July 29, 2013

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

RE: Comments on Proposed Rule - Derivatives; Docket No. NCUA-2013-0029; RIN 3133-AD90

Dear Mary Rupp,

I am writing on behalf of the California and Nevada Credit Union Leagues (Leagues), the largest state trade association for credit unions in the United States, representing the interests of more than 400 credit unions and their 10 million member-consumers. The Leagues welcome the opportunity to provide comments to the National Credit Union Administration (NCUA) on its derivatives proposal.

The proposed rule would permit credit unions to engage in limited derivatives activities for the sole purpose of hedging interest rate risk (IRR). The Leagues applaud NCUA for considering permitting eligible credit unions to use simple derivatives to hedge against IRR and for issuing the proposed rule. In addition, the Leagues acknowledge the current proposal allows federally insured credit unions (FICUs) to apply for derivatives authority prior to experiencing a material interest rate risk (IRR) exposure need. The Leagues thank the NCUA for responding to comments made on the January 2012 ANPR regarding this and for incorporating those comments in the current proposal.

In general, the Leagues support the proposal and believe that derivatives can be an effective IRR management tool when managed properly. However, the Leagues have concerns with a number or provisions in the proposal, including: the proposed fee structure, overly restrictive limits, and the limited use of third-parties to help meet requirements. As currently drafted, the costs for credit unions to participate in a derivatives program will likely far outweigh the potential benefits. The Leagues respectfully submit the following views on the proposed rule.

Fees and Cost Burdens

The Leagues strongly oppose the imposition of application fees and supervision and/or examination fees to maintain a derivatives program – or for ***any other*** financial activity allowed credit unions by law. To charge any fees associated with derivatives authority would set a precedent that, if applied to other products and services, could suppress credit union innovation and growth by imposing additional costs and burdens.

The NCUA is proposing derivatives use for the sole purpose of hedging interest rate risk (IRR). The NCUA should encourage this risk reduction instead of imposing cost prohibitive application fees or supervision and/or examination fees.

Application Fees

The NCUA is considering instituting a fee structure for those credit unions that apply for derivatives authority. NCUA states, “Rather than pass this cost on to the credit union industry as a whole, the Board believes it may be prudent to pass this cost directly to the credit unions seeking approval.”

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 NCUA Board would set this fee in periodic guidance based on the evolving costs of processing an application. These fees are in addition to any fees charged by a state supervisory authority (SSA) for a federally insured state credit union (FISCU).

NCUA is also proposing to maintain authority to modify the Level II application fee when a credit union operates under Level I authority for a period of time. This reduction in application fee would largely depend on the length of time a credit union operates under Level I authority before applying for Level II authority.

As stated above, the Leagues cannot support any fees in connection with derivatives authority. Further, we find that setting a range for fees is even more troublesome. Using ranges leaves credit unions in the dark as to how much it might cost them to have their application reviewed. We also find it ironic that the more a credit union would utilize derivatives to manage risks, the greater its fees would be.

Supervision and/or Examination Fees

In addition to an application fee, the NCUA is requesting comments on the best method for recovering costs associated with the ongoing supervision of credit unions engaged in derivatives. NCUA states that the ongoing enhanced supervision is labor and resource intensive, and is specifically asking for comments on whether annual costs associated with staffing, contractors, and/or examination hours should be borne entirely by credit unions engaged in derivatives or shared by all federally insured credit unions.

The Leagues strongly oppose fees associated with the supervision or examination of credit unions engaged in derivatives authority. The Leagues question why NCUA needs additional staffing and expertise when NCUA has experience examining credit unions in the pilot program. Based on the simple, plain-vanilla derivatives transactions permitted in the proposed rule, the Leagues feel that existing examiners and practices should accommodate the agency's efforts to examine and supervise credit unions with derivatives authority.

Additional Costs

In addition to any application fees and supervision and/or examination fees, the Leagues are concerned the costs to comply with the requirements of the proposal are prohibitive. Credit unions are concerned that the costs for conducting derivatives transactions under the proposed rule will vastly outweigh any potential benefit from the risk reduction derivatives may provide.

Another concern regarding costs under the proposed rule is that many of the requirements must be met ***before*** a credit union applies for derivatives authority. For example, a credit union will have to put experienced derivatives personnel in place before applying for derivatives authority. This expense makes no sense when a credit union is not certain their application will be approved. These requirements should be amended to provide that the credit union must meet the requirements within a certain time-frame after approval and before conducting derivatives transactions.

Asset Eligibility Threshold

The Leagues do not support an asset eligibility threshold for derivatives participation. The NCUA has stated that they arrived at this threshold by analyzing interest rate exposure at credit unions of varying asset size, the share of these credit unions' assets as a share of the credit union system, and the use of interest rate derivatives by similarly sized community banks. While we appreciate the analysis that went into setting the threshold, we do not believe that an asset threshold is appropriate or necessary. An asset threshold ignores the needs of credit unions under that threshold that also have IRR and may benefit from using derivatives to hedge these risks. The Leagues suggest that an asset threshold be removed.

We recognize it may be difficult for small credit unions to find counterparties and to meet other requirements of the rule, but those that can should be given derivatives authority. If credit unions under a certain asset level are unable to find counterparties then the asset threshold is unnecessary and does nothing more than create an additional obstacle within the rule.

Authorities and Limits

The proposed rule includes limits for Level I and Level II authorities on the amount of derivatives exposures a credit union may take. The proposed limit on interest rate caps is measured by the exposure of book value to net worth. The proposed limit on interest rate swaps is measured using notional exposure and fair value loss. Both measurements use the credit union's net worth as the basis. Net worth is an overall indicator of a credit union's financial strength and does not specifically reflect a direct link to the management of IRR. The better capitalized a credit union is, the less it needs derivatives to mitigate IRR because it has higher capitalization to absorb potential losses. By tying limits to net worth, the credit unions that need derivatives most will have lower limits.

In addition, the Leagues believe the proposed duration limits are too short for credit unions making long-term loans where there is an historical record of few early repayments. Early repayment may become even less prevalent in the future as low interest rates on existing mortgages are held to maturity.

The Leagues believe that the proposed investment and duration limitations are too constraining, do not provide the capacity for hedging interest rate risk, and will ultimately deter credit unions from participating in such a limited derivatives program. The Leagues recommend that credit unions that have the expertise, or contract with external service providers for the expertise, should be permitted to invest in derivatives to manage interest rate risk subject to their own board approved derivatives policy.

External Service Providers

The Leagues are very concerned with the proposed rules limits on external service providers (ESP). First, the NCUA proposes to limit the use of credit union service organizations (CUSOs). Footnotes 27 and 28 in the proposed rule state that an external service provider does not include a wholly-owned CUSO, and a wholly-owned CUSO may provide derivatives functions for the credit union that owns it. However, if the wholly-owned CUSO provides derivatives services to other credit unions, it will be an ESP and subject to the restrictions in the proposed rule.

The Leagues do not agree with this approach and believe such a requirement will weaken CUSOs and will create additional expenses for credit unions considering conducting derivatives activities. CUSOs allow credit unions to share resources while retaining control and ownership of the resource provider. Therefore, the Leagues suggest credit unions be allowed to utilize a CUSO owned by multiple credit unions for the same services and activities for which it or other credit unions utilize their wholly owned CUSO.

Second, the proposed rule prescribes the derivatives functions that ESPs can perform for Level I and Level II credit unions. Level I credit unions can utilize ESPs to conduct far more activities than Level II credit unions.

The Leagues recommend that both Level I and Level ll credit unions have the ability to rely on external service providers for any or all aspects of their derivatives programs. Alternatively, at a minimum, Level I and Level II credit unions have the same ability to rely on ESPs. There is minimal risk associated with allowing Level II credit unions to utilize ESPs for the same services for which Level I credit unions would be authorized to use such entities.

Investment Types

The proposed rule limits credit unions' authority to simple, "plain vanilla" derivatives instruments known as interest rate caps and swaps. With regard to interest rate swaps, only pay fixed/receive floating, or pay floating/receive fixed swaps are permitted.

The Leagues support the use of simple derivatives and we suggest the rule also allow Mortgage Backed Securities/To-Be- Announced (MBS/TBAs). MBS/TBAs would better allow credit unions to hedge the risks associated with fixed-rate mortgage activity.

Collateral Requirements

The proposed rule restricts the forms of collateral that are permitted for a credit union to the most liquid and easily valued instruments so that they can be easily negotiated even in times of market illiquidity. The proposal limits eligible collateral to: cash, Treasury securities, fixed-rate non-callable agency debentures, and zero-coupon non-callable agency debentures.

The Leagues agree with the proposed requirements and recommend that acceptable collateral include mortgage-backed pass-through securities. These securities are also highly liquid and easily valued.

Internal Controls Review

The NCUA proposes several internal controls measures for credit unions with derivatives authority, including an internal controls review. Under the proposal, a credit union must have an internal controls audit at least annually that ensures the timely identification of weaknesses in internal controls, modeling methodologies, and the risk oversight process. This internal controls review must be performed by external individuals qualified to evaluate the attributes of a derivatives program. An internal controls audit must incorporate an evaluation of the effectiveness of internal controls relevant to measuring, monitoring, reporting, and limiting risks. The scope of the internal controls review must also include coverage of the accounting, legal, operating, and risk controls.

The Leagues find this requirement to be excessive, unnecessary, and costly for most credit unions. Most of the necessary requirements of an internal controls audit can be accomplished through the external audit process. External auditors with derivatives experience should be able to perform an audit in a manner that is sufficient to assure NCUA proper internal controls are in place and the credit union safely engages in derivatives transactions. The Leagues recommend removing the cost prohibitive requirement for a separate internal controls audit.

Application Process

The application process begins with the credit union submitting comprehensive documentation demonstrating that it meets the requirements for the level of authority it is applying for. After a credit union has compiled all of the information for its application, it must submit it to NCUA, or its SSA in the case of a FISCU. An SSA will evaluate an application and send its decision to NCUA for concurrence.

Time Frames

Under the proposed rule, a Field Director will determine that an application is complete and in compliance with the regulation and any applicable supervisory guidance within 30 days of the date it receives an application from a credit union, and that NCUA will approve or deny an application within 90 days for Level I and 120 days for Level II.

The Leagues question these time frames. The NCUA indicated these time frames are being proposed to ensure NCUA has adequate time to conduct a thorough review. Further, NCUA is proposing an application fee structure (that the Leagues oppose) based on the application review process being “labor and resource intensive.” However, no analysis was presented to justify the time frames or the proposed application fees. A timeframe of 30-45 days would be more reasonable and enable credit unions to address their interest rate risks in a timely manner.

State Chartered Federally Insured Credit Unions

While all eligible credit unions should be permitted to engage in derivatives to hedge against IRR, state chartered credit unions should not be subject to this rule. Rather, they should be permitted to engage in derivatives activities as authorized by state law implemented by state regulators.

Under the proposed rule, FISCUs would be required to comply with NCUA's derivatives rule or the derivatives rule issued by the state where they are chartered, whichever is more stringent. The effect of this requirement is that NCUA would set the minimum derivatives rules for all federally insured credit unions.

The Leagues are seriously concerned that this is an overreach of NCUA's regulatory authority, which would have an adverse impact on the dual chartering system. This approach would marginalize the state charter by minimizing state regulators' abilities to set standards for institutions that choose a state option. Furthermore, the proposed derivatives rule discounts any experience that state regulators may have with regulating entities that already have derivatives authority.

The Leagues recommend the rule allow FISCUs to apply to their SSAs for approval and comply with the derivatives rule issued by their state. State regulators may elect to have their credit unions apply to NCUA and follow NCUA's rule.

Pilot Program

Credit unions that have participated in the pilot program on derivatives should be allowed to continue to do so without having to reapply. In addition, concessions should be made for these credit unions regarding training, experience, and fees (if fees are implemented in the final rule). Requiring pilot program credit unions to comply with the new requirements could result in these credit unions terminating their derivatives activity and trigger a requirement for them to divest of existing trades. Presumably, pilot program credit unions have already been conducting derivatives transactions in a safe and sound manner; otherwise, the NCUA would not be moving forward with a rule for all FICUs.

Conclusion

The Leagues enthusiastically support the proposal and thank the NCUA for the opportunity to comment on the proposed rule. We ask the NCUA to consider our views and the issues presented in this letter to ensure the final rule will be a viable IRR mitigation tool for as many credit unions as possible. We also implore the NCUA to move forward with a revised rule in a timely manner so that credit unions can engage in derivatives authority in sufficient time to help them be well positioned for rising interest rates.

Sincerely,

Diana R. Dykstra
CEO/President
California and Nevada Credit Union Leagues

cc: California and Nevada Credit Union Leagues