



July 17, 2013

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

Dear Ms. Rupp:

On behalf of the partners of ALM First Financial Advisors and its management staff, I am writing in response to the Notice of Proposed Rulemaking - Derivatives. We thank you for this opportunity.

Issues for Comment

The practice of using off balance sheet derivatives for constructing hedging strategies is a diligent approach to managing interest rate risk. Without the ability to hedge using derivatives, institutions are forced to either take undue amounts of interest rate risk or manage their balance sheets in sub-optimal ways. Derivative use can clearly reduce the industry's aggregate NEV sensitivity to increases in interest rates and add to the stability of the NCUSIF. Outlier "what-if" scenario analysis for large and rapid increases in interest rates, uncover levels of economic capital loss that could be considered "catastrophic" for some institutions. Lessons learned from recent history make prudent risk management, even for low probability events, necessary.

ALM First applauds the NCUA for its efforts in drafting the derivatives notice of proposed rulemaking, which will allow credit unions to engage in derivative activity to manage interest rate risk. We have the following suggestions.

Section 703.102 – Permissible derivative transactions

As part of its regulatory approved strategy, a credit union may only purchase interest rate caps or enter into interest rate swap transactions that are:

The regulation should more broadly define "permissible derivative instruments" to include interest rate floors, options on swaps (swaptions) and exchange traded futures.

Institutions managing their interest rate and convexity risks using derivatives would be better served having an expanded menu of derivatives to accomplish their risk management goals. Many benefits accrue to institutions using exchange traded instruments for hedging like Eurodollar futures, U.S. Treasury futures and call and put options on these instruments. Liquidity is generally higher, price discovery is generally clearer, and counterparty risk is generally lower. The Chicago Mercantile Exchange (CME), the Chicago Board of Trade (CBOT), and The Chicago Board Options Exchange (CBOE) are all well established, CFTC regulated exchanges used by bona fide hedging institutions daily to accomplish their risk management goals. We feel that risk

management programs within the U.S. credit union industry would be more complete if exchange traded futures were permissible items.

A swaption is an option granting its owner the right but not the obligation to enter into an underlying swap. Some of our credit unions want to protect themselves in the future should rates move up. Swaptions are a great way to hedge interest rate risk with limited downside risk. Should rates fall, the credit union writes off the swaption premium and does not deal with the market value loss of the underlying swap that it never entered into.

Interest rate risk can and does manifest itself in credit union balance sheets for changes in interest rates in either direction. For example, many credit unions sell member mortgage loans, creating mortgage servicing rights (MSR assets) that are sensitive to falling interest rates. Interest rate floors are simple derivatives that have been used for years in other industries to hedge MSR sensitivity to falling interest rates. In any event, although exposure to falling rates is less burdensome to the share insurance fund, interest rate mitigation tools are essential to effectively managing both falling and rising interest rates.

- (g) Interest rate swaps that do not have fluctuating notional amounts.

There is no additional risk in swaps with amortizing principal. Amortizing swaps could be useful in managing specific mortgages.

Section 703.103 – Eligibility

- (a) A credit union may apply for Level I or Level II derivatives authority if it meets the following criteria:
 - (a)(3) It has assets of at least \$250 million, as of its most recent call report.

Asset size restrictions should not prevent credit unions from using derivatives. The market will most likely dictate those credit unions that will be able to contract with counterparties.

Section 703.105 – Collateral requirements for operating a Level I or Level II program

- (b) Acceptable collateral is limited to cash, Treasury securities, fixed-rate non-callable agency debentures, and zero-coupon agency debentures.

Acceptable collateral should also include mortgage-backed pass-through securities. Pass-throughs are highly liquid securities and therefore easy to price. The addition of this collateral type will also broaden the collateral that credit unions can post with out-of-the money positions.

- (e) A credit union must set threshold amounts to zero.

The Dodd-Frank protocol has not been finalized. The final ruling should incorporate requirements that also adhere to the Dodd-Frank regulations.

- (g) The minimum transfer amount must be less than or equal to \$250,000.

The Dodd-Frank protocol has not been finalized. The final ruling should incorporate requirements that also adhere to the Dodd-Frank regulations.

Section 703.108 – Systems, processes, and personnel requirements for operating a Level I or Level II derivatives program

(a) Required experience and competencies. A credit union operating a derivatives program must internally possess the following experience and competencies:

(b)(3) *Qualified derivatives personnel.*

To engage in derivatives transactions with Level I authority, a credit union must have knowledgeable and experienced employees that, except as provided in § 703.110(f) of this subpart for Level II authority, have at least three years of direct transactional experience in the trading, structuring, analyzing, monitoring, or auditing of financial derivatives transactions at a financial institution, a risk management advisory practice, or a financial regulatory organization.

It will be very difficult for credit unions to obtain employees with a minimum of three years of direct transactional experience. In addition, it is not prudent to hire someone to oversee (not even execute, as this can be outsourced) just a few trades. This restriction could be problematic if a credit union hires someone solely for derivatives and then the person leaves the organization. As a case in point, ALM First has approximately 30 credit union clients that are exploring the use of derivatives and we believe that only one would obtain authority, given this restriction.

Experience should entail capital market responsibilities and knowledge of back office work and derivative analytics. Plain vanilla interest rate swaps and caps are not very complicated to transact. The qualifications can be achieved by hiring experienced personnel or obtaining guidance through third-party consultants.

(b)(3) *Internal controls review.* A credit union must have an internal controls audit at least annually that ensures the timely identification of weaknesses in internal controls, modeling methodologies, and the risk oversight process. This internal controls review must be performed by external individuals qualified to evaluate the attributes of a derivatives program. An internal controls audit must incorporate an evaluation of the effectiveness of internal controls relevant to measuring, monitoring, reporting, and limiting risks. The scope of the internal controls review must also include coverage of the accounting, legal, operating, and risk controls

Internal control audits are different from financial statement audits. This is an imprudent and potentially very expensive requirement. Derivative activities are much less complicated than other credit union activities, for which this provision is not required. The credit union should have the option to have an internal auditor review the internal controls, modeling methodologies, and oversight process.

(e) Use of external service providers

(e)(1) The external service provider, including affiliates cannot

(e)(1)(ii) Be a principal or agent in any derivatives transaction involving the credit union

The NCUA should specifically define “agent”. We assume the term “agent” is defined as a broker when it executes orders on behalf of clients, whereas a “dealer” is defined as a broker that acts in behalf of its own account.

(b)(5) *Legal review.*

Before executing any transactions under this subpart, a credit union must receive a legal opinion from qualified counsel stating that the credit union’s ISDA agreements are enforceable and that the credit union is complying with applicable laws and regulations relating to operating a derivatives program. Qualified counsel means an attorney with at least five years of experience reviewing derivatives transactions. A credit union must also ensure any counterparty is authorized to enter into such transactions.

Five years of experience from a qualified counsel is somewhat extensive, as the contracts are fairly boilerplate.

Section 703.109 – Specific Level I limits and requirements

A credit union with Level I derivatives authority must comply with the following specific limits and requirements:

(a) A credit union approved only to enter into interest rate swaps must restrict the aggregate notional amount of its interest rate swap transactions to 100 percent of net worth.

Limits set solely based upon an absolute notional amount will discourage the use of proper hedging strategies, which the OCC clearly states in its guideline. As interest rate swaps age, they decrease in duration and lose some of their hedging benefit, potentially requiring additional hedges and again, making a notional exposure amount illogical.

Limits should be based upon the market value change of the aggregate swap portfolio, specifically as a measurement of DV01\$, which is defined as the dollar value of a basis point. While many make the mistake of matching notional values or tick increments, the proper method to hedge is to match the DV01 in the yield of the underlying hedged item to that of the hedging vehicle. We strongly suggest that the limit be set at the projected market value change in an up 100 basis point scenario at no greater than 5 percent of assets. This limit should be calculated by using the DV01 times 100.

Although the DV01 will not remain fixed as rates change, the chart below proves the point that hedging based on notional values is illogical. The market value loss of \$1 billion of a 1-year payer swap (paying fixed for floating) given a 50 basis point drop in rates is estimated at \$4.765 million, while the loss of one-tenth of this holding, or \$100 million of a 10-year payer swap is almost equivalent, at \$4.509 million.

Years	Notional Amount	DV01\$	Change - down 50 bps	Market Value Change - down 50 bps	MV Change as a % of Capital	MV Change as a % of Assets
1	1,000,000,000	0.00953	-0.48% *	(4,765,000)	-10%	-1.0%
2	500,000,000	0.01992	-1.00%	(4,980,000)	-10%	-1.0%
5	200,000,000	0.04861	-2.43%	(4,861,000)	-10%	-1.0%
10	100,000,000	0.09019	-4.51%	(4,509,500)	-9%	-0.9%
15	66,666,667	0.12370	-6.19%	(4,123,333)	-8%	-0.8%

**The down 50 basis point change assumes that all fixed swap rates are greater than 50 basis points.*

If NCUA is determined to set limits based on notional amounts, ALM First suggests that the maturity be considered. In addition, notional limits should not be placed as a percent of net worth. The institution that has a lower capital ratio will most likely be the one that needs hedging the most. The concept of hedging is to reduce risk and usually the higher the credit union's capital, the greater its options to use borrowings or to manage risk in general.

ALM First understands that NCUA would like a fairly simple formula, so we suggest calculating the aggregate notional limit by risk weighting the notional amounts based upon the maturity bucket in which it lies. As an example, interest rate swaps that lie within one year of maturity would be weighted by 5 percent and those that are greater than 15 years would be set at a risk weighting of 200 percent.

The chart below is an example. The credit union's \$10 million in interest rate swaps that have maturities less than one year would have a risk weighted notional amount of \$0.5 million, while the \$10 million in swaps greater than 15 years would have a risk weighted notional of \$20 million. In this example, although the credit union has \$60 million notional amount of interest rate swaps, the risk weighted notional is \$45 million. We believe this risk weighted notional amount as a percent of assets should be used as a limit.

We believe risk weighting notional amounts in this way is very conducive to call report preparation and transparency across institutions. Also, risk weighting notional amounts will allow NCUA to rank order institutions with derivative powers by risk weighted notional exposure. Using actual notional amounts will not allow for such ranking. Comparing institutions based on risk weighted notional will make regulatory oversight simpler, more effective and more meaningful.

As an additional measure, the weighted average life notional for this portfolio falls in the 3.5 year category and its market value change given 100 basis points is within 4 percent of net worth.

Assets	500,000,000		
Net Worth	50,000,000		
Maturity Bucket Years	Notional	Risk Factor	Risk Weighted Notional
Less than 1 year	10,000,000	0.05	500,000
1 - 3	10,000,000	0.20	2,000,000
3 - 6	10,000,000	0.45	4,500,000
6 - 10	10,000,000	0.80	8,000,000
10 - 15	10,000,000	1.00	10,000,000
More than 15 years	10,000,000	2.00	20,000,000
Total	60,000,000	0.5553	45,000,000
Percent of Assets			9%

We suggest that the risk weighted notional limit of interest rate swaps for Level I be set at 15% of the credit union's assets.

(b) A credit union approved only to purchase interest rate caps must restrict the aggregate book value of its interest rate cap transactions to 10 percent of net worth.

(c) A credit union approved to transact interest rate swaps and purchase interest rate caps may not exceed a combined limit of 100 percent of the aggregate amount of each limit the credit union used under paragraphs (a) and (b) of this section. For example, a credit union may hold 80 percent of the limit for interest rate caps and 20 percent of the limit for interest rate swaps, but cannot hold 100 percent of the limit for each.

This aggregate limit combining caps and interest rate swaps could be problematic. As an example, suppose that a credit union holds caps at a limit of 10 percent of net worth and interest rate swaps at a limit of 90 percent. If the cap gains value to an amount equal to 30 percent of net worth, the market value gain could be reflected in the book value of the cap. Given this scenario, the credit union would be forced to sell its position in interest rate swaps.

The limits set forth for interest rate caps are acceptable, but should not be combined with notional limits of interest rate swaps. As stated, these limits should be set as a percent of assets.

(d) The aggregate fair value loss of all swap positions into which the credit union has entered cannot exceed 10 percent of net worth.

Limits on mark-to-market changes independent of the asset or liability being hedged are inappropriate and will negatively impact effective hedging strategies. Theoretically, if there is a loss on the derivative there should be a gain on the asset. Therefore, the market valuation limit should take into consideration the asset or liability being hedged.

The 10 percent net worth limit should be based as an exposure to the aggregate mark-to-market limit, including gains on the hedged item.

(e) The maximum permissible weighted average life on all derivatives positions may not exceed five years and the maximum permissible maturity for any single derivatives position may not exceed seven years.

Maturity and average life restrictions are arbitrary and inappropriate for effective hedging strategies, especially because in-the-money trades are collateralized. At the very least, maturities should be allowed at 20 years with no weighted average life restrictions.

ALM First has a number of very sophisticated clients that work with key rate durations, and placing the price sensitivity on the correct part of the yield curve is as important as hedging parallel rate moves; in essence, this effectively hedges a change in the slope of the yield curve.

The majority of the duration of a mortgage asset sits out in the 10-to-15- year part of the curve. Restricting the maturity of a hedge will unnecessarily expose the credit union to changes in the slope. As an example, if a credit union has a 14 percent duration series of cash flows that needs to be hedged, this restriction will force hedging with two times the notional of a 7 percent duration hedge. From a parallel perspective, the asset would appear to be hedged. But if the yield curve steepens, the hedge would not be effective as the shorter hedge's price appreciation multiplied by two will not equal the market value loss in the longer end of the curve.

The use of key rate duration analytics allows specific client hedging needs to be measured, and the ability to therefore hedge the more appropriate part of the yield curve required. The restrictions are not conducive to proper hedging practices and ALM First would not be able to construct effective hedges so that the economics work in the best interest of the credit union's balance sheet. The following table illustrates a partial duration analysis. The majority of interest rate sensitivity is clearly in the longer maturity parts of the yield curve.

	Current	Total	Partial Duration			
	Balance	Duration	3 - 9 Month	1 Year - 2 year	3 Year - 5 Year	7 Year - 30 Year
Assets						
Single Family Mortgage Loans	50,000	5.50%	0.27%	-0.21%	1.82%	3.62%
Commercial Mortgage Loans	6,000	4.50%	0.09%	0.68%	1.27%	2.46%
Total	56,000	3,020	138	(62)	988	1,956
Liabilities and Hedges						
3 month FHLB Advance	56,000	0.25%				
2 year FHLB Advance	-	1.90%				
5 year Interest Rate Swap	20,000	4.85%			970	
10 year Interest Rate Swap	20,000	9.10%				1820
Total	56,000	2,790	-	-	970	1,820
Net	-	230	138	(62)	18	136
		Hedged Duration:	0.41%			

Level 1 maturity requirements should be the same as Level II. As stated above, proper hedging strategies will require the use of longer duration hedges. Level I credit unions should learn how to properly hedge, but just use fewer of them.

Section 703.110 – Specific Level II and requirements

A credit union with Level II derivatives authority must comply with the following specific limits and requirements:

- (a) For a credit union approved only to enter into interest rate swaps, NCUA will establish the aggregate notional amount of its interest rate swap transactions at an amount not to exceed 250 percent of net worth.
- (b) For a credit union approved only to purchase interest rate caps, NCUA will establish the aggregate book value of its interest rate cap transactions at an amount not to exceed 25 percent of net worth.
- (c) For a credit union approved to transact interest rate swaps and interest rate caps, NCUA will establish the appropriate cumulative limit not to exceed individual limits in paragraphs (a) and (b) of this section.
- (d) The aggregate fair value loss of all swap positions into which the credit union has entered cannot exceed 25 percent of net worth.
- (e) The maximum permissible weighted average life on all derivatives positions may not exceed seven years and the maximum permissible maturity for any single derivatives position may not exceed ten years.
- (f) The qualified derivatives personnel described in § 703.108(a)(3) must have at least

five years of direct transactional experience in the trading, structuring, analyzing, monitoring, or auditing of financial derivatives transactions at a financial institution, a risk management advisory practice, or a financial regulatory organization. In addition to the activities the qualified derivatives personnel are required to conduct in Section 703.108(a)(3), they must also price options and undertake statement of financial condition simulations under multiple interest rate scenarios.

Our comments on section 703.109 apply here. As stated, proper hedging strategies require the use of longer duration hedges, so ALM First recommends allowing maturities out to 20 years. Level I credit unions should learn how to properly hedge, and eventually graduate to Level II and be allowed to use a greater amount.

For Level II credit unions, we recommend the same formula as expressed in section 703.109; however the allowable risk weighted notional limits should be expanded to be equal to 25 percent of assets.

(g) The exposure by notional amount to any single derivatives counterparty cannot exceed 100 percent of net worth for interest rate swaps and the book value may not exceed ten percent of net worth for interest rate caps.

This limit should be altered to the suggested limit referenced in Section 703.109.

Section 703.114 – Pilot program participants and FISCUs with active derivative positions

The service should be grandfathered into a currently approved third-party provider to ensure that the service is uninterrupted. Further, credit unions that currently hold derivatives (and have not conducted trades through the ALM First pilot program) should be able to participate with derivative activity within the regulatory guidelines.

This requirement is especially burdensome if concessions are not made on fees or internal staff requirements. ALM First has a few client credit unions that have expressed concern with the proposed regulations and will terminate derivative activity if the regulations are accepted as proposed. This would then trigger a requirement for them to divest of existing trades.

Application Fees

ALM First is strictly opposed to the idea of instituting a fee structure for those credit unions that apply for derivative authority. We are also against fees for continued supervision and examination. Derivatives are a common practice for financial institutions outside the credit union industry, and its introduction is not dissimilar to other products throughout credit unions' history, such as CMOs or commercial loans. To introduce a fee would set a precedent that could cause the Agency concerns.

Derivatives Costs

We express concern throughout this document that the ruling as proposed would cause credit unions to incur excessive expenses.

We estimate that annual costs for a Level I credit union are \$189 thousand for the first year and \$181 thousand for the remaining six years (assuming the credit union already performs an external audit on its financials) with the proposed regulation. This will greatly discourage derivative use. Should the ruling be modified as we suggest the cost is reduced significantly to approximately \$50 thousand per year.

The appendix also demonstrates the cost savings of hedging versus borrowing given the proposed ruling versus ALM First's suggested concessions. The appendix assumes a \$40 million notional 7-year swap versus borrowing for seven years at the Dallas Federal Home Loan Banks. The spread between the 7-year swap rate and the 7-year borrowing rate is approximately 50 basis points but varies among the banks. The 10-year is approximately 75 basis points.

At a 50 basis point spread, the credit union is somewhat neutral (outside of capital restraints). Given ALM First's proposed concessions, the credit union saves approximately \$150 thousand per year by conducting the swap for a total savings of over \$1 million throughout the life of the trade.

We thank you for allowing ALM First Financial Advisors to comment. We are hopeful NCUA finds these suggestions useful and welcome any future dialogue.

Sincerely,



Emily More' Hollis, CFA
Partner

APPENDIX A

Expenses as Proposed by NCUA		FHLB Dallas Fixed-Rate Standard Advances	
<u>Expense</u>	<u>Amount (\$)</u>		
CICI/LEI Registration	200	7-yr Borrowing versus Swap Spread	50
ISDA Amend *	500	10-yr Borrowing versus Swap Spread	75
Hedge Accounting	15,000	Swap Notional	40,000,000
SSAE 16 Audit	50,000	Annual Savings on 7 Yr Swap vs borrowing ****	200,000
NCUA Application **	75,000		
Legal Counsel w/ IRD experience *	7,500		
Tri- Party Safekeeping	5,000		
Staff w/ IRD experience	100,000		
			<u>BP difference</u>
			<u>between hedging</u>
			<u>and borrowing</u>
Pro Forma - Costs	Annual Expenses	Pro Forma - 7 Yr Swap Savings vs Cost	
Year 1	188,914	Year 1	\$200,000 - \$188,914 = 11,086 0.03%
Year 2	180,814	Year 2	\$200,000 - \$180,814 = 19,186 0.05%
Year 3	180,814	Year 3	\$200,000 - \$180,814 = 19,186 0.05%
Year 4	180,814	Year 4	\$200,000 - \$180,814 = 19,186 0.05%
Year 5	180,814	Year 5	\$200,000 - \$180,814 = 19,186 0.05%
Year 6	180,814	Year 6	\$200,000 - \$180,814 = 19,186 0.05%
Year 7	180,814	Year 7	\$200,000 - \$180,814 = 19,186 0.05%
Total Hedging Program Cost	1,273,800	Total Hedging Program Savings	126,200

* Expensed in the first year only

** NCUA application fee is amortized over 7 years

*** Does not include clearing costs for credit unions > \$10 billion

**** \$40 million times 50 basis points

Expenses Modified		FHLB Dallas Fixed-Rate Standard Advances			
<u>Expense</u>	<u>Amount (\$)</u>				
CICI/LEI Registration	200	7-yr Borrowing versus Swap Spread			50
ISDA Amend *	500	10-yr Borrowing versus Swap Spread			75
Hedge Accounting	15,000	Annual Savings on 7 Yr Swap vs borrowing ****			40,000,000
SSAE 16 Audit	-	Annual Savings on 7 Yr Swap vs borrowing			200,000
NCUA Application **	-				
Legal Counsel w/ IRD experience *	2,000				
Tri- Party Safekeeping	5,000				
External Service Provider	30,000				
					<u>BP difference</u>
					<u>between hedging</u>
					<u>and borrowing</u>
<u>Pro Forma - Costs</u>	<u>Annual Expenses</u>	<u>Pro Forma - 7 Yr Swap Savings vs Cost</u>			
Year 1	52,700	Year 1	\$200,000 - \$52,700 =	147,300	0.37%
Year 2	50,100	Year 2	\$200,000 - \$50,100 =	149,900	0.37%
Year 3	50,100	Year 3	\$200,000 - \$50,100 =	149,900	0.37%
Year 4	50,100	Year 4	\$200,000 - \$50,100 =	149,900	0.37%
Year 5	50,100	Year 5	\$200,000 - \$50,100 =	149,900	0.37%
Year 6	50,100	Year 6	\$200,000 - \$50,100 =	149,900	0.37%
Year 7	50,100	Year 7	\$200,000 - \$50,100 =	149,900	0.37%
Total Hedging Program Cost	353,300	Total Hedging Program Savings		1,046,700	

* Expensed in the first year only

** NCUA application fee is amortized over 7 years

*** Does not include clearing costs for credit unions > \$10 billion

**** \$40 million times 50 basis points