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1001 Connecticut Ave. NW. Suite 1001//Washington, DC 20036

July 29, 2013

Via E-Mail
regcomments@ncua.gov

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

Re: Comments on Proposed Rule—Derivatives (RIN 3133-AD90)

Dear Ms. Rupp:

In its proposed rule issued for comment in May 2013 (78 FR 32191) (the "Proposed Rule"), the National Credit Union Administration ("NCUA") allows credit unions to engage in limited derivatives activities for the purpose of mitigating interest rate risk ("IRR"). This letter is submitted by the Board of Trustees of Trust for Credit Unions ("TCU") in response to NCUA's request for comments on whether the Proposed Rule is understandable and minimally intrusive. We believe that the Proposed Rule places clear and reasonable limitations on credit unions seeking to directly utilize derivatives to mitigate the portion of IRR attributable to credit unions' direct investments. We also believe, however, that NCUA could significantly enhance the Proposed Rule's effectiveness by providing guidance to credit unions seeking to mitigate the portion of IRR attributable to investments held by credit unions through mutual funds. Specifically, we recommend that NCUA provide guidance indicating that mutual funds marketed to credit unions may mitigate IRR by engaging in the limited derivative activities set forth in the Proposed Rule. Such guidance would help mutual fund managers with a high level of derivatives expertise and a well-developed derivatives program infrastructure to mitigate the portion of IRR attributable to credit unions' indirect investments. Without such guidance, the efforts of credit unions to mitigate their overall exposure to IRR would be severely hamstrung.

About TCU.

TCU is an open-end diversified management investment company registered under the Investment Company Act of 1940 (the "1940 Act") and the Securities Act of

1933. Mutual funds advised by TCU (the "TCU portfolios") are offered only to federal credit unions ("FCUs") and state chartered credit unions. Shares of each TCU portfolio are designed to qualify as eligible investments for FCUs pursuant to Sections 107(7), 107(8) and 107(15) of the Federal Credit Union Act ("FCUA"), Part 703 of NCUA Rules and Regulations and NCUA Letter Number 155, and may or may not qualify as eligible investments for particular state chartered credit unions. Each investment practice and technique that may be used by the TCU portfolios is permitted by the 1940 Act but utilized only to the extent permitted by NCUA Rules and Regulations. Goldman Sachs Asset Management, L.P. ("GSAM") is the investment adviser for the TCU portfolios. GSAM's Global Fixed Income & Liquidity Management Team of almost 200 professionals has been managing active fixed income portfolios since 1989 and has first-hand experience in managing bond portfolios where derivatives are employed as an integral part of the asset management process and fully integrated within the risk management framework governing a portfolio as a whole. Callahan Credit Union Financial Services, LLLP ("CUFSLP"), a Delaware limited liability limited partnership in which 36 credit unions are limited partners, acts as the administrator of the TCU portfolios. For 25 years, TCU has helped its credit union shareholders invest excess member deposits and provide an investment alternative intended to enhance the credit unions' cash management. Section 703.14(c) provides that an FCU may invest in a registered investment company or collective investment fund, as long as the prospectus of the company or fund restricts the investment portfolio to investments and investment transactions that are permissible for FCUs.

<u>Indirect IRR from Mutual Fund Investments.</u>

We applaud the Proposed Rule's acknowledgement of the material risk that IRR poses to FCUs' direct investments, especially given the historically low interest rate environment of the last few years. The types of derivatives permitted by the Proposed Rule (the "Permitted Derivatives"), when utilized by well-informed managers with demonstrated derivatives experience, will provide FCUs with an effective tool for mitigating a portion of their overall IRR exposure.

Noticeably absent from the Proposed Rule, however, is a discussion of the role that mutual funds play in FCUs' investments and the IRR associated with that role. Mutual funds marketed to credit unions and restricted to FCU-permissible investments, such as the TCU portfolios, should be expected to encounter risks similar to those faced by FCUs themselves. Those risks, including IRR, are passed on to shareholder credit unions if left unmitigated by the portfolios. We recommend that, in revising the Proposed Rule, NCUA clarify that mutual funds such as the TCU portfolios have access to the same IRR-mitigating derivatives as credit unions themselves.

Mitigation of Indirect IRR.

Managers of mutual funds such as the TCU portfolios are well-positioned to assess the IRR inherent in the funds' investments and to work to counter such IRR using Permitted Derivatives. Institutions such as GSAM have the derivatives expertise and derivatives program infrastructure that the Proposed Rule requires credit unions to develop, as well as knowledge of the day-to-day operations of the mutual funds. In contrast, credit unions boards/managers have varying degrees of derivatives experience, may face challenges in developing a suitable derivatives program infrastructure and are not involved with the day-to-day operations of the funds they invest in. Managers of mutual funds such as the TCU portfolios, therefore, can provide significant assistance in mitigating IRR. We believe it would be beneficial to credit unions, then, for NCUA to acknowledge this potential assistance and afford such managers access to Permitted Derivatives. Indirect IRR from an FCU's investments in mutual funds could then be addressed as effectively, if not more effectively, than direct IRR from an FCU's other investments. We believe this broad, comprehensive view of IRR mitigation would ultimately reduce risk to the National Credit Union Share Insurance Fund ("NCUSIF").

As noted in the Proposed Rule, a credit union must retain overall "responsibility and control over the [Permitted Derivatives] and balance sheet management process and decision making." Additional protections afforded by the regulation of registered investment companies such as the TCU portfolios, however, can only help ensure that Permitted Derivatives are utilized in a prudent manner. A registered investment company is subject to all of the restrictions and limitations contained in the 1940 Act and its regulations as well as to other requirements under the 1940 Act, other federal securities laws and related regulations and the Internal Revenue Code of 1986, as amended (the "Code"). For example, each of the TCU portfolios is "diversified" and as such is subject to limitations imposed by both the 1940 Act and the Code as to the amount of its assets that may be invested in the securities of any one issuer (with certain exceptions). Likewise, each TCU portfolio is subject to certain concentration limitations imposed by the 1940 Act as to the amount of its assets that may be invested in the securities of issuers in a particular industry (with certain exceptions). Most importantly, registered investment companies are required to have a board of directors or trustees to oversee the operations of the investment company and generally at least a majority of the members of such board must consist of independent outside directors or trustees, technically referred to as persons who are not "interested persons" of the investment company (in the case of TCU, all of the members of the board of trustees are considered independent trustees). The board of directors or trustees of a registered investment company receives reports at least quarterly from the investment company's investment adviser, Chief Compliance Officer and other service providers as to the operations of the investment company, including, if applicable, reports on derivatives holdings.

Please also note that the mutual fund structure described above captures the major concepts set forth in the Proposed Rule's "Internal controls structure" section: duties are divided so that no one person has sole control over any transaction and its reporting and accounting; written frameworks describe derivatives decision processes; and activities are subject to internal controls, financial statement audits, legal review and hedge review.

Given the registered investment company protections detailed above, it would be in the best interests of credit unions and the NCUSIF for NCUA to allow mutual funds to engage in limited Permitted Derivatives transactions on behalf of all credit union shareholders, including those that have not received NCUA Level I or Level II authorization to utilize Permitted Derivatives. While a truly comprehensive credit union IRR mitigation strategy would address both direct and indirect IRR, a credit union that lacks the ability to meet NCUA's requirements for utilizing Permitted Derivatives to mitigate direct IRR can still safely benefit from a fund's use of such Permitted Derivatives to mitigate that credit union's indirect IRR. For example, a credit union may face a material risk from IRR, but fail to meet the Proposed Rule's $250 million threshold for receiving NCUA authorization to engage in Permitted Derivatives transactions. As noted in the Proposed Rule, such a credit union may be unwilling to incur the costs necessary to build staff/execute trades and may be unable to meet counterparty requirements for many derivatives contracts. If such a credit union invests in a mutual fund, however, we see no reason to prevent that credit union from benefitting from the mutual fund's IRR-mitigating use of Permitted Derivatives.

With 6,066 of 6,819 credit unions system-wide failing to meet the $250 million threshold (and those credit unions holding 22% of credit union assets under management system-wide), mutual funds utilizing Permitted Derivatives could significantly reduce overall IRR to the NCUSIF. We recognize that the 753 credit unions meeting the $250 million threshold face greater IRR risk, on average, than those credit unions failing to meet the threshold. Even for those larger credit unions, however, mutual fund managers are better-positioned to assess indirect IRR exposure from the credit unions' mutual fund investments and develop programs that mitigate indirect IRR. We believe that permitting mutual funds such as the TCU portfolios to engage in limited Permitted Derivatives activities would benefit smaller credit unions, benefit larger credit unions, and safely and significantly enhance IRR-mitigation efforts system-wide. We also note that system-wide analyses do not account for the danger that IRR may pose to any one particular credit union.

Permitting mutual funds such as the TCU portfolios to engage in limited Permitted Derivatives activities for the purpose of mitigating IRR would not place NCUA in unfamiliar territory. As noted in the Proposed Rule, NCUA has permitted a limited number of FCUs to invest in derivatives through third parties in pilot programs since as early as 1999. We recognize that NCUA is concerned that certain FCUs may have suffered losses in certain programs, most notably, a mortgage-focused fund launched into the teeth of the 2008 financial crisis. It is our understanding that any losses experienced by that mortgage-focused fund were attributable to investments in non-agency mortgage-backed securities and were in no way attributable to Permitted Derivatives contemplated by the Proposed Rule. We also recognize that NCUA is concerned about liquidity issues that the mortgage-focused fund encountered during the financial crisis. The Proposed Rule's prudent limitations on Permitted Derivatives, however, should alleviate such liquidity concerns—Markets for the Permitted Derivatives and, at least in the case of the TCU portfolios (which do not invest in non-agency mortgage backed securities), the securities underlying the Permitted Derivatives are highly liquid, even in the most unusual of market conditions.

Because of the aforementioned pilot programs, NCUA may already have the necessary resources in place to monitor mutual funds' IRR-mitigation efforts, at least to the extent that such efforts are limited to Permitted Derivatives discussed in the Proposed Rule. Permitting mutual funds such as the TCU portfolios to engage in limited Permitted Derivatives activities for the purpose of mitigating IRR may conserve NCUA resources in other ways, as well. If FCUs find that such funds' IRR-mitigation efforts are sufficient to protect the FCUs' safety and soundness, for example, the number of FCU applications submitted to NCUA for the purposes of engaging in derivatives transactions may be much smaller than previously estimated. Reporting requirements and other regulatory burdens discussed in the Proposed Rule may also be reduced, to the extent that NCUA deems such requirements for mutual funds redundant with those already in place under the 1940 Act and other statutes/regulations.

<u>Suggested Revisions to the Proposed Rule</u>.

We suggest adding a section to the Proposed Rule addressing "Indirect Investments in Permitted Derivatives." We propose explicitly stating that, in addition to investing in all other FCU-permissible investments, mutual funds that possess an NCUA-approved level of financial sophistication, risk management and operational capabilities (and market to credit union investors) may invest in Permitted Derivatives to mitigate the inherent risks of those other FCU-permissible investments. For consistency with the Proposed Rule's limits on credit unions' mitigation of direct IRR using derivatives, we suggest applying the Proposed Rule's Level II limitations to mutual funds' mitigation of indirect IRR using derivatives.

We also suggest adding interest rate futures to the list of Permitted Derivatives that can help credit unions mitigate direct IRR and mutual funds mitigate indirect IRR. Interest rate futures are exchange-traded instruments that can be used to hedge interest rate exposure. They tend to be highly liquid, are most commonly cash-settled, and are highly regulated by the U.S. government through the Commodity Futures Trading Commission.

Conclusion.

In short, the Proposed Rule is an important step forward in allowing credit unions to safely mitigate direct IRR using Permitted Derivatives. We believe that allowing mutual funds such as the TCU portfolios to safely mitigate indirect IRR using the same Permitted Derivatives would help to further the goals articulated in the Proposed Rule: Credit unions would be armed with effective tools to comprehensively manage IRR, the safety and soundness of credit unions and the NCUSIF would be greatly enhanced and the regulatory burden incurred by NCUA and credit unions would be minimized.

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Thank you for the opportunity to comment on the Proposed Rule. TCU and GSAM would also greatly welcome an opportunity to discuss further (in person or via teleconference) any revisions to the Proposed Rule that could benefit credit unions and mitigate risk to the NCUSIF, whether set forth in this letter or proposed by others. Please do not hesitate to contact me at 757-259-2104 or counsel to TCU, Mary Jo Reilly, at 215-988-1137.

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