



Office of the President

July 24, 2013

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

Re: Derivatives; RIN 3133-AD90

Dear Ms. Rupp:

Navy Federal Credit Union provides the following comments on the National Credit Union Administration's (NCUA) proposed rule to permit Natural Person Credit Unions (NPCUs) to engage in derivatives activities for the purpose of mitigating interest rate risk. Navy Federal is the nation's largest NPCU with \$54 billion in assets and over 4 million members.

Navy Federal generally supports the agency's proposals and believes this rule is a welcome step that will allow NPCUs to better manage interest rate risk. Based on our review of the proposed rule and our experience with the derivative pilot program, we recommend the following revisions:

- Eliminate the weighted average maturity constraint of 7 years for Level II transactions so interest rate swaps can be more effectively used as a hedge against mortgage loans
- Expand the list of authorized instruments to include: interest rate floors and basis swaps
- Establish provisions for those NPCUs that are required, or voluntarily elect, to clear derivative transactions via an exchange
- Amend the proposed limit structure to: base limits on a percent of assets instead of net worth, eliminate the combined swap and cap limit, and eliminate the fair value loss limit

The attachment below provides a more complete description of our position regarding the proposed rule and our suggested enhancements.

By establishing a two-tier system, NCUA acknowledges different institutions have different risk management needs. NCUA recognizes certain institutions have more complex balance sheets and these institutions must make additional investments in personnel, systems and controls in order to have access to the tools needed to manage their risks. Unfortunately, the proposed rule does not provide these NPCUs all of the tools necessary to effectively manage risk. Additional derivatives authorities (e.g., swaptions, futures, amortizing swaps, etc.) would allow qualified NPCUs to lower their hedging costs and be more effective at managing risk. We

recommend NCUA consider establishing a process by which select Level II institutions can apply for expanded authorities to use some of these additional instruments (e.g., Level II+). These authorities could be granted by NCUA on a case by case basis once agency staff has performed a thorough evaluation of the NPCU's ability to effectively manage the risks associated with these additional instruments.

We are opposed to any application and/or exam fees pertaining to specific activities of NPCUs, derivative or otherwise. We believe establishing activity based fees will set a poor regulatory precedent, and, is inconsistent with the practices of other regulatory agencies. The ability to use derivatives is commonplace within the banking industry and is a staple of sound risk management. In our view, providing NPCUs with the ability to execute these transactions would allow them to mitigate risk using well-established tools already available to other financial institutions. Allowing NPCUs to use these instruments would also "de-risk" the balance sheets of these institutions, which would have a direct benefit to all NPCUs. Finally, for those NPCUs that consider participating in the program, the proposed costs will negatively impact the financial benefit, and will likely discourage institutions from participating in an activity that can reduce financial risk.

Finally, as detailed in the attachment, we recommend against a broad additional audit requirement and recommend any additional audits be in the context of specific applications or exams. In most cases, for Level II NPCUs, this audit requirement is likely to be duplicative and a subset of existing audits, providing no additional controls and only additional costs.

Navy Federal welcomes agency efforts to address interest rate risk and will continue to work with NCUA to craft a reasoned approach on this important issue. Should you or a member of your staff have additional questions about our comments, please contact Vincent Pennisi at (703) 255-8740.

Sincerely,



Cutler Dawson
President/CEO

CD/pm

Attachment – Navy Federal Comments on Derivatives Proposed Rule

This attachment is provided as a supplement to our response on the Notice of Proposed Rulemaking (NPRM) for Part 703 - Derivatives. The information in this addendum expands on the comments provided in the body of our response. It is designed to provide NCUA directors and staff a more complete description of our position regarding the NPRM and our suggested enhancements. For consistency with the proposed changes to Part 703, we have organized our comments to align with the relevant sections of the Regulation.

1. §703.101 – Definitions

To clarify NCUA's intent and to ensure consistency with market terminology, we recommend NCUA amend the following definitions:

- a. **Leveraged Derivative:** The definition of leveraged derivatives in §703.101(m) says it is a derivative with an interest rate that changes proportionally with the contractual rate or index; we believe the definition of a leveraged derivative is one where the value of the derivative does *NOT* change proportionally with the contractual rate or index. For example, multipliers are used to magnify the impact of changes in rates; these multipliers are consistent with the concept of leverage. Transactions where multipliers are not used, or more specifically, where the value of the derivative changes proportionally with the change in the underlying rate or index, are not considered leveraged transactions.
- b. **Weighted Average Life:** The term weighted average life in §703.101(x) should be restated as "weighted average maturity." The term "weighted average life" is normally used to provide an average measure of the expected timing of principal cash flows either paid or received. As swaps do not involve the exchange of principal cash flows, per se, we suggest NCUA amend its terminology to reflect "weighted average maturity" to eliminate any possible confusion amongst fixed income practitioners. We also suggest any limits proposed clearly state that such measures apply to the remaining time to maturity, and not to the original time to maturity. Finally, should certain types of amortizing swaps be added to the list of permissible instruments, we suggest the calculation of weighted average maturity for these instruments reflect a series of maturities based upon their expected amortization.

2. §703.102 – Permissible Derivatives Transactions

We support the use of interest rate swaps and caps for managing interest rate risk; however, we recommend NCUA expand the scope of authorized instruments to include transactions that allow Natural Person Credit Unions (NPCUs) to better manage different types of risk and to better manage risk in different rate environments.

- a. **Interest Rate Floors:** We recommend NCUA allow NPCUs to purchase interest rate floors. NCUA has stated an effective derivative risk management program will help NPCUs better

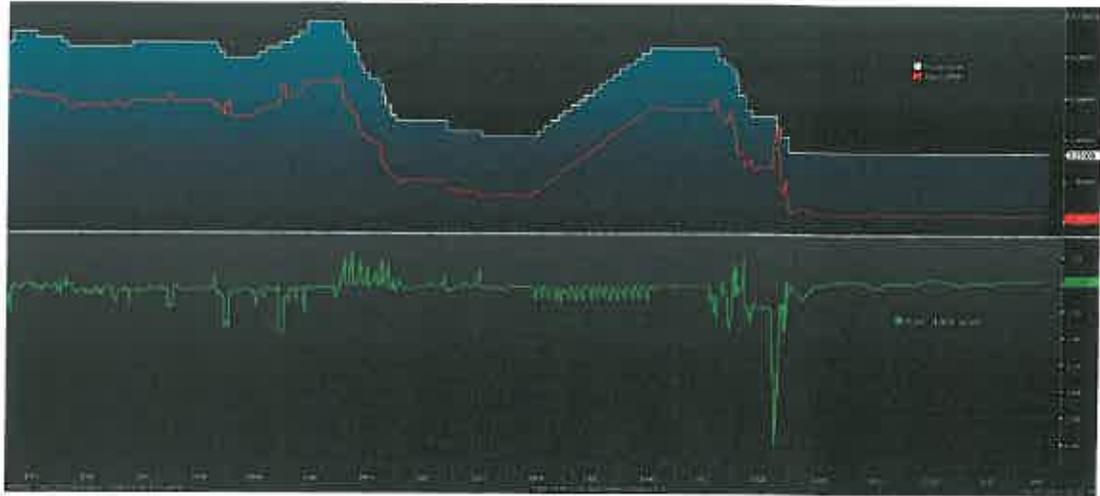
manage the risks from changing interest rates. The tools NCUA has proposed are effective for managing rising interest rates; however, they do not provide NPCUs all the tools necessary to manage risk across a variety of interest rate environments. As history has shown, interest rates rise and fall with the various economic cycles; as such, NPCUs are exposed to changes in interest rates in either direction. While the current rate environment suggests rates are likely to increase, NCUA's regulations should envision a market where the Federal Reserve's influence is muted and the level of interest rates more freely fluctuates around whatever future mean the market determines. In other words, we expect symmetry will return to the risk of rising *and* falling rates. NPCUs need the ability to purchase interest rate floors to protect themselves from falling rates. The risks of purchased floors are effectively the same as purchased caps. We recommend NCUA alter the language of §703.102 by substituting "... a credit union may only purchase interest rate caps..." with "... a credit union may only purchase interest rate options...". Changing the wording from "caps" to "options" will allow NPCUs the flexibility to purchase either caps or floors.

- b. Basis Swaps:** We recommend NCUA allow NPCUs to use basis swaps. These types of swaps are low risk transactions that help NPCUs manage the mismatch between different floating rates (e.g., Prime vs. LIBOR, or, 1 month LIBOR vs. 3 month LIBOR). The types of interest rate swaps NCUA has proposed already allow NPCUs to synthetically create a basis swap; however, this process is less efficient and more costly than allowing NPCUs to use a basis swap. Since NPCUs can structure interest rate swaps to replicate a basis swap, we recommend NCUA add basis swaps to the list of authorized transactions so NPCUs can use them in a more cost effective manner.

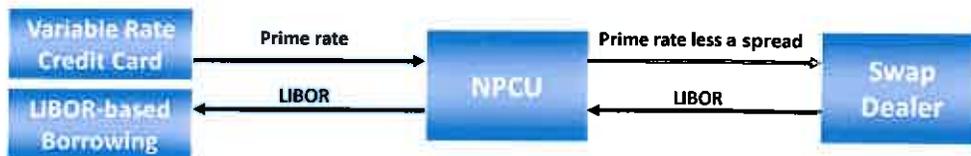
Basis risk typically arises from floating rate assets based on one index and floating rate liabilities based on a different index. For most NPCUs this risk manifests itself in the variable rate credit card portfolio. Typically, variable rate credit cards are indexed to the Prime rate. In other words, the rate earned by NPCUs will fluctuate when the Prime rate changes. Conversely, most NPCUs have liabilities that are tied to LIBOR; typically, FHLB advances and other forms of LIBOR-based borrowing.¹ Simply put, basis risk is the risk that changes in LIBOR are not reflected in the Prime rate. For example, LIBOR may increase 50bp but the Prime rate remains unchanged. In this example, a NPCU's Net Interest Margin (NIM) is compressed because the cost of its liabilities has increased 50bp but its income remains constant because the Prime rate has not changed. The chart below shows the Prime / 1 Month LIBOR basis over time. The upper panel shows the rates and the lower panel shows the change in the basis between the two indices.

¹ Examples of LIBOR-based borrowing include other forms of capital markets funding (e.g., repos) and deposits which are explicitly indexed to LIBOR (e.g., money market deposits). Alternatively, while it is possible to use basis swaps to offset the risk of traditional deposit products (e.g., core deposits and certificates), it is more complicated to use basis swaps in this fashion. Our comments are limited to liabilities that are explicitly tied to LIBOR.

Prime/LIBOR Basis: 1995 - 2013



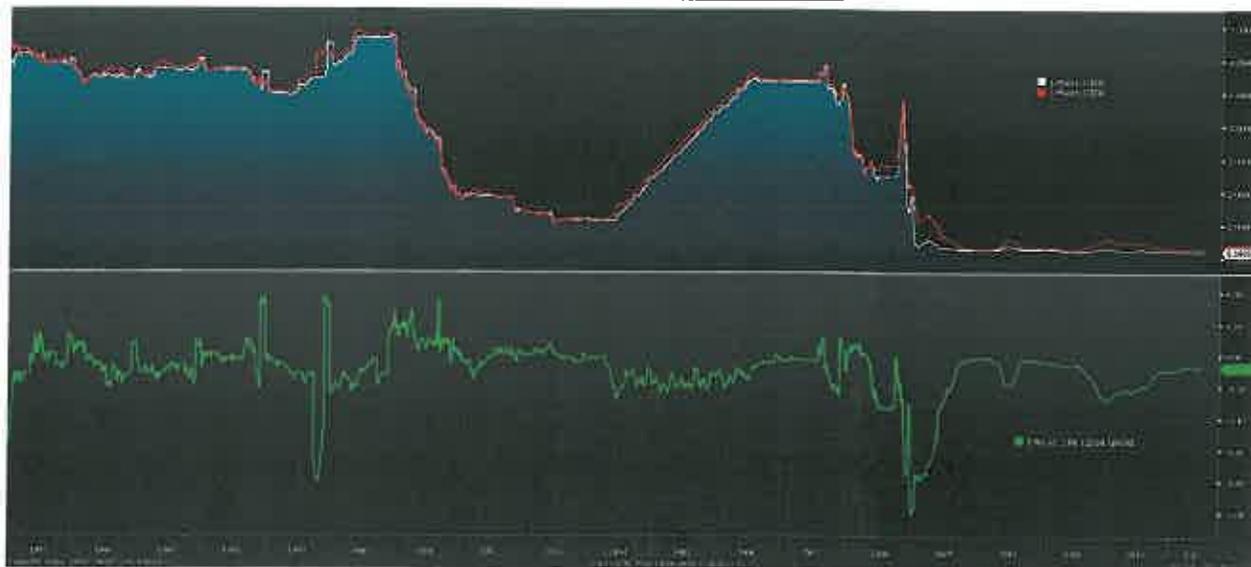
A basis swap is the perfect tool to hedge this risk. Recall: the NPCU receives interest income based on the Prime rate and pays interest expense based on LIBOR. Assuming the NPCU wanted to hedge this risk, the NPCU would enter into a basis swap where it paid the Prime rate less a fixed spread and received LIBOR (see diagram below).



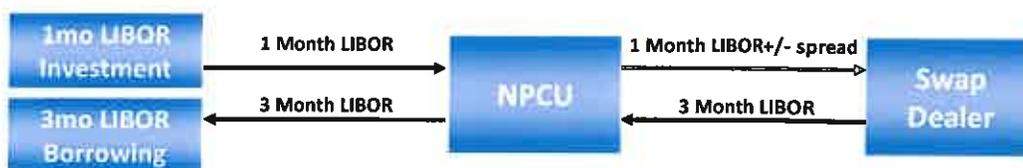
As the diagram illustrates the NPCU locks in a spread and is insulated from changes in the relationship between Prime and LIBOR. As LIBOR fluctuates, the receipts from the swap mirror the changes in interest expense; conversely, changes in Prime based income are matched by changes in the payable side of the swap. This strategy is a highly common risk mitigation tool used by financial institutions that are concerned with their exposure to different indices. When used properly, these are low risk transactions that can provide meaningful risk reduction in a manner unachievable today.

Another useful type of basis swap is one with the same index but different tenors. For example; consider a swap where one party receives 3 month LIBOR and the other party pays 1 month LIBOR. This type of swap is useful when there is a mismatch between the tenors of the floating rates. For example; a NPCU may have an asset that reprices based on 1 month LIBOR (e.g., an investment security) but it is funded with a 3 month variable rate borrowing (e.g., FHLB advance). This NPCU is exposed to changes in the shape of the yield curve (e.g., the 1 month rate does not move in tandem with the 3 month rate). The chart below shows how the basis between 1 moth and 3 month LIBOR has changed over time.

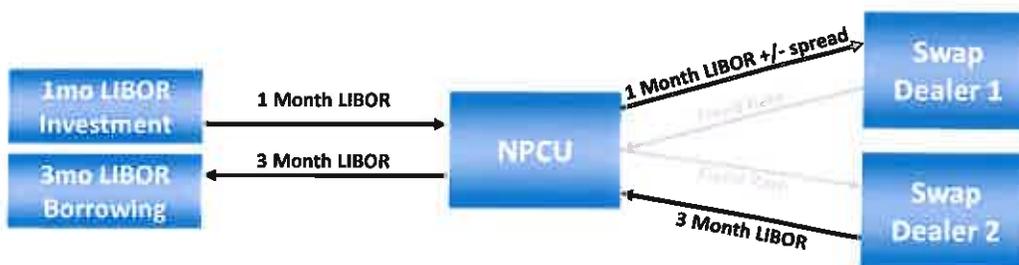
1 vs. 3 month LIBOR Basis: 1995 - 2013



To hedge this risk, the NPCU would enter into a basis swap where it paid 1 month LIBOR plus or minus a spread and received 3 month LIBOR. See diagram below.



This transaction neutralizes the risk that rates do not move in tandem. In §703.101 Definitions, NCUA has limited swaps to those that are fixed to floating or floating to fixed. Floating to floating interest rate swaps are not expressly authorized. We recommend NCUA authorize these types of swaps because they can be easily replicated with the standard pay/receive fixed swaps proposed by NCUA. For example, to hedge the risk described above, a NPCU would enter into one swap where it receives fixed and pays 1 month LIBOR +/- a spread, and, it would also enter into a swap where it pays fixed and receives 3 month LIBOR (see diagram below).



Since the fixed rate legs of the two swaps offset each other, the NPCU has structured the desired basis risk hedge. This type of structure could also be used to replicate the Prime/LIBOR basis hedge described above. Hedging in this manner is inefficient because it results in additional transaction costs (i.e., bid/offer, initial margin for those institutions clearing, etc.), and, it utilizes more of a NPCU's derivative limit than is necessary. Rather than requiring NPCU's to structure, and bear the cost of, two transactions; we recommend NCUA explicitly allow these types of basis swaps.

- c. **Forward Starting Swaps:** §703.102(f) states interest rate swaps must settle within three business days of entering into the transaction. This is consistent with market convention which is to settle transactions within two days.

It appears some of the early responses to NCUA's NPRM have interpreted NCUA's language as a prohibition against forward starting swaps. Market convention dictates there is a difference between the start date and the settlement date of a swap. Typically, the settlement date of a swap refers to the date when the trade is effective, which determines the subsequent dates on which periodic cash payments are made. The start date of the swap typically refers to the day interest begins to accrue. For most swaps, the settlement date and start date are the same date. In the case of forward starting swaps, the settlement date precedes the starting date. For example, a swap traded on September 1st would typically "settle" on September 3rd. Under most circumstances interest would begin to accrue on September 3rd; however, in certain cases swap counterparties may delay the start of interest accruals to some point in the future (i.e., a forward starting swap). Delaying the start of interest accruals allows swap counterparties to lock in forward rates but not begin the accrual and payment of interest until some period in the future. For example, two counterparties enter into an agreement on September 1st and the transaction settles on September 3rd, but, interest begins to accrue on December 3rd. In this case, the start date of the swap is 3 months from the settlement date. It is important to note that although the accrual of interest does not begin at settlement, the fixed rate to be paid is known and established at the time of execution; a key difference between forward starting and forward settling transactions. NCUA's language expressly refers to the settlement date of the transaction, not the start date of interest accruals. We believe NCUA's intention is to ensure derivatives are settled in a timely manner, and, to limit financial risk taking and ensure proper accounting.

We do not believe it was NCUA's intent to limit NPCUs from executing forward starting swaps because a forward starting swap can be easily replicated with standard fixed/floating swaps. For example, a NPCU may want to enter into a forward starting swap with the following parameters: a 5 year swap paying a fixed rate but interest accruals do not begin until one year from today. The NPCU can easily enter in a 6 year swap paying a fixed rate and receiving LIBOR. The NPCU would then enter into an offsetting 1 year swap receiving a fixed rate and paying LIBOR. Effectively, the economics of this transaction are akin to a 5 year swap with a one year forward starting date. We recommend NCUA clarify its language to allow NPCU to enter into forward

starting transactions provided the transactions settle within three business days. If, however, it was NCUA's intent to prohibit forward starting swaps, we recommend NCUA reconsider its position. Similar to basis swaps, NPCUs can achieve the same risk mitigation strategies by executing offsetting legs of different fix/floating swaps; however, this would increase the cost and administrative burden of having multiple transactions when a single transaction could have been executed. It would also consume two times a NPCU's limit capacity assuming the limit framework does not allow the netting of offsetting positions.

- d. **Expanded Authorities:** We recommend NCUA provide expanded authorities (e.g., Level II+) to select institutions that have demonstrated an ability to effectively manage derivatives. By establishing a two-tier system, NCUA recognizes different institutions have different risk mitigation needs. NCUA also recognizes institutions with more complex risk management needs must also make additional investments in personnel, systems and controls to manage these risks effectively. We believe the two-tier approach strikes the correct balance between granting NPCUs the flexibility to use these instruments to manage their risk, and, ensuring these activities are conducted in a safe and sound manner.

As currently structured, the differences between Level I and Level II authority primarily focus on the degree to which NPCUs can use the same types of instruments (e.g., different limits). We fully understand why NCUA has chosen to limit the initial derivatives regulation to the basic transactions of plain-vanilla interest rate swaps and purchased caps. However, most financial institutions (e.g., small community banks to large commercial banks) have access to the full suite of derivative products to manage their risk. The ability to use these instruments can materially enhance the risk mitigation efforts of NPCUs. In some cases, these instruments are more cost effective than plain-vanilla instruments, and in other cases, they are materially more effective at neutralizing risk. Either way, limiting access to these instruments can put NPCUs at a disadvantage.

To balance the needs of maintaining safety and soundness with the desire to provide NPCUs a broader suite of risk mitigation tools, we recommend NCUA establish criteria to provide select NPCUs with the authority to make broader use of the tools commonly available to other financial institutions. Specifically, we propose NCUA consider establishing a process by which select Level II institutions can apply for expanded authorities (e.g., Level II+). This process allows NCUA to evaluate, on a case by case basis, whether a particular NPCU has the ability to effectively manage the risks of the instruments covered by the expanded authority; and, it also recognizes not all NPCUs have the same risk mitigation needs. We recommend NCUA create a set of expanded authorities which includes the following risk mitigation tools:

- i. **Amortizing Swaps:** NCUA is prohibiting interest rates swaps that have "fluctuating notional amounts". We assume NCUA is referring to swaps where the notional value of the swap is dependent on the outstanding balance of a pool of loans or investments. For example, the notional value of a swap could be tied to the balance of an MBS security or a pool of

mortgage loans to hedge convexity risk. These types of swaps are very different than swaps where the notional value amortizes based on a fixed schedule which is set at the time of execution. The notional value of this type of swap does not “fluctuate” in response to changes in rates; rather it is set at the time of execution and follows a pre-determined amortization schedule. We assume NCUA is referring to the former type of swap, not the latter. With respect to swaps where the notional value truly fluctuates, we recommend NCUA allow NPCUs, under select circumstances, to use these swaps. These instruments are effective tools for hedging the principal uncertainty of indeterminate maturity assets and liabilities (e.g., mortgages and core deposits). We acknowledge these instruments are more complex than traditional plain-vanilla swaps but, when used properly, they provide an enhanced level of interest rate risk mitigation effectiveness over and above the instruments proposed by NCUA. We recommend NCUA make these structures available to those NPCUs that apply, and qualify, for expanded authorities.

- ii. **Swaptions:** We recommend NCUA allow NPCUs to use swaptions. Simply put, a swaption is an option to enter into a swap on a specific date at a predetermined rate.² These instruments are effective tools for managing the convexity risk of holding mortgages on the balance sheet. More specifically, interest rate swaps hedge duration risk but they are not the best tool for managing the negative convexity associated with mortgages. In order to fully manage the risk of mortgages, risk managers must hedge the residual risks of both Vega, the effect of changes in implied volatility, and Gamma, the rate of change of delta (i.e., convexity). If risk managers only focus on duration risk, changes in volatility and/or large changes in interest rates will render their hedges less effective than planned. To fully hedge risk, NPCUs should be allowed to use a combination of instruments such that all types of risk are reduced. Swaptions are an effective tool for managing the residual risks of Vega and Gamma because of their inherent optionality, and the long life of the underlying derivative (e.g., a 10 year swap). Simply put, portfolios that are hedged only with interest rate swaps underperform portfolios that are hedged with swaptions. We believe these instruments are appropriate for select NPCUs because the underlying instruments (e.g., an option and a swap) are already included under permissible investments. As a result, the inherent risks of these transactions are not materially different. Additionally, pricing models are readily available so users of these instruments have the ability to value these instruments and evaluate their effectiveness as part of a NPCU’s overall risk management strategy. Similar to other types of more complex derivatives, these instruments provide significantly more hedge effectiveness but they require an additional investment in personnel, systems and controls. As such, we recommend the ability to use these instruments be limited to only those NPCUs that have demonstrated an ability to manage more complex instruments, and, have the infrastructure necessary to ensure these transactions are conducted in a safe and sound manner.

² This refers to an American style swaption. Other types of swaptions include European and Bermudan style swaptions, but these are less common amongst interest rate risk managers.

- iii. **Futures:** Futures contracts are effective tools for hedging interest rate risk. In many ways, they are more cost effective and carry substantially less credit risk than interest rate swaps. Similar to an interest rate swap, futures allow risk managers to hedge their exposure to changing interest rates. Long and short positions in these contracts allow NPCUs to hedge their exposure to a number of different rate indices (e.g., Treasury rates, LIBOR, etc.). Since futures trade on an exchange, there is greater price transparency which makes daily valuation and mark to market materially more reliable. Additionally, this price transparency can result in more cost effective hedging strategies. Finally, the daily posting of margin materially reduces the credit risk inherent in over-the-counter derivative transactions. While these instruments do not address all of the risks a NPCU needs to manage, they are a valuable compliment to an effective interest rate risk management program. We recommend NCUA make interest rate futures available to those NPCUs that apply, and qualify, for expanded authorities.

- iv. **Sold Options:** NCUA has proposed limiting the use of options to only purchased transactions. The ability to execute sold options is an effective risk management strategy that allows financial institutions to hedge their exposure at a reduced cost. Consider an example where a NPCU's risk profile is such that it will benefit from falling interest rates, but suffer from rising rates. As such, the NPCU wants to purchase a cap to mitigate this risk; however, the cost of the cap is substantial. The NPCU could sell an option were it would incur a loss if rates fell. The premium earned from the sale of the option in this strategy partially offsets the cost of the purchased cap. The NPCU is not concerned about the sold option being exercised if rates fall because the structure of their balance sheet benefits from falling rates which offsets the impact of the option. In this example the NPCU has effectively managed its exposure to rising rates, is still protected from falling rates, and, has done so in a more cost effective manner than simply purchasing the cap. This is a common risk mitigation strategy for financial institutions that use options as part of their risk mitigation efforts. We recommend NCUA make sold options available to those NPCUs that apply, and qualify, for expanded authorities.

3. §703.105 – Collateral Requirements

NCUA's NPRM establishes rules for NPCUs that execute derivatives transactions directly with swap counterparties. The rule is largely silent for those NPCUs that are either required by the Dodd-Frank Act, or voluntarily elect to clear derivative transactions through an exchange (e.g., CME).

- a. **Exchange Traded Transactions:** §703.105 is silent on the requirements for clearing transactions via an exchange. §703.105(a) states a NPCU's collateral arrangements must be supported by a bilateral ISDA Credit Support Annex and comply with all applicable requirements of the Commodity Futures Trading Commission. It is our understanding NCUA intends to allow NPCUs to clear derivatives via an exchange, as such, we recommend NCUA amend the language in §703.105 to expressly authorize NPCUs to clear via an exchange and, more specifically, to

authorize NPCUs to use the processes and agreements necessary to comply with the governing rules of the exchange. The current language focuses on bilateral trading relationships and some of the specific requirements in §703.105 are inconsistent with the requirements and processes for clearing transactions through an exchange.

Currently, the Dodd-Frank Act requires all financial institutions greater than \$10 Billion to clear certain derivatives (e.g., interest rates swaps) via an exchange and execute these transactions through a Swap Execution Facility (effective Fall of 2013). In July, 2012 the Commodity Futures Trading Commission (CFTC) proposed a rule which would exempt “end-users of derivatives” from the clearing requirement. As part of that rule, the CFTC proposed financial cooperatives that execute transactions on behalf of their members would also be exempt from the clearing requirement. The rule was primarily written to exempt the Farm Credit System from the clearing requirement; however, there is some ambiguity regarding whether this exemption also applies to large NPCUs. The CFTC had planned to issue a final rule by June, 2013 but instead it has only issued three No-Action letters. Practically speaking, these letters enable large NPCUs to temporarily execute transactions under the tri-party requirements of the NCUA pilot program even though they are currently required to clear transactions via an exchange.

Although some ambiguity remains regarding large NPCU’s clearing requirements, there are benefits from clearing transactions through an exchange even if not explicitly required to do so by the CFTC. Specifically, the operational and credit risks of traditional derivative ISDA CSA agreements are reduced because the exchange stands as the financial intermediary backing the performance of the derivative transactions. For example, the credit risk associated with the traditional bilateral derivative agreement is mitigated because the CME stands behind the performance of the trade. Clearly, this reduces many of the concerns associated with long-term derivative transactions. Additionally, the concerns about the valuation of collateral are alleviated because the CME is responsible for valuing collateral and executing daily margin calls. In many ways, clearing derivatives via an exchange reduces risk and may make this a preferred means of execution for many NPCUs.

Unfortunately, clearing derivatives via an exchange also requires an investment in systems and personnel in order to monitor and manage the daily variation margin and collateral requirements of the exchange. The decision whether to voluntarily clear via an exchange, or continue to execute under a bilateral arrangement as proposed in the NPRM, is a decision each NPCU will need to make based on their need, resources, and their appetite for credit and operational risks. Since there are material benefits to clearing via an exchange, we recommend NCUA explicitly grant NPCUs the ability to clear via an exchange if they believe it is in their best interest to do so, even if not mandated by the CFTC.

We recommend NCUA establish guidelines for those institutions required to clear derivatives under the Dodd-Frank Act. Since the rules governing the execution, settlement and on-going maintenance of these transactions are established by the CFTC, we recommend NCUA simply

require NPCUs to adhere to the rules established by the CFTC. We also recommend NCUA explicitly allow NPCUs to voluntarily clear derivatives via an exchange.

- b. Bilateral Transactions:** The following comments pertain to transactions that are not executed and cleared via an exchange.
- i. §703.105(b):** Generally, NCUA limits acceptable collateral to securities which would otherwise be considered eligible investments under Part 703. However, §703.105(b) further limits the types of securities NPCUs can accept as collateral. NCUA has proposed limiting eligible collateral to Treasury securities, fixed-rate non-callable agency debentures and zero-coupon non-callable agency debentures because these are highly liquid instruments whose market value is easily verified. We understand NCUA's rationale for selecting securities that are highly liquid and easy to value. We believe Agency MBS Pass-Through bonds also meet the standards set by NCUA. The Agency MBS pass-through market is highly liquid and values for these securities are readily verifiable by a number of sources. These types of securities are not esoteric Private-Label MBS structures which are more thinly traded or more challenging to value; instead Agency MBS pass-throughs are used as eligible collateral by many market participants across a variety of collateralized transactions. In fact, the CME allows MBS securities as eligible collateral when posting variation margin for cleared derivative transactions. We recommend a) NCUA allow Agency MBS pass-through securities as eligible collateral, and b) for institutions that clear via an exchange, NCUA allow NPCUs to use the eligible collateral rules set by the exchange.
- ii. §703.105(d):** NCUA requires derivatives to be fully collateralized up to 100 percent of the transaction. While we understand and support the intent behind this requirement, as written, it contradicts §703.105(g). Under §703.105(g) the minimum transfer amount must be less than or equal to \$250,000. As a result, a NPCU can extend credit to the swap counterparty up to \$250,000 resulting in a portion of the swap's value being uncollateralized. This means the swap will not meet the 100 percent test established in §703.105(d). It should also be noted a NPCU may fall below the daily 100% threshold when the market value of the swap and/or the collateral value is being disputed; something that can easily occur during the normal course of business. We recommend NCUA eliminate paragraph §703.105(d) because the desired controls are already established under §703.105(e) and §703.105(g), which establish the threshold amounts and the minimum transfer amounts, respectively. Eliminating §703.105(d) will remove the contradiction without impacting the controls established by NCUA. Finally, as noted above, we recommend NCUA establish guidelines for those NPCUs that clear transactions via an exchange. Typically, the margin and collateral rules are set by the exchange; as such, we recommend NCUA instruct NPCUs to adhere to the guidelines established by the exchange.

4. §703.107 – Reporting Requirements

NCUA has proposed significant requirements for reporting to the Board of Directors. Specifically, NCUA is proposing monthly reports on the compliance and utilization of limits; an itemization of individual transactions including book and market values; an overview of the NPCU's financial condition including Net Economic Values with and without derivatives; and the cost of executing new derivative transactions. We understand NCUA's desire to ensure the Board of Directors is aware of the program, its risks, and its benefits; however, we request NCUA consider whether monthly is an appropriate frequency for this level of reporting. We believe, for those NPCUs that have already demonstrated a proficiency in managing these instruments, a quarterly review of the derivatives program allows for a more meaningful conversation with the Board of Directors. We recommend NCUA use its tiered approach for the reporting requirements; Level I institutions would be required to report monthly whereas Level II institutions would be held to a quarterly reporting requirement. We believe this recommendation strikes a balance between a NPCU whose Board of Directors has a nascent understanding of derivatives and a NPCU whose Board of Directors is well versed on its derivatives program.

5. §703.108 – Systems, Processes and Personnel Requirements

§703.108(b)(3) requires NPCUs to have an internal controls audit performed at least annually by an external party. We believe NCUA should evaluate whether this is necessary as part of each NPCU's application. Some NPCUs already have extensive internal and external audit processes conducted annually. Requiring these institutions to incur the added expense of a third audit does not appear to provide value to the process. We understand the control and audit functions of each NPCU are different and, in certain cases, this requirement may be appropriate to ensure NPCUs stay abreast of best practices. We believe the value of this audit requirement is best handled on a case by case basis rather than a blanket regulatory requirement. We recommend NCUA remove this as an absolute requirement and, in cases where it believes it is warranted, implement this requirement as part of the application approval process.

6. §703.109/703.110 – Specific Limits and Requirements

As noted above, we support NCUA's two-tier system. NCUA's approach recognizes different institutions have different risk mitigation needs. We believe the two-tier approach strikes the correct balance between granting NPCUs the flexibility to use these instruments to manage their risk, and ensuring these activities are conducted in a safe and sound manner. As noted above, we recommend NCUA provide select Level II institutions with expanded authorities provided they demonstrate the capabilities of managing more complex derivative instruments (e.g., Level II+).

We also understand NCUA's desire to establish a straight-forward, easily understood system of controls for these activities; however, we recommend the proposed limits be revised before a final rule is published.

- a. **§703.109(a)/703.110(a)**: NCUA has proposed limits on interest rate swaps up to 100% of net worth for Level I institutions and 250% of net worth for Level II institutions. Unfortunately, limits based on an institution's net worth ratio create two issues.

First, limits based on net worth do not keep pace with the changing risk profile of the balance sheet. The risk profile of the institution is driven by changes in the mismatch between assets and liabilities. Consider a NPCU with a 7% net worth ratio that has effectively used derivatives to reduce interest rate risk so it is near its net worth based limit. This institution continues to grow its 5 year auto loan portfolio but depositors are only taking out shorter-term CDs. In this example the institution is exposed to rising interest rates. Prudently, the institution wants to execute an interest rate swap to reduce the risk. Unfortunately, it does not have the capacity to use swaps to hedge the risk. Term borrowings are a less attractive hedging tool because they gross up the balance sheet which puts unnecessary pressure on the institution's net worth ratio. Given NCUA's proposed limit structure, this institution is unable to mitigate risk without adversely impacting net worth. This example highlights a key problem with net worth based limits; net worth does not keep pace with the drivers that affect financial risk. Risk is created by changes in assets and liabilities; these changes occur much more rapidly than changes in net worth. As a result, limits based on net worth will always fall short of the capacity needed to manage the drivers of risk; namely the assets and liabilities of the institution. We believe limits based on the asset size of the balance sheet would be more effective. If the limits were based on assets as risk is created, the institution would have the immediate headroom to hedge the risk. In our example, this institution could continue to grow its auto loan portfolio and immediately use derivatives to hedge the financial risk.

Second, net worth limits give the appearance of a sizable derivative position when, in fact, the amount of authority granted can be materially less than what is needed to alter the risk profile of the balance sheet. For example, a \$1 billion Level II NPCU has a net worth ratio of 8%. Based on the NCUA's proposed limit structure, this NPCU would be limited to \$200 million of interest rate swaps (e.g., 250% of \$80mm). In this example, the institution could only hedge 20% of its assets using interest rate swaps. If this institution wanted to materially reduce its risk, it would require substantially more than 20% of its assets to affect a risk reduction strategy. Many sophisticated institutions use derivatives to hedge both assets and liabilities. As a result, these institutions typically have derivative positions greater than their total assets and materially greater than 250% of their net worth. Limits which constrain an institution to 20% of assets hinder the ability to use these instruments effectively.

We acknowledge NCUA does not intend for derivatives to be the sole tool for managing interest rate risk; however, we recommend NCUA grant NPCUs greater latitude in using derivatives. Specifically, we recommend NCUA adopt limits based on asset size rather than net worth, and, NCUA expand the limits to 50% of assets for Level I institutions and 100% of assets for Level II institutions.

Finally, we recommend limits be based on the net of all positions. For example, short positions should be netted against long positions when determining exposures.

- b. §703.109(b)/703.110(b):** NCUA has proposed limits on interest rate caps tied to the aggregate book value. Limits tied to the book value of an option can result in a NPCU exceeding their limit simply because the option has increased in value. For example, if a NPCU purchases an option with a premium of \$1 million it will record this value on its books at the time the transaction is purchased. For simplicity, let's assume this brings the NPCU's exposure up to the 25% limit. Next month, if interest rates move in favor of the NPCU, the book value of the cap has increased to \$2 million³ causing the NPCU to exceed its limit. In essence, the NPCU purchased a cap to protect against rising rates and because the option is functioning as planned, it is now in violation of its regulatory limits.

One solution to this problem, which still maintains the simplicity of the book value approach, is to base the limit on the book value at the time the transaction executed, otherwise known as "at inception." For example, a NPCU has \$100 million in net worth and it buys an option with an initial book value of \$20 million resulting in a position equal to 20% of net worth. The next day rates change and the book value of the option increases to \$30 million. Using the proposed current book value approach the NPCU would be in violation of its 25% limit (i.e., they would have a position equal to 30% of net worth); however, using the inception test, the NPCU would not be in violation of its limit because at the time the transaction was executed, the position equaled 20% of net worth. In other words, even though the current book value exceeds the 25% limit, the NPCU would not be in violation of its limit because its initial value was within its limit. This prevents the NPCU from being penalized because the option has gained value. Obviously, going forward, the NPCU could not execute any more transactions because its current position is 30% of net worth. To operationalize this structure, a NPCU would calculate its position based on the lower of either current book value or book value at the time of inception; this figure would then be compared to the regulatory limit of 25%. An inception based approach still provides a simplistic measure of control but it does not automatically penalize a NPCU for positions that rise in value. Should NCUA establish specific limits based on the book value of the option, we recommend NCUA allow NPCUs to use the inception test to determine if they are in violation of their regulatory limits.

- c. §703.109(c)/703.110(c):** NCUA has proposed limits on interest rate swaps and separate limits for options. Additionally, NCUA has proposed limits on the aggregate of these derivative instruments. We believe NCUA's approach for aggregating the limits to be problematic. Specifically, the limits on interest rate swaps are based on a static notional value while options are based on the book value of the option. As noted above, since the book value of the option is subject to changes in market value, the NPCU's utilization of the limit will change even though the NPCU has not made any changes to their derivative risk position. We believe NCUA should

³ Assumes the decline in book value due to the erosion of time value is more than offset by the increase in the intrinsic value of the option resulting in a write-up of the option's book value.

maintain separate limits for interest rate swaps and options and not co-mingle them. We do not see any benefit from co-mingling these limits.

- d. **§703.109(d)/703.110(d)**: NCUA has proposed limits on the fair value loss of all interest rate swaps. This limit is not consistent with the principles of effective risk management. When an interest rate swap is executed, it is a hedge of a specific balance sheet item (e.g., a loan). Assuming the hedge is executed properly, the change in the market value of the swap should largely offset the change in the market value of the loan. For example, if a NPCU has a fixed-rate loan on their balance sheet funded by a floating rate liability, it could execute a pay-fixed interest rate swap to convert the fixed rate loan into a variable rate asset which offsets the risk of the variable rate funding. Assuming the hedges are effective, over time as interest rates change, the market value of the loan and the swap will change proportionally. For example, if interest rates rise, the market value of the fixed rate loan would drop (i.e., because the institution is receiving a below market rate); conversely, the market value of the swap would increase (i.e., because the institution is paying a below market rate). Simply put, the hedge is effective. The opposite holds true if rates fall. The market value of the loan would increase while the market value of the derivative would decline. In this example, although the swap has a fair value loss, it remains an effective hedge. The institution has not experienced a net loss because there is an offsetting gain related to the asset being hedged. This dynamic can also be seen in the institution's Net Interest Margin which would remain unchanged. Isolating the fair value loss on the derivative ignores both the offsetting gain on the asset, and, the NIM benefit from the hedge. From a market risk perspective, the NPCU remains hedged with a constant NIM despite the fair value loss on the derivative; the derivative worked exactly as planned.

Consider an alternate scenario: a NPCU wants to hedge its MBS portfolio. To hedge the risk it executes a 10 year fixed-rate borrowing. There is no difference between this scenario and one in which the institution uses a 10 year swap to hedge the risk. If interest rates decline, the market value of the borrowing will experience the same fair value loss as the swap. In other words, the institution would be in the same place regardless of whether it used a derivative or some other form of hedge. Establishing a limit that singles out the market value loss of one type of hedging instrument is not consistent with the concept of hedging. NCUA rightfully has not established limits on the market value loss of assets or liabilities; there is no reasonable justification for establishing a limit based solely on the market value loss of derivatives.

Consider a more draconian scenario where a NPCU executes a hedge against its MBS portfolio and disruptions in the mortgage market render the MBS securities worthless at the same time interest rates have fallen (e.g., a scenario similar to 2008). Under this scenario, the institution will likely experience a net loss because the market value of the hedge is negative at the same time the asset has lost value. Even under this draconian scenario, it is important to note the loss experienced from the derivative contract is not because the NPCU used a derivative; it is because the assets being hedged were no longer viable (e.g., credit risk). The net result would have been the same had the NPCU used a different type of hedge (e.g., borrowing or deposit).

Finally, should NCUA move forward with a fair value loss limit, we do not believe NCUA should require automatic suspension of derivative activity because the fair value loss of the derivative portfolio reaches the limit. For the reasons noted above, derivative losses can be expected in an effective risk management program. Instead, we recommend NCUA reclassify the fair value loss amount from a limit requiring prescriptive action to a trigger that requires communication with NCUA. The NPCU should consult with NCUA to demonstrate why its derivatives remain effective hedges but derivatives activity should be allowed to continue while these conversations with NCUA are progressing so the NPCU can continue to manage its financial risk.

- e. **§703.109(e)/703.110(e)**: NCUA has proposed limits on the maximum weighted average life (a.k.a. maturity) of all derivatives in the portfolio and limits on the maturity of any single transaction. Proposed Level I limits are a weighted average maximum of 5 years with no single transaction exceeding 7 years, and Level II limits are a weighted average maximum of 7 years with no single transaction exceeding 10 years.

While these limits are sufficient to hedge short-term assets (e.g., auto loans), they are not sufficient to hedge the risks of long-lived assets, in particular, mortgages. The weighted average life of a 30 year fixed rate mortgage ranges from 7 to 10 years. Additionally, there is significant risk in the tail portion of the mortgage which extends into the 15 to 20 year range. As such, NPCUs that retain mortgages on their balance sheet need the flexibility to execute hedges well beyond the currently proposed limits.

Executing longer-term derivatives allows NPCUs to effectively hedge interest rate risk at different points on the curve. Without the ability to execute these longer-term hedges, NPCUs will need to “delta hedge” their portfolios to mitigate the market value risk of holding mortgages on the balance sheet. Delta hedging is a process by which incrementally more short-term hedges are used to hedge a longer-term position. The goal is to construct a hedge such that the change in the market value of the short-term hedge offsets the change in the market value of the longer-term asset. By restricting the weighted average maturity of the derivatives portfolio, NCUA would cause NPCUs to execute more swaps than would otherwise be necessary to achieve the same risk mitigating effect. Additionally, delta hedging increases a NPCU’s curve risk. In other words, delta hedges would be constructed along fewer points along the curve (i.e., less than 7 years). If the NPCU had the ability to hedge further out on the curve, it would be able to construct a hedge that included the 10 to 15 year points on the curve. As the shape of the curve changes, shorter-term delta hedges are at greater risk than hedges more evenly spread across the curve. More specifically, delta hedges are not as effective because the change in the value attributable to the part of the curve they hedge does not directly correlate to the change in the value of the part of the curve that more directly impacts the market value of the item being hedged. Simply put, delta hedging is less effective than hedging across the entire curve. NCUA’s limit structure will inadvertently increase a NPCU’s exposure to this risk.

Considering the importance of hedging across the entire curve, we recommend NCUA amend its proposed limits to eliminate the weighted average maximum maturity limit. Eliminating this limit will allow NPCUs to execute a higher percentage of longer-term transactions so they can better match their hedges with their risk along different parts of the yield curve.

While other types of financial institutions are not subject to maturity limits, we recognize NCUA's desire to establish maturity limits to control this activity during its initial stages. As noted above, we support NCUA's tiered limit system; as such, we recommend NCUA adopt the following single transaction position limits:

Type	Single Position Limit
Level I	7 years
Level II	10 years
Level II (with expanded authorities)	15 years

We believe these limits strike a balance between NPCU's need to use these instruments for effective risk management, and NCUA's dual desire to control the risks of this activity and ensuring NPCUs use instruments that are appropriate for the risks on their balance sheet. We believe institutions comfortable with Level I authority are not likely to have a material exposure to long-term assets; hence, a maximum maturity of 7 years is sufficient to hedge the risk of assets typically found on these credit union balance sheets (e.g., auto loans). Institutions requiring Level II authority will clearly have a need for hedging longer-term assets. Allowing Level II institutions to hedge to 10 years provides sufficient flexibility to hedge a sizable portion of their risk. Finally, consistent with our recommendations regarding permissible instruments, we recommend NCUA establish an expanded authority category where select NPCUs can apply for longer maturity limits up to 15 years. These expanded authorities allow NCUA to evaluate the business need for the additional authority as well as the individual NPCU's ability to effectively manage these longer dated transactions.

7. Application / Exam Fees

We are opposed to application and/or exam fees pertaining to any isolated activity for NPCUs, derivative or otherwise. We believe establishing activity based fees will set a poor regulatory precedent, and, is inconsistent with the practices of other regulatory agencies.

The ability to use derivatives is commonplace within the banking industry and is a staple of sound risk management. In our view, providing NPCUs with the ability to execute these transactions would allow them to mitigate risk using well-established tools already available to other financial institutions.

Allowing NPCUs to use these instruments would also "de-risk" the balance sheets of these institutions which would have a direct benefit to all NPCUs.

Finally, for those NPCUs that consider participating in the program, the proposed costs will negatively impact the financial benefit, and will likely discourage institutions from participating in an activity that can reduce financial risk.