

**7535-01-U**

**NATIONAL CREDIT UNION ADMINISTRATION**

**12 CFR Part 701, 703, 741, and 746**

**RIN 3133-AF29**

**Derivatives**

**AGENCY:** National Credit Union Administration (NCUA).

**ACTION:** Proposed rule.

**SUMMARY:** The NCUA Board (Board) is proposing to amend the NCUA's Derivatives rule in Subpart B to part 703. This proposal is intended to modernize the NCUA's Derivatives rule and make it more principles-based. This proposal retains key safety and soundness components, while providing more flexibility for federal credit unions (FCUs) to manage their interest rate risk (IRR) through the use of Derivatives. The changes included in this proposal would streamline the regulation and expand credit unions' authority to purchase and use Derivatives for the purpose of managing IRR. This proposal also reorganizes rule content related to loan pipeline management into one section, which will aid in readability and clarity.

**DATES:** Comments must be received by [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE *FEDERAL REGISTER*].

**ADDRESSES:** You may submit written comments, identified by RIN 3133-AF29, by any of the following methods:

- Federal eRulemaking Portal: <http://www.regulations.gov>
  - Follow the instructions for submitting comments.
- Fax: 703-518-6319
  - Include “[Your Name]—Comments on Proposed Rule: Derivatives” on the transmittal cover page.
- Mail: Melane Conyers-Ausbrooks, Acting Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.
- Hand Delivery/Courier: Same as mail address.

**Please send comments by one method only.**

**PUBLIC INSPECTION:** You may view all public comments as submitted on the Federal eRulemaking Portal at <http://www.regulations.gov>, except those that cannot be posted for technical reasons. The NCUA will not edit or remove any identifying or contact information from submitted public comments. Due to social distancing measures in effect, the usual opportunity to inspect paper copies of comments in the NCUA’s law library is not currently available. After social distancing measures are relaxed, visitors may make an appointment to review paper copies by calling 703-518-6540 or e-mailing [OGCMail@ncua.gov](mailto:OGCMail@ncua.gov).

**FOR FURTHER INFORMATION CONTACT:** *Policy and Analysis:* Tom Fay, Capital Markets Manager, Office of Examination and Insurance, 703-518-1179; *Legal:* Justin Anderson, Senior Staff Attorney, Office of General Counsel, 703-518-6540; or by mail at National Credit Union Administration, 1775 Duke Street, Alexandria, VA 22314.

## **SUPPLEMENTARY INFORMATION:**

### **I. Introduction**

As discussed throughout the remainder of this document, the Board is proposing to modernize its Derivatives<sup>1</sup> rule by progressing from a prescriptive construct to a more expansive, principles-based approach. The Board believes the proposed amendments will make it easier and more efficient for FCUs to manage IRR with Derivatives while maintaining the necessary safety and soundness controls.

### **II. Background**

In 2014, the Board finalized the NCUA's current Derivatives rule,<sup>2</sup> which only applies to FCUs.<sup>3</sup> Before finalization of the current Derivatives rule, FCUs could only use Derivatives to hedge real estate loans produced for sale on the secondary market; hedge interest rate lock or forward sales commitments for loans that the FCU originated; or fund dividend payments on member share certificates where the share certificate rate was tied to an equity index.

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<sup>1</sup> The term "Derivatives" is defined in both the current rule and this proposal.

<sup>2</sup> 79 FR 5228 (Jan. 31, 2014).

<sup>3</sup> As of this proposal, to use Derivatives, federally insured, state-chartered credit unions must have authority from the applicable state regulator (explicit authority or case-by-case authority).

Beginning in 1999, however, the Board had approved several IRR Derivative pilot programs. The pilot programs, which remained active until the 2014 rulemaking, provided important insight into the safety and efficacy of the use of Derivatives in managing IRR over a significant time horizon that included periods of both rising and falling interest rates.

As noted above, in 2014, the Board, based largely on its experience observing the successful use of Derivatives through the pilot programs, finalized the current Derivatives rule. As noted in the preamble in the proposed and final versions of that rule, the Board concluded that it was both safe and beneficial to authorize the use of Derivatives for managing IRR.

The scope of the 2014 final rule was intentionally prescriptive, given most FCUs' lack of experience using Derivatives for IRR management and the NCUA's need to increase its specialized expertise to manage and supervise the use of such instruments and the accompanying application process included in the rule. The prescriptiveness of the final rule enabled the Board to safely expand Derivatives authority while also ensuring that FCUs which engaged in Derivatives did not pose an undue safety and soundness risk to themselves, the broader credit union industry, or the National Credit Union Share Insurance Fund (the Fund). As such, the 2014 final rule included a number of restrictions on Derivative authorities. These included, but were not limited to, discrete limits on the types of Derivative products an FCU could purchase; requiring FCUs to receive NCUA preapproval before engaging in Derivatives; and regulatory limits on the amounts of Derivatives an FCU could hold relative to its net worth.

Since 2014, the NCUA has received many applications from FCUs and notifications from federally insured, state-chartered credit unions (FISCUs)<sup>4</sup> planning to use Derivatives to manage

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<sup>4</sup> FISCUs are required to notify the NCUA; they are not required to receive NCUA approval.

IRR. As of June 2020, approximately 30% of all FCUs with an approved Derivatives application and FISCUs that have notified the NCUA of their use of Derivatives have outstanding Derivative transactions.

Under the current rule, the Board and staff have gained critical knowledge and experience through oversight of credit unions actively using Derivatives. This experience has helped the NCUA streamline the focus of its examinations while also identifying areas where additional regulatory relief could be granted safely. Many of these relief items were included as part of the Board's December 2018 Regulatory Reform Agenda;<sup>5</sup> most of those items are included in this proposal. The Board notes that comments from the Regulatory Reform Agenda were generally supportive of a principles-based approach for permissible Derivative products for FCUs managing IRR.

Given the observable safe and effective management of Derivatives by credit unions since the 2014 final rule, the Board believes it is appropriate to modernize the Derivatives rule to expand the Derivatives authority for FCUs and shift the regulation toward a more principles-based approach. In developing this proposed rule, the Board carefully considered the risks Derivatives pose, contemporary developments in the marketplace, and the NCUA's experiences with credit unions using Derivatives. While using Derivatives to manage IRR, the Board reminds credit unions that Derivatives are not a panacea for managing market risks. Derivatives, when used responsibly, are only a part of a credit union's IRR framework. Credit unions will still require appropriate risk management by experienced staff, as well as suitable policies, procedures, and management oversight. Further, the Board reminds credit unions that implicit in

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<sup>5</sup> [83 FR 65926 \(Dec. 21, 2018\)](#).

a principles-based approach is the expectation that FCUs will maintain strong prudential controls around their Derivative use at all times.

The Board remains committed to the principle that any authorized Derivative activity should be limited to the purpose of mitigating IRR within a discreet hedging strategy, and may not be used to increase risks deliberately or conduct any otherwise speculative transactions. This proposal continues to authorize Derivative activity by FCUs that demonstrate risk characteristics highly correlated to the FCU's assets and liabilities, such that Derivatives would be an efficient and effective risk mitigation tool.

For the reasons stated above, the Board is proposing to amend the Derivatives rule as described in the following sections. The Board believes these changes will provide regulatory relief in a safe and sound manner for credit unions choosing to utilize Derivatives as part of their IRR mitigation strategy.

### **III. Proposed Rule**

As described in more detail below, the Board is proposing to make numerous changes to the Derivatives rule, both substantive and technical. The proposed changes make the Derivatives rule less prescriptive and more principles based. Significant elements of this proposal include eliminating the preapproval process for FCUs that are complex with a Management CAMEL component rating of 1 or 2; eliminating the specific product permissibility; and eliminating the regulatory limits on the amount of Derivatives an FCU may purchase.

The aforementioned changes, as well as proposed changes to other sections of the NCUA's regulations and less significant changes to the Derivatives rule are described in the following section-by-section analysis below.

## **A. Part 701**

The Board is proposing to remove paragraph (i) from § 701.21 to consolidate it with related provisions without intending any substantive change. This section currently allows FCUs to purchase put options to manage increased IRR for real estate loans produced for sale on the secondary market. A *put option* is a financial options contract which entitles the holder to sell, entirely at the holder's option, a specific quantity of a security at the specified price at or before the stated expiration date of the contract. Using put options in the manner permitted by § 701.21(i) is a form of loan pipeline management. *Loan pipeline management* involves transactions that are made to protect an FCU from the changes in the value of loans between origination and sale.

The Board is proposing to move the authority in § 701.21(i) to a revised § 703.14(k) (discussed in more detail in subsection B of this section). The Board's intent in proposing to move this paragraph is to consolidate all loan pipeline management into one paragraph and to use a principles-based approach for this activity. The Board notes that this proposed change would not eliminate or change this authority for FCUs.

## **B. Subpart A to part 703**

The Board is proposing to revise paragraph (k) of § 703.14. This section currently lists permissible Derivative activities for FCUs. This section includes a list of permissible Derivatives, the majority of which are addressed in Subpart B to part 703 or elsewhere in the NCUA's regulations. As such, this section only grants unique authority for interest rate lock commitments or forward sales commitments made in connection with a loan originated by an FCU. The Board is proposing to revise § 703.14(k) to only address transactions for loan pipeline

management, which would include the purchase of put options permissible in the current § 701.21(i) and interest rate lock commitments or forward sales commitments made in connection with a loan originated by an FCU in the current § 703.14(k). In addition to the current permissible transactions for loan pipeline management, the proposed revision to § 703.14(k) would allow other transactions as long as they are for managing interest rate exposure of the FCU's loan pipeline.

Due to the revised purpose of the paragraph, the Board is proposing to remove § 703.14(k)(1), which refers to the activities in § 701.21(i), § 703.14(g), and subpart B. As discussed previously, the Board is proposing to move the authority in § 701.21(i) to a revised § 703.14(k). Section 703.14(g) permits FCUs to purchase European financial option contracts to fund the payment of dividends on member share certificates where the dividend rate is tied to an equity index. While the reference in § 703.14(k)(1) to subparagraph (g) will be removed, the Board notes that it is not making any changes to the aforementioned subparagraph. Subpart B is the Derivative authority addressed below.

As such, the Board believes § 703.14(k)(1) is no longer necessary, because the revised paragraph (k) would only address instruments for loan pipeline management and not a broader Derivative authority. The Board notes that this proposed revision is technical in nature and does not change an FCU's current Derivative authority.

For similar reasons to the proposed removal of § 703.14(k)(1), the Board is proposing to move § 703.14(k)(2) to a new subsection (l). This new subsection will retain the authority for FCUs to enter into transactions where Generally Accepted Accounting Principles (GAAP) do not require the embedded options to be accounted separately from the host contract.



Further, the Board notes that this authority contains an implicit prohibition on FCUs entering into embedded options where GAAP requires the option to be accounted for separately from the host contract. The Board notes that such transactions would be considered Derivatives. As discussed in more detail below, the Board is proposing to make this prohibition explicit in subpart B to part 703. The Board believes this change is clarifying in nature and is not intended to make a substantive change.

The proposed revision would continue to allow FCUs to enter into transactions related to the management of their loan pipeline without limiting the activity to specified transaction types. The current § 703.14(k)(3) specifies that FCUs can enter into interest rate lock commitments or forward sales commitments made in connection with a loan originated by an FCU. Consistent with proposed changes to subpart B, the Board is making this paragraph principles-based by not specifying product types, which will allow FCUs more flexibility when managing their loan pipeline.

Examples of transactions that an FCU might use to protect itself from IRR between origination and sale include forward sales commitments, selling “to be announced” (TBA),<sup>6</sup> or purchasing put options referenced in the current § 701.21(i). These examples would be permissible under the proposed § 703.14(k). Other transactions not mentioned would also be permissible if they are related to the management of interest rate exposure of an FCU’s loan pipeline.

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<sup>6</sup> To be announced. A forward-settling agency mortgage pass-through trade.

The Board is aware that GAAP may classify some transactions for loan pipeline management as Derivatives. Such accounting classification would not preclude an FCU from engaging in the activity. The Board would also like to make it clear that a Derivatives transaction for loan pipeline management would not be subject to the proposed subpart B of part 703, and the transacting FCU will not be subject to the requirements of the aforementioned subpart.

The Board is soliciting comments on whether loan pipeline management should be limited to mortgage loans as opposed to all loans on an FCUs balance sheet. If so, why should loan pipeline management be limited to mortgage loans? If not, what types of loans other than mortgage loans would an FCU manage using the tools in this section?

### **C. Subpart B to part 703**

#### ***§ 703.101 Purpose and scope.***

The Board is proposing to retain a majority of the purpose and scope section in the current Derivatives rule. Specifically, the purpose and scope section of this proposal would continue to make it clear that the Derivatives rule only applies to FCUs, except for a limited provision related to notifications FISCUs provide the NCUA.<sup>7</sup> In addition, the proposed section continues to make it clear that an FCU may enter Derivatives under this rule for the exclusive purpose of managing IRR.

While the majority of this section would remain unchanged, the Board is proposing to eliminate the requirement related to mutual funds. The Board is proposing to remove the

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<sup>7</sup> Section 703.108 (Notification and application requirements) addresses FISCU notification requirements.

prohibition for mutual funds to engage in Derivatives if an FCU purchases the mutual fund under the general investment authority.<sup>8</sup> The current rule states that subpart B does not permit FCUs to “invest in registered investment companies or collective investment funds under § 703.14(c) of this part, where the prospectus of the company or fund permit the investment portfolio to contain Derivatives.”<sup>9</sup> In 2014, the Board was concerned with the risk Derivatives could add to credit unions and the Fund. The Board believes this prohibition is no longer necessary. The Board believes a mutual fund can enter into Derivative transactions in a safe and sound manner as long as the transactions are limited to managing IRR. This belief stems from the experience the Board gained from FCUs that have engaged in Derivative transactions since the 2014 final rule.

By removing this prohibition, the Board would permit FCUs to invest in mutual funds that enter into Derivative transactions to manage IRR. Mutual funds that enter into derivatives to manage IRR are able to increase or decrease the interest rate sensitivity of the mutual fund, thereby providing the owners of such fund with the target duration<sup>10</sup> of the investment that accounts for volatility in interest rates. For example, a mutual fund may have a target duration of four years, and the current portfolio has a duration of five years. The mutual fund may enter into a Derivative transaction to decrease the mutual fund’s duration, which would be a form of IRR management.

The Board would like to make it clear that mutual funds permissible for FCUs under the general investment authority will only be permitted to engage in Derivatives to manage IRR. A mutual fund may not engage in Derivatives that do not manage IRR. For example, a mutual fund

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<sup>8</sup> 12 CFR part 703, subpart A.

<sup>9</sup> 12 CFR § 703.100(b)(2).

<sup>10</sup> Duration is the sensitivity of the price of the mutual fund to a change in interest rates.

that purchases Derivatives related to equities, credit, or commodities would not be permissible for an FCU under the general investment authority.

The Board is also proposing to add two paragraphs to this section to address FCUs that are currently operating under an approved application for Derivatives authority or have submitted an application for Derivatives authority under the current Derivatives rule and are awaiting a determination. As discussed in the portion of this preamble addressing § 701.108 of the proposal, the Board is proposing to eliminate the application requirement for Derivatives authority except for certain FCUs that do not meet limited conditions. As such, the proposed new paragraphs in this section would clarify that any FCU with a current approval would be subject only to the terms and conditions of a final rule based off this proposal and would no longer be subject to the requirements included in its approved application. In addition, any credit union not required to submit an application under this proposal that has submitted an application under the current Derivatives rule and is awaiting a determination would be deemed to have such application withdrawn and would only be subject to the terms and conditions of a final rule based off of this proposed rule.

If this proposal is finalized, the NCUA would continue to process any pending application from an FCU that would be required to submit an application under this proposed rule. The Board notes, however, that the NCUA would process such application in accordance with the more flexible standards under this proposal rather than the standards in the current Derivatives rule.

**§ 703.102 *Definitions.***

The Board is proposing to revise several definitions from the current rule; add new definitions; remove definitions that are no longer applicable to this proposed rule; and retain definitions from the current rule with no changes.

The Board is proposing to modify the definitions of the following terms in the current Derivatives rule:

- Counterparty;
- Interest Rate Risk;
- Margin;
- Master Service Agreement;
- Net Economic Value;
- Senior Executive Officer;
- Threshold Amount; and
- Trade Date.

The Board is proposing to revise the definition of Counterparty to include reference to the regulatory citations for the terms “Swap dealer” and “Derivatives clearing organization.”

Including these citations in the definition will allow the Board to remove the definitions for “Swap dealer” and “Derivatives clearing organization” in this proposal and the corresponding cross-references. This change would make the Derivatives rule more user-friendly and aid in readability.

The Board is proposing to revise the definition of Interest Rate Risk to make it consistent with the definition used in the Interest Rate Risk chapter of the NCUA’s Examiner’s Guide.<sup>11</sup> The proposed revision changes “vulnerability” to “current and prospective risk” and changes “earnings or economic value” to “capital and earnings.” The Board believes these proposed revisions help better articulate what IRR is, from the NCUA’s perspective. The proposed revised definition of IRR also removes “Federal” when referring to a credit union and removes “market” when referring to interest rates. The Board views the qualifiers of “Federal” and “market” as unnecessary, and views these changes as technical.

The Board is proposing to revise the definition of Margin to add clarity. The proposed revision to Margin changes “funds” to “eligible collateral, as defined by § 703.104(c)” to make the definition more user-friendly to the reader. The Board believes readers can more easily reference eligible collateral with this change through directing the reader to the section where eligible collateral is defined. The Board is also proposing to change “as detailed in a Master Services Agreement” to “as detailed in a credit support annex or clearing arrangement.” The Board is proposing this change to reflect the location of contractual requirements for eligible collateral, which is contained in the credit support annex for non-cleared Derivative transactions. The Board considers these changes clarifications and technical.

The Board is proposing to change the definition of Master Service Agreement. The proposed revised definition removes the language regarding the application of the Master Service Agreement to future transactions with the same counterparty. The Board believes the

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<sup>11</sup> <https://www.ncua.gov/regulation-supervision/manuals-guides/examiners-guide>.

reference to future transactions is unnecessary since the Master Service Agreement, not the NCUA definition, will define the terms of the agreement.

The Board is proposing to revise the definition of Net Economic Value. The proposed revision changes “economic value of assets minus the economic value of liabilities” to “measurement of changes in the economic value of net worth caused by changes in interest rates.” As with the change in the definition of Interest Rate Risk, the proposed Net Economic Value definition would be consistent with the definition used in the NCUA’s Interest Rate Risk Examiner Guidance. The Board believes this will add clarity by providing readers with a consistent definition across the NCUA’s regulatory and supervisory framework.

The Board is proposing to revise the definition of Senior Executive Officer by removing “as identified in a Federal credit union's process and responsibility framework, as discussed in § 703.106(b)(1) of this subpart.” The Board is proposing this change, as this proposal removes the process and responsibility framework referenced in the definition. The proposed definition for Senior Executive Officer will still have the meaning as specified in § 701.14 and include any other similar employee that is directly within the chain of command for oversight of an FCU’s Derivative program. Senior Executive Officers will continue to have reporting requirements as specified in § 703.105 and be responsible for the operational support requirements in § 703.106.

The Board is proposing to revise the definition of Threshold Amount to add clarity to the permissible collateral. The proposed revision changes “collateral” to “eligible collateral.” Furthermore, the proposed revised definition adds a clarifier that eligible collateral is “as defined in § 703.104(c).” The Board believes these changes will provide clarity to the reader on where

to find eligible collateral type within the proposed rule, and does not believe such change is material.

Finally, the Board is proposing to revise the definition of Trade Date to replace the reference to “in the market” with “with the counterparty.” The Board believes this change provides specificity to the definition, because a trade is executed with a counterparty and not a market.

The Board is proposing to add the following definitions:

- Domestic Counterparty;
- Domestic Interest Rates;
- Earnings at Risk; and
- Written Options.

The Board is proposing to add a definition for Domestic Counterparty. This proposal would define a Domestic Counterparty as a counterparty domiciled in the United States. This definition is necessary because the Board is proposing that FCUs can only enter into Derivatives transactions with Domestic Counterparties.

The Board is proposing to add a definition of Domestic Interest Rates. This proposal would define Domestic Interest Rates as interest rates derived in the United States and are U.S. dollar denominated. The Board is including this definition to ensure there is no ambiguity in the term Domestic Interest Rates.

The Board is proposing to add a definition for Earnings at Risk. This proposal would define Earnings at Risk as the changes to earnings, typically in the short term, caused by changes



in interest rates. This is consistent with the definition in the NCUA's Interest Rate Risk Examiner Guidance. This definition is necessary because this is a type of modeling would be required for an FCUs asset/liability risk management under this proposed rule.

Finally, the Board is proposing to add a definition for Written Options. The Board is defining Written Options as options where compensation has been received and the purchaser has the right, not obligation, to exercise the option on a future date. This definition is necessary because the Board is proposing to prohibit Written Options in this proposed rule.

The Board is proposing to eliminate the following definitions that appear in the current rule:

- Amortizing Notional Amount;
- Basis Swap;
- Cleared Swap;
- Credit Support Annex;
- Derivative Clearing Organization;
- Exchange;
- Fair Value;
- Forward Start Date;
- Futures;
- Futures Commission Merchant (FCM);
- Hedge;
- Interest Rate Swap;
- Introducing Broker;

- ISDA Protocol;
- Leveraged Derivative;
- Minimum Transfer Amount;
- Non-cleared;
- Notional Amount;
- Reporting Date;
- Swap Dealer;
- Swap Execution Facility; and
- Unamortized Premium.

The Board is proposing to remove the above mentioned definitions as they are no longer relevant in this proposal. Most definitions lose their relevancy due to the proposal's shift to a principles-based approach from the more prescriptive approach in the current rule. The Board is proposing to move the regulatory citations for Derivative Clearing Organization and Swap Dealer into the definition of Counterparty, making these definitions no longer necessary.

The Board is proposing to retain the following definitions from the current rule without amendment:

- Derivative;
- Economic Effectiveness;
- External Service Provider;

- Field Director;<sup>12</sup>
- Interest Rate Cap;
- Interest Rate Floor;
- Net Worth;
- Novation;
- Reference Interest Rate; and
- Structured Liability Offering.

The Board is proposing to retain the above mentioned definitions from the current rule because they are still relevant and necessary for this proposed rule.

***§ 703.103 Requirements related to the characteristics of permissible interest rate Derivatives.***

The Board is proposing to replace the “Permissible Derivatives” section of the current rule with the new proposed § 703.103 titled “Requirements related to the characteristics of permissible interest rate Derivatives.” The proposed title change will better reflect the intent of the section.

As established in the background section of this document, the Board is proposing to use a principles-based approach with Derivatives to manage IRR. This approach will replace the prescriptive list of products permitted and some of the required characteristics in the current rule.

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<sup>12</sup> The Board is proposing to change “Field” to “Regional” to better align with the NCUA’s other regulations. Such change will not, however, amend the definition of this term.

The Board is proposing that FCUs may use Derivatives to manage IRR, provided such Derivatives have all of the following characteristics:

- Denominated in U.S. dollars;
- Based off Domestic Interest Rates or dollar-denominated London Interbank Offered Rate (LIBOR); The Board notes that The United Kingdom Kingdom's Financial Conduct Authority has announced that it will not guarantee LIBOR's availability beyond the end of 2021, and risks associated with LIBOR discontinuation could occur prior to the end of 2021. On July 1, 2020 the FFIEC released a Joint Statement on Managing the LIBOR Transition, that among other things, highlights LIBOR transition risks and encourages supervised institutions to continue their efforts to prepare for and manage associated risks.<sup>13</sup> As such, the Board will monitor the LIBOR transition and will make any necessary changes to a final Derivatives rule.
- A contract maturity equal to or less than 15 years, as of the Trade Date; and
- Not used to create Structured Liability Offerings for members of nonmembers.

All of the characteristics above are in the current Derivatives rule. Consistent with the current Derivative rule and the limitations for variable rate investments set in § 703.14(a),<sup>14</sup> the Board is proposing to continue to limit permissible indices for Derivatives to Domestic Interest Rates. In addition, any Derivatives transaction must be denominated in U.S. dollars. These restrictions are consistent with the use of Derivatives to manage IRR, as an FCU's IRR is

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<sup>13</sup> <https://www.ffiec.gov/press/pr070120.htm>

<sup>14</sup> 12 CFR § 703.14(a).

correlated to changes in domestic interest rates. Further, an FCUs Derivatives program will be hedging against transactions that are also denominated in U.S. Dollars.

Consistent with the current Derivative rule, the Board is proposing to keep the current contract maturity limit (15 years, as of the Trade Date). As with the current rule, the Board believes this will continue to allow FCUs to effectively hedge various points of the yield curve for longer-term assets like mortgages, while preventing an excessive exposure to very long Derivative maturities.

Lastly, the Board is proposing to continue to prohibit Derivatives to create Structured Liability Offerings for members or nonmembers.<sup>15</sup> The Board continues to believe this activity is inconsistent with FCUs managing IRR.

The Board believes the above-mentioned characteristics are consistent with a principles-based approach while maintaining guardrails for safety and soundness and consistency with requirement for Derivatives to be used for managing IRR.

As mentioned in the background section of this document, the Board is proposing to remove reference to specific product types. The current Derivative rule allows credit unions to enter into interest rate swaps, basis swaps, purchased interest rate caps, purchased interest rate floors, and U.S. Treasury note futures, with some conditions applied. The proposed rule will allow for all of the specific product types identified in the current rule, as well as additional product types that meet the above characteristics.

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<sup>15</sup> European financial put options are permissible per 12 CFR § 703.14(g).

The Board has found that Derivatives not included in the current rule would allow FCUs to manage IRR without adding an incremental risk versus the current rule. For example, an FCU could decide to manage short-term IRR with Eurodollar futures. This transaction could be done in a safe and sound manner without adding incremental risk versus a Derivative that is currently permissible for FCUs.

In addition, the Board is proposing to remove the following requirements for the characteristics of Derivatives authorized for FCU use that appear in the current rule:

- Forward start date limitations;
- Fluctuating notional amount limitations;
- Restriction on leveraged Derivatives; and
- Meet the definition of Derivative under GAAP.

The Board is removing forward start date limitations in the proposal because it no longer believes a forward start date beyond 90 days poses an undue risk to an FCU. When making this determination, the Board considered two potential scenarios, one in which an FCU enters into a ten-year swap which settles in three days, and one in which an FCU enters into a ten-year swap which settles in one year. The FCU would record both swaps on the FCU's financial statements as of trade date and both will have a contract maturity of 10 years. The major difference between the two is that cash-flows (excluding margin requirements) will not be exchanged in the first year for the swap that has a longer settlement. The Board no longer believes this extended settlement would create an undue risk for an FCU, at least no more than the conventional

settlement of an interest rate swap since the price volatility and modeling for both swaps are similar.

The Board is also proposing to remove the fluctuating notional amounts limits in the current rule. The Board believes keeping this limitation would be inconsistent with the new principles-based approach and would not add any additional safety and soundness protections.

The Board is proposing to remove the restriction on leveraged Derivatives from the current rule. As discussed in the section below, the Board is proposing to remove limits on the amount of Derivatives an FCU can have exposure to. The current restriction on leveraged Derivatives was included due to the notional limits in the current rule. Therefore, there is no need for a leveraged Derivative prohibition if there are no notional limits on Derivatives in this proposal.

The Board is also proposing to remove the requirement that a Derivative “(m)et the definition of Derivative under GAAP.” The Board believes this requirement is moot, because all the Derivatives in the proposed rule would meet the definition of a Derivative under GAAP.

In the process of broadening the Derivative products and characteristics in this proposal versus the current rule, the Board did retain one prohibition. The Board is proposing to prohibit an FCU from engaging in Written Options. This activity is impermissible under the current Derivative rule. A Written Option would obligate a credit union to pay the purchaser if the option is in the money<sup>16</sup> at maturity. If an FCU were to engage in Written Options, it would receive a payment from the purchaser. The payment would be the maximum profit the FCU

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<sup>16</sup> Option expires with a positive value at maturity.

could realize if the option were to expire with no value. However, the Written Option could produce losses in excess of the maximum profit an FCU could realize. The gain/loss profile of an option limits the gain to the premium the option writer receives at inception of the option. The loss profile of the option, however, can be multiples of the premium received from the purchaser. The Board believes this asymmetric return profile could potentially cause a safety and soundness issue for an FCU engaging in Written Options.

The Board is specifically seeking comment on whether the NCUA should allow FCUs to engage in Written Options for managing IRR, and specific scenarios where a Written Option could be used to manage IRR.

The Board is proposing to retain and clarify the current prohibition on FCUs engaging in embedded options required under GAAP to be accounted for separately from the host contract. This prohibition is implicit in the current § 703.14(k)(2). The Board notes that currently § 703.14(k)(2) permits FCUs to enter into embedded options where the option is not, under GAAP, required to be accounted for separately from the host contract. While not explicit the Board has historically interpreted this provision as also prohibition FCUs from engaging in embedded options that *are required*, under GAAP, to be accounted for separately from the host contract. For clarity purposes the Board is making this prohibition explicit rather than implicit and moving it to this section of the proposed rule. The Board believes retaining this prohibition is necessary, as these types of derivatives are overly complex compared to the limited derivatives that are permissible under the current rule and this proposal.

Finally, the Board is proposing to remove all limitations that appear in § 703.103 in the current rule. The Board believes Derivative limits are inconsistent with a principles-based



approach, especially when the activity is to manage IRR. The current rule has limits on the weighted average remaining maturity notional and fair value loss limits, both of which would be removed by the current proposal.

In the current rule, FCUs are subject to two types of limits: a fair value loss limit and a weighted average remaining maturity notional (WARMN) limit. The *fair value loss limit* put a cap on the unrealized losses an FCU could have associated with its Derivative holdings. The *WARMN limit* is based on the notional amounts of Derivatives an FCU adjusted for the maturity of the transactions. Using notional with maturity captures price risk better compared to only using notional.

These limits were designed to limit an FCU's Derivative unrealized losses and the price risk of an FCU's Derivative positions. The limits were either entry limits or standard limits. The entry limit was the lower of the two limits and was for an FCU that had been engaging in Derivative transactions for less than a year. The entry limit in the current rule caps the fair value loss at 15 percent of Net Worth and caps the WARMN at 65 percent of Net Worth. The intent of this limit was to ensure an FCU did not take a large amount of Derivative exposure without offering the NCUA an opportunity to examine the activity.

The standard limit is higher than the entry limit, and allowed FCUs to take more Derivative exposure after a year's worth of Derivative activity. The standard limit in the current rule caps the fair value loss at 25 percent of Net Worth and caps the WARMN at 100 percent of Net Worth.

Based on the supervisory experience from the past six years, the Board has determined that the limits from the current Derivative rule do not offer the safety and soundness protections

they were intended to provide. First, the Board has found that FCUs do not generally approach the limits in the current Derivative rule. Moreover, in cases where an FCU did approach the limit, the Board found that additional Derivative exposure would not have created a safety and soundness concern for the NCUA. The Board also believes removing the burden of measuring and reporting the limits in the current rule outweighs the potential benefit of having limits. The Board would like to note that the NCUA will still review Derivative exposure when examining an FCU's Derivative program and may determine that excessive exposures may be a safety and soundness finding, subject to the various administrative remedies permissible under the Federal Credit Union Act.

***§ 703.104 Requirements for counterparty agreements, collateral and margining.***

The Board is proposing to revise the requirements for counterparty agreements, collateral and margining. The Board proposing to require FCUs to:

- Have an executed Master Services Agreement with a Domestic Counterparty that must be reviewed by counsel with expertise in similar types of transactions to ensure it reasonably protects the FCU's interests;
- Use contracted Margin requirements with a maximum margin threshold amount of \$250,000; and
- Accept as collateral, for Margin requirements, only the following:
  - Cash (U.S. dollars);
  - U.S. Treasuries
  - Government-sponsored enterprise debt

- U.S. government agency debt
- Government-sponsored enterprise residential mortgage-backed security pass-through securities; and
- U.S. government agency residential mortgage-backed security pass-through securities.

These requirements are generally consistent with the requirements in § 703.104(a) in the current rule,<sup>17</sup> with a few exceptions. The current rule breaks down permissible counterparties and requirements for exchange-traded and cleared Derivative transactions and for non-cleared Derivative transactions. In *exchange-traded and cleared Derivative transactions* there is a clearinghouse between the two counterparties. The Dodd-Frank Act requires a clearinghouse for these types of Derivative transactions.<sup>18</sup> *Non-cleared Derivative transactions* are those that take place between two parties without involving a clearinghouse. Federal credit unions are exempt from mandatory use of a clearinghouse due to the CFTC exemption for cooperatives.<sup>19</sup>

For simplification, the Board is proposing to create one standard for both exchange-traded and cleared Derivative transactions, and for non-cleared Derivative transactions. In the proposed standard, the Board requires an FCU to enter a Master Services Agreement with a Domestic Counterparty before engaging in Derivative transactions under this proposal. A Master Service Agreement is the contract that dictates the terms of the Derivative contract.

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<sup>17</sup> 12 CFR 703.104(a).

<sup>18</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 723, 124 Stat., July 21, 2010.

<sup>19</sup> 17 CFR § 50.51

The current rule does not dictate that exchange-traded and cleared Derivative transactions are required to have a Master Service Agreement, but the Board believes it is standard practice for exchange-traded and cleared Derivative transactions to document standard terms that apply to all transactions entered into between two parties. The Board believes the proposed Domestic Counterparty requirement is consistent with the current rule that requires Commodity Futures Trading Commission (CFTC) registrants for exchange-traded Derivatives and registered swap dealers for non-cleared Derivatives. The Board also believes the requirement of having a Master Services Agreement is consistent with the current rule and reflects standard industry practice.

The Board is also proposing to require that the Master Services Agreement be reviewed by counsel that has expertise with similar types of transactions to ensure the agreement reasonably protects an FCU's interests. This is a clarifying change compared to the current rule, but is not a new requirement. The current rule requires the legal review be performed by counsel that has legal expertise with Derivative contracts and related matters. The proposal will only require the Master Services Agreement be reviewed by counsel with similar types of transactions to ensure the agreement reasonably protects an FCU's interest. The Board believes that complex loan or securities documents meet the standard for similar types of transactions.

The Board is proposing a contracted Margin requirement with a maximum margin threshold amount of \$250,000 for both exchange-traded and cleared, and non-cleared Derivative transactions. Margin helps protect counterparties from the credit risk of a counterparty by requiring the counterparty to post collateral if they are in a net loss position. The permissible type of collateral for FCUs is discussed later in this document. The maximum margin threshold is the maximum amount a party in the Derivative transaction can be undercollateralized.

The Board did not specify a maximum margin threshold for exchange-traded and cleared Derivatives in the current rule, but did specify the same threshold for non-cleared Derivatives, which is the same as in this proposed rule. The Board believes the maximum margin threshold in the proposal for exchange-traded and cleared Derivatives is consistent with clearing houses for exchange-traded and cleared Derivatives.

The Board is proposing to revise the existing eligible collateral requirements in two ways.<sup>20</sup> First, the Board is proposing to add a requirement that exchange-traded and cleared Derivatives be subject to the collateral requirements. The current rule does not specify collateral types for exchange-traded and cleared Derivatives. The Board believes the eligible collateral requirements are generally consistent with the collateral requirement for the clearing houses for exchange-traded Derivatives. The Board is seeking specific comment on whether specifying acceptable collateral for exchange-traded and cleared Derivatives may create unintended consequences for FCUs. If so, the Board is seeking comment on what the unintended consequences may be, and how the NCUA should modify the proposal. For example, should the NCUA revert to not having collateral standards for exchange-traded and cleared Derivatives as in the current rule?

The second change from the current rule is that the Board is proposing to add U.S. government agency residential mortgage backed pass-through securities (for example, Government National Mortgage Association (GNMA) pass-through securities) as an acceptable collateral type. GNMA pass-through securities are guaranteed by the United States government and are highly liquid. Not including this collateral type was an oversight from the current rule,

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<sup>20</sup> Eligible collateral is used to satisfy the margin requirements for FCUs.

which the Board is proposing to remedy with this amendment. The proposal continues to restrict the forms of collateral to the most liquid and easily valued instruments so they can be easily negotiated even in times of market illiquidity.

**§ 703.105 *Reporting requirements.***

The Board is proposing to retain certain parts of the reporting requirements in the current Derivatives rule. The current rule requires that FCUs provide their board of directors, senior executive officers, and, if applicable, asset liability committee a comprehensive Derivatives report.

Specifically, the Board is retaining the required frequency of reporting (at least quarterly to the FCU's board of directors, and at least monthly to the FCU's senior executive officer and applicable asset liability committee). The Board is also retaining the requirements outlining what must be included in these reports. This includes identification of any areas of noncompliance with any provision of this rule or the FCU's policies; an itemization of the FCU's individual transactions subject to the rule; the current values of such transactions; each individual transaction's intended use for IRR mitigation; and a comprehensive view of the FCU's risk reports, including, but not limited to, IRR calculations with details of the transactions subject to the rule.

The Board has also consolidated and streamlined the current rule's reporting requirements in this proposal in § 703.105(c)(3) to include the relative risk reports and intended use of Derivatives for IRR management. The Board is also proposing to eliminate the reporting of compliance with regulatory limits, which aligns with this proposal's elimination of the regulatory limits

The Board believes that retaining these reporting requirements is essential to FCUs maintaining strong internal controls related to Derivative transactions, given the principles-based approach of this proposed rule. The Board also believes that the proposed reporting requirements are less burdensome to FCUs, while ensuring the proper credit union officials receive reports that are necessary to oversee a credit union's Derivatives program.

In conjunction with the regulatory violation requirements of proposed § 703.109, discussed later in this document, the Board is proposing to require that an FCU submit the Derivatives management report to the applicable Regional Director<sup>21</sup> when there has been a regulatory violation or violation of the FCU's policies. This is not a new reporting requirement; the current rule requires an FCU to submit a description of the violation and the corrective action within three business days of a violation.<sup>22</sup> The Board is proposing to allow an FCU to submit the Derivatives management report to its board of directors before submitting such report to the applicable Regional Director. The Board notes that an FCU is required to submit the Derivatives management report to the applicable Regional director when there has been a violation of the regulation or the FCU's policies. The Board has also added a requirement that the Derivatives report be made available to NCUA examiners upon request. The Board notes that this is not a new burden, but merely a transparent codification of existing authority, which will provide NCUA examiners the documents to support the compliance with the requirements of this subpart.

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<sup>21</sup> Regional Director is a defined term in the Derivatives rule, which means the applicable NCUA Regional Director or the Director of the Office of National Examinations and Supervision.

<sup>22</sup> 12 CFR § 703.114(a)(2).

The Board is proposing to add the requirement that FCUs retain reports to the Board and Senior Executive Officers in accordance with the Record Retention Guidelines set forth in Appendix A to part 749.<sup>23</sup>

**§ 703.106(a) *Operational support requirements; Required experience and competencies.***

The Board believes that a credit union's board of directors and senior executive officers need sufficient experience and knowledge to effectively oversee a Derivatives program. Therefore, the Board is proposing to retain many of the experience and competency requirements from the current rule<sup>24</sup> in this proposal. First, the Board is proposing to retain the requirement that an FCU's board of directors receive training before an FCU engages in its first Derivative transaction. Any new board of director subsequent to the initial training of the board of directors must receive Derivatives training. Such training must provide board members a general understanding of Derivative transactions and the knowledge required to provide strategic oversight of the FCU's Derivatives program. The Board, however, is proposing to remove the requirement, in the current Derivatives rule, that an FCU's board members receive annual Derivatives training. As discussed further in the next paragraph, the Board is substituting the required annual training with an annual briefing from the FCU's Senior Executive Officers.

The Board considers the transparency of the Derivatives program with the board of directors to be a critical part of the FCU's internal controls and communication. As such the Board is replacing the requirement in the current rule that requires annual training after the initial

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<sup>23</sup> *Id.* at Appendix A to part 749.

<sup>24</sup> *Id.* at § 703.106.



training with a requirement that the board be briefed, at least annually, on the Derivatives program using the required reporting to the board as prescribed in §703.105(a) of this subpart.

In addition to the annual training, the Board believes that the required reporting requirements to the board of directors (proposed § 703.105 of this subpart) will provide the necessary transparency and disclosure of such activities on an ongoing basis. .

The Board is proposing to retain the requirement that an FCU's senior executive officers must be able to understand, approve, and provide oversight for a Derivatives program. Senior executive officers must have a comprehensive understanding of how Derivatives fit into the credit union's risk management process.

The Board believes that an FCU must have qualified personnel to manage the asset/liability risk management functions when a Derivatives program is in place. Personnel must have enhanced capabilities to estimate the credit union's Earnings at Risk and Net Economic Value based on the market's expectation of future interest rates and any potential changes from those expectations. The Board is retaining the staff qualifications from the current rule to support the complexity of Derivatives for trade execution, financial reporting, accounting, and the operational processes related to margin requirements.

***§ 703.106(b) Operational support requirements; Required review and internal controls structure.***

The Board is proposing to retain the current requirements for Transaction Review and Internal controls.<sup>25</sup> For transaction reviews, the Board is retaining the requirement that an FCU

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<sup>25</sup> Id. at 703.106(b).

identify and document the circumstances that lead to the decision to execute a transaction, specify the strategy the credit union will employ, and demonstrate the economic effectiveness of the transaction. The Board is retaining the requirement for transaction reviews because such reviews are critical to an FCU and the NCUA understanding how Derivatives are being used to manage IRR.

For internal controls review, the Board is proposing to reduce the number of required internal controls reviews an FCU must conduct. The current rule requires internal controls reviews from the first two years an FCU commenced its Derivatives program.<sup>26</sup> The Board is proposing to reduce this to only the first year after an FCU engages in its first Derivative transaction. The Board believes that retaining at least one internal controls review, along with the required reporting and operational provisions in this proposal, is prudent in supporting a safe and sound Derivatives program. However, credit unions should continue to review and strengthen controls accordingly.

The Board believes the internal controls review should be a comprehensive review of all aspects of an FCU's Derivatives functions, with timely identification and resolution of all findings. The Board is retaining the other provisions of the current rule associated with internal controls reviews including that an internal controls reviews must be conducted by an independent external unit or, if applicable, the FCU's internal auditor. The Board believes that an independent unit would be objective to the business processes in supporting Derivatives.

The Board is retaining the current rule's requirement that any FCU engaging in Derivatives transactions pursuant to this subpart must obtain an annual financial statement audit,

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<sup>26</sup> Id.

as defined in § 715.2(d), in supporting that all transactions are accurately accounted for in accordance with GAAP.

The Board is also proposing to remove the specific provision from the current rule (§ 703.106(b)(4)) for the Process and responsibility framework as credit unions have generally included these items as part of their policies and procedures. The Board believes that, irrespective of a specific requirement, FCUs entering into Derivatives would continue to include the necessary information in their policies and procedures.

The Board is proposing to retain the requirement for Separation of duties in the current to further support the prudent risk management and internal controls in supporting a Derivatives program. The Board believes adequate separation of duties is necessary to effectuate a Derivatives program in a safe and sound manner by eliminating the propensity for insider fraud and abuse.

The Board is proposing to add a requirement for a Liquidity review as part of the Operational support requirements, given the importance of asset/liability management and the potential liquidity pressures associated with margin requirements with a Derivative counterparty and having the eligible collateral as a potential use for margin requirements. In addition, the Liquidity review must also address how an FCU is planning on responding to potential changes in interest rates, which may require significant and unpredictable margin requirements from the Derivative counterparty that must be settled on a daily basis over and above the margin threshold.

The Board is retaining the requirements of policies and procedures in that the policies must address the requirements of this subpart and any additional limitations imposed by the Federal credit union's board of directors. The Board is retaining the requirement that a review of

the policies and procedures must be completed annually by the board of directors. The Board believes that effective policies and procedures which are reviewed annually are critical to maintaining and supporting a Derivatives program.

**§ 703.107 *External service providers.***

The Board is proposing some changes to FCU's use of External Service Providers (ESPs) from the current rule. The general requirements in this proposal address restrictions on ESPs, an FCU's ability to oversee and manage ESPs, and an FCU's documentation of the specific uses of ESPs.

As with the current Derivative rule, the Board is proposing to allow ESPs, provided the ESP (including its affiliates), does not:

- Act as a counterparty to any Derivatives transactions that involve the FCU;
- Act as a principal or agent in any Derivatives transactions that involve the FCU; or
- Have discretionary authority to execute any of the FCU's Derivatives transactions.

The above prohibitions on ESPs are identical to the prohibitions in the current rule. The Board continues to believe there would be an inherent conflict of interest if an ESP (including its affiliates) acted as a counterparty or principle/agent for a Derivative transaction. Therefore, the Board is proposing to retain this prohibition.

The Board is also proposing to retain the prohibition of an ESP having discretionary authority to execute any of an FCU's Derivative transactions. Allowing discretionary authority for an ESP would remove a level of control from an FCU, which is inconsistent with an FCU's operational support requirements.

The Board also is proposing to retain the current requirements in the Derivatives rule that an FCU must have the internal capacity, experience, and skills to oversee and manage any ESP it uses. This requirement is consistent with an FCU's duties required in the operational support requirements and safety and soundness.

The Board is proposing a slight modification in how FCUs will be required to document specific uses of ESPs. The Board is proposing to remove the reference to its "process and responsibilities framework" from the current rule, because the Board is proposing to no longer require the framework in this proposal.

The Board is proposing to replace the process and responsibilities framework requirement with the documentation being required in its policies and procedures. The Board believes this proposed change offers FCUs a clearer understanding of the NCUA's requirements, because FCUs are more familiar with policies and procedures than process and responsibilities frameworks, which may be considered nebulous. The process and responsibilities framework is unique to the current Derivative rule; policies and procedures are either required or expected for many FCU activities outside of Derivatives.

The Board is also proposing to clarify that an FCU's use of ESPs does not alleviate the credit union of its responsibility to employ qualified personnel in accordance with the operational support requirements of the proposed rule. The Board believes this requirement is consistent with the current rule and the proposed operation support requirements in § 703.106, and also believes such clarification is necessary due to the proposed removal of an application process in the proposed § 703.108 for some FCUs.

Lastly, the Board is proposing to remove the support functions paragraph in the current rule. The support functions paragraph in the current rule requires an FCU to perform asset/liability management and liquidity risk management internally and independently. The Board believes this paragraph is not necessary for two reasons. First, the proposed operational support requirements section in the proposed § 703.106 already contains an FCU's requirements for asset/liability management and liquidity risk management. Second, the Board believes the current requirement created confusion in cases where an FCU had oversight and control of both functions and was using models housed at the ESP to perform these functions.

The Board believes removing this requirement will make it clear that an FCU may house asset/liability management and liquidity risk management at an ESP if the credit union has oversight and control of both functions. The Board believes the proposed changes remain consistent with the intent of the current rule, albeit less prescriptive.

***§ 703.108 Notification and application requirements.***

The Board is proposing to eliminate the application process for FCUs with at least \$500 million in assets and that have a CAMEL Management component rating of 1 or 2. However, the Board is proposing that an FCU provide the applicable Regional Director a written notification within five business days after entering into its first Derivative transaction.

In determining the proposed dollar threshold of \$500 million, the Board takes the position that FCUs that will be subject to the NCUA's risk-based capital (RBC) requirements and will be deemed "complex" and generally have the required infrastructure to enter into Derivative transactions without preapproval. The Board also contemplated thresholds higher and lower than

\$500 million, but believes the threshold of \$500 million is appropriate due to FCU's this size generally having the required infrastructure to enter into Derivative transactions. The Board is specifically requesting comment on whether the dollar threshold for the new notification provision in the proposal should be increased or decreased, and why such increase or decrease is warranted. For example, should the Board change the dollar threshold to \$250 million or \$1 billion? Furthermore, as an added safeguard beyond the "over \$500 million in assets" criteria, the Board is proposing to only allow FCUs that have a CAMEL Management component rating of 1 or 2 to be exempt from the application process.

The Board believes a CAMEL Management component rating of 1 or 2 demonstrates FCUs with over \$500 million in assets have at least satisfactory management and board practices relative to the FCU's size and, in general, have effectively identified, measured, monitored, and controlled risks at the FCU. However, the Board is proposing to require FCUs with more than \$500 million in assets and a CAMEL Management component rating of 1 or 2 to provide written notification to the appropriate NCUA Regional Director within five business days after entering into their first Derivative transaction to ensure the NCUA is aware of their activity. This will provide the NCUA the opportunity to schedule a supervision contact or an examination if it is deemed necessary.

The Board is proposing that an FCU that does not meet the notification criteria (those with less than \$500 million in assets and/or a CAMEL Management component rating of 3, 4, or 5) submit an application to the NCUA for Derivatives authority that contains content generally

consistent with the current rule.<sup>27</sup> Requiring such content will ensure that such an FCU can demonstrate the requisite systems and expertise to support Derivatives.

The Board is proposing three non-technical changes to the application content in the current rule. First, instead of requiring an FCU to provide a list of Derivatives products and product characteristics it is applying for authority to use, the Board is proposing requiring the FCU to provide a list of products and characteristics it intends to use. This change is necessitated by the Board moving towards a principles-based approach on products and characteristics.

Second, the Board is proposing to remove the requirement for an FCU to provide “a description of how it intends to use the products and characteristics listed, an analysis of how the products and characteristics fit within its interest rate risk mitigation plan, and a justification for each product and characteristic listed.”<sup>28</sup> The Board believes this requirement is too prescriptive and creates an unnecessary burden on FCUs.

Finally, the Board is proposing the addition of a provision that the Regional Director may request additional information as part of an FCU’s application for Derivatives authority. The Board believes the Regional Director has always had this authority, but believes adding it to the rule provides clarity.

The NCUA plans to modify its current application guidance to be consistent with any new final Derivative rule. The Board would like to note that the proposed rule no longer has a provision to apply for interim approval. The Board believes the interim approval provision in the

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<sup>27</sup> 12 CFR § 703.110.

<sup>28</sup> Id. at § 703.110(b).



current rule provided no benefits for FCUs and, conversely, increased burden on both FCUs and the NCUA.

In this proposal, the Board included an application review paragraph for FCUs subject to application requirements. The application review paragraph is consistent with the current rule's approval section, but does not address interim approval. The Board is proposing to only allow final approvals for Derivative applications. The Board has retained the right for an FCU to appeal the denial of a Derivative application, consistent with the current rule.

The Board also is proposing a change in condition paragraph that requires FCUs to immediately cease entering into any new Derivatives and contact the applicable Regional Director if the FCU experiences a change in condition such that it no longer meets the requirements for a notification FCU or if an FCU's application becomes materially inaccurate.

For example, an FCU that engaged in Derivatives after notifying its applicable Regional Director (required after entering into the first Derivative transaction) and is subsequently downgraded to a CAMEL Management component rating of 3 must immediately stop entering into new Derivatives and contact the applicable Regional Director of the change of condition. In this example, an FCU could subsequently apply for Derivative authority under the application process.

Another example would be if an FCU's asset size drops below \$500 million. As with the previous example, the FCU must immediately stop entering into new Derivatives and contact the applicable Regional Director of the change of condition. The FCU can subsequently apply for Derivative authority under the application process.

An FCU must also notify the applicable Regional Director if it determines its approved application inaccurate. An application would be rendered inaccurate if an FCU no longer meets the operational support requirements in the proposed § 703.106. These requirements are focused on an FCU's management capabilities and the FCU's required reviews. For example, if an FCU no longer has qualified Derivative personnel required by the proposed rule, it would be required to immediately stop entering into new Derivatives and contact the applicable Regional Director of the change of condition. The proposed rule would not require an FCU to notify the applicable Regional Director on the basis of staff turnover if the FCU still meets the qualified personnel in the operational support requirements section.

**§ 703.109 *Regulatory violation or unsafe and unsound condition.***

The Board is retaining the provisions of the current rule for Regulatory violations when an FCU no longer meets the requirements of this subpart or its internal policies, in that such an FCU must immediately stop entering into any new Derivative transactions. However, the determination of the regulatory violation will be made by the applicable NCUA Regional Director, who will provide written notice to the credit union.

The Board is proposing changes for Regulatory violations to include when an FCU is operating in an unsafe or unsound condition and establish that the applicable NCUA Regional Director will determine whether a Regulatory violation has occurred. If the applicable Regional Director determines that the credit union is operating in an unsafe or unsound condition the applicable Regional Director may prohibit an FCU from engaging in Derivatives transactions. If the applicable Regional Director renders such a determination, he or she will provide the FCU written notice that includes the reason for such determination.

The Board believes the principles-based approach of the proposed rule creates greater responsibility on an FCU's senior executive officers, who are responsible for ensuring that the Derivative program is properly and safely integrated into the credit union's internal controls, policies, and procedures.

#### **D. Other affected parts**

In addition to the changes aforementioned changes, the Board is also proposing to amend parts 741 and 746.

#### ***§ 741.219 Investment requirements. [Amended]***

The Board is proposing to maintain the notification requirement for FISCUs. However, the proposal adjusts the timeframe for a FISCU to notify the NCUA of its Derivatives activity. The 2014 final rule required a FISCU to notify the NCUA at least 30 days before it begins engaging in Derivatives. The Board is proposing to amend this to require a FISCU to notify the NCUA within five business days after entering into its first Derivatives transaction.

The Board believes that adjusting the notification to occur after a FISCU enters into its first Derivatives transaction will provide the applicable Regional Director more certainty for planning examiner time and specialists resources. The Board is proposing that this notification will not be required for transactions covered under § 703.14 for loan pipeline management. This amendment would align this section with the notice provisions discussed elsewhere in this document (§ 703.108 - Notification and application requirements) by removing the 30-day time requirement. The Board is proposing this change to ensure consistency between FCUs and FISCUs that engage in Derivatives and notifications to NCUA related thereto.

The Board is also proposing to amend § 746. 201 to correct a citation that would change based on the proposed change to Subpart B to part 703. The Board notes that this change is strictly technical, and will not affect the substance of this section of part 746.

#### **IV. Regulatory Procedures**

##### ***Regulatory Flexibility Act***

The Regulatory Flexibility Act (RFA) generally requires that, in connection with a notice of proposed rulemaking, an agency prepare and make available for public comment an initial regulatory flexibility analysis that describes the impact of a proposed rule on small entities (defined for purposes of the RFA to include credit unions with assets less than \$100 million).<sup>29</sup> A regulatory flexibility analysis is not required, however, if the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities and publishes its certification and a short, explanatory statement in the *Federal Register* together with the rule.

The proposed rule would amend the NCUA's Derivatives rule to shift from a prescriptive construct to a principles-based approach. As a result, it would not cause any increased burden or impose any new requirements on FICUs. Accordingly, the NCUA certifies that the proposed rule would not have a significant economic impact on a substantial number of small credit unions.

##### ***Paperwork Reduction Act***

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<sup>29</sup> See NCUA Interpretive Ruling and Policy Statement 87-2, as amended by IRPS 03-2 and IRPS 15-1, 80 FR 57512 (Sept. 24, 2015).

The Paperwork Reduction Act of 1995 (PRA) applies to information collection requirements in which an agency creates a new paperwork burden on regulated entities or modifies an existing burden. For purposes of the PRA, a paperwork burden may take the form of a reporting, recordkeeping, or third-party disclosure requirement, each referred to as an information collection. The NCUA may not conduct or sponsor, and the respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number.

The NCUA anticipates more FCUs to engage in derivatives, which would increase the recordkeeping requirement associated with reports made to the FCU board and senior executive officers under §703.105. This would increase the number of respondents from 20 to 50. The proposed rule would also increase the number of FCUs that would be required to maintain the policies and procedures annually under §703.106(c) from 43 to 50 respondents. These policies and procedures would also include the process and responsibility framework requirements of external service providers, eliminating separate recordkeeping requirement of §703.107(a)(3). Section 703.108(a) provides for FCUs that meet certain requirements to provide notification of its readiness to engage in derivatives in lieu of an application. An increase is estimated in the number of FCUs that would engage in derivatives from 4 to 15. The NCUA does not anticipate any increase in the number of FCUs currently providing applications under proposed §703.108(b) annually. Information collection requirements previously identified under §§703.112 through 703.114 are being removed due to obsolete reporting. Burden under these sections had previously been reported as zero hours. It is estimated that program changes to the information collection requirements associated with this proposed rule increase the burden by 254 hours.

Adjustments to the information collection burden is also being made at to include information collection requirements not previously captured and to update respondents and response times to reflect a more accurate and up-to-date accounting of the burden. Adjustments to the information collection requirements will increase the burden by 290 hours.

The proposed rule would revise the information collection requirements currently approved under OMB number 3133-0133, as follows:

*Title of Information Collection:* Investment and Deposit Activities, 12 CFR Part 703.

*Estimated Number of Respondents:* 50.

*Estimated Annual Responses per Respondent:* 23.86.

*Estimated Total Annual Responses:* 1,193.

*Estimated Hours per Response:* 0.70.

*Estimated Total Annual Burden Hours:* 839.

*Affected Public:* Private Section: Not-for-profit institutions.

The NCUA invites comments on: (a) whether the collection of information are necessary for the proper performance of the agencies' functions, including whether the information has practical utility; (b) the accuracy of the estimates of the burden of information, including the validity of the methodology and assumptions used; (c) ways to enhance the quality, utility, and clarity of the information to be collected; (d) ways to minimize the burden of the information collection on respondents, including through the use of automated collection techniques or other forms of information technology; and (e) estimates of capital or start-up costs and cost of operations, maintenance, and purchase of services to provide information.

All comments are a matter of public record. Due to the limited in-house staff, email comments are preferred. Comments regarding the information collection requirements of this

rule should be (1) mailed to: [PRAComments@ncua.gov](mailto:PRAComments@ncua.gov) with “OMB No. 3133-0133” in the subject line; faxed to (703) 837-2406, or mailed to Dawn Wolfgang, NCUA PRA Clearance Officer, National Credit Union Administration, 1775 Duke Street, Suite 6032, Alexandria, VA 22314, and to the (2) Office of Information and Regulatory Affairs, Office of Management and Budget, at [www.reginfo.gov/public/do/PRAMain](http://www.reginfo.gov/public/do/PRAMain). Select “Currently under 30-day Review – Open for Public Comments” or by using the search function.

### ***Executive Order 13132***

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. In adherence to fundamental federalism principles, the NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the principles of the executive order. This rulemaking will not have a substantial direct effect on the states, on the connection between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. The NCUA has determined that this proposal does not constitute a policy that has federalism implications for purposes of the executive order.

### ***Assessment of Federal Regulations and Policies on Families***

The NCUA has determined that this proposed rule will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999, Pub. L. 105-277, 112 Stat. 2681 (1998).

## **LIST OF SUBJECTS IN 12 CFR**

### **12 CFR Part 701**

Advertising, Aged, Civil rights, Credit, Credit unions, Fair housing, Individuals with disabilities, Insurance, Marital status discrimination, Mortgages, Religious discrimination, Reporting and recordkeeping requirements, Sex discrimination, Signs and symbols, Surety bonds.

### **12 CFR Part 703**

Credit unions, Investments, Reporting and recordkeeping requirements.

### **12 CFR Part 741**

Bank deposit insurance, Credit unions, Reporting and recordkeeping requirements.

### **12 CFR Part 746**

Administrative practice and procedure, Claims, Credit unions, Investigations

By the National Credit Union Administration Board on October 15, 2020.

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Melane Ausbrooks,

Acting Secretary of the Board.

For the reasons discussed above, the Board is proposing to amend 12 CFR parts 701, 703, 741, and 746 as follows:

## **PART 701 – ORGANIZATION AND OPERATION OF FEDERAL CREDIT UNIONS**

1. The authority citation for part 701 continues to read as follows:



**Authority:** 12 U.S.C. 1752(5), 1755, 1756, 1757, 1758, 1759, 1761a, 1761b, 1766, 1767, 1782, 1784, 1786, 1787, 1789. Section 701.6 is also authorized by 15 U.S.C. 3717. Section 701.31 is also authorized by 15 U.S.C. 1601 et seq.; 42 U.S.C. 1981 and 3601-3610. Section 701.35 is also authorized by 42 U.S.C. 4311-4312.

2. Amend § 701.21 by removing paragraph (i).

## **PART 703—INVESTMENT AND DEPOSIT ACTIVITIES**

3. The authority citation for part 703 continues to read as follows:

**Authority:** 12 U.S.C. 1757(7), 1757(8), 1757(15).

4. Amend § 703.2 by deleting the definition of “Derivative.”

5. Amend § 703.14 by revising paragraph (k) and adding new paragraph (l) to read as follows:

### **§ 703.14 Permissible investments. [Amended]**

\* \* \* \* \*

(k) *Loan pipeline management.* A Federal credit union may enter into the following transactions related to the management of its loan pipeline:

- (1) Interest rate lock commitments and forward sales commitments; and
- (2) Transactions to manage interest rate exposure.

(l) *Embedded options.* A Federal credit union may enter into embedded options not required under generally accepted accounting principles (GAAP) adopted in the United States to be accounted for separately from the host contract. Embedded options that *are* required, under GAAP, to be accounted for separately from the host contract are addressed in § 703.103(c) of this part.

6. Revise Subpart B to Part 703 to read as follows:

## **Subpart B—Derivatives. [Amended]**

### **§ 703.101 Purpose and scope.**

(a) *Purpose.* This subpart grants Federal credit unions limited authority to enter into Derivatives only for the purpose of managing Interest Rate Risk.

(b) *Scope.* This subpart applies to all Federal credit unions. Except as provided in § 741.219, this rule does not apply to federally insured, state-chartered credit unions.

(c) *Prior Approvals.* Any Federal credit union with an active approval, under the prior version of this Subpart, on [FEDERAL REGISTER TO INSERT EFFECTIVE DATE OF FINAL RULE] is subject to the provisions of this subpart and is no longer subject to the restrictions, limits, or terms contained in the Federal credit union's approved application.

(d) *Pending Approvals.* Any application for Derivatives authority pending on [FEDERAL REGISTER TO INSERT EFFECTIVE DATE OF FINAL RULE], except for such applications submitted by a Federal credit union that would be subject to the requirements of § 703.108(b) of this subpart, is deemed to be withdrawn and such applicant is subject to the provisions of this subpart.

### **§ 703.102 Definitions.**

For purposes of this subpart:

*Counterparty* means a swap dealer (as defined by the Commodity Futures Trading Commission in 17 CFR 1.3(ggg)), Derivatives clearing organization (as defined by the Commodity Futures Trading Commission in 17 CFR 1.3(d)), or central financial clearing market (exchange) that participates as the other party in a Derivatives transaction with a Federal credit union;

*Domestic Counterparty* means a counterparty domiciled in the United States;

*Domestic Interest Rates* means interest rates derived in the United States and are U.S. dollar denominated;

*Derivative* means a financial contract that derives its value from the value and performance of some other underlying financial instrument or variable, such as an index or interest rate;

*Earnings at Risk* means the changes to earnings, typically in the short term (for example, 12 to 36 months), caused by changes in interest rates;

*Economic Effectiveness* means the extent to which a Derivatives transaction results in offsetting changes in the Interest Rate Risk that the transaction was, and is, intended to provide;

*External Service Provider* means any entity that provides services to assist a Federal credit union in carrying out its Derivatives program and the requirements of this subpart;

*Regional Director* means an NCUA Regional Director or the Director of the Office of National Examinations and Supervision;

*Interest Rate Cap* means a contract, based on a reference interest rate, for payment to the purchaser when the reference interest rate rises above the level specified in the contract;

*Interest Rate Floor* means a contract, based on a reference interest rate, for payment to the purchaser when the reference interest rate falls below the level specified in the contract;

*Interest Rate Risk* means the current and prospective risk to a credit union's capital and earnings arising from movements in interest rates.

*Margin* means the minimum amount of eligible collateral, as defined in § 703.104(c), that must be deposited between parties to a Derivatives transaction, as detailed in a Master Services Agreement;

*Master Service Agreement* means a document agreed upon between two parties that sets out standard terms that apply to all transactions entered into between those parties. The most common form of a master service agreement for Derivatives is an International Swap Dealer Association (ISDA) Master Agreement

*Net Economic Value* means the measurement of changes in the economic value of Net Worth caused by changes in interest rates;

*Net Worth* has the meaning specified in part 702 of this chapter;

*Novation* means the substitution of an old obligation with a new one that either replaces an existing obligation with a new obligation or replaces an original party with a new party;

*Reference Interest Rate* means the index or rate to be used as the variable rate for resetting Derivatives transactions;

*Senior Executive Officer* has the meaning specified in § 701.14 of this chapter and any other similar employee that is directly within the chain of command for the oversight of a Federal credit union's Derivatives program;

*Structured Liability Offering* means a share product created by a Federal credit union with contractual option features, such as periodic caps and calls, similar to those found in structured securities or structured notes;

*Threshold Amount* means an unsecured credit exposure that a party to a Derivatives transaction is prepared to accept before requesting additional eligible collateral, as defined in § 703.104(c), from the other party;

*Trade Date* means the date that a Derivatives order (new transactions, terminations, or assignments) is executed with a counterparty; and

*Written Options* means an option where compensation has been received and the Domestic Counterparty has the right, not obligation, to exercise the option on a future date(s).

**§ 703.103 Requirements related to the characteristics of permissible interest rate risk Derivatives.**

(a) A Federal credit union may only enter into Derivatives, under this subpart that have the following characteristics:

(1) Denominated in U.S. dollars;

(2) Based on Domestic Interest Rates or the U.S. dollar-denominated London Interbank Offered Rate (LIBOR);

(3) A contract maturity equal to or less than 15 years, as of the Trade Date; and

(4) Not used to create Structured Liability Offerings for members or nonmembers.

(b) A Federal credit union may not engage in Written Options. Examples of Written Options include swaptions, interest rate caps and interest rate floors.

(c) A Federal credit union may not engage in embedded options required under U.S. Generally Accepted Accounting Principles (GAAP) to be accounted for separately from the host contract.

**§ 703.104 Requirements for counterparty agreements, collateral and margining.**

To enter into Derivatives transactions under this subpart, a Federal credit union must:

(a) Have an executed Master Services Agreement with a Domestic Counterparty. Such agreement must be reviewed by counsel with expertise in similar types of transactions to ensure the agreement reasonably protects the interests of the Federal credit union;

(b) Utilize contracted Margin requirements with a maximum Margin threshold amount of \$250,000; and

(c) Accept as eligible collateral, for Margin requirements, only the following: cash (U.S. dollars), U.S. Treasuries, government-sponsored enterprise debt, U.S. government agency debt, government-sponsored enterprise residential mortgage-backed security pass-through securities, and U.S. government agency residential mortgage-backed security pass-through securities.

### **§ 703.105 Reporting requirements.**

(a) *Board reporting.* At least quarterly, a Federal credit union's Senior Executive Officers must deliver a comprehensive Derivatives report, as described in paragraph (c) of this section to the Federal credit union's board of directors.

(b) *Senior Executive Officer and asset liability or similarly functioning committee.* At least monthly, Federal credit union staff must deliver a comprehensive Derivatives report, as described in paragraph (c) of this section to the Federal credit union's Senior Executive Officers and, if applicable, the Federal credit union's asset liability or similarly functioning committee.

(c) *Comprehensive Derivatives management report.* At a minimum, the reports required in paragraphs (a) and (b) of this section must include:

(1) Identification of any areas of noncompliance with any provision of this subpart or the Federal credit union's policies, and the planned remediation of such noncompliance;

(2) An itemization of the Federal credit union's individual transactions subject to this subpart, the current values of such transactions, and each individual transaction's intended use for Interest Rate Risk mitigation;

(3) A comprehensive view of the Federal credit union's risk reports, including, but not limited to, Interest Rate Risk calculations with details of the transactions subject to this subpart.

(d) Reports required by this section must, at a minimum, be retained in accordance with the requirements in Appendix A to part 749.

(e) Notification of any noncompliance as part of the Derivatives management report required in paragraph (c)(1) of this section must be submitted to the applicable Regional Director immediately after it has been submitted to the Federal credit union's board of directors.

(f) The NCUA may, at any time, request the Derivatives management report required by paragraph (c) of this section.

#### **§ 703.106 Operational support requirements.**

(a) *Required experience and competencies.* A Federal credit union using Derivative transactions subject to this subpart must internally possess the following experience and competencies:

(1) *Board.*

(i) Before entering into the initial Derivatives transaction, a Federal credit union's board members must receive training that provides a general understanding of the Derivative transactions, and the knowledge required to provide strategic oversight of the Federal credit union's program.

(ii) Any person that becomes a board member after the initial Derivatives transaction must receive the same as required by paragraph (a)(1)(i) of this section.

(iii) At least annually after the initial Derivatives transaction, as part of the Derivatives reporting requirement in §703.105(a), the Federal credit union's Senior Executive Officers must brief the board on the Federal credit union's use of Derivatives to manage Interest Rate Risk.

(2) *Senior executive officers.* A Federal credit union's Senior Executive Officers must be able to understand, approve, and provide oversight for the Derivatives program. These individuals must have a comprehensive understanding of how the Derivative transactions fit into the Federal credit union's Interest Rate Risk management process.

(3) *Qualified Derivatives personnel.* To engage in the Derivative transactions, a Federal credit union must employ staff with experience in the following areas:

(i) *Asset/liability risk management.* Staff must be qualified to understand and oversee asset/liability risk management, including the appropriate role of the transactions subject to this subpart. Staff must also be qualified to understand and undertake or oversee the appropriate modeling and analytics related to Net Economic Value and Earnings at Risk;

(ii) *Accounting and financial reporting.* Staff must be qualified to understand and oversee appropriate accounting and financial reporting for Derivatives in accordance GAAP;

(iii) *Derivatives execution and oversight.* Staff must be qualified to undertake or oversee Derivative trade executions; and

(iv) *Counterparty, collateral, and Margin management.* Staff must be qualified to evaluate counterparty, collateral, and Margin risk as described in § 703.104 of this subpart.

(b) *Required review and internal controls structure.* To effectively manage the transactions subject to this subpart, a Federal credit union must assess the effectiveness of its management and internal controls structure. At a minimum, the internal controls structure must include:



(1) *Transaction review.* Before executing any transaction, a Federal credit union must identify and document the circumstances that lead to the decision to execute a transaction, specify the strategy the Federal credit union will employ, and demonstrate the economic effectiveness of the transaction;

(2) *Internal controls review.* Within the first year after commencing its first Derivatives transaction, a Federal credit union must have an internal controls review that is focused on the integration and introduction of the program, and ensure the timely identification of weaknesses in internal controls, accounting, and all operational and oversight processes. This review must be performed by an independent external unit or, if applicable, the Federal credit union's internal auditor;

(3) *Financial statement audit.* Any Federal credit union engaging in Derivatives transactions pursuant to this subpart must obtain an annual financial statement audit, as defined in § 715.2(d) of this chapter, and be compliant with GAAP for all Derivatives-related accounting and reporting;

(4) *Collateral management review.* Before executing its first Derivative transaction, the Federal credit union must establish a collateral management process that monitors the Federal credit union's collateral and margining requirements and ensures that its transactions are collateralized in accordance with the collateral requirements of this subpart and the Federal credit union's Master Services Agreement with its counterparty; and

(5) *Liquidity review.* Before executing its first Derivative transaction, the Federal credit union must establish a liquidity review process to analyze and measure potential liquidity needs related to its Derivatives program and the additional collateral requirements due to changes in interest rates. The Federal credit union must, as part of its liquidity risk management, calculate

and track contingent liquidity needs in the event a transaction needs to be novated or terminated, and must establish effective controls for liquidity exposures arising from both market or product liquidity and instrument cash flows.

(6) Separation of duties. An FCUs process, whether conducted internally or by an external service provider, must have appropriate separation of duties for the following functions defined in subsection (a)(3) of this section:

- (i) Asset/liability risk management;
- (ii) Accounting and financial reporting;
- (iii) Derivatives execution and oversight; and
- (iv) Collateral, counterparty, and margining management

(c) *Policies and procedures.* A Federal credit union using Derivatives, permitted under this subpart, must operate according to comprehensive written policies and procedures for control, measurement, and management of Derivative transactions. At a minimum, the policies and procedures must address the requirements of this subpart and any additional limitations imposed by the Federal credit union's board of directors. A Federal credit union's board of directors must review the policies and procedures described in this section at least annually and update them when necessary.

#### **§ 703.107 External service providers.**

(a) *General.* A Federal credit union using Derivatives may use external service providers to support or conduct aspects of its Derivative management program, provided:

- (1) The external service provider, including affiliates, does not:

(i) Act as a counterparty to any Derivative transactions that involve the Federal credit union;

(ii) Act as a principal or agent in any Derivative transactions that involve the Federal credit union; or

(iii) Have discretionary authority to execute any of the Federal credit union's Derivative transactions.

(2) The Federal credit union has the internal capacity, experience, and skills to oversee and manage any external service providers it uses; and

(3) The Federal credit union documents the specific uses of external service providers in its policies and procedures, as described in § 703.106(c) of this subpart.

(b) This section does not alleviate the responsibility of the Federal credit union to employ qualified staff in accordance with § 703.106 of this subpart.

### **§ 703.108 Notification and application requirements.**

(a) *Notification* - A Federal credit union that meets the following requirements must notify the applicable Regional Director in writing within five business days after entering into its first Derivatives transaction:

(1) The Federal credit union's most recent NCUA Management component is a rating of 1 or 2; and

(2) The Federal credit union has assets of at least \$500 million as of its most recent call report.

(b) *Application* – A Federal credit union that does not meet the requirements of paragraphs (a)(1) and/or (2) of this section must obtain approval before engaging in Derivatives

under this Subpart from its applicable Regional Director, by submitting an application, that, at a minimum, includes the following:

(1) An interest rate risk mitigation plan that shows how Derivatives are one aspect of the Federal credit union's overall interest rate risk mitigation strategy, and an analysis showing how the federal credit union will use Derivatives in conjunction with other on-balance sheet instruments and strategies to effectively manage its Interest Rate Risk;

(2) A list of the Derivatives products and characteristics of such products the Federal credit union is planning to use;

(3) Draft policies and procedures that the Federal credit union has prepared in accordance with § 703.106 of this subpart;

(4) How the Federal credit union plans to acquire, employ, and/or create the resources, policies, processes, systems, internal controls, modeling, experience, and competencies to meet the requirements of this subpart. This includes a description of how the Federal credit union will ensure that Senior Executive Officers, the board of directors, and personnel have the knowledge and experience in accordance with the requirements of this subpart;

(5) A description of how the Federal credit union intends to use external service providers as part of its Derivatives program, and a list of the name(s) of and service(s) provided by the External Service Providers, as described in § 703.107 of this subpart, it intends to use;

(6) A description of how the Federal credit union will support the operations of Margining and collateral, as described in § 703.104 of this subpart;

(7) A description of how the Federal credit union will comply with the accounting and financial reporting in GAAP; and

(8) Any additional information requested by the Regional Director.

(c) *Application review.*

(1) After the applicable Regional Director has completed his or her review, including any requests for additional information, the Regional Director will notify the Federal credit union in writing of his or her decision. Any denials will include the reason(s) for such denial. A Federal credit union subject to paragraph (b) of this section may not enter into any Derivative transactions under this subpart until it receives approval from the applicable Regional Director. At a Field Director's discretion, a federal credit union may reapply if its initial application is denied.

(2) A Federal credit union that receives a denial of its application may appeal such decision in accordance with Part 746 of the NCUA's regulations.

(d) *Change in condition.* A Federal credit union must immediately cease entering into any new Derivatives and contact the applicable Regional Director, if the Federal credit union experiences a change in condition such that it no longer meets the requirements of paragraph (a) of this section or renders its approved application inaccurate. The applicable Regional Director may take all necessary actions, including, but not limited to, revoking a Federal credit union's authority to engage in Derivatives and/or requiring divestiture of current Derivatives.

**§ 703.109 Regulatory violation or unsafe and unsound condition.**

(a) Upon determination by the applicable Regional Director, and written notice by the same, a Federal credit union that: no longer meets the requirements of this subpart; if applicable, fails to comply with its approved application; or is operating in an unsafe or unsound condition must immediately stop entering into any new Derivative transactions until the Federal credit

union is notified by the applicable Regional Director that it is permitted to resume engaging in transactions under this subpart.

(b) If the applicable Regional Director renders an unsafe or unsound condition in their determination, he or she will provide the Federal credit union as part of the written notice the reason(s) for such determination.

(c) During this period, however, the Federal credit union may terminate existing Derivative transactions. A Regional Director may permit a Federal credit union to enter into offsetting transactions if he or she determines such transactions are part of a corrective action strategy; and

(d) A Federal credit union that receives written notice under this section may appeal such determination in accordance with Part 746 of the NCUA's regulations.

## **PART 741 – REQUIREMENTS FOR INSURANCE**

7. The authority citation for part 741 continues to read as follows:

**Authority:** 12 U.S.C. 1757, 1766(a), 1781-1790, and 1790d; 31 U.S.C. 3717.

8. Amend § 741.219 by revising paragraph (b) to read as follows:

### **§ 741.219 Investment requirements. [Amended]**

\* \* \* \* \*

(b) Any credit union which is insured pursuant to title II of the Act must notify the applicable NCUA Regional Director in writing within five business days after entering into its first Derivatives transaction. Such transactions do not include those included in § 703.14 of this chapter.

**PART 746—APPEALS PROCEDURES**

9. The authority citation for part 746 continues to read as follows:

**Authority:** 12 U.S.C. 1766, 1787, and 1789.

10. Amend § 746.201 by revising paragraph (c) to read as follows:

**§ 746.201 Authority, purpose, and scope. [Amended]**

\* \* \* \* \*

(c) *Scope.* This subpart covers the appeal of initial agency determinations by a program office which the petitioner has a right to appeal to the NCUA Board under the following regulations: §§ 701.14(e), 701.21(h)(3), 701.22(c), 701.23(h)(3), 701.32(b)(5), and 701.34(a)(4), appendix A to part 701 of this chapter, appendix B to part 701 of this chapter, Chapters 1-4, §§ 703.20(d), 703.108(b), 705.10(a), 708a.108(d), 708a.304(h), 708a.308(d), 709.7, 741.11(d), and 745.201(c), subpart J to part 747 of this chapter, and § 750.6(b).