STATE OF CONNECTICUT

DEPARTMENT OF BANKING

260 CONSTITUTION PLAZA • HARTFORD, CT 06103-1800

Howard F. Pitkin

Commissioner

July 26, 2013

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

Via e-mail to: regcomments@ncua.gov

Re: Connecticut Department of Banking – Comments on Proposed Rule – Derivatives

Dear Ms. Rupp:

The State of Connecticut Department of Banking ("CTDOB") appreciates the opportunity to provide comment on the National Credit Union Administration's ("NCUA") proposed rule regarding derivatives published in Volume 78, No. 103 of the Federal Register on May 29, 2013 that seeks to amend 12 CFR Parts 703, 715 and 741.

The CTDOB believes that credit unions should be allowed to utilize derivatives as part of an effective asset liability management program under appropriate regulatory supervision. In fact, Connecticut law already contemplates investments in derivatives by our state-chartered credit unions ("Connecticut credit unions"). Under § 36a-459a(e) of the Connecticut General Statutes, the Connecticut Banking Commissioner can authorize a Connecticut credit union to invest its funds in derivatives.[1] Furthermore, Connecticut's parity law, § 36a-455a(23) of the Connecticut General Statutes, allows a Connecticut credit union to engage in any activity that a federal credit union or out-of-state credit union may be authorized to engage in under federal or state law, with the approval of the Banking Commissioner.

[1] § 36a-459a(e) states, in pertinent part, that a Connecticut credit union may, with the prior written approval of the banking commissioner, invest its funds:

> "[S]ubject to any limitations imposed by the commissioner, in any [other] investment the commissioner deems appropriate in light of such factors as the financial condition and strategic goals of the Connecticut credit union and the degree of risk inherent in the investment, provided the credit union demonstrates that sufficient resources, knowledge, systems and procedures are in place to monitor and control the risks involved."

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While the CTDOB supports regulatory supervision of asset liability management programs that utilize derivatives, the CTDOB does not support the NCUA's proposal to apply its derivatives regulatory scheme to Connecticut credit unions in particular and federally-insured state-chartered credit unions ("FISCUs") in general. In the preamble to the proposed rule, the NCUA states "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 National Credit Union Share Insurance Fund (NCUSIF)." However, investing in derivatives is not unregulated in Connecticut as Connecticut law requires a credit union to seek prior approval of the Banking Commissioner to utilize derivatives for investment purposes.

As a preliminary matter, although the NCUA has solicited and considered comments on developing a derivatives program for federal credit unions (for which NCUA is the primary regulator) over the past two years, NCUA has only recently indicated its intention to apply these rules to FISCUs (for which the state is the primary regulator). In fact, state regulators have only had two months[2] to digest these proposed rules and formulate meaningful commentary. Because this NCUA proposal seeks to supplant existing state laws and limit the scope of authority by which FISCUs can engage in derivative investing, states and FISCUs should be afforded a greater amount of time to respond – at least the same amount of time NCUA expended in developing the rule for its own institutions.

More importantly, the CTDOB has both the statutory authority as well as experienced and trained examination staff to continue to monitor the investment activities of Connecticut financial institutions. Connecticut law[3] requires Connecticut credit unions to adopt and implement a written investment policy establishing prudent investment standards. The credit union's board of directors must ensure adherence to said policy and standards. The CTDOB has supervision authority over both the investment policy and any investments made by the credit union. All state chartered credit unions are subject to regular and thorough examination by CTDOB staff. The CTDOB supervises various institutions that may engage in sophisticated and complex derivative transactions, including domestic state chartered banks with total assets ranging from $28 million to $3.6 billion, trust banks, credit unions and some of the world's largest international banks. As of March 31, 2013, the Connecticut state chartered domestic banks held derivatives in excess of $630 million. The CTDOB is unaware of any evidence in OIG reports or otherwise that derivative investing under existing state authority caused the failure of any FISCU or otherwise negatively impacted the NCUSIF. For these reasons, no current state regulation of derivative investing represents a threat to the NCUSIF significant enough to warrant such an extreme act of federal preemption.

In addition, the CTDOB offers the following comments on the structure, state involvement, eligibility for participation and general framework of the proposed NCUA derivatives rules:

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[2] Notice of the proposed rule was published in the Federal Register on May 29, 2013.

[3] § 36a-459a of the Connecticut General Statutes.

STRUCTURE

The CTDOB does not support the inclusion of Connecticut credit unions within the NCUA proposed rule because the rule does not clearly articulate which FISCUS or in which derivative transactions it applies.

§703.100(a) of the proposed rule states that the requirements of Subpart B (regarding derivatives authority) apply to (1) federal credit unions and (2) "federally insured, state-chartered credit unions that are permitted to engage in derivatives transactions under applicable state law (emphasis added)." The Supplementary Information, on the other hand, indicates that the proposed rule applies to all federal credit unions and "all federally insured state-chartered credit unions (FISCUs) that are expressly permitted by applicable state law to engage in derivatives transactions (emphasis added)." Connecticut law permits a Connecticut credit union to engage in derivatives transactions, but does not expressly permit it. Other states may have similarly structured rules that allow FISCUs to engage in derivatives transactions implicitly, but not expressly. NCUA should clarify whether and how the proposed rule applies to FISCUs in such states that implicitly allow derivatives investing.

Furthermore, Subpart B deals with interest rate cap purchases and interest rate swap transactions (§703.102), but does not address other derivative transactions. Subpart A (§703.14(k)) limits derivative transactions for federal credit unions, but this provision does not apply to FISCUs. NCUA should specifically set forth which transactions are allowed for FISCUs under this proposal.

STATE INVOLVEMENT

Since the state regulator is the primary regulator for FISCUs, any federal regulatory scheme should recognize and respect the resources already expended and processes employed by the state to supervise FISCUs and to reduce unnecessary regulatory burden on credit unions. Specifically, this NCUA proposal sets forth a cumbersome time period for NCUA review of a FISCU's application, fails to articulate the state's role in revocation of authority, and should increase NCUA reliance on the states' CAMEL(S) and Composite ratings[4].

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[4] Connecticut analyzes the "S" or Sensitivity component when issuing a credit union's CAMELS and Composite rating. The Sensitivity component addresses interest rate risk and is an important factor not contemplated in the CAMEL rating that can help determine a credit union's fitness to engage in derivatives transactions.

NCUA Application Review

§ 703.113 proposes providing NCUA with 90 and 120 days to review Level I and Level II applications, respectively. For FISCUs, these time periods do not begin until NCUA receives the state regulator's decision.[5] In other words, the 90 and 120 days for NCUA processing is <u>in addition to</u> the amount of time the state takes to review and process the FISCU application. However, NCUA will not review a FISCU application to the same extent as it will review an application from a federal credit union; rather, NCUA will rely upon the state regulator's decision and concur (or not) with that decision. Because the scale of NCUA's review of a FISCU's application will be significantly less than the scale of NCUA's review of a federal credit union's application, the CTDOB recommends substantially reducing the time periods for NCUA's review of FISCU applications to no more than 30 days after receiving the state regulator's decision as submitted to the NCUA Field Director.

State's Role in Revocation of Authority

§ 703.115(b) allows NCUA to revoke a credit union's derivatives authority at any time for failure to comply with NCUA requirements or for any other safety and soundness reason. NCUA and the state regulator will determine whether a FISCU must terminate existing derivatives transactions.

The state regulator should be involved in the revocation of a FISCU's derivatives authority, in addition to the determination whether a FISCU must terminate existing derivatives transactions. The proposal, however, does not make clear the nature or extent of such involvement by the state regulator. The CTDOB recommends that NCUA clarify the role of the state regulator in the decision-making process both for revocation of derivatives authority and for termination of existing derivatives transactions.

Deference to State CAMEL(S) Ratings

NCUA relies on the composite CAMEL code and management component ratings to make certain determinations under the proposed rules. Because the state is the primary regulator of a FISCU, the NCUA should give considerable deference to the states' Composite and CAMELS Component ratings when making these determinations.

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[5] It is unclear whether the 90 and 120 day time periods are in addition to the 30 days the NCUA Field Director has to determine whether the application is complete or whether the 30 days is part of the 90 and 120 day time periods. In either case, these time periods are excessive as applied to FISCUs for the reasons noted above.

ELIGIBILITY

Additionally, several provisions in the NCUA proposal that establish a credit union's eligibility for participation in derivatives investing do not necessarily serve a regulatory or insurance need and may actually deter credit unions from participating. The proposed application fees, asset size threshold, direct transactional experience required of credit union employees and qualifications for legal review of the derivatives program are likely to prove too burdensome for some credit unions to engage in derivatives investing.

Proposed Application Fees

The proposed application fees, ranging between $25,000 and $125,000 per application, seem unjustifiably high. The CTDOB does not charge an application fee to credit unions for this authority and has not found any good policy or precedent at any other federal or state regulatory agency for charging application fees of this heightened level. Furthermore, charging a FISCU the same application fee as a federal credit union does not take into consideration that the majority of the application review for a FISCU will be performed by the state regulator with NCUA concurring with the state's decision. NCUA's limited involvement does not warrant an application fee at all, let alone one of this magnitude. High application fees will serve to deter credit unions from taking advantage of the derivatives program.

Asset Size Threshold

§ 703.103(a)(3) as proposed allows credit unions to apply for authority to engage in derivatives transactions only if the credit union has assets of at least $250 million. Connecticut law does not establish an asset threshold to approve a credit union engaging in derivatives transactions and such a threshold does not serve a legitimate regulatory purpose in this case. For instance, only 4 out of the 30 Connecticut credit unions would be eligible to participate based on the proposed asset threshold. Yet those 4 Connecticut credit unions control the vast majority (81%) of assets held by Connecticut credit unions. Eliminating the asset threshold and allowing all Connecticut credit unions to participate would not pose a significant risk to the NCUSIF because the credit unions with less than $250 million in assets represent a small (19%) percentage of total assets. The risk in allowing these credit unions to apply for derivative authority does not outweigh the benefit that such authority could provide to these credit unions to expand their investment opportunities and implement an effective asset liability management program.

Direct Transactional Experience Required of Credit Union Employees

§§ 703.108(a)(3) and 703.110(f) set forth the requirements a credit union employee must have to engage in derivatives transactions, including at least three years of direct transactional experience in the trading, structuring, analyzing, monitoring, or auditing of financial derivatives transactions at a financial institution for Level I authority and at least five years of direct transactional experience in the trading, structuring, analyzing, monitoring, or auditing at a financial institution, a risk management advisory practice, or a financial regulatory organization for Level II authority.

The CTDOB suggests changing this requirement to allow the substitution of a certain amount of training and/or education for (part of) the years of direct transactional experience, with any substitution reviewed and approved by the state regulator and NCUA. Credit unions likely do not have existing employees who possess three to five years of direct experience with derivatives transactions and would otherwise need to hire additional employees to meet this direct transactional experience requirement. By allowing the substitution of training and/or education for direct transactional experience, credit unions may be able to utilize their existing staff to meet this criteria. Additionally, such a level of direct experience may not be warranted for the limited scope of plain vanilla derivatives transactions in which credit unions would be authorized to engage.

On another note, whether a credit union must hire additional staff or invest in training current staff to meet the requirements for background or experience, this proposal would require a credit union that applies for Level II authority to expend considerable resources in a specific area of investments without knowing whether the credit union will ultimately be allowed to participate in that area. The high operational costs that a credit union would have to pay up front before receiving approval to engage in derivatives investing will likely discourage credit unions from participating in such investing.

Qualifications for Legal Review

§ 703.108(b)(5) requires credit unions to obtain a legal opinion from qualified counsel. Qualified counsel is defined in this section as an "attorney with at least five years of experience reviewing derivatives transactions." Requiring credit unions to engage an attorney with at least five years of experience reviewing derivatives transactions may not be practical and may serve as a deterrent. Furthermore, licensed attorneys are bound by a code of professional conduct, including the obligation to provide competent representation. Competent representation generally requires an attorney to have the requisite skills and knowledge to properly represent a client. An attorney without such skills and knowledge could be subject to disciplinary sanctions. In light of existing professional obligations, setting forth qualifications for legal review within this proposal may not offer any additional regulatory protection.

GENERAL FRAMEWORK

Finally, the CTDOB offers comments on two aspects of the NCUA's proposal relating to the operation of a derivates program.

Transactions in Non-U.S. Denominations

§ 703.102 allows credit unions to purchase interest rate caps and enter into interest rate swap transactions only if, among other things, the caps and transactions are denominated in U.S. dollars. Engaging in non-U.S. denomination purchases and transactions can be beneficial and integral to the success of certain credit unions' investment strategies. The CTDOB suggests amending this provision to allow credit unions that demonstrate the need for and possess sufficient knowledge and expertise in dealing with non-U.S. denomination purchases and transactions to engage in non-U.S. denomination purchases and transactions by waiver.

Separation of Duties Required for Management and Internal Controls Structure

§ 703.108(b)(1) requires four different employees to process four categories of functions: (i) derivatives execution and oversight; (ii) accounting for and confirmation of the derivatives transactions; (iii) asset/liability risk management; and (iv) credit, collateral, and liquidity management. However, these four functions are not so necessarily distinct as to require a separate employee to perform these functions. The CTDOB suggests requiring separate employees only for (1) derivatives execution, (2) accounting for and confirmation of the derivatives transactions, and (3) credit and collateral management. A committee process to monitor oversight, asset/liability risk management and liquidity management, as is typical in many financial institutions, would be sufficient to meet the policy goals of the proposal.

SUMMARY

Derivatives investing can be a useful tool, as part of an effective asset liability management program, for credit unions to mitigate interest rate risk ("IRR"). Regulators in states that already authorize derivatives investing by FISCUs, including the CTDOB, have established statutory and regulatory frameworks for credit unions to follow regarding derivatives investments. The CTDOB opposes the application of NCUA's proposed rule to FISCUs because state regulators were not meaningfully involved in the development of the rule and federal preemption is not justified. The proposed rule itself is highly restrictive, complicated and costly, and will likely deter credit unions from participating in derivatives investing. Since derivatives investing can function as an effective tool for asset and liability management, discouraging participation may actually lead to a heightened threat to the NCUSIF. Finally, the proposed rule as applied to FISCUs will increase regulatory burden with excessive application fees, duplication of regulatory efforts and extended application time periods. NCUA should not preempt state laws; most specifically, this proposed rule should not apply to Connecticut State Chartered Credit Unions. The CTDOB strongly encourages NCUA to engage the National Association of State Credit Union Supervisors (NASCUS) and all state regulators when considering implementation of rules and regulations which may directly impact FISCUs and defer to state authority for regulating FISCUs.

We appreciate the opportunity to comment on the NCUA's proposed rule regarding derivatives.

Very truly yours,

HOWARD F. PITKIN
BANKING COMMISSIONER

cc: The Honorable Debbi Matz, NCUA Chairman
The Honorable Michael E. Fryzel, NCUA Board Member
The Honorable Richard Blumenthal
The Honorable Christopher Murphy
The Honorable John Larson
The Honorable Joe Courtney
The Honorable Rosa DeLauro
The Honorable Jim Himes
The Honorable Elizabeth Esty
The Honorable Carlo Leone
The Honorable William Tong
The Honorable Art Linares
The Honorable Mike Alberts
Mary Martha Fortney, President/CEO NASCUS