VyStar Credit Union

P.O. Box 45085 • Jacksonville, Florida 32232-5085 • (904) 777-6000 or 1-800-445-6289 • www.vystarcu.org

July 8, 2013

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

Re: VyStar Credit Union's Comments on NCUA's Proposed Rule for Derivatives:
NCUA 12 C.F.R. Part 703, 715 and 741

Dear Ms. Rupp:

Thank you for providing us an opportunity to respond to NCUA's Proposed Rule referenced above. On behalf of the Board of Directors and Senior Management of VyStar Credit Union, headquartered in Jacksonville, Florida we offer the following comments, perspectives and suggestions.

General Comments:
VyStar Credit Union was pleased to see the Advance Notices of Proposed Rulemaking (ANPRs) on derivatives in June 2011 and January 2012 from the National Credit Union Association (NCUA). We were encouraged by the NCUA opening the discussion on the topic; we believe interest rate risk is potentially a systemic risk to credit unions. VyStar Credit Union responded to the ANPRs and was, in general, optimistic about the prospect of using select derivative products to help manage interest rate risk. Our growth in non-core deposits experienced over the past three to four years, coupled with our share of loans in fixed rate mortgages, is consistent with Table 1 of the Proposal and would make VyStar a candidate for derivatives use.

Unfortunately, upon reading the current Proposed Amendments, we have determined that we would not be able to utilize this valuable additional tool for interest rate risk management. As stated in the proposal, we believe derivatives could be a complementary tool to help credit unions manage interest rate risk. We recognize that derivatives, used in combination with other strategies, present the most effective and cost efficient approach to help manage the mounting interest rate risk inherent in many credit unions. The proposed amendments, as written, will be too onerous and costly for most credit unions to consider implementing. Specific items in the amendments that will limit our consideration of derivatives are (1) the proposed application and ongoing charges; (2) staffing to meet experience requirements and (3) limitations on permissible transaction types. Overall, we are discouraged by the Proposed Amendments and find them to be prohibitive for considering using derivatives if approved. From our perspectives, the Proposed Amendments are a stark contrast to the ANPRs.

The application fee is an unprecedented attempt to spread examination costs to the very few credit unions to which the rule would apply. The fee will discourage many of the credit unions that can benefit most from this type of program from applying. The application fee would also have to be considered as an increase in the transaction fee for derivatives, which would be unfairly placed on credit unions while banks do not have such fees or requirements from their regulators. If NCUA charges a fee to credit unions to apply for derivatives authority, we are concerned this could become a precedent for other types of fees NCUA might decide to charge. While it is understandable that NCUA may believe it has the need for additional expertise in derivatives to properly ensure safety and soundness of credit unions, the current staff at NCUA should be of a high enough caliber to learn about derivatives from outside experts. It should not be necessary to hire a team of derivative experts to examine credit union derivative positions. The proposed type of derivatives that credit unions would be permitted to use under this proposal are all relatively straight forward to understand and value given an appropriate amount of education and training. Furthermore, when taking the proposed application and, perhaps, annual costs imposed by the NCUA to fund additional examiners along with the internal costs implied by the proposal's staffing requirements, credit unions who are involved in derivatives would be effectively paying twice for the same "check-and-balance."

We agree that the credit union must have the expertise to appropriately utilize and manage derivatives; however, we believe the requirements set out in the proposal are burdensome to the extent they will prohibit most credit unions from considering applying for derivatives authority. The separation of responsibilities requirement of the proposal could result in a credit union hiring a number of additional staff, each with 3-5 years of specialized derivatives experience. Hiring the required staff with this type of experience will be quite expensive as well as difficult to find. Personnel with that type of expertise typically would not want to work for a credit union or other type of financial institution where they are only going to do an occasional simple swap or cap. The challenge would not be sufficient for an individual with that level of expertise. The separation of responsibilities and experience requirements are excessive and this, alone, will discourage many credit unions from applying for the program. Providing a firsthand illustration of the hiring difficulty, our credit union uses Quantitative Risk Management (QRM) for balance sheet management and interest rate risk measurement, which is used by most of the top banks in the world. When VyStar had vacant financial analyst positions to run QRM, the applicant pool was very shallow and few applicants had prior QRM experience. This was despite a very competitive pay and a desirable northeast Florida location. We found that because VyStar is a credit union many qualified bankers with QRM experience were not willing to take the move from banking to credit unions. While it is common for bankers to shift between jobs at different banks, it is not as common for bankers to switch to a credit union. It is generally a one way ticket from banking to credit unions without the ability to return to banking. Bankers who have the experience necessary to fulfill NCUA's experience requirement will not be very easy to attract and retain. Couple this difficultly with the fact that credit unions who attain derivatives authority and perhaps NCUA itself will be competing to hire this fairly small pool of experienced bankers, making the situation even more challenging.

While the proposed rule calls for 3-5 years of "direct transactional experience in the trading, structuring, analyzing and monitoring or auditing of financial derivatives at a financial institution", this experience does not necessarily equate to competence at valuation and use of derivatives in these described functions. Many financial institutions strategize and integrate the use of derivatives and outsource many of these functions. Therefore, it would be difficult to verify and likely provide little safeguard in the use of derivatives as the proposal would seek to accomplish. The derivatives proposed are no more complex than much of the risk that can already exist on credit unions' balance sheets. For example, credit unions routinely borrow long term fixed rate funds from the Federal Home Loan Bank (FHLB) and invest the funds in floating rate securities to hedge existing risk on their balance sheet. This is just an on balance sheet swap-like transaction that uses up capital rather than collateral. The transactional risk is just as risky as a swap but with the inefficiency of using capital rather than collateral and residing on balance sheet rather than off balance sheet. To place an experience restriction for derivative transactions and functions would be equivalent to placing an experience restriction for managing the balance sheet of a credit union. Decisions about the experience and expertise of staff managing interest rate risk should be left to the executives and Board of Directors of individual credit unions.

Some separation of duties between strategy, trade and accounting is understandable and appropriate. However, the proposed separation of responsibilities into 5 areas is excessive. The additional separation of responsibilities does not seem necessary and it places an additional high cost for credit unions to use derivatives. These staff members would be in place to conduct a very limited amount of transactions each year, which would generally be fewer than 2 to 4 transactions per year. This may seem like a reasonable cost of doing business from a regulator's perspective because of separating responsibilities. However, operationally and resource wise this is quite expensive and would add a significant cost to each transaction. The staff positions as proposed would likely add at least an additional $200 to $300 thousand per year to the cost of using derivatives. This would make the programs available to only a handful of credit unions that could justify such a rich expenditure for so few transactions.

The combination of the application fee, the heavy administrative experience and the number of staff required for separation of responsibilities would create a high cost structure to be able to use derivatives. The cost structure required to comply with either program as proposed would make these types of derivative transactions too costly for all but the few largest credit unions. The cost structure as proposed would further raise the transaction cost for even basic derivatives to the point where the costs could potentially exceed the benefits, thus making participation in the program economically unfeasible.

Suggestions:

As previously stated, charging an application fee to be considered for the derivatives program is without precedent and places an excessive cost structure on credit unions that apply for either program as currently proposed. NCUA should have examiners who are of sufficient caliber that they could learn about derivatives from an internal or external expert without having to hire teams of derivative experts for examinations. This is especially the case given the very straight-forward nature of the swaps and caps being proposed.

The proposed level 1 and level 2 programs should be modified in terms of permissible products, notional and book value limits and eligibility for the program. The level 1 program should allow the use of only plain vanilla bullet swaps and not interest rate caps for the management of interest rate risk. Interest rate caps are somewhat more complex derivatives that require additional expertise that should be reserved for the level 2 program. The proposed level 1 limits for derivatives should be expanded to a notional value of 250% of net worth and book value of 25% of net worth. The ability to apply for authority to enter the level 1 program should be accessible for all credit unions with assets over $250 million.

The ability to apply for authority to enter the level 2 program should be limited to all credit unions with assets above $1 billion. The combination of internal expertise, asset/ liability management expertise and the ability to build derivative knowledge comes with economies of scale that are more easily afforded by larger credit unions. The proposed level 2 program should be modified to allow the use of plain vanilla swaps, amortizing swaps and forward start swaps plus interest rate caps and floors for management of interest rate risk. These derivative products more closely align with the level of sophistication and needs to manage interest rate risk in the larger credit unions. For example, a credit union that is trying to hedge 15 year amortizing fixed rate mortgages would get greater hedge effectiveness testing by using an amortizing interest rate swap where the cash flows more closely align with the cash flows of the loans than they would with a bullet interest rate swap. In addition, the tenor limits should also be expanded for the level 2 program to include maturity limits of up to 15 years, which would more closely align with the 15 year fixed rate mortgage hedge example. In addition, the proposed limit for interest rate caps should be increased from 25% of net worth to 100% of net worth. If the intent in proposing the use of interest rate caps is to potentially manage interest rate risk in liabilities, then limiting interest rate caps/floors to a small percentage of capital would not allow these products to be an effective tool. This is because many credit unions have experienced growth in non-maturity deposit growth that is in excess of net worth. Therefore, the inclusion of interest rate caps/floors should be at least 100% of net worth so that these products can be used effectively to manage interest rate risk.

Please note that while today most, if not all, credit unions are liability sensitive, a regulation should be broader and also consider the possibility that some credit unions may be asset sensitive or that this might become a possibility in the future. Therefore, the suggestion above includes adding interest rate floors to the proposed interest rate caps. The interest rate floor product would be useful for managing interest rate risk in a falling interest rate environment and protecting asset sensitivity. A derivative proposal should be well thought out, comprehensive and cover all the possibilities, both rising and falling rates, rather than seeming to be centered just on rising rates..

In section 9 "External Service Providers" NCUA describes the different functions that must be conducted internally and those that can be supported. Asset liability management (ALM), credit risk and liquidity risk should all be required to be conducted internally to be part of any derivative program. A pre-request for applying to use derivatives should include a demonstrated understanding of ALM principals and concepts, ALM modeling knowledge and understanding modeling assumptions used in the credit union. These basic competencies can only be developed internally and not through third party providers. Liquidity risk and liquidity risk management are fundamental outcomes of a solid ALM process and should be performed internally. Without a sound internal program for managing interest rate risk, it would be difficult to develop a compelling argument for why a credit union would need financial derivatives. To allow credit unions to outsource such fundamental functions would suggest that the credit union lacks the resources or commitment to these areas and they are not making an appropriate investment in managing interest rate risk and managing risk in general. If these functions are outsourced because more expertise lay outside the particular credit union, then they should not be allowed to use derivatives because they potentially lack sufficient internal resources to carryout basic risk management.

In general, the proposed rule should not dictate whether accounting and reporting, counterparty exposure, collateral management, trade execution, trade management, financial statement auditing and legal services are performed internally or externally. There are many large banks and regional banks as well as Fortune 500 companies and Real Estate Investment Trusts (REITS) that routinely use similar financial derivatives through a third party. Third party providers such as Chatham Financial in Kennett Square PA, perform all or some of these functions for a fee. These same companies find the cost of maintaining internal systems far too expensive and therefore, find it more cost effective to pay a per transaction fee for derivatives. The service providers offer independent valuation services, hedge effectiveness testing and guidance for derivative accounting within generally accepted accounting principles. The third party providers have the resources and expertise to provide sound financial advice and efficient services. Requiring credit unions to perform all of these functions internally would place too high an administrative burden on them. Credit union management should have the ability to make the choice of whether to manage systems internally or use external providers for these matters.

Again, while we agree that credit unions should have the authority to use certain derivatives, we believe the Rule as presently proposed will be too costly and burdensome for most credit unions to consider. We encourage NCUA to reconsider some of the more recently added Amendments and revert back to the initial ANPRs as it seeks to finalize this rule.

Again, thank you for providing credit unions an opportunity to comment on this Proposed Rule. If you have any questions about our comments, please contact our President/CEO, Terry West at 904-908-2500.

Sincerely,

George Berry

George Berry
Chairman of the Board
VyStar Credit Union

Cc: Board of Directors
Terry West, President/CEO
John Turpish, EVP/Chief Financial Officer
Rich Alfirevic, EVP/Chief Operations Officer
Daniel Mashevsky, Vice President Finance
Joan Hill, Vice President Accounting
Jeff Greenert, Senior Portfolio Manager