SELF HELP

CREATING OWNERSHIP AND ECONOMIC OPPORTUNITY

July 29, 2013

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

Re: Self-Help Federal Credit Union Comments on Proposed Rule-Derivatives

Via e-mail: regcomments@ncua.gov

Dear Ms. Rupp,

Thank you for the opportunity to comment on the National Credit Union Administration (NCUA)'s Proposed Rule on Financial Derivatives Transactions to Offset Interest Rate Risk. We believe that the greatest threat facing credit unions over the next decade is the interest rate risk (IRR) associated with serving members' needs through long-term real estate lending – the most viable lending product that credit unions can produce at sufficient scale to both serve their members' needs and sustain themselves financially.

Self-Help has substantial experience using interest rate swaps to mitigate interest rate risk. Self-Help Federal Credit Union is an authorized participant in ALM First's derivatives pilot program. Self-Help Credit Union (SHCU), our affiliated state-chartered credit union, was granted independent swaps authority by the state supervisory authority in 2003. Since then, SHCU has entered into pay-fixed, receive-floating swaps with a total notional amount of $193 million. And Self-Help Ventures Fund, our jointly-managed, affiliated community development financial institution loan fund, has entered into $612 million of swaps since 2002. Our comments are based on the substantial experience of these three institutions in managing an effective asset-liability management program using a combination of member deposits, borrowings and interest rate swaps.

Self-Help commends NCUA for proposing to permit federal credit unions to engage in swaps to counter this embedded interest rate risk. Without the ability to use interest rate swaps, credit unions (CUs) will repeat the savings and loan crisis, since short-term interest rates will inevitably rise at the same time that CUs hold long-term assets originated at historically low interest rates. This scenario represents the most significant medium-term threat to the financial viability of CUs. Without greater hedging that derivatives afford, rising rates could wipe out substantial CU net worth in a decade.

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The need for hedging through swaps is significant:

- 35% of CU assets are long-term (greater than 3 years), compared with only 4% of CU deposits, and

- 53% of CU loans are real estate loans, and 35% of CU loans are fixed-rate real estate loans.

Self-Help shares NCUA's opinion that CUs need the ability to use derivative swaps and caps for the limited purpose of IRR mitigation and never to speculate. "Plain vanilla" pay-fixed cash flow swaps convert floating-rate liabilities into fixed-rate liabilities that can be structured in a maturity ladder, to match both the loan amortization and the borrowing members' expected prepayments.

We agree with NCUA that CUs that use interest rate swaps must apply appropriate training, policies, and experience to their IRR program, and must eliminate counterparty risk by using standard International Swaps and Derivatives Association agreements (ISDAs) with bilateral collateral agreements with zero thresholds and safe collateral. In particular, this last requirement – to use industry-standard agreements with zero thresholds – substantially reduces the counter-party risk created by derivatives. When combined with the ban on speculative hedges that increase risk in the search for higher returns, these counterparty risk mitigants free CUs to use them to solely mitigate interest rate risk without creating other significant risks.

However, Self-Help recommends the following five changes to the proposed rule, in order to permit CUs to better manage IRR:

1. **Remove the limitation that the notional amount of swaps cannot exceed 250% of net worth.** The proposed limit that participating CUs' notional swaps outstanding cannot exceed 250% of net worth restricts the use of swaps to a lower level than many CUs need. If adopted, limitations on maximum and aggregate exposures tied to CUs' net worth would hamper CUs' ability to appropriately manage risk. Self-Help proposes basing the aggregate notional value threshold for interest rate swaps at 80% of long-term assets a CU holds or, alternatively, increasing the percentage to 600% of net worth.

2. **Allow CUs to buy swaps in longer terms than proposed for effective hedging**. CUs should be permitted to use derivatives of longer durations in order to appropriately hedge IRR. Arbitrary limits of 7-year weighted average maturity and 10-year maximum term are too short for CUs making 30-year fixed rate mortgage loans, as well as multi-family loans.

3. **Remove fair market value loss restriction**. CUs should not be limited to an aggregate fair market value loss on their swaps that is tied to net worth. Derivatives hedge against the risk of both rising and falling interest rates, and this proposed loss limit constrains CUs' ability to mitigate IRR since it does not take into account an offsetting rise in value of loans held at book value when rates fall.

4. **Create a waiver process or Level III category for CUs with extensive derivatives experience and demonstrated need for greater authority.** If NCUA does not adopt the

80% of long-term assets or 600% of net worth tests, it should establish a waiver process for CUs that have an effective swaps program and the need to exceed generic, one-size fits-all limits, or establish a Level III category for these CUs that permits greater derivatives flexibility.

5. **Allow credit unions to accept, and therefore provide, all government-guaranteed securities.** We agree that the collateral a CU accepts from a derivatives counterparty should be marketable, such that a CU can value and liquidate that collateral at any time. We propose, however, that NCUA permit a CU to accept any collateral that it is otherwise permitted to own under federal law and that is guaranteed by the U.S. government or any federal agency. In particular, such collateral should include agency pass-through mortgage-backed securities, which CUs commonly hold.

These modest expansions to permitted derivatives authority from the proposed rule would help equip CUs to appropriately hedge IRR. Below, we discuss our five suggested changes to the proposed derivatives rule, in addition to responding to several of NCUA's specific questions included within the proposed rule:

1. Remove the limitation that the notional amount of swaps cannot exceed 250% of net worth.

Tying notional value limits to a small multiple of net worth, as opposed to the amount of long-term assets the CU holds, fails to match permissible risk mitigation to the risk created by holding those long-term assets. If a CU has 8% net worth, a 250% limit means the CU cannot have notional swaps of more than 20% of assets. Such a limit is sufficient if the CU has long-term assets limited to 25% of its assets, but it is probably insufficient if a CU has more long-term assets. For example, a CU with 60% of its assets in mortgage loans should be permitted to hedge 80% of this amount with swaps, or roughly 50% of assets (or 600% of net worth). If instead the CU can only hedge 20% of assets, as short-term rates rise sooner than assets mature, the CU's net worth can quickly dissipate, given the fact that 30% of the long-term assets are largely un-hedged.

Using net worth as the limiting factor for the notional amount of swaps provides an undue incentive for CUs to enter into longer duration interest rate swaps when swaps with laddered maturities, mixing short-term and long-term swaps, would provide a more effective hedge. A CU needs to essentially lengthen its liabilities through pay-fixed interest rate swaps to match the duration of its long-term assets. This can be achieved two ways. First, a credit can use a lower notional amount of swaps, and therefore a lower multiple of net worth, by using only long-term swaps. Second, it can use a ladder of maturities that come to the same average duration with a higher total notional amount and therefore a higher multiple of net worth. Longer-term swaps alone are ineffective at matching cash flows – particularly prepayments – as well as potential changes in interest rates in the short- to mid-term. Just having long-term swaps gives CUs less flexibility to dynamically re-balance its balance sheet as its asset mix changes and/or prepayment speeds change than if the total notional amount of swaps was higher with laddered maturities at the same average duration. A rule tying swaps limits with net worth pushes credit unions to the first strategy, when the second provides more effective IRR.

It is important that swaps are able to address CUs' hedging need. Self-Help uses derivatives as one tool in a comprehensive IRR management approach. However, while alternatives to interest rate swaps can be helpful in addressing asset-liability management issues, each has significant limitations that cannot replace swaps as a risk reduction tool.

First, CUs can borrow fixed-rate Federal Home Loan Bank (FHLB) advances at terms matching anticipated asset prepayments. However, borrowing money is counterproductive when CUs have excess liquidity, as most now do, and dilutes CU net worth. In addition, it is difficult to dynamically rebalance FHLB debt, since FHLB advances have an asymmetrical prepayment structure. The FHLB does not pay out the gain owed a CU when the CU prepays an advance after rates have moved in the CU's favor (up), but does charge a yield maintenance penalty to the CU when rates move in the FHLB's favor (down).

Second, CUs can sell mortgage loans. This strategy is counterproductive, however, when CUs need to deploy cash into interest-earning assets. Further, Fannie Mae and Freddie Mac underwriting is so tight that many members cannot qualify (the average credit score of a Fannie or Freddie denial is 734 and average down payment is 19%[1]). In addition, only writing secondary market-eligible loans is inconsistent with the character-based lending for which CUs are known and eliminates a critical niche that CUs are able to fill in the marketplace.

Finally, while depositors can buy longer-term certificates of deposit to match asset durations, demand is inherently limited.

Tying swaps limits to net worth can exacerbate the hedging needs of many CUs. Generally, the better capitalized a CU is, the less it needs interest rate swaps to hedge since zero-cost retained earnings are themselves a form of interest rate risk protection. Thus, tying swaps limits to net worth increases risk for CUs that may need to hedge the most – those with less capital.

Self-Help would suggest the following test on swaps limits: NCUA should permit CUs to hedge the interest rate risk created by holding long-term loans funded by shorter-term liabilities, primarily member shares, by adding swaps with a net notional principal equal to 80% of long-term assets, defined as assets with re-pricing terms equal to or greater than three years. This test would permit CUs to ladder out their swaps over a 2-to-15 year period to mimic the likely cash flows generated by a hedged mortgage loan portfolio.

Should NCUA decide against tying derivatives authority to the amount of long-term assets, NCUA should increase the notional threshold for derivative use to 600% of net worth. A 600% threshold would allow a credit union with 8% net worth to enter into swaps with a notional amount outstanding of 48%. Such hedging should protect that CU from the interest rate risk associated with a 60% real estate loans-to-assets ratio.

[1] http://www.washingtonpost.com/realestate/mortgage-lenders-set-higher-standards-for-the-average-borrower/2012/09/27/74ef973a-0676-11e2-a10c-fa5a255a9258_story.html.

2. Allow CUs to buy swaps in longer terms than presently proposed for effective hedging.
When effectively used, derivatives can help CUs fill the interest rate gap between longer-term fixed-rate assets and non-maturity deposits. NCUA should allow CUs to appropriately mitigate risk by matching derivatives to their underlying risks. The proposed derivative maturity average of 7 years and single derivative position limit of 10 years prevent CUs from appropriately using derivatives. CUs are increasingly the lender of choice to meet their members' real estate loan needs. Mortgages generally have a 30 year term, and expected durations of loans originated at today's low interest rates are higher than in the past. Further, many multi-family developments have a need for fixed rate financing, typically for 15-to-20 years, allowing for the provision of stable rents to tenants with a need for payment predictability. Given the prevalence of long term fixed-rate loans and the accompanying funding of shorter-term deposits, longer duration swaps help ensure that CUs are not unduly exposed to IRR.

The proposed 7- and 10-year limits have no clear relation to the IRR that they are intended to mitigate. Such limits are effective for hedging 50% to 75% of the IRR associated with a long-term real estate loan portfolio. However, they fail to address the tail risk of holding long-term assets 10-to-30 years into the future. This risk can be easily demonstrated by looking at the record low loan rates CUs have offered in recent years compared with the recent 1.25% increase in 30-year mortgage rates during May-to-June 2013. Many borrowers that obtained a mortgage from their CU in the past few years may well hold on to that loan to maturity. Limiting credit unions to hedging only the first 7-to-10 years of a portfolio fails to help CUs lock in the spread associated with such loans.

In addition, the limit on single counterparty exposure – 100% of net worth for Level II authority – is an excessive constraint. SHFCU generally supports the principle of diversifying counterparties. Doing so has the benefit for a CU of minimizing cost, through bidding out swaps competitively. In addition, having multiple counterparties protects a CU from the risk of counterparty bankruptcy. This risk is not so much a risk of financial loss when using a zero threshold with liquid collateral, but is rather the risk of losing the only "insurer" of a CU's interest rate risk and needing to find an alternative provider in the market at that time. Nonetheless, some CUs may only be able to negotiate ISDAs with two or three counterparties, leaving them unable to enter into sufficient swaps to hedge their IRR fully. We believe the zero threshold requirement – which we support putting in regulation, as it gives a CU leverage to insist on such a threshold with potential counterparties – plus the liquid collateral requirement effectively limits counterparty risk, such that the 100% of net worth single counterparty limit is redundant. As described above, a CU has an easy solution to a counterparty bankruptcy under its ISDA with that counterparty.

3. Remove fair market value loss restriction.
CUs should not be limited to an aggregate fair market value loss tied to net worth that triggers suspending the CU's swaps program and submitting to a corrective action plan to reduce the loss valuation. The fair value of a derivatives portfolio must be recognized under GAAP as unrealized losses or gains in net worth. However, any such loss (or gain) is more than offset by a commensurate gain (or loss) in the value of long-term fixed rate loans, though these are almost exclusively carried at book value, and thus the offsetting gain or loss is not recognized. As such,

a CU's balance sheet may continue to be well-hedged with very little, if any, net economic value volatility even when it is carrying a large net unrealized loss on cash flow hedges in its GAAP net worth. The market valuation limit simply reflects an effective hedge offset by mortgages that have gained in value, albeit unrecognized GAAP value.

The entire precept of hedging is being neutral on the future path of interest rates, and therefore being protected whether rates rise or fall. Artificially limiting fair value losses on half of the equation means that a CU can be protected against rates rising, when pay-fixed swaps rise in value, but not when rates fall, and swaps fall in value. CUs must be able to deal symmetrically with both rising and falling rates. Requiring a CU to stop hedging simply because its existing hedges are effective when rates fall – which is often what a net unrealized loss reflects – would require a CU to shut off its lending business simply because it bought interest rate insurance on that business. Another CU that had the same balance sheet but hedged with FHLB advances that are underwater could continue lending, even though the two CUs have identical IRR profiles.

These three limits – on total notional, maximum term and fair value loss – all appear to be aimed toward limiting counterparty risk. Bilateral collateral agreements with zero thresholds, low minimum transfer amounts, and strong collateral all but eliminate the counterparty risk associated with swaps even with terms over 7 or 10 years, and are a much more effective tool for limiting counterparty risk than using one-size fits-all regulation on notional swaps and terms. A CU can terminate a swap relationship and enter into a new swap if a counterparty files for bankruptcy. The CU would be able to declare the counterparty in default under the ISDA, cancel the swap and take whatever collateral it already has (if any) and sell the collateral for the net value of the position. The CU can then put on a new trade with another counterparty to continue to be hedged. There should be no more than one or two days of exposure as the default notice is provided to the counterparty. Therefore, we do not see a compelling reason for NCUA to create additional constrain counterparty risk constraints beyond zero thresholds, low minimum transfer amounts and strong collateral requirements.

4. Create a waiver process or Level III category for CUs with extensive derivatives experience and demonstrated need for greater authority.

While many CUs lack the internal experience to administer derivatives, others have extensive experience internally with derivative use as a risk mitigation tool. A waiver process or Level III designation that provides greater flexibility on limits would permit CUs with a demonstrated need, and proven internal capacity to proactively assess and limit loss exposure that derives from IRR, to use the tools they need to manage IRR.

5. Broaden permitted collateral to all federal securities.

We agree with NCUA that collateral used by CUs and counterparties to meet their bilateral obligations should be safe. Agency pass-through MBS meets this definition and should be permissible collateral. Congress has defined, in the Federal Credit Union Act, the types of investment assets that FCUs are permitted to own, and setting collateral restrictions in a substantially narrower, more limited manner than those permissible investments limits CUs' access to necessary collateral.

Bilateral collateral agreements generally dictate that the counterparties only provide comparable collateral, i.e., if a CU cannot accept agency MBS, than it cannot provide agency MBS when it is required to post collateral. Limiting collateral to cash, Treasuries and non-callable agency debentures would severely limit the collateral CUs can provide to counterparties, creating an undue constraint on CUs' ability to hedge. Self-Help's credit unions, for example, do not own either Treasuries or agency debentures, yet they hold more than sufficient amounts of agency pass-through MBS to respond to margin calls. SHCU has provided, and received, agency pass-through MBS as collateral on swaps for ten years, including during the peak of the financial crisis in 2008-2009, without any constraints on its ability to value or liquidate that collateral.

Additional suggestions:

Permit additional CUs to participate.
NCUA should lower the asset threshold below the $250 million proposed, in order to allow more CUs to also hedge their risks. Many CUs that hold less than $250 million in assets should be permitted to hedge their mortgage portfolios. 349 CUs under $250 million in assets have long-term asset ratios in excess of 40%, including 150 that are in excess of 50%. These CUs – many of which are neither "small" nor "unsophisticated" – may benefit from using interest rate swaps to effectively manage their interest rate risk. The fact in NCUA's study that 7.7% of community banks under $250 million in assets – 347 out of 4,506 – use derivatives suggests that a significant number of similarly-sized CUs might benefit from the IRR mitigation that derivatives authority provides.

Limit Application and Supervision Fees.
Requiring application fees as well as on-going supervision fees for those CUs that apply for and utilize derivatives authority presents an undue burden and serves as a deterrent for CUs that need to mitigate IRR from considering, and using, derivatives. Furthermore, given that effective derivative use helps mitigate interest rate risk and thus reduces the risk to the National Credit Union Share Insurance Fund, and therefore benefits all CUs, those CUs that use derivatives should not be required to pay higher supervision costs.

Irrespective of the whether such fees should be charged, the proposed application and supervision fee amounts are very high. As we noted, SHCU has used pay-fixed interest rate swaps to manage IRR for ten years. Each year, SHCU's derivatives program has been reviewed by NCUA as part of our annual insurance review. Even in years when NCUA sent a national derivatives specialist to examine SHCU's swaps program, we believe NCUA dedicated less than 40 hours to the subject. If NCUA spends an additional 5 hours/quarter reviewing our program, that would be no more than 60 hours/year for a single institution.

Federalism.
NCUA should provide evidence that hedging by state-chartered CUs has created, rather than ameliorated, risk to the share insurance fund, prior to federalizing the powers of all state-chartered CUs. In general, FDIC and NCUA are required to defer to state law on the powers of a state-chartered institution unless the federal insurer can demonstrate that state-chartered

institutions engage in unsafe and unsound practices. Absent documentation that such is the case, we believe NCUA lacks the statutory authority to limit the powers of state-chartered CUs in the handful of states that authorize the use of derivatives.

Even if NCUA has the authority, we believe that the agency should defer to state supervisory authorities that have existing derivatives supervision programs. Many of those states have joint financial institution supervisors that actually have more experience than NCUA supervising the use of derivatives by banks and credit unions, and thus, may be better equipped to monitor safety and soundness, as NCUA has acknowledged its own limited experience in this area.

Operational Burden.
As we have previously noted, Self-Help generally supports NCUA's focus on ensuring that a CU develop the operational rigors necessary to manage a derivatives portfolio before it begins using derivatives. This includes the ability to value and account for its derivatives; manage collateral; and make or respond to margin calls, as described in the hedge review and transaction management sections of the proposed rule. We also support an annual financial statement audit by an outside CPA firm, as the accounting risk associated with derivatives is significant and the assurance services of a qualified CPA auditor is one of the best ways to ensure a CU develops and maintains adequate accounting controls.

However, we believe the mandated annual internal controls audit is excessive and will lead to undue costs that will discourage CUs from using derivatives to manager IRR. In the current pilot program, a CU is required to have a CPA firm review its controls before it first enters into a derivatives agreement, which is an appropriate requirement. Our CPA firm – a multi-state firm with a large banking practice – routinely reviews a client's accounting controls, segregation of duties, valuation systems and record-keeping capacity before its clients begin using derivatives. However, they have not seen other clients, or regulators, require a separate "agreed-upon-procedures" audit, let alone, seen it required annually. We do not see any evidence that the existing standard in the pilot program is inadequate.

Finally, we believe the standard that all legal agreements be reviewed by an attorney with at least five years' experience reviewing derivatives transactions is unnecessary. ISDA agreements and their appendices, while complex, are industry-standard agreements. Our experience is that competent counsel – in-house or external – is able to read and understand an ISDA agreement. The Bar already requires that an attorney only represent areas in which s/he is competent, and therefore do not believe it's appropriate for NCUA to create a different standard for such reviewers. As with the special examination and application fees, and the annual internal controls audit, raising the standard above what is reasonable and customary will add undue expense to a CUs use of derivatives, thereby discouraging CUs from using derivatives to manage IRR or adding undue costs to those that do use derivatives.

Thank you again for the opportunity to comment on CU derivatives authority. Helping CUs access tools to prudently manage the IRR associated with serving their members' needs and strengthening the institution's financial stability through long-term real estate lending are crucial steps forward for CUs and NCUA.

Sincerely,

Martin D. Eakes

Martin Eakes
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