TO:	National Credit Union Administration
FROM:	Brett Vanderkolk, CFO – Centra Credit Union
	Doug Harris, CEO – Centra Credit Union
RE:	Comments on Proposed Rule - Derivatives

June 26, 2013

Dear NCUA,

Thank you for the opportunity to provide comments on your Proposed Rule to allow qualifying credit unions to utilize interest rate swaps and caps as an additional tool to manage interest rate risk. As a $1.1 billion credit union that issues medium to long-term loans in auto, first mortgage and commercial lending markets and funds the loans primarily with deposits, we believe we will benefit from having an additional tool to manage the interest rate risk associated with this activity. We respectfully submit the following comments for your consideration.

We believe the usage of swaps and caps will enhance our ability to manage interest rate risk. We acknowledge that the usage of such derivatives introduces new risks to our institution, but, when taken in whole with the benefits, the net result is an enhanced ability to lower risk to Centra. You obviously agree, subject to the proper management and oversight of the processes and products. Since the benefits sought in using derivatives is to reduce risk, the proper usage of derivatives should therefore be encouraged, not discouraged.

We believe the aggregated burdens that may include a substantial application fee, a substantial ongoing licensing fee and some of the monitoring and process requirements discourage usage, even by those credit unions that have the need, expertise and wherewithal to run a derivatives program properly. We understand and agree that a substantial need exists to ensure programs are run properly, but some requirements go beyond what is necessary in our opinion.

Counterparty credit risk: the requirements to fully collateralize all positions on a bilateral basis greatly reduces the need for enhanced credit functionality. While some credit work should be required at the outset of a relationship and some monitoring of the counterparty's financial condition is prudent, the collateral requirements curtail the likelihood of a substantial loss due to counterparty credit risk. It should also be noted that swap dealer pricing will be worse to credit unions due to the provision for full bilateral collateralization, which is not the normal condition. That is an indication that the bilateral requirement has value to the credit unions. In addition to a higher cost on the swap due to bilateral collateral requirements, we do not also want to be saddled with significant costs to increase credit functionality and perform work to protect against very limited credit risk (due to full collateralization). We favor a bilateral collateral agreement, but believe that that significant additional credit functionality is not necessary as a result and may prove burdensome.

<u>Aggregate Fair Value Loss Limits on all interest rate swap positions cannot exceed 10% of net worth:</u> Our issue with this limitation is that it totally ignores the value of the hedged item. A common problem I have experienced during my time using derivatives is the desire by many to view them in isolation rather than in conjunction with the hedged item. In isolation, hedges can build up large gains or large losses. The tendency is to think of large gains as resulting from good decisions and large losses to be the result of bad decisions, which misses the point entirely. A good derivative outcome is one that is effective in hedging the risk that it is intended to hedge. As long as the derivative is effective, its losses are offset by gains in the hedged item. We understand the buildup of large derivatives losses is a good trigger for further review of hedge effectiveness, but by itself should not automatically curtail further derivative activity.

<u>Maximum weighted average life of all derivatives may not exceed 5 (or 7) years:</u> We agree that placing a term limit on derivatives is a good idea. We request clarification as to whether the average life calculation utilizes the <u>original</u> life of a derivative or the <u>remaining</u> life. We believe remaining life is the better indicator of the risk and therefore should be used. Second, Centra issues time deposits for time periods of up to five years, so we feel reasonably comfortable in using that mechanism to offset fixed rate asset risk for up to five years. However, our only tool to match-fund longer assets is to borrow. Since we have a significant amount of excess funding, we don't wish to borrow funds. Swaps or caps are a good tool for us to hedge longer assets. We therefore will likely use them exclusively to hedge longer-term assets. If we wish to execute primarily 7-year or 10-year swaps, we would have to issue a like amount of shorter swaps for the average to remain within the requirement. We don't believe this makes good policy.

<u>Application Fee:</u> We believe that charging substantial application fees and ongoing licensing fees is providing a monetary disincentive to improve risk management, is misguided and sets a bad precedent. If the purpose for which credit unions were to use derivatives were to increase profits of the credit unions or create higher risks overall, we would have a different view. While derivatives can enhance profits by reducing losses, they are doing exactly that, preventing poor income results, not enhancing or increasing profits. We therefore believe that charging credit unions to better manage risk is the wrong approach. If application fees remain high, our alternative suggestion is to at least allow them to be amortized over a longer period of time to be less of a deterrent.

<u>Swap Structures</u>: NCUA asked for comments regarding which complex swap structures are necessary and why. We believe that having some ability to execute forward-starting swaps will further enhance our risk management. For instance, we perform rate locks for our members for periods that commonly range up to 30 days. If we cannot lock the interest rate on our hedge at the time the loan pricing is locked in, then we are exposed to changes in interest rates until such time as the loan closes. We believe that allowing forward-starting swaps for up to 30 days will improve risk management.

Variance of Swap Notional is not allowed: It is not clear to us whether this refers to swaps in which the notional schedule is not defined in the transaction or whether it also refers to swaps in which the notional value declines over time, but based upon a pre-established schedule. If the limitation includes the latter, we believe it is a counterproductive limitation. Most of the loans that Centra makes, whether they be auto, home, commercial or other; include regular principal payments that cause the loan balance to decline over time. To hedge those individually, or in aggregate, it works best if we allow the notional value of the swap to decline in a fashion similar to the gradual paydown of the loans.

Personnel Experience Requirements: Our CFO has many years of experience executing and managing derivatives, but none of our staff have direct experience. As a result, our CFO will initially execute all transactions while training others. It therefore will require three years for anyone else in our organization to execute a derivatives transaction. We believe an alternative requirement of certification or similar proof of knowledge is a better requirement. A good example is that our President has 20+ years of banking and investment experience working with embedded options, caps and floors in securities and loans. That experience should receive credit toward the ability to issue derivatives, perhaps with an add-on certification requirement that could be attained through a derivatives seminar or similar training.

Limit on Caps based upon book value: In the definition section, book value is defined as the value at which the cap is carried on the books. In certain circumstances, that book value will be equal to the fair value of the caps. If the caps are functioning as intended and in an environment when the fair value of the cap increases meaningfully, it seems counterintuitive to limit further cap execution because existing caps are successfully serving their purpose. We suggest limiting the amount of caps based upon the lesser of their original cost or current book value.

Who will benefit?: The NCUA specifically asked for comments as to who will benefit from interest rate risk derivatives usage (credit unions that use derivatives, the NCUSIF, credit unions that do not use derivatives): The proper use of swaps and caps is an enhancement to financial risk management. Overall, that helps all three named groups. Most directly, those institutions that use derivatives properly, but with the potential for a major increase in interest rates over the next several years, having the tool can help prevent credit unions from suffering severe margin compression or, worse, negative margins that they cannot overcome. The failure or forced merger of such institutions puts the NCUSIF and other credit unions that will have to pay for those failure at risk. Therefore, better risk management benefits all three groups.

703.105 Requirement to be 100% collateralized at all times: This would eliminate minimum transfer amounts and require a transfer of collateral potentially every single day as opposed to having a minimum transfer amount of $250,000 that would only require additional collateral once the shortfall of collateral reaches $250,000.

Ability to Value Derivatives: NCUA requires the Credit Union's swap counterparties to be dealers or major swap participants as defined by the CFTC. These counterparties are well qualified to value derivatives and they will require that the derivative value used to determine daily collateral requirements be the value they calculate. Credit unions need to be able to check that valuation for reasonability, but not replicate its accuracy. Perhaps a compromise would be to require the ability to calculate a reasonability test on the valuation, but not to replicate it.

Reporting Requirements: the requirement to provide a full net economic value to our Board every month, done with derivatives included and excluded is a significant deterrent to executing derivatives. Centra performs a net economic value calculation quarterly, not monthly, and increasing this requirement will be an expensive endeavor and will prevent us from executing derivatives for some time. This requirement is burdensome and a deterrent to improving interest rate risk management through the use of derivatives. Perhaps a compromise would be to provide a valuation of the derivatives and hedged items each month. This has the benefit of direct oversight of hedge effectiveness and, likely a better understanding of the derivative, by the credit union boards.

Timing: with interest rates already having increased over 100 basis points on some parts of the yield curve, delays in implementation of the new derivative rules puts at risk that rates will rise substantially more before the rule is in effect. Our understanding of the following time requirements: 60 day comment period, time needed to finalize the proposal, the time needed to apply for the program and the 90 or 120 day application approval period means that, at minimum, it will be six months until we can begin using the program. Our concern is that interest rates could rise meaningfully within that time period. We therefore encourage the NCUA Board to expedite the final steps leading to program implementation.

We thank you for providing us the opportunity to respectfully submit our comments.