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federal credit union

July 22, 2013

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

Dear Ms. Rupp:

Thank you for the opportunity to submit this letter in response to the Notice of Proposed Rulemaking – Derivatives. The ability to utilize derivatives as a tool to manage interest rate risk is important to the industry and the steps you are taking to make it possible are appreciated.

Section 703.102 – Permissible Derivative Transactions:

The proposed regulation allows for the use of caps and swaps which are important tools for mitigating the effects of rising interest rates. However, credit unions are also exposed to the effects of falling interest rates and the ability to purchase floors could also assist with risk management.

An example of exposure to declining rates is mortgage servicing rights (MSRs). Many credit unions originate, sell and service mortgages for their members. In so doing they acquire MSRs. As interest rates decline, the value of MSRs also declines and as rates rise, the value of MSRs increases. Another example is home equity lines of credit. Historically many credit unions have tied the rates on these loans to prime and not included an interest rate floor. As rates declined to historically low levels, the financial performance on these portfolios declined as rates were no longer able to cover operating, funding and credit costs. The ability to purchase a floor would allow for these risks to be mitigated.

Another issue is that the NPR requires settlement within three business days. This limits the value of the proposed derivatives authority in that it would not be possible to enter into forward settlement contracts. The ability to utilize forward settlements would permit the hedging of various types of assets and liabilities ahead of predictable events such as rate and cap resets.

Section 703.105 – Collateral Requirements for Operating Level I or Level II program:

Mortgage-backed pass through securities should be eligible collateral. These securities are highly liquid and there is a substantial amount of price transparency. We see no reason to exclude them as eligible collateral and they would provide increased latitude in collateralizing derivative portfolios. Further, the other securities listed as eligible collateral tend to have lower price volatility all else being equal and they may be the preferred securities to sell given a liquidity need. As a result, allowing pass through mortgage-backed securities to be used as collateral may reduce liquidity risk.

Section 703.108 – Systems, Processes, and Personnel Requirements.....:

There is no question that the utilization of qualified staff is vitally important to the success of a derivatives program. The proposed regulation utilizes years of experience as a proxy for qualification. It should be remembered that experience is no guarantee of expertise. Further, the use of derivatives in credit unions has been rare meaning that there are few professionals working in the credit union industry with the required years of experience as outlined in the NPR.

The requirements for either three or five years of experience would, from a pragmatic perspective make it very difficult to start a sustainable level of derivatives use across the industry. Because derivative use should reduce overall levels of interest rate risk, such a program should benefit all credit unions by placing a lower level of risk on the NCUSIF. The issue is that without experienced staff it is not possible to start a program and without a program it is not possible to develop experienced staff.

There are solutions to this dilemma. One would be to allow credit unions to contract with third parties with the necessary level of expertise acting in a fiduciary, non discretionary capacity. This would allow for credit union staff to gain expertise, the credit union to benefit from an appropriate derivatives program, and the industry to benefit from an overall lower level of risk. Being able to contract with a third party would also work as part of a succession plan for staff turnover. Another solution would be to allow for the substitution of a professional credential that requires in-depth knowledge of derivatives as a substitute for experience.

Section 703.109 – Specific Level I Limits and Requirements and Section 703.110 – Specific Level II and Requirements:

In these sections, limits are placed on notional amounts presumably to avoid over concentration in derivatives exposure. The effect of this type of limitation is to paint all derivatives with the same brush in terms of how they expose a credit union to risk and this is not appropriate. For example, all else being equal, a contract with a longer life will have more market value risk exposure than one with a shorter life. Similarly, an interest rate cap further away from its strike will have less exposure than one that is closer to its strike. Simply utilizing the notional amount of a contract as a way to limit risk exposure may be overly simple as a way to ensure that excessive exposure does not occur.

There are also comparatively short limits on the lives of contracts. Given that credit unions would be expected to use derivatives to hedge risks on longer term assets, utilizing comparatively short term contracts could increase the expense and complexity of hedging. It could also require the use of higher notional value contracts than would otherwise be necessary. For these reasons, we recommend that the allowable average lives of contracts be extended and that the exposure limitations be described in terms of changes in value given changes in market rates.

Application Fees:

The NPR considers charging credit unions who utilize derivatives to pay fees designed to cover the extra costs associated with derivatives oversight. We do not support fees for this purpose. There are a number of reasons for this position:

- Derivatives are expected to be utilized to manage risk and to presumably reduce the risk and expense to the NCUSIF,
- Charging a fee for derivatives would set a precedent that it is appropriate to charge for oversight of activities that are engaged in by a minority of credit unions,
- Other financial regulators do not 'up charge' institutions that utilize derivatives in their risk management programs,
- Charging a fee for oversight may discourage credit unions that would otherwise utilize derivatives and may result in a higher level of risk to the fund.

Again, thank you for your work to allow credit unions to utilize an important risk management tool and for the opportunity to comment on the NPR.

Sincerely,

Brad Miller
Senior Vice President and CFO
Coastal Federal Credit Union