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

Via email to: regcomments@ncua.gov

Re: UNFCU Comments on Proposed Rule – Derivatives 12 CFR Parts 703, 715 and 741

Dear Ms. Rupp:

On behalf of the United Nations Federal Credit Union (UNFCU), we would like to thank the National Credit Union Administration (NCUA) Board for inviting comments on the above referenced item. The proposed rule permits credit unions to engage in limited derivatives activities for the purpose of mitigating interest rate risk.

In sum, UNFCU supports the proposed rule and welcomes the expansion and modernization of credit union investment authorities--amendments which, if enacted, should also help in establishing and advancing parity between credit unions and other financial services providers. UNFCU agrees with the NCUA Board that interest rate derivatives contracts provide a valuable risk mitigation solution to credit unions given derivatives' ongoing evolution toward greater standardization, improved collateral requirements, and price transparency—all of which characteristics make interest rate derivatives increasingly more suitable to meet the risk mitigation needs of credit unions. Although UNFCU finds the proposed rule well intentioned, UNFCU has concerns regarding the details and eligibility requirements for the proposed authority, which are described below.

Permissible Instruments

While the proposed rule will permit plain vanilla interest rate swaps and interest rate caps, UNFCU believes that the authority overlooks certain similar instruments and other common features of these instruments that would collectively be of strategic risk management value. More specifically, the proposed rule does not permit the use of interest rate corridor or interest rate floor contracts. An interest rate cap corridor (or collar) could be created by selling a high strike interest rate cap in conjunction with a related purchase of a lower strike interest rate cap. Such a strategy would be of particular use in lowering hedge premium expense while also enabling a credit union to express a view of a lower likelihood for extremely high interest rates over the term of the hedge. Additionally, the use of an interest rate floor contract, and (in parallel to the above) an interest rate floor corridor, are not permitted in the proposed rule. Like its interest rate cap counterpart, an interest rate floor contract is used to hedge interest rate risk, but such instrument would be used in order to provide protection against a decrease in interest rates. As currently written, the only tool permissible within the proposed rule to hedge against declining rates are pay-floating/receive-fixed swaps, thus providing a credit union with the rather asymmetric ability of more easily hedging against a rise in interest rates than against a decline.

Finally, the proposed rule 703.102 within Subpart B, explicitly states that fluctuating notional amounts for interest rate swaps are not permitted. However, when hedging against an increase in interest rates for a specific pool of long-term fixed-rate amortizing mortgages, the use of declining, or amortizing, notional values would have strategic usefulness. For example, if strategically hedging against a rise in interest rates through a pay-fixed/receive-floating swap, employing amortizing notional schedules would serve as a way of optimizing hedge effectiveness against a pool of amortizing fixed-rate mortgages, which will surely decline in unpaid principal balance even in higher rate environments. In a declining rate environment under the same pay-fixed/receive-floating swap strategy, and if the strategy is not otherwise offset or unwound, amortizing nationals will also optimize hedge effectiveness in that voluntary refinancing may sharply reduce the pool's unpaid principal balance, while simultaneously minimizing the impact of a negative netting of swap payments (meaning a credit union's fixed payer rate could be higher than its floating receiver rate). Such declining notionals would also be useful in interest rate caps and floors when similarly hedging the risk underlying a specific pool of fixed-rate mortgages while simultaneously acting as a premium expense reduction measure. Finally, although neither explicitly permitted nor prohibited, the use of increasing or decreasing strikes in an interest rate cap (floor) contract across the caplet (floorlet) schedule would allow for further expense reduction and risk management flexibility.

We believe that these additional instruments and features are fundamental in mitigating interest rate risk in evolving interest rate regimes and would provide credit unions with added risk management flexibility while not also introducing unneeded complexities. Finally, these additional authorities, in our estimation, would continue to preserve and further strengthen the safety and soundness of an insured credit union and the NCUSIF at large, which remains in accord with the intended aim of the proposed ruling.

Personnel Requirements

The idealized requirements regarding a credit union's qualified derivatives personnel (or those involved with transacting, structuring, analyzing, monitoring, or auditing such instruments), in our view, seem somewhat removed from any realistic or practical implementation given that the proposed rule is a new authority not previously afforded to the credit unions and should necessitate a cost prohibiting expansion in staffing levels. In addition, credit union investment and risk management practitioners have clearly questioned the usefulness of stating specific experience thresholds:

The second Advanced Notice of Proposed Rulemaking (ANPR) on derivatives, which was issued in February 2012, asked for public comments on "the minimum kind and amount of derivatives experience and expertise that an FCU's staff should demonstrate before the FCU receives independent derivatives authority." According to the background guidance contained in the proposed rule, nineteen of the comments, or the vast majority of the total received on this particular ANPR question, stated "that experience or demonstrated skill was necessary to conduct derivatives transactions, but they did not want NCUA to condition approval of independent derivatives authority on specific experience requirements".

We agree with this collective assessment, which was also evidently recognized by the NCUA Board in the proposed rule's supplementary information, although the proposed rule as written places an unrealistic requirement for Level I authority and a stricter, more punitive requirement for Level II authority. Moreover, in order to fulfill these requirements, a credit union would likely be obligated to hire additional staff in areas covering execution, accounting, and collateral management — expenses which would greatly offset or even negate the financial benefit of having such a program in place.

Rather than requiring a specific number of years experience, which may disproportionately disqualify certain credit unions from being granted derivatives authority, UNFCU believes that it is more imperative that a qualified credit union staff seeking derivatives authority should independently demonstrate a deep understanding of the risk exposures related to its balance sheet, while also possessing knowledge of the risks, complexities, and operational mechanics of the derivative instruments intended for use and the instruments' potential effects on the credit union's financials across a range of interest rate scenarios.

Unwinding Hedge Positions

The proposed rule does not address the unwinding, exiting, or offsetting of hedge positions. UNFCU believes that such guidance should be stipulated in the final rule to better assist credit unions when this need arises, particularly when a credit union may have justification for exiting an interest cap position as the unwinding would typically require selling the position back to the counterparty or entering in an offsetting position by selling a new cap contract to the same or different counterparty.

Application Requirements and Fees

As mentioned throughout this commentary, the credit union industry would certainly benefit from the approval of a limited use derivatives program, however, the application fee structure imposed by the NCUA Board in the proposed rule is expensive and will potentially create an additional barrier to entry for many credit unions, especially when taken in consideration with the above staffing expense concerns. While UNFCU understands that permitting this new authority would increase costs to the NCUA, credit unions are already assessed operating fees by the NCUA, which may cover these increased costs. NCUA should reconsider its application fee structure, including the cost estimates for the increased authority on which the proposed fee structure is based, given the expertise already possessed by the NCUA staff, the limited range of permissible instruments proposed, and the likelihood that only a small number of credit unions will be able to participate. Finally, as the aim of the proposed rule is to provide an interest rate risk mitigation tool in order to preserve and support the safety and soundness of a credit union and the system at large, the NCUA Board may fall short of this goal by creating rules that impose requirements that limit the program's effectiveness while also erecting barriers that will sharply restrict the number of entrants.

External Service Providers

The substance of this comment is not intended to portray an opinion that the proposed rule is overly restrictive. In fact, in certain places we believe that the NCUA Board has given credit unions too much leeway on relying on external service providers. More specifically, we feel that accounting reporting, counterparty exposure management, collateral management, and trade execution should all be conducted internally for both Level I and Level II classifications. Meanwhile, we do agree that external service providers should continue to be engaged for legal services and financial statement auditing, as contracting for these services is generally standard for most credit unions. While we also agree that external service providers may be useful in acting as advisors and consultants with respect to a wide range of areas, we believe that the deployment and design of a credit union's interest rate derivatives program should be executed, managed, and monitored entirely in-house.

In summary, UNFCU sincerely commends the NCUA Board's decision to move forward with permitting the use of certain interest rate derivatives for credit unions. UNFCU asks that the NCUA Board reconsider the above outlined items as they may potentially and unnecessarily restrict the authority's intended usefulness by reducing the willingness of well managed credit unions from meeting the terms of the rule.

Thank you again for the opportunity to comment and for your consideration of UNFCU's position on this proposed rule.

Very truly yours,

Christopher J. Sullivan, CFA
Chief Investment Officer
United Nations Federal Credit Union

Richard J. Colavecchio, CFA
Vice President – Investment Management
United Nations Federal Credit Union

cc: The Honorable Debbie Matz, Chairman, NCUA
The Honorable Michael E. Fryzel, Board Member, NCUA
William Predmore, President/CEO, UNFCU