July 17, 2013

Local Government Federal Credit Union
Charter Number: 24003
323 West Jones Street
Suite 600
Raleigh, NC 27603

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

Re: Commentary for further consideration of NCUA's proposed rule changes on Derivatives affecting 12 CFR Parts 703, 715, and 741

Dear Ms. Rupp:

Local Government Federal Credit Union ("LGFCU") appreciates the opportunity to comment on the National Credit Union Administration Board's ("NCUA") request for comments on its proposed amendments to the ownership of fixed assets ("Derivatives") rule. For informational purposes, LGFCU was founded in 1983 as a not-for-profit, federally-insured financial cooperative, chartered specifically to serve North Carolina's local government employees, elected/appointed officials, volunteers and their families. LGFCU is a $1.3 Billion dollar credit union serving 225, 270 members, with the majority of its members located in North Carolina.

As requested, LGFCU has made several comments to NCUA's proposed questions regarding the rule changes on Derivatives. LGFCU is in support of the Derivatives rule, but simply believes it is too rigid and restrictive in certain areas. We believe that substantive changes to the rule, as provided by our comments and recommendations outlined below, will provide a more effective and significant rule for credit unions, while still upholding the intent of the Federal Credit Union Act. For ease of review and to further highlight our position, we have also provided examples below and the rationale supporting our respective comments.

Comments to Question 1: Authorities and Limits for Qualified Credit Unions

Comment 1: The Level I & II derivatives authorities and limits noted on page 18 of the proposed rule are cumulatively restrictive in the application of Interest Rate Swaps transactions with regard to the ***tenor***. If institutions are successfully raising long term fixed rate mortgages at attractive spreads, and serving a key product need to members, then equal long term swaps may be relevant to hedge the associated interest rate risk ("IRR").

Example: Limitations in the rule are denoted on single derivative maturity as well as maximum weighted average life of all derivative positions; however, including a restriction on the weighted average life of derivatives is unnecessarily restrictive. If institutions find their members utilizing long term fixed rate mortgage products in an increasing volume due to improvements in the housing market and increase volume of housing turnover, driving greater mortgage demand, such institutions may seek to use 10 year pay-fixed swaps to manage the risk arising from the new volume.

Recommendation: Maintain the maximum maturity for single derivative transactions and remove the weighted average life restrictions on all derivatives. Furthermore, allowing a maximum maturity of 15 years for both Levels I and II is important for institutions to most effectively use interest rate swaps as a tool to manage the risk arising from holding long term fixed rate mortgages. As such, the maximum tenor of a swap should match the maximum weighted average life of loan cash flows which would arise from 30 year fixed rate mortgages.

Rationale: Derivatives are tools for IRR management, whether used individually or as a portfolio. Weighted average life metrics on derivatives do not have the same context as weighted average life metrics on an investment portfolio; more specifically, weighted average life does not effectively measure the risk of derivative positions used to hedge a balance sheet.

It is the net exposure, the net economic value offset to the balance sheet, that is important; and therefore, it's the respective institution's balance sheet that should determine the effective weighted average maturity of derivative positions.

Derivatives are used to hedge both market value change and potential earnings compression against exposure existing on an institution's balance sheet. Restricting the overall weighted average life of all derivative positions to less than the tenor allowed for individual derivative transactions can hamper the ability of an institution to use derivatives to effectively manage the risks arising from organic loan generation.

Further, restricting Level I derivative authorization hampers an institution's ability to more effectively manage the risk arising from exposure due to holding long term fixed rate mortgages, which can be an important product for an institution's members.

Additionally, it is not clear from the rule as to whether weighted average maturity metrics refer to receive-fixed and pay-fixed positions separately or combined. Weighted average maturity metrics become less relevant when combining both receive-fixed and pay-fixed swap positions.

Comment 2: The Level I & II derivatives authorities and limits noted on page 18 of the proposed rule are cumulatively restrictive in the application of Interest Rate Swaps transactions with regard to the ***notional*** and ***fair*** value limitations.

Requirements in the rule regarding limitations on aggregate fair value loss on all interest rate swap positions in relation to net worth is understandable; however, when combined with a notional limit in relation to net worth, such requirements are unnecessarily restrictive and impede the goal of implementing IRR strategies.

Example: An institution may desire to implement a strategy using received-fixed swaps of a 2 year tenor and pay-fixed swaps of a 10 year tenor. The receive-fixed swaps may be needed if insufficient short term fixed rate loans are originated to provide IRR offset and targeted stability of income against the institution's deposit book. The institution may desire to simultaneously employ a 10 year pay-fixed swap strategy to manage the IRR, if they were overly successful in originating long term fixed rate mortgages at attractive spreads.

An example would be: an institution with $100 million in net worth determines it needs to build a position of $100 million of 10 year pay-fixed swaps to effectively manage the rate risk from its long term mortgage positions, and also build a position of $500 million of 2 year receive-fixed swaps to provide sufficient intermediate earnings stability against core deposits. Such positions would have nearly offsetting fair value changes for a given uniform change in rates and therefore may never bump up against the 10% fair value loss restriction, unless a curve twist were to occur. However, this position would be six times the allowable notional amount of swaps based on the regulation as written.

Recommendation: Maintain the aggregate fair value limitation of 10% of equity but increase the **notional** limit to 100% of an institution's asset base.

Rationale: Derivatives are used to hedge both market value change and potential earnings compression against exposure existing on an institution's balance sheet. It is the impact of the net dollar value change that is important should the aggregate derivative positions need to be liquidated in an adverse scenario. Consequently, restricting the notional amount of interest rate swaps allowable to less than the notional amount of assets held by an institution may hamper the ability of an institution to use derivatives to effectively manage earnings and market value risks on its balance sheet.

Comments to Question 2: Fee Structure

Comment: NCUA contemplates inordinate fees for the oversight and implementation of the proposed rule, which are inconsistent with the application of existing rules and regulations currently implemented by the agency.

Additionally, implementing the fee structure as written establishes a precedence of an *a la carte* approach to covering regulation costs and may have future unintended consequences. This fee structure also creates additional cost burdens on the IRR management process.

Example: Existing rules and regulations were implemented without a special fee assessment structure. For example, 12 CFR 703 authorizes certain types of investment securities to be purchased and held by credit unions. Authorized investment instruments such as US Agency Callable Bond and US Agency Mortgage Backed Securities can be viewed as having a complex risk profile given the potential variability in their cash-flows. No special fees are assessed for the implementation and regulatory oversight of 12 CFR 703.

Recommendation: NCUA should strongly consider covering the additional cost burdens of implementing proposed derivative regulation through the existing Premium Assessment process.

Rationale: Implementing the fee structure as written creates inordinate cost hurdles and burdens for institutions seeking to implement a derivatives program to support their overall IRR management program. It also establishes a precedence of an *a la carte* approach to covering regulation costs, which can result in unintended consequences, including increased complexity of the oversight process.

If NCUA realizes increased cost burdens associated with implementation of this proposed regulation, consistent application would suggest such costs be covered through the premium assessment process. If the proposed derivatives regulation is to apply only to credit unions of $250 million asset size or greater, it would only be relevant and beneficial to the large credit unions. As such, NCUA may want to consider a more progressive approach to premium assessments.

Comments to Question 5: Restrictions on Derivative Tools

Comment: As written, the proposed rule contemplates Interest Rate Swaps (Pay & Receive Fixed) as well as Interest Rate Caps as authorized instruments. The NCUA should consider a more complete set of fixed income derivatives within authorization of this rule to include Interest Rate Floors as well as Interest Rate Swaptions [long option only].

Example: Interest Rate Floors are an effective tool to mitigate the downside risk (both net interest income ("NII") and net economic value ("NEV")) against an institution's deposit book. Just as caps can be a very effective tool to mitigate unexpected changes between forecasted and actual future deposit pricing as rates rise, so too can floors provide similar protection at higher levels of interest rates. Since NII and NEV risks are both two dimensional, in that risks to earnings and capital can manifest themselves as both higher and lower changes to interest rates, it would be prudent to allow for both interest rate caps and floors as IRR management tools.

Similarly, but driven primarily out of NEV risk offset, both interest rate payer and receiver swaptions [long option only] are instruments that can provide important risk mitigation of the impact from mortgage loan extensions and contractions, respectively, often occurring in conjunction with large moves in interest rates. The lingo typically utilized to describe such exposure is *convexity risk*, the risk of which is two dimensional and in the case of mortgages is the manifestation of either slower or faster actual prepayments on the loan cash-flows.

Recommendation: NCUA should strongly consider authorizing Interest Rate Floors as well as Payer and Receiver Interest Rate Swaptions [long option only].

Rationale: Interest Rate Floors are very relevant tools in the IRR management of both the NII and NEV risks of an institution's deposit book. Likewise, but driven primarily out of NEV risk offset, both payer and receiver interest swaptions are relevant IRR mitigation tools in helping offset extension and contraction risks on loan cash-flows. It cannot be emphasized enough that this refers to swaptions where the credit union has *purchased* the option to either pay-fixed or receive-fixed (generally referred to as long option position) in the swaption instrument. From this standpoint, the maximum loss of a purchased (long) swaption is the initial premium paid, just as is the case with an interest cap and floor.

Comments to Question 8: Collateral Requirements

Comment: The proposed rule is overly restrictive on collateral requirements, which may have unintentional consequences on an institution's investment portfolio. As the rule stands now, an institution may be forced to take actions counter to its current investment strategy in order to secure eligible collateral for swap positions, likely resulting in an increase in effective costs for using derivatives.

Example: An institution has transacted $10 million of 10 year pay-fixed swaps at current rates to manage the interest rate risk arising from originating and holding long term fixed rate mortgages, and subsequently 10 year interest rates fall 50 basis points from current levels. This would require the institution to post upwards of $425,000 in eligible collateral, assuming full collateralization is required. If the institution was not currently holding or purchasing US Treasuries or fixed rate Agency debentures, the credit union would need to purchase such instruments for the sole purpose of pledging them as collateral against the derivative positions used for interest rate risk management purposes.

Recommendation: NCUA should strongly consider allowing Agency mortgage backed securities (MBS), as well as federal home loan bank (FHLB) letters of credit to be used as eligible collateral to post against negative mark to market derivative positions.

Rationale: There should be consistency between eligible securities authorized under section 703 and eligible securities allowed for derivative exposure collateralization. Specifically, if an institution has eligible Agency MBS securities, they should be allowed to use them for maximum flexibility in the management of collateral for derivative exposure. Daily collateral repositioning would already be necessary to manage derivative exposure given a requirement of full collateralization; thus, introducing the factors of MBS would not make the collateral management process any more complex.

Additionally, FHLB letters of credit are an effective and low cost tool for institutions to pledge more illiquid loan portfolios to FHLB, which is important because of the agency's quality credit. Institutions must fully appreciate the impact on their liquidity management of using FHLB's borrowing capacity in this manner; however, it's another relevant tool for maximizing flexibility in the management of collateral for derivative exposure.

Comments to Question 11: Internal Controls Requirements

Comment: The proposed rule requires … "a credit union maintain separation of duties for the functions of: 1) derivatives execution and oversight 2) accounting for and confirming of derivatives transactions 3) ALM and 4) credit, collateral and liquidity management. The Board believes these core functions must be accomplished by different people to ensure an effective systems of checks and balances." While we understand the need for checks and balances, certain functions noted in this requirement can be aggregated and still meet the needed control.

Example: An institution could have separate derivatives execution and oversight rolled up within its investment portfolio and tactical liquidity/cash management, while having the accounting for and confirming of derivatives transactions in a separate department. These departments could include both collateral management and financial risk management groups to fulfill the ALM, credit and liquidity management functions required by the proposed rule.

Recommendation: We recommend NCUA not require such a rigid adherence to the separation of these four functions of the proposed rule, and instead craft the rule in such a way that gives institutions the flexibility to comply with the spirit of rule.

Rationale: The enforcement of such a rigid requirement would amount to the forcible determination of an institution's organizational structure. Institutions need to have the flexibility to consider activities and exposure beyond derivatives, and to implement what they believe to be the proper and most efficient segregation controls to support the activities undertaken within their staffing model.

As stated before, LGFCU supports the Derivatives Rule and NCUA's efforts to enhance it. However, as the rule is currently constructed, we believe there are a number of areas in need of improvement. By implementing our recommendations for the rule, we believe a more effective and significant rule for credit unions can be established, while still upholding the meaning and intent of the Federal Credit Union Act.

Once again, LGFCU would like to thank you for the opportunity to provide comments on the proposed amendments to the Derivatives Rule. Should you have any questions, please feel free to contact me at (919) 755-0534.

Sincerely,

Sander Casino
Senior Vice President, Finance