KOZIUS SOLUTIONS LLC

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July 26, 2013

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

Dear Ms Rupp and NCUA Board members:

I would like to commend the Board and staff in developing and bringing forth necessary regulation to allow credit unions a more complete range of tools to manage interest rate risk through interest rate swaps and caps. This allows credit unions to operate safer and more effectively and reduce risk to the share insurance fund. I would also thank the Board for the opportunity to provide feedback for consideration in the development/refinement of the final regulation on derivatives for credit unions.

I have had the opportunity to work for and with both corporate and natural person credit unions (NPCUs) since 1993. More directly related to the proposed rule, I led a corporate in successfully applying for and implementing derivatives authorities under the Expanded Authorities Guidelines for corporates in place at that time. I commend the NCUA for utilizing a similar approach to the previous corporate program, ensuring NPCUs demonstrate sufficient expertise and infrastructure to effectively execute and manage derivative positions for their own accounts.

Section 703.12 Permissible derivatives transactions
...(g) "Interests rate swaps that do not have fluctuating notional amounts"

Currently NPCUs utilize multiple on balance sheet tools and strategies to manage interest rate risk. One of the leading methods of extending liabilities to balance interest rate risk is to use longer term liabilities. These can be added through deposit programs from members or "jumbo" or brokered deposits, and corporate credit union borrowings or Federal Home Loan Bank (FHLB) Advances. While these are all effective tools they have resultant benefits/considerations. While new borrowings supply liquidity they also can be dilutive to capital ratios. Derivative instruments will allow NPCUs to mitigate interest rate risk, similar to borrowings or advances while not having the consequence of inflating the balance sheet.

Credit unions currently utilizing borrowings or advances have a wide variety of structures to select from. Many help credit unions more closely match or reduce other interest related risks. For instance, a borrowing can be taken down with a fixed amortization

schedule as opposed to a single fixed maturity date. These types of borrowings more closely resemble the cashflow structure of most loan products credit unions offer currently.

Additionally borrowings can be taken down with putable structures. These structures give the option to credit unions to pay back the borrowing (usually at par and at fixed dates) should interest rates fall. This is similar to the option homeowners have with fixed rate home mortgages. By using these types of borrowings NPCUs are able to not only extend their liabilities, but also partially mitigate some of the options risk inherent in fixed rate term mortgage portfolios.

Recommendation: Credit unions already have the on-balance sheet tools with options and variable balances available to them. Derivative authority should not be more restrictive than usage than other risk management tools. Based upon appropriate requirements for systems and infrastructure specifically related to derivatives, currently available derivative pricing models should easily handle interest rate swaps with fixed amortization schedules or call features. ***Amortizing and Callable Swaps should be allowed under the new regulation.***

703.109 Specific Level I limits and requirements.
(e) The maximum permissible weighted average life on all derivatives positions may not exceed five years and the maximum permissible maturity of any single derivatives position may not exceed seven years.

703.110 Specific Level II limits and requirements
(e) The maximum permissible weighted average life on all derivatives positions may not exceed seven years and the maximum permissible maturity of any single derivatives position may not exceed ten years.

Both these sections appear to limit exposure to interest rate risk and as such are necessary for the safe operations of hedging with derivatives. However the dual requirement based upon both final maturity and average life are duplicative and provided limited benefit when taken together. A credit union, with Level I authority, would not be able to initiate a seven year swap without adding another additional shorter swaps to balance the total position weighted average life.

Should a credit unions adapt a strategy of adding seven year swaps to mitigate interest rate risk in regular increments over time (as might be the case to manage origination of fixed rate mortgages), the portfolio would eventually have an average life less than the seven year final maturity from time erosion. The limitations based on final maturity place an effective control on derivative risk. It also important to remember that derivatives are used to hedge risk on the balance sheet. The price risk of derivative

instruments or portfolio of derivatives should be offset in a similar fashion and magnitude by the decrease in overall or specific balance sheet risk.

Recommendation: The proposed regulation controls risk effectively with the proposed limitations of final maturity on interest rate swaps for both Level I and Level II derivatives users. ***Restrictions on weighted average life in both the Level I and II derivative authority limits and requirements should be removed from the regulation.***

703.109 Specific Level I limits and requirements.
(d) The aggregate fair value loss of all swap positions into which the credit union has entered cannot exceed 10 percent of net worth.

703.110 Specific Level II limits and requirements
(d) The aggregate fair value loss of all swap positions into which the credit union has entered cannot exceed 25 percent of net worth.

The Board, in developing parameters for derivative instruments, wisely limits NPCU derivative activity to hedging interest rate risk and prohibits speculative derivatives strategies/transactions. As mentioned in the previous comment the use of derivative to hedge interest rate risk expressly assumes a corresponding risk currently on the NPCU balance sheet. The implementation of the hedge creates a "balancing" effect between the balance sheet and the hedge instrument. In theory, changes in the economic (though not necessarily accounting) value of derivative instruments used in hedging risk should be offset by changes in the market value or projected income stream of the NPCU. Thus the limitation based on the fair value of the derivative instruments alone is insufficient to prevent ineffective hedges or losses for credit unions.

Recommendations: It is important for the new regulation to provide visibility of risks associated with hedging with derivatives usage. Previous corporate credit union regulation required investment securities whose ratings had fallen below certain rating thresholds, to trigger a review and action plan to be developed and submitted to NCUA in a timely basis. I believe a similar approach related to derivative fair values would be a more effective means of identifying and managing derivatives risk ensuring the safety and soundness of the NPCU and share insurance fund.

When the fair value of derivatives reaches 10% (Level I) or 25% (Level II) of Net Worth, NPCU management should produce and submit a review of the effectiveness of all derivative transactions. This would not preclude NPCU from continuing to hedge interest rate risk, but trigger an assessment of the efficiency and therefore also the risk of derivative transactions and strategies.

Supplementary Information, II. Proposed Amendments, D. Levels of Authority. "...Level II allows for higher transaction limits set by NCUA up to a specific ceiling, but entails an onsite evaluation, a higher application fee, and the necessary personnel and systems to be in place before a credit union may apply."

I strongly agree on-site evaluation of systems, processes and staff are vital to allow expanded Level II derivative activities. However, it recalls the perennial "which came first" question. It seems possible a credit union might, in good faith, hire staff and buy and install systems to meet the requirements of Level II. A subsequent review of both staff and infrastructure by NCUA examination staff may find one or both insufficient for Level II authorities after substantial cost of implementation by the credit union. This would end up being very time consuming, expensive and frustrating for both the credit union and NCUA review staff.

Recommendations: To avoid potential conflict over interpretations of qualified staff or the rigorousness of systems and process a small change in application process might be beneficial. Applications for Level II can be made with detailed plans on systems, processes and hiring requirements for qualified staff. NCUA examination staff would provide feedback as to potential weaknesses in either. Credit union staff then have the opportunity to update their planned infrastructure roll-out. Once implemented NCUA staff would then conduct a review of the process, staff and infrastructure based upon tests of sample transactions aligning with established hedge strategies. ***Preliminary application can be made for Level II authorities detailing projected systems, processes and staffing requirements. Final approval would be contingent upon NCUA on-site examination of implemented and tested systems ,staff and processes.***

703.105 Collateral requirements for operating a Level I or Level II program (b)"...Acceptable collateral is limited to cash, Treasury securities, fixed-rate non-callable agency debentures, and zero-coupon non-callable agency debentures."

The NCUA Board has created an extremely safe process for NPCUs to utilize derivatives with requirements for both 100% collateralization and pre set threshold amounts. Additional collateral common to many credit union investment portfolio would help ensure continued smooth operations of margin collateralization. There are significant amounts of callable Agency debentures and Agency Mortgage-backed Securities (MBS) that are readily priced in the market place and are extremely liquid should the need to protect NPCUs from adverse credit events arise. ***Revise the proposed regulation to allow***

Callable Agency debentures and Agency (GNMA, FHLMC, FNMA[1]) MBS to be used as collateral for derivative transactions.

> ***703.105 Collateral requirements for operating a Level I or Level II program***
> ***(g) The minimum transfer amount must be less than or equal to $250,000.***

The $250,000 minimum transfer amount is an excellent way to ensure a minimum level of risk due to under collateralization. However, selecting a fixed dollar limit may create some level of operational burden for larger credit unions with larger capital base and derivative limits. Let us look at a $1 billion credit union with a derivatives portfolio of $90 million (equal to total capital) with a 5 year average life and maturity. A $250,000 minimum transfer amount would require a transfer for every 6 basis point movement in 5 year swap rates[2]. For a NPCU with similar capitalization ratio and derivatives usage, but with assets of $250 million, it would require almost 5 times that change or a 25 basis point shift in rates. Intuitively that means 5 times more operational burden for larger credit union. ***Based upon the 100% collateralization, $0 threshold amounts and required detailed review of counterparty financial condition, a minimum transfer amount based on a percentage of net worth might be more equitable for all credit unions while maintaining the rigor of the initial requirement.***

Additional comments:

The proposed regulation does require hedge reviews, however there is no requirement for co-ordination with external accountants. My experience showed me that there can be a high degree of differentiation among public accounting firms regarding exact qualifications and requirements for hedge accounting. Clearing hedge strategies and processes with external accountants pre-trade would provide a strong assurance that yearend financial review and production would occur with little incident. While this may not be possible to include in regulation, it should represent a "best practice" for derivative usage.

[1] Government National Mortgage Association, Federal Home Loan Mortgage Corporation and Federal National Mortgage Association

[2] Based on a estimated duration of 4.5 for the 5 year swap portfolio or a 4.5% change in portfolio value for every 100 basis point change in interest rates.

Questions:

a) *On the appropriateness of charging "application fees" to offset Increased cost to the agency (NCUA).*

b) *Should NCUA try to recapture the cost of on-going examinations by directly charging credit unions utilizing derivatives?*

c) *The NCUA board requests comments on whether the rule is understandable and minimally intrusive.*

a) and b) . Such a novel approach is readily understood as it balances NCUA examinations fees based upon products and services utilized and regulatory examination burdens/requirements. However, based upon additional requirements for staff, infrastructure, training and potentially the utilization of external service providers, I fear this will be seen as another impediment in implementing a useful risk management tool.

Additionally two other considerations. First, it is at least my understanding NCUA examinations for credit unions with mobile banking platforms or indirect lending business lines, CUSO's or other complex business process are not commonly charged additional examination fees or one-time or first time exam fees. It seems counter-intuitive to begin such a structure for a process that actually reduces NPCU and share insurance fund risk.

Second, NCUA staff has previously been able to effectively manage likely larger and more complex derivative positions in the recent past. Based on NCUA call report information as recently as early 2010 interest rate swaps notional balances at 4 corporate credit unions topped $37 billion dollars. Under the corporate program NCUA was able to effectively examine and manage these larger and more complex swap positions. These swaps, to my recollection, included the types currently included in the regulation as well as amortizing , callable , basis and other more complex interest rate swaps.

c) The proposed regulation is understandable and while requiring extensive enhancement for many NPCU infrastructure, is minimally invasive while ensuring continued safe operations.

Once again I thank the NCUA Board for the opportunity to provide feedback to the proposed derivatives regulation. Providing these risk management tools is well timed as interest rates are generally viewed at or near historical lows and likely to rise at some point in the future. The diligent use of derivatives by NPCUs to mitigate interest rate risk will help the continued safety and soundness of credit unions and the share insurance fund.

Sincerely,

Ronald E Koza
Manager