NASCUS
National Association of State Credit Union Supervisors

July 26, 2013

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

Re: NASCUS Comments on Proposed Rule on Derivatives

Dear Ms. Rupp:

The National Association of State Credit Union Supervisors (NASCUS)[1] submits the following comments in response to NCUA's proposed changes to NCUA Rules and Regulations, Parts 703, 715, and 741, Derivatives. NCUA's proposed rule would grant a new authority to federal credit unions to engage in certain limited derivatives transactions. With respect to federally insured state-chartered credit unions (FISCUs), the proposed rule would grant no new authority. Rather, the proposed rule would limit the ability of states to allow FISCUs to engage in derivatives transactions. In general, NASCUS' comments are confined to the application of the proposed rule to FISCUs and its effect on the state regulatory system. NCUA's proposed rule also raises several provocative, and timely, questions regarding the nature of the cooperative system and the allocation of the costs of risk. NASCUS submits several thoughts on those matters as well.

Derivatives transactions are as varied as they can be complex. NASCUS agrees with NCUA that credit unions engaging in derivatives transactions should have appropriate experience, policies, procedures, controls, and oversight in place to manage the activities. However, well managed derivatives activities can significantly mitigate interest rate risk on a credit union's balance sheet, and reduce risk to the insurance fund. NASCUS is confident that state examiners remain capable of supervising a wide range of derivatives activities in FISCUs. As discussed in more detail below, many of the state credit union regulatory agencies have experience supervising derivatives activities at the state level in state credit unions, and substantially more experience supervising the activity in state banks. That state experience, coupled with the historic independence of states to determine appropriate investments for state-chartered credit unions, should mean that NCUA make a compelling case for such sweeping preemption. This the agency has not done.

[1] NASCUS is the professional association of the nation's state credit union regulatory agencies.

Preemption of State Authority is Unjustified and Unnecessary

As noted in the introduction to our comments, NCUA's proposed derivatives rule is intended to grant a new power for federal credit unions to assist some of those institutions in managing their interest rate risk. However, for FISCUs, NCUA is limiting their ability to manage interest rate risk by engaging in derivatives activity. In the preamble to the proposed rule, NCUA justifies preempting state authority to regulate derivatives by stating, "In the area of derivatives, the Board recognizes the risks inherent in these instruments and that ***the unregulated use of derivatives*** poses significant risk to the NCUSIF." See 78 Fed. Reg. 32194 (May 29, 2013). [emphasis added].

NASCUS is unaware of any FISCUs engaged in the unregulated use of derivatives and NCUA provides no support for the contention that there are. In fact, as NCUA is aware, most states currently do not authorize derivatives transactions for their FISCUs. In the states that currently allow derivatives transactions for their FISCUs, the activity is supervised by the state regulator. In either event, the activity would be regulated and supervised. Those states that do not currently allow the transactions could presumably invoke their state parity statutes once NCUA authorized the activity for federal credit unions. In that case the activity would be regulated in an identical manner as NCUA's proposal. In those states that independently allow the activity, it is regulated and supervised by the state. Preemption of state laws is unnecessary. Furthermore, preemption of state derivatives authority for credit unions would run contrary to practice on the state banking side. In fact, Congress has expressly considered state regulation of bank derivatives authority, and left state regulation in place.

Section 611 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") addressed state bank regulation of derivatives. In considering the issue, Congress specifically allowed state regulation of bank derivatives activity to continue conditioned only on the state's lending-limit law taking credit exposure to derivatives transactions into consideration.[2] As a result, many state bank regulators either certified their regulations compliant or promulgated new regulations.[3] NCUA's preemption of existing state derivatives authority would be a substantial break from the common practice among state and federal regulators with respect to derivatives with little offered to support the need for such a drastic measure.

We note that many of state credit union regulatory agencies are combined agencies with responsibilities beyond credit union regulation. In addition to credit unions, many of our state regulators supervise banks, trust companies, securities, money transmitters, mortgage brokers and other financial service providers. State regulatory agencies that supervise credit unions also supervise assets in other financial services entities that taken together are more than twice the

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[2] 111 Pub. L. 203, sec. 611; 12 U.S.C. § 1828(y).

[3] *See, e.g.,* Maryland Commissioner of Financial Regulation: Declaratory Ruling, "Wildcard Lending Limit," Jan. 16, 2013; or "Derivative Transactions in Lending Limits," State of Rhode Island Department of Business Regulation, *available at* http://sos.ri.gov/documents/archives/regdocs/released/pdf/DBR/7145.pdf; or Maine Department of Professional and Financial Regulation, "Loans to One Borrower Limitations," 02.029 CMR Ch. 128 *available at http://www.maine.gov/sos/cec/rules/02/chaps02.htm.*

asset size of the entire federally insured credit union system. Those state regulators that allow their FISCUs to engage in derivatives transactions are confident of their ability to regulate the activity, and in many cases may have far more experience than NCUA in this regard.

There is simply no compelling reason to preempt state law. NCUA, under current rules, may treat state derivatives authority that do not conform in risk mitigation with what is proposed here as a non-conforming investment and require a reserve. This approach makes more sense than preempting state laws without any demonstration that they have posed, or currently pose, a material risk to the insurance fund. NASCUS also notes that there will always be time in the future to revisit these issues should concern arise among state and federal regulators about state specific derivatives authority. This would allow for a more informed discussion of the issues based on accumulated data specific to FISCUs rather than supposition.

<u>Limited Comment Period for FISCUs</u>

NCUA states in the preamble to the proposed rule that it considered the feedback received from public comments submitted to prior Advanced Notice of Proposed Rulemakings (ANPRs) published on this subject.[4] It must be noted that the most recent ANPR published in February 2012, at no point indicates NCUA's intentions to extend the rulemaking to FISCUs. While federal credit unions and their interests have had extended opportunities to submit comments to NCUA on the principles involved in regulating derivatives, FISCUs and the state system have had a substantially more limited opportunity. NCUA should have communicated its intention to break with the historic precedent of deference to state law in natural person credit union investments in the February 2012 ANPR. Had it done so, the agency might have benefitted from a more complete discussion of the preemption issues before now.

At a minimum, if NCUA proceeds with final rulemaking, those final rules should be limited to federal credit unions. Preemption of state authority in this regard is deserving of a more focused and robust discussion that would come from separate rulemaking.

<u>NCUA Should Clarify the Extent of Preemption Intended by the Proposed Rule</u>

The extent to which NCUA intended to limit state authority under the proposed rule is unclear. The question is whether NCUA intended to preempt all state authority with respect to derivatives powers or, in the alternative, intended to preempt only state swap or cap authority but not other derivatives related powers. The confusion arises because of NCUA's resistance to providing FISCUs their own section of NCUA's Rules and Regulations for share insurance rules. While we address the need for NCUA to incorporate share insurance rules into Part 741 in their entirety below, we raise here the conflict between the preamble accompanying the proposed rule and the actual wording of the rule as proposed by NCUA.

The preamble to the proposed rule implies that the purpose of the rule with respect to all FICUs is to limit derivatives activity to that which the rule would allow for federal credit unions: simple swaps and caps. For example, subsection C of the preamble states the rule applies to all FISCUs without distinguishing parts of the rule that might be federal credit union specific. Subsection E

[4] 78 Fed. Reg. 32194, 32195 (May 29, 2013).

of the preamble reads in part, "As stated above, this proposed rule limits permissible derivatives transactions for both Level I and Level II to interest rate caps and interest rate swaps."[5] However, the proposed text of the rule, for FISCUs, is controlled by proposed Part 741.219. This is the provision which applies the new derivatives rule to FISCUs, and it reads:

> § 741.219 Investment requirements.
> (a) Any credit union which is insured pursuant to Title II of the Act must adhere to the requirements stated in part 703 of this chapter concerning transacting business with corporate credit unions.
> (b) Derivatives. Any credit union which is insured pursuant to Title II of the Act and permitted by its state law to engage in derivatives must follow the requirements of subpart B of part 703 of this chapter.

New Subpart B of Part 703 contains the proposed requirements for conducting swap and cap transactions; however, in no place does Subpart B prohibit engaging in other derivatives transactions. That prohibition is found in proposed Part 703.14, but this provision does not apply to FISCUs.[6] There is no reference to Part 703.14 in Part 741. Because the proposed rule would only add a reference to subpart B in the FISCU's part 741, NCUA has not actually prohibited OTHER derivatives activity for FISCUs, it has only limited what FISCUs may do with respect to swaps and caps. Of course, we do not believe the proposed rule should preempt state law in whole, or in part, but do think it is important that NCUA clarify its intent.

<u>The Proposed Eligibility Requirements Raise Questions</u>

NASCUS agrees that FISCUs seeking derivatives authority must have sufficient expertise to safely manage the program. This view is consistent with our expectations for credit unions engaged in any activity. However, several of the eligibility requirements as proposed seem far to stringent.

- The $250 Million Asset Threshold

NASCUS opposes the setting of an asset threshold as an eligibility requirement. Given that the proposed rule establishes numerous detailed requirements for a credit union seeking to exercise this authority, the asset threshold seems arbitrary. Once regulators have set their expectations for

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[5] Ibid.

[6] 78 Fed. Reg. 32194, 32195 (May 29, 2013). It reads:
§ 703.14 Permissible investments.
* * * * *
(k) Derivatives. A federal credit union may only enter into in the following derivatives transactions:
(1) Any derivatives permitted under § 701.21(i) of this chapter, § 703.14(g), or subpart B of this part;
(2) Embedded options not required under generally accepted accounting principles (GAAP) adopted in the United States to be accounted for separately from the host contract; and
(3) Interest rate lock commitments or forward sales commitments made in connection with a loan originated by a federal credit union.

management of a program, any credit union able to meet those expectations should be allowed to engage in the activity.

The asset threshold is hard to defend as a practical manner. NASCUS doubts that the sophistication difference between the average $240 million asset credit union and the $251 million asset credit union is sufficient to provide the latter a tool to manage its balance sheet that is denied the former. We also note that NCUA's interest rate risk rule, which served as the basis for allowing derivatives transactions, applies to credit unions below the proposed asset threshold.

- Experience Requirements

Requiring credit unions engaged in certain activities to have staff with enumerated experience is not a new concept. For example, at the state and federal level, FISCUs may be required to employ someone with 2-5 years minimum member business lending experience. However, what NCUA proposes here is of an altogether different scope. Under the proposed rule, nearly all of the credit union executive employees and board would be required to have derivatives expertise. This would be in addition to the stringent requirements for the numerous employees the rule requires for segregation of duties. It is unclear how credit unions, other than those already engaged in the activity under state law, would possibly meet these requirements in a realistic manner.

NCUA's proposed rule also extends beyond the credit union's employees. Proposed §703.108(b)(5) would require the credit union obtain a legal opinion from counsel with at least five years experience in derivatives transactions. While NCUA states that the opinion may come from in-house counsel, in practical terms it will require credit unions to seek outside counsel. NCUA's rule is devoid of any discussion as to how the five year experience requirement was determined. Given that all licensed attorneys are governed by Bar Associations that require competency in the matter for which the attorney has been retained, NCUA's requirement is unnecessary.[7]

We understand that NCUA seeks to create an enforceable obligation on the part of the credit union rather than rely on the discipline of the state Bar. This could be accomplished with a simple requirement that credit union obtain an opinion from an attorney qualified to act in matters involving complex derivatives.

[7] For example, the rules for an attorney practicing in the District of Columbia require:

> [1] In determining whether a lawyer employs the requisite knowledge and skill in a particular matter, relevant factors include the relative complexity and specialized nature of the matter, the lawyer's general experience, the lawyer's training and experience in the field in question, the preparation and study the lawyer is able to give the matter, and whether it is feasible to refer the matter to, or associate or consult with, a lawyer of established competence in the field in question. In many instances, the required proficiency is that of a general practitioner. Expertise in a particular field of law may be required in some circumstances. Comment [1] Rule 1.1 Competency.

The Application Process as Proposed Would Discourage Participation

The proposed rule would require a FISCU seeking "Level I" derivatives authority to submit a detailed application to its state regulator. The application must demonstrate how the credit union intends to use derivatives as one aspect of its overall interest rate risk mitigation strategy. The credit union must also demonstrate how it plans to meet the eligibility requirements with respect to internal policies, procedures, processes, and employee experience and expertise. FISCUs seeking "Level II" authority must demonstrate that the eligibility requirements are already satisfied. In addition, NCUA suggests in the proposed rule that it might charge an application fee ranging from $25 thousand to $125 thousand. If the state regulator approves the FISCU application for derivatives authority, the application is then reviewed by NCUA for approval.

- Application Fees

NASCUS opposes NCUA charging FISCUs an application fee to exercise derivatives authority. Such a fee would undoubtedly disadvantage the smaller eligible credit unions. In addition, the eligibility requirements themselves already ensure that managing a derivatives program at a FISCU will be an expensive undertaking.

The proposed fee also troubles NASCUS as a matter of precedent. In its proposed rule, NCUA cites the supervisory expense of regulating derivatives and states that the cost might best be borne by those credit unions exercising the authority rather than the system as a whole.[8] Such a practice seems antithetical to the cooperative nature of the credit union system in general, and of the share insurance fund in particular. Furthermore, NCUA's proposal lacks any discussion of what distinguishes derivatives from other credit union activities that present risk to the insurance fund and increase the cost of supervision.

NASCUS also questions why NCUA's fee would be the same for FISCUs and federal credit unions. Given that a FISCU's application would be processed by the state regulator and that the state regulator would remain the primary regulator, it would seem NCUA's "cost" of administering a derivatives programs for FISCUs would be lower than for that of federal credit unions.

The issue of allocating the "cost" of the risk is presented as a question of the equity of smaller credit unions bearing the cost of the risk, and supervision, of larger credit unions. However, in many respects, the larger credit unions, including those that might exercise derivatives authority, already fund the majority of NCUA's operations and those of the insurance fund. In the case of large FISCUs, this is especially so given that the Overhead Transfer from the insurance fund defers many of NCUA' safety and soundness expenses related to all federal credit unions and yet still pay the full cost of their own safety and soundness state examinations as well.

- Timeframes for NCUA Review of Applications

The proposed rule establishes specific timeframes for NCUA's review of a FISCU's derivatives application after that application has been approved by the state regulator. While we commend

[8] 78 Fed. Reg. 32204 (May 29, 2013).

NCUA for establishing time certain for a FISCU to expect a response, we question whether the timeframes for FISCUs are too long. As proposed, NCUA's timeframes for review a federal credit union application and a FISCU application are the same. Because a FISCU submits its application first to its state regulator, it is more than likely that a FISCU will have a longer time horizon for review of their application than their federal counterpart. Furthermore, NASCUS notes that the FISCU's application is reviewed by the state regulator before coming to NCUA. That should reduce the amount of time needed by NCUA to review the application. From NCUA's perspective, the application of a FISCU has been pre-screened by the state regulator.

<u>The CAMEL Rating Component of Eligibility for a FISCU Should be the State Rating</u>

Proposed §703.103 states that eligibility is contingent on a FISCU's most recent CAMEL ratings from NCUA. This provision disregards the primary role of the state regulator in supervising the FISCU. The state regulator is in the best position to evaluate the suitability of the FISCU for engaging in derivatives. Furthermore, because the CAMEL requirement is only a basic eligibility requirement and not a guarantee of regulatory approval to engage in the transactions, it is unclear how respecting the state CAMEL code increases potential risk the insurance fund.

<u>NCUA Should Incorporate Provisions Applying to FISCUs in Part 741 in their Entirety</u>

Once again we note that NCUA has chosen in proposed rulemaking to apply the rule to FISCUs by incorporating a reference in Part 741 rather than by incorporating the rule in its entirety in the section of NCUA's rules applicable to FISCUs. NCUA's continued insistence on its approach creates a regulatory imbalance between federal credit unions and FISCUs which is indefensible. For federal credit unions, NCUA's rules and regulations make sense, at least in an organizational manner. For FISCUs however, compliance with NCUA's rules increasingly involves starting in Part 741, and then searching through NCUA's federal credit union rules for the random provisions, scattered here and there, that apply.

For example, under the proposed rule, FISCUs seeking to comply with the proposed collateral requirements would reference Part 741.219 which redirects the FISCU to new Subpart B of §703. Subpart B §703.105(b) reads:

> (b) A credit union may only accept collateral to secure a derivatives transaction that is permissible for a credit union to hold as enumerated in the ***Federal Credit Union Act, subpart A of this part,*** and its investment policies. Acceptable collateral is limited to cash, Treasury securities, fixed-rate non-callable agency debentures, and zero-coupon non-callable agency debentures. [emphasis added]

- <u>78 Fed. Reg. 32208 (May 29, 2013).</u>

This provision is inherently confusing for a FISCU (presumably a federal credit union knows what other collateral is acceptable). The proposed provision seems to enumerate acceptable collateral. If that is the case, then the reference to collateral acceptable in the Federal Credit Union Act and Subpart A is superfluous for a FISCU. However, its inclusion in the provision serves as a secondary incorporation by reference that may, or may not, require a FISCU to then research what other collateral requirements may exist.

There is simply no compelling justification for continuing to require state credit unions to search through NCUA's federal credit union rules to ensure compliance. Incorporating rules within §741 ***in their entirety*** would seem to be consistent with NCUA Chairman Matz's pronounced regulatory modernization initiative.[9] We acknowledge that reorganizing NCUA's rules to retroactively incorporate all insurance rules within a single section is not a simple undertaking. However, the regulatory relief benefits would almost certainly be worth the effort. At a minimum, as NCUA revisits and amends its share insurance rules, those applicable to state charters should be incorporated in their entirety within §741.

In addition to reducing confusion for credit unions, and examiners, as to which rules apply to state-chartered credit unions, incorporating insurance rules within Part 741 in their entirety would also help clarify when NCUA is engaged in rulemaking as a share insurer and when it is engaged in rulemaking as the charterer of federal credit unions. It would also, as pointed out in several places in these comments, make clear what exactly NCUA intended in its regulations.

<u>The Proposed Requirements for Managing a Derivatives Program May Be Too Restrictive</u>

The proposed rule contains numerous detailed provisions for managing a derivatives program. In general NASCUS cautions about overly restrictive provisions that may stray from industry norms. The rationale for permitting credit unions to engage in derivatives transactions is predominantly to provide a means of offsetting interest rate risk. However, restricting derivatives to such an extent out of an abundance of caution might render the purpose for which those transactions are undertaken moot. Furthermore, such stringently prescribed requirements provide little flexibility for either regulators or credit unions to adapt in the future. NASCUS provides the following as examples of provisions in the proposed rule that deserve more discussion as to the balance of safety and soundness and the effectiveness of a program in terms of mitigating interest rate risk.

Proposed §703.105 lists collateral requirements such as acceptable collateral, collateral levels, and daily pricing. In particular, NASCUS questions whether the requirement to price the credit unions derivatives position daily is consistent with common practice.

Proposed §703.107 requires monthly reporting to the credit union's board. At a minimum NCUA should recognize that not all states require monthly board meetings, and therefore, should amend the provision to require "regular" reporting to the board. NASCUS also notes the increasing number of other NCUA regulations requiring detailed monthly reporting to the board. Of course, we agree that a credit union's board must be involved in the oversight of the credit union's activities. However, we wonder if the preponderance of requirements for monthly reporting to the board will begin to create a situation where the board is merely receiving a long list of obligatory reports rather than taking time to focus on specific areas in a meaningful manner at different meetings.

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[9] We note that the Consumer Financial Protection Bureau has announced its intention to republish all of its inherited rules within a consolidated section of the federal code to ease compliance.

In conclusion, we urge NCUA to limit application of the proposed derivatives rule to federal credit unions. Absent any demonstration that current state authority endangers the insurance fund it is entirely premature for sweeping aside state laws.

NASCUS and state regulators remain committed to working with NCUA to mitigate material risk throughout the credit union system. We appreciate the opportunity to submit comments on this proposed rule. NASCUS and state regulators would be pleased to discuss these comments at NCUA's convenience.

Sincerely,

- signature redacted for electronic publication -

Brian Knight
General Counsel