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July 22, 2013

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

Re: Comments on Proposed Rule 703, 715 and 741, Derivatives:

Dear Ms. Rupp:

This comment letter represents the views of Credit Union of Southern California (CU SoCal) regarding the National Credit Union Administration's (NCUA's) proposed derivatives rule. CU SoCal has 56,000 members and $724 million in assets. We appreciate the opportunity to provide comment on this rule.

<u>Fees</u>
CU SoCal does not concur with the imposition of the proposed application fee or the supervision and/or examination fees in this proposal. The imposition of fees of this nature potentially set a precedent for further application of fees for other credit union activities that NCUA might deem to carry higher levels of risk.

<u>Derivatives</u>
If the proposal is approved, CU SoCal will likely not enter into interest rate swaps and purchase interest rate caps for the following reasons. We recognize that other credit unions may have a different view of these derivatives and may want the flexibility to use them.

From previous experience and observation of financial institutions using these derivatives, many financial institutions generally lose money, as the payments received are less than the payments made. This loss certainty arises from the following:

A) The counterparty in these transactions is generally a more sophisticated party and prices the swap or cap in such a way as to greatly increase the odds of the counterparty winning on the trade.

B) On a long interest rate swap (pay fixed and receive variable), the financial institution starts out receiving a variable rate payment that is significantly less than the fixed rate payment it pays, normally for a period of 3 months, as most swaps have quarterly resets. Since many swaps have 3-5 year terms, this disadvantage is significant.

C) On a long interest rate swap (pay fixed and receive variable), the variable rate received does not always track the fixed rate paid, so an increase in fixed rates does not result in an increase in the variable rate received. This is a problem if the hedged instrument is a long-term asset.

D) Many long interest rate swaps have quarterly resets, meaning the variable rate received is based on an index on a particular date, not an average during the quarter. Many swaps have 90 day LIBOR as the variable rate, and this rate can fluctuate and on a single date not be reflective of what occurred during the quarter.

E) In order for the swaps or caps to payoff, rates generally have to move significantly in a short period of time. This generally does not happen. Also see (A) above.

F) On a long interest rate swap (pay fixed and receive variable), the variable rate received does not always track the financial institution's cost of funds (basis risk), so an increase in the cost of funds may not be matched by the increased variable rate received. This can be remedied by adjusting the hedge ratio, but this requires a sophisticated estimate.

G) Given (F) above, sufficient correlation may not exist to allow for hedge accounting to be used, resulting in the derivative being marked to market monthly with changes flowing through the income statement. This is disruptive to net income and capital.

H) The accounting for caps and swaps is complex and requires ongoing monitoring and measurement, counter party risk exists, collateralization of underwater swaps is generally required, regulatory requirements will cause a time burden, and regulatory usage fees will be charged.

I) Nearly 90% of a credit union's funding base is retail funding (shares), with about 10% net worth. Over 50% of shares are comprised of regular shares, checking, and money market accounts, which are relatively rate-insensitive, core deposits. Given this, swaps and caps are not necessary, especially with their dismal track record.

J) The proposal allows for short interest rate swaps (receive fixed and pay variable), which seems unusual as most credit unions are funding longer term assets with shorter term liabilities.

K) The idea that these instruments make sense because they are insurance against a catastrophic rise in rates event is not tenable, given (I) above and the unlikelihood of a catastrophic event.

Thank you for the opportunity to comment and for considering our views on the proposed rule for derivatives.

Sincerely,

Rick Hoffman

Rick Hoffman
VP/Business Development and Legislative Affairs