From:	Smith, Steve
To:	_Regulatory Comments
Subject:	Comments on Proposed Rule - Derivatives
Date:	Tuesday, July 23, 2013 11:14:08 AM

Dear NCUA,

Thank you for the opportunity to provide comments on your Proposed Rule to allow qualifying credit unions to use interest rate swaps and caps as tools to manage interest rate risk. Sharonview Federal Credit Union is a federally chartered credit union with just over $1 billion in assets headquartered in Fort Mill, South Carolina. We have eighteen branches in North Carolina, South Carolina, and New Jersey and serve 65,000 member/owners. We have a heavy concentration in real estate loans at 69% of our loan portfolio and primarily hedge interest rate risk with long-term borrowings from the Federal Home Loan Bank of Atlanta. We currently have $180 million in long-term loans outstanding with them. In addition, we have $20 million in interest rate swaps with six year original terms maturing in mid-2014.

We believe the use of swaps and caps enhances our ability to manage interest rate risk and therefore support the spirit of the Proposed Rule. However, the Proposed Rule includes significant costs in using these tools and will likely make them too expensive to use for our institution and others like us. It is prudent for NCUA to ensure derivatives are used only for risk mitigation reasons versus for speculative purposes. The Proposed Rule accomplishes that but places far too many additional restrictions and expensive requirements such that only the largest (multi-billion dollar) credit unions will be able to use derivatives cost effectively.

Section 703.102 – Permissible derivative transactions
A credit union may only purchase interest rate caps or swaps under the Proposed Rule. Permissible derivative instruments should be broadened to include interest rate floors and options on swaps or swaptions.

Section 703.103 – Eligibility
An institution must have a minimum of $250 million in assets. Asset size should not prevent credit unions from using derivatives. As stated earlier, the Proposed Rule includes so many additional costs that only the largest credit unions will be able to cost effectively use derivatives.

Section 703.104 – Policies and procedures for operating a Level I or Level II program
This section requires the board of directors to review derivatives policies and procedures annually. The board of directors should not be required to review procedures at any time and certainly not annually.

Section 703.105 - Collateral requirements for operating a Level I or Level II program
Acceptable collateral is limited to cash, Treasuries, fixed-rate non-callable agency debentures, and zero-coupon agency debentures. Acceptable collateral should also include agency mortgage-backed securities and pass-through certificates which are fully guaranteed and highly liquid instruments.

A credit union must set threshold amounts to zero and the minimum transfer amount must be less than or equal to $250,000. The Dodd-Frank protocol has not been finalized and the final ruling should incorporate requirements that adhere to the Dodd-Frank regulations.

703.105 (c) and (d) states or implies that daily a credit union must price derivatives positions, calculate its fair value exposure, and must be collateralized for 100% of the fair market exposure. The daily valuation and collateral monitoring requirement imposes an excessive burden on credit unions. NCUA requires that swap counterparties be dealers or major swap participants as defined by the CFTC. These counterparties will require that the derivative value used to determine collateral requirements be the value they calculate. Credit unions should check these values for reasonableness but not be required to calculate the value daily.

Section 703.107 – Reporting requirements for operating a Level I or Level II program
This section requires a full net economic value report, both with derivatives and without, reviewed with the Board monthly. We perform this calculation quarterly as there is not enough benefit to justify the cost of preparing this report monthly. This is one example of many in this response that points to unnecessary costs that will deter many credit unions from cost effectively using derivatives to mitigate interest rate risk.

Section 703.108 – Systems, processes, and personnel requirements for operating a Level I or Level II derivatives program
This section requires qualified derivatives personnel to have at least three years of direct transaction experience in the trading, structuring, analyzing, monitoring, or auditing of financial derivatives transactions at a financial institution. Most credit unions do not have personnel with this experience since so few credit unions participated in the existing pilot program. It is simply not prudent or cost effective to hire someone with this experience to oversee a few derivative transactions. In addition, plain vanilla swaps and caps are not very complicated to transact. We recommend that procurement of the necessary expertise through a qualified external service provider be permitted.

Section 703.108 (b) (3) requires an internal controls audit be performed at least annually by qualified external individuals that ensures the timely identification of weaknesses in internal controls, modeling methodologies, and the risk oversight process. This is an imprudent and potentially very expensive requirement. The derivative activities included in the Proposed Rule are much less complicated than other credit union activities for which no such provision is required. At the very least, the credit union should be able to use internal audit to conduct the review annually.

Section 703.108 (b)(5) requires a credit union receive a legal opinion from qualified counsel stating that the credit union's ISDA agreements are enforceable and 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. Given the limited number and high quality of counterparties that credit unions will transact with, coupled with standard (boilerplate) ISDA agreements and contracts used in these transactions, this requirement is both expensive and unnecessary. In addition, requiring five years of experience seems excessive.

Section 703.109 – Specific Level I limits and requirements

Section 703.109 (a) states a credit union only approved to enter into interest rate swaps must restrict the aggregate notional amount to 100 percent of net worth. Limits set solely based upon an absolute notional amount will discourage the use of proper hedging strategies. As swaps age, they decrease in duration and lose some of their hedging benefit, potentially requiring additional hedges and making a notional exposure amount illogical. We believe using a risk weighted (by maturity bucket) notional amount as a percent of assets is a better limit. As an example, swaps that will mature within a year may be weighted 5 percent while those with greater than fifteen years may be set at a risk weighting of 200 percent. We recommend the risk weighted notional limit of interest rate swaps for Level I be set at 15 percent of credit union's assets.

Section 703.109 (b) states that a credit union approved only to purchase interest rate caps must restrict the aggregate book value of its cap transactions to 10 percent of net worth.

Section 701.109 (c) says 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.

Section 701.109 (d) states the aggregate fair value loss of all swap positions 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.

Section 703.109 (e) says the maximum permissible weighted average life on all derivative positions may not exceed five years and the maximum permissible maturity for any single derivative position may not exceed seven years.

Maturity and average life restrictions are very arbitrary and inappropriate for effective hedging strategies. When we borrow long-term with the Federal Home Loan Bank, we usually borrow term loans with maturities ranging from five to ten years. Given the current low rate environment, we anticipate relatively long average lives on the fixed rate mortgages we are booking today. Restricting the weighted average life of all derivative positions to five years significantly reduces the effectiveness of these transactions. If maturity and average life restrictions are necessary, Level II restrictions of a maximum weighted average life of all derivative positions of seven years and the maximum permissible maturity of any single derivative position at ten years are workable limits.

Section 703.110 – Specific Level II limits and requirements
Allowable risk weighted notional limits (as described in comments to 703.109) should be expanded from 15 percent of assets to 25 percent of assets.

Section 703.110 (f) This section requires qualified derivatives personnel to have at least five years of direct transaction experience in the trading, structuring, analyzing, monitoring, or auditing of financial derivatives transactions at a financial institution. Most credit unions do not have personnel with this experience since so few credit unions participated in the existing pilot program. It is simply not prudent or cost effective to hire someone with this experience to oversee a few derivative transactions. In addition, plain vanilla swaps and caps are not very complicated to transact. We recommend that procurement of the necessary expertise through a qualified external service provider be permitted.

Section 703.114 Pilot program participants and FISCUs with active derivatives positions
703.114 (a) says a credit union that, as of January 1, 2013, is holding derivatives under NCUA's derivatives pilot program, like we are, must comply with the requirements of this subpart, including the application procedures, within 12 months from the effective date of this subpart. We firmly believe that credit unions, like ourselves, that have been approved to participate in the pilot program and have active derivative positions should be grandfathered and approved for derivative activity under the new regulations. The application documentation required to be submitted for the pilot program is similar to that required for approval in the Proposed Rule and "starting all over" with a new application process with associated fees could deter us from seeking approval to do derivative transactions in the future. We understand that if we do not comply with the requirements of this subpart (application, etc.) within 12 months we must stop entering into new derivatives transactions and, 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. In our case, we would simply let our $20 million in interest rate swaps mature in mid-2014, as scheduled, and discontinue doing derivatives transactions in the future.

Application Fees
The Proposed Rule requires applicants to pay an application fee starting at $25,000 for Level I authority and $75,000 to $125,000 for Level II authority. We believe that charging substantial application fees and ongoing licensing fees is providing a monetary disincentive to improve risk management. It is misguided and sets a bad precedent. If the purpose for which credit unions were to use derivatives were to increase profits of the credit unions or create higher risks overall, we would have a different view. Derivatives only enhance profits by reducing future losses with changes in interest rates – in other words, reducing interest rate risk. We therefore believe that charging credit unions to better manage risk is the wrong approach. If application fees remain high, an alternative suggestion is to at least allow them to be amortized over a longer period of

time to be less of a deterrent.

In summary, significant changes are needed in the Proposed Rule to reduce the initial and ongoing costs to be approved to do derivative transactions. The permissible transactions are fairly straightforward and reduce risk, not increase it. With interest rate risk justifiably a major focus for NCUA and credit unions, the use of derivatives should be strongly encouraged by NCUA. The Proposed Rule, if adopted as is, discourages all but the very largest credit unions from using derivatives to mitigate risk due to the high cost imposed by NCUA. Please consider all comments that lower the cost of participation so that more credit unions can benefit from a tool that can help mitigate a very important risk in all interest rate cycles, but this interest rate cycle in particular.

We thank you for providing us the opportunity to provide our comments.

Steve Smith, CPA, CFP®, PFS
Chief Financial Officer
Sharonview Federal Credit Union
1081-521 Corporate Center Drive
Fort Mill, SC 29707
(P) 704-969-6705 (F) 704-719-2266
(M) 980-297-2908
steve.smith@sharonview.org
