MICHIGAN CREDIT UNION LEAGUE & AFFILIATES

July 29, 2013

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

RE: **Comments on Proposed Rule - Derivatives**

VIA ELECTRONIC MAIL: www.regulations.gov

Dear Ms. Rupp,

The Michigan Credit Union League (MCUL), the statewide trade association representing 98% of the credit unions located in Michigan and their 4.5 million members, appreciates the opportunity to comment on the National Credit Union Administration's (NCUA) proposal for credit unions to engage in certain derivatives transactions for the purpose of mitigating interest rate risk.

The MCUL appreciates that the NCUA recognizes the challenge that credit unions will face in a rising interest rate environment and is being proactive in considering alternative products and investments to mitigate that risk.

The MCUL's primary concerns with the proposed rule are the costs associated with the application fees and the burdensome qualification requirements. In the financial services industry, institutions are constantly evolving, with new products and services, regulations, social media, etc. In order to remain competitive and compliant, credit unions must continuously adapt. Credit unions are not provided any additional resources or finances to assist them in interpreting and implementing the ever-increasing amount of regulations, which has included thousands of pages of new regulations in the past twelve months alone.

The NCUA is considering a Level I application fee with amounts starting at $25,000 and a Level II application fee with amounts ranging from $75,000 to $125,000, based on the complexity of the application. The fees would be updated in periodic guidance based on the evolving costs of processing applications. In an environment where compliance costs are soaring, income is declining, and risk is increasing, it is counterintuitive to have the NCUA require compensation by credit unions for a "review process and ongoing supervision" of credit unions investing in derivative products which are highly complex in and of themselves, and designed to offset risk. To this end, the NCUA sought comments on the proposed fees and annual charges, to determine if such would deter qualified credit unions from using derivative products to mitigate interest rate risk. The MCUL strongly believes that it would deter participation with such products, and strongly believes that creating a "pay to play" structure for regulation of beneficial, risk-mitigating products sets a terrible precedent for the creation of future tools that may be necessary for the health and survival of credit unions, and in particular those in the small to mid-size range.

Credit unions of all sizes are in the same predicament, needing to maintain loans on their balance sheet with low interest rates, which are funded with short-term liabilities that are rate sensitive. In this rising interest rate environment, credit unions need opportunities to mitigate this risk. The NCUA specifically indicates that "responsibly used derivatives can help protect credit union balance sheets and in turn protect the National Credit Union Share Insurance Fund (NCUSIF) from potential losses at those credit unions, should interest rates rise dramatically rather than gradually over time." With the potential for a direct impact to the NCUSIF, it seems counterproductive for the NCUA to propose rules that would limit credit unions from participating in a program that could help protect both themselves and the NCUSIF.

Additionally, the NCUA also encouraged commenters to consider the benefit to the credit union industry as a whole if more credit unions engaged in risk mitigating derivatives and if the NCUA enhances derivatives supervision. The MCUL believes that the credit union industry as a whole would benefit from the ability to purchase interest rate derivative products, however the NCUA needs to reconsider their current limitations on participation along with the proposed costs.

The NCUA's proposal contains a significant number of requirements that credit unions will need to comply with in order to utilize interest rate derivatives. First, the MCUL is concerned with the personnel requirements. Since derivatives are currently impermissible investments for credit unions, most current employees will not have gained direct transactional experience at their credit union and expertise in the statement of financial condition analysis. To ensure that this requirement doesn't limit credit unions from participating, without diminishing the need for appropriately skilled personnel, the MCUL encourages the NCUA to consider the broader use of external service providers (ESPs) and expanding the criteria for determining "qualified derivatives personnel."

The option to purchase interest rate derivatives will be potentially critical for credit unions of many sizes to reduce potential losses as rates continue to rise. The NCUA indicates that interest rate risk is more prevalent among credit unions with assets over $250 million, and this threshold will allow those credit unions with the need and capacity to take advantage of this mitigation tool. However, the MCUL believes that there are additional credit unions with interest rate risk that are under that asset threshold and would benefit from this type of derivative product. The NCUA should consider removing the threshold, provided the applying credit union can meet the other necessary requirements.

Section 703.106 requires the credit union to analyze counterparty credit risks, including "counterparty exposures, concentrations, credit exceptions, and non performing contracts." Additionally a "detailed report" addressing aggregate counterparty credit exposure is to be provided to the Board on a monthly basis. The MCUL believes further clarification and justification is warranted. The derivatives products being proposed have the requirement of being fully collateralized, which significantly diminishes the counterparty credit risk. In the commentary for the proposed rule, the NCUA indicates that the proposed collateral requirements "ensure that a credit union's exposure is [minimal] by specifying that derivatives positions are priced daily, that the threshold amounts at which collateral is required are zero, and that mandatory triggers for transfer amounts are low." Additionally, counterparties are limited to swap dealers and major swap participants defined by the CFTC. With this in mind, although the MCUL agrees that a review of the counterparty is prudent, further guidance needs to be provided and requirements relaxed as to what analysis needs to be provided to the Board on a monthly basis so as not to be overly burdensome, without further justification.

Additionally, the general reporting requirement in the proposed regulation indicates that the Board must be provided with a monthly report that includes: "identification of noncompliance, with the credit union's policies or any applicable law or regulation (including the proposed rule), utilization limits, an itemization of the credit union's individual position, a comprehensive view of the credit union's balance sheet, and the cost of executing new derivatives transactions." The proposal imposes additional collateral requirements, a comprehensive internal controls structure (including separation of duties, framework, internal controls audits, financial statement audits, legal reviews, hedge reviews, transaction management requirements, specific asset-liability management strategy, etc.), and also identifies that Senior Executive Officers are required to have a comprehensive understanding of derivatives, including the evaluation and oversight of the program. Many of these requirements could effectively be done in partnership with a qualified ESP, and therefore in an effort to reduce burden, as opposed to alleviate responsibility, the MCUL encourages the NCUA to allow certain aspects of these reporting requirements to be delegated to an ESP.

Lastly, the MCUL does not agree with the provision that would require federally insured state chartered credit unions to comply with the derivative requirements in the NCUA rule, to the exclusion of state requirements that may conflict or be less stringent. The MCUL believes that this would have an adverse impact on the dual chartering system and is an overreach of the NCUA's authority.

<u>Conclusion</u>

The NCUA needs to consider the derivatives product as an alternative for credit unions to manage their interest rate risk and to protect the NCUSIF. The NCUA should not limit otherwise eligible credit unions from participating because of an application fee that lacks proper justification and overly burdensome qualifications for participation. Additionally, the purchase of interest rate swaps is a portfolio hedge that attempts to keep the portfolio delta neutral, as opposed to generating revenue or increasing profits for credit unions. Coupling the costs of the actual transaction, application fees, audit fees, legal fees, needed account system enhancements, employee training, or time required to meet the eligibility requirements proposed, makes this proposal extremely costly for credit unions already under tightened margins, without any “enhanced supervision” or “application” fees inflicted by the regulator.

The MCUL is extremely concerned that the NCUA’s proposal to implement a fee for derivatives activity could set a precedent for the NCUA to impose fee structures for other new products or services which may be essential to the health and survival of the credit union industry. As previously discussed, credit unions have never been provided with additional resources or finances to assist in interpreting and implement new laws or regulations or for learning about new products and services to remain competitive in the market. Credit unions with successful business models must evolve and adapt to changing times, as is currently the case with the interest rate environment. As the credit union regulator, the NCUA should be sensitive to this and follow suit in evolving in the same manner. The MCUL strongly urges the NCUA to reconsider their proposal to require a fee for participation and encourages more leniency on the stifling eligibility requirements, to allow otherwise eligible credit unions to mitigate their interest rate risk through derivatives and thereby protect the individual credit union and the NCUIF.

The MCUL appreciates the opportunity to provide comment.

Sincerely,

Dave Adams
Chief Executive Officer