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July 15, 2013

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

Dear Ms. Rupp:

On behalf of San Antonio Federal Credit Union, I am writing in response to the Notice of Proposed Rulemaking – Derivatives. SACU appreciates the NCUA for its efforts in drafting the derivatives notice of proposed rulemaking, which will allow credit unions to utilize derivatives to manage interest rate risk. We have the following comments and/or suggestions, indicated in italicized format following each applicable section of the proposal, for your consideration.

Section 703.102 – Permissible derivative transactions. As part of its regulator approved strategy, credit unions may only purchase interest rate caps or enter into interest rate swap transactions that are:

1. For the purpose of managing interest rate risk;
2. Not leveraged;
3. Based on domestic rates;
4. Denominated in US dollars;
5. Not used to create structured liability offerings for members or nonmembers;
6. Settled within three business days of entering into the transaction;
7. Interest rate swaps that do not have fluctuating notional amounts.

The regulation should define "permissible derivative instruments", specifically to include interest rate floors and options on swaps (swaptions).

A swaption is an option that grants its owner the right, but not the obligation, to enter into an underlying swap. Credit unions should have the ability to protect themselves should rates move up. Swaptions can be used to hedge interest rate risk with limited downside risk in that if rates fall, the credit union writes off the swaption premium without having to deal with the market value loss of the underlying swap that they never entered into.

Also, interest rate risk can exist in credit union balance sheets for changes in interest rates in either direction. Interest rate floors are simple derivatives that have been used for some time in other industries to hedge sensitivity to falling interest rates. Although exposure to falling interest rates poses considerably less risk to the share insurance fund, interest rate mitigation tools are necessary to

effectively manage both falling and rising interest rates. This is truly a safety and soundness consideration that NCUA, as administrator of the share insurance fund, should be open to authorize in the current environment. It reflects what is commonly accepted as conservative investment philosophy and asset-liability management.

Section 703.103 – Eligibility. A credit union may apply for Level I or Level II derivatives authority if it meets the following criteria:

1. 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.

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

Acceptable collateral should also include mortgage-backed pass through securities. The addition of this collateral type will broaden the collateral that credit unions can post with out-of-the money positions.

A credit union must set threshold amounts to zero.

The Dodd-Frank protocol has not been finalized; the final ruling should incorporate requirements that adhere to Dodd-Frank regulations. It is premature to impose threshold amounts in advance of the regulations required by Dodd-Frank.

Minimum transfer amount must to less than or equal to $250,000.

The Dodd-Frank protocol has not been finalized; the final ruling should incorporate requirements that adhere to Dodd-Frank regulations. Likewise, in this case, it is premature to impose minimum transfer amounts in advance of the regulations required by Dodd-Frank.

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:

(1) Board. Before entering into any derivative transactions, and annually thereafter, a credit union's board members must receive training to provide a general understanding of derivatives and knowledge to provide strategic oversight of the credit union's derivatives program. The credit union must maintain evidence of this training, in accordance with its document retention policy, until its next NCUA or state supervisory authority examination.

The board of directors is responsible for oversight of their credit union and for approving policy, major strategies, and prudent limits regarding IRR[1]. The use of derivatives is one of many tools credit unions may utilize to mitigate interest rate risk. Accordingly, the board should ensure management uses the appropriate tools and processes necessary to execute an effective IRR program. Credit union boards should annually assess if their derivative program, as part of their overall interest rate risk program, sufficiently mitigates the IRR exposure of the credit union. Where necessary, the board may consider obtaining professional advice and training to enhance its understanding of derivatives. Additionally, credit unions granted authority to use derivatives under the NCUA's pilot program were required to demonstrate they obtained the proper training and education for staff and boards prior to their acceptance; the fulfillment of this requirement should be sufficient

[1] Appendix B to Part 741 (III)(a) – Guidance for an Interest Rate Risk Policy and Effective Program.

towards the initial training requirement. <u>The rule should be expanded to grandfather credit unions in the pilot program to ensure they do not have to repeat this initial training requirement.</u>

(2) <u>Senior executive officers</u>. A credit union's senior executive officers must have sufficient knowledge and experience to understand, approve, and provide oversight for the derivatives activities commensurate with the complexity of the derivatives program. A credit union must immediately notify NCUA (and, if applicable, the appropriate SSA) when a senior executive officer position as defined in the rule becomes vacant. A credit union must also immediately provide NCUA (and, if applicable, the appropriate SSA) with documentation evidencing knowledge and experience for any person who becomes a senior executive officer as defined in this rule while the credit union has derivatives authority.

Management is responsible for the daily management of activities and operations. In order to implement the board's IRR policy, management should:

- ***Develop and support competent staff with technical expertise commensurate with the IRR program***[2]

(3) <u>Qualified derivatives personnel.</u> 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.

While perhaps not impossible, it will be difficult and extremely costly for credit unions to obtain employees with a minimum of three years direct transactional experience because of marketplace considerations. Experience should entail capital market responsibilities and knowledge of back office work and derivative analytics. Plain vanilla interest rate swaps and caps are fairly straightforward; the necessary qualifications can be achieved by hiring experienced personnel or by obtaining guidance through third-party providers. <u>Credit unions operating within the pilot program should be grandfathered.</u>

(b) <u>Required management and internal controls structure</u>. To effectively manage its derivatives activities, a credit union must allocate resources sufficient to support the scope and complexity of its derivatives activities. An effective management and internal controls structure includes, at a minimum, the following:

(1) <u>Separation of duties</u>. A credit union's process, whether conducted internally or by an external service provider, must have appropriate separation of duties for the following functions:

(i) Derivatives execution and oversight;
(ii) Accounting for and confirmation of the derivatives transactions;
(iii) Asset/liability risk management; and
(iv) Credit, collateral, and liquidity management.

As the use of derivatives falls within the framework of asset liability management, it is unreasonable to expect credit unions to not utilize staff accountable for risk management in

[2] Appendix B to Part 741 (III)(b) – Guidance for an Interest Rate Risk Policy and Effective Program.

the use of derivatives. Furthermore, management is responsible for establishing clear lines of authority and responsibility for managing interest rate risk.

<u>(3) Internal controls review</u>. 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 very different from financial statement audits. This is a potentially very expensive requirement. Derivative activities are arguably less complicated than other credit union activities, for which this provision is not required. While we see potential value in such a review, credit unions should have the option to use a qualified internal auditor or external service provider to review the internal controls, modeling, methodologies, and oversight process.

(4) <u>Legal review</u>. 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.

Five years of experience from qualified counsel is somewhat extensive, as the contracts are fairly standard. It is important to recognize that, even though many credit unions may be new to utilizing them, derivatives are not new in the marketplace and are generally considered a very conservative investment strategy and asset-liability management tool throughout the financial services marketplace.

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 based solely upon an absolute notional amount will discourage the use of proper hedging strategies (the OCC states this in their guideline). As swaps age, they decrease in duration and lose some of their hedging benefit, potentially requiring additional hedges. A more sensible limit would be one based upon the market value change of the aggregate swap portfolio, specifically as a measurement of DV01$, or the dollar value of a basis point. Additionally, notional limits should not be placed as a percent of net worth, as institutions that have lower capital ratios will likely be the ones that need to hedge the most. The concept of hedging is to reduce risk, usually the higher the credit union's capital, the greater its options to use borrowings or to manage risk in general.

(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. For example, given a scenario where a credit union holds caps at a limit of 10% of net worth and rate swaps at a 90% limit. If the cap gains value to an amount equal to 30% of net worth, the market value gain could be reflected in the book value of the cap and consequently, the credit union would be forced to sell its position in interest rate swaps.

The limits proposed for interest rate caps are acceptable; however they should not be combined with notional limits of interest rate swaps.

(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. The market valuation limit should consider the asset or liability being hedged as in theory, if there is a loss on the derivative there should be a gain on the asset. The 10% 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 inappropriate for effective hedging strategies; especially given "in the money" trades are collateralized. The majority of the duration of mortgage assets sits in the 10-15 year part of the curve. Restricting the maturity of a hedge will expose credit unions to changes in the slope. Maturities should be allowed at 15 years with no weighted average life restrictions as the majority of interest rate sensitivity is in the longer maturity parts of the yield curve.

Level I maturity requirements should be the same as Level II. Proper hedging strategies will require the use of longer duration hedges.

Section 703.110 – Specific Level I limits and requirements. A credit union with Level I 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 it 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.

Our comments in Section 703.109 apply here as well. Additionally, Level I credit unions should learn how to properly hedge, and eventually graduate to Level II.

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

(a) A credit union that, as of January 1, 2013, is holding derivatives under NCUA's derivatives pilot program or applicable state law must comply with the requirements of this subpart, including the application procedures, within 12 months from the effective date of this subpart.

(b) A credit union holding derivatives under NCUA's derivatives pilot program or state law that does not comply with the requirements of this subpart within 12 months or does not want to continue engaging in derivatives transactions must:
   (1) Stop entering into new derivatives transactions; and
   (2) Within 30 days, present a corrective action plan to the appropriate Field Director describing how it will cure any deficiencies or unwind its derivatives program.

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 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.

Additionally, with respect to application fees, SACU is 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 common practice for financial institutions outside the credit union industry, and their introduction is not dissimilar to other products offered throughout credit unions' history, such as commercial loans. To introduce a fee for a credit union seeking expanded authority by law would set a precedent that could cause concern as it inevitably expands to other areas of special authorization fees and examination fees. Safety and soundness regulation should not be checkbook regulation, driven by authorities granted only to those willing to pay for the privilege.

In closing, with a historically unprecedented low interest rate environment, credit unions must have multiple tools in their risk management "tool kit" to facilitate the safe and prudent mitigation of interest rate risk. We are concerned that the ruling as proposed would cause credit unions to incur excessive expenses that may discourage derivative use.

Thank you for the opportunity to comment. We are hopeful NCUA finds these suggestions useful.

Sincerely,

Eric Malagamba
Chief Financial Officer