given that the proposed regulation defines all of the variables on the CSA and most of the items in the Schedule, counsel with 5 years of experience in the field is not necessary and is costly.

### **Grandfather Existing Pilot Program Participants**

We suggest that the existing users of derivatives be grandfathered into the program. We have gone thru the pilot program application process TWICE, shown the expertise, analysis and reporting required to effectively mitigate Affinity's interest rate risk. Our program has been audited by internal audit, NCUA, Enterprise Risk Management and our outside auditor. Why would we have credit union resources engage in another lengthy process when they have many years of experience and successful programs that had no findings?

Thank you again for the opportunity to comment on the proposed rule.

Sincerely,

A handwritten signature in blue ink that reads "Denise McGlone". The signature is written in a cursive style with a long horizontal flourish at the end.

Denise McGlone