July 29, 2013

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

VIA OVERNIGHT MAIL AND EMAIL

Re: Comment on Proposed Regulation to Allow Federally Insured Credit Unions to Engage in Limited Derivative Activities

Dear Ms. Rupp:

Thank you for the opportunity to comment on the proposed rule concerning derivative activities for federally insured credit unions. We appreciate that the NCUA recognizes the importance of derivatives as a tool used in mitigating interest rate risk. We commend NCUA's proposal as a positive first step and appreciate the agency's desire to use a targeted approach to this new authority for federal credit unions, which have historically been prohibited from engaging in derivatives transactions.

By way of background, BECU is a state-chartered, federally insured credit union headquartered in Washington state with assets of $11.5 billion. Our size ranks BECU as the fourth largest credit union in the United States. As a state-chartered credit union subject to the supervision of the Washington State Department of Financial Institutions, BECU is already vested with the authority to conduct derivatives transactions.

We are certainly aware of the potential for continued margin compression should rates rise rapidly. BECU fully supports the use of derivatives as a tool to mitigate this risk, and correspondingly, assist in preserving the National Credit Union Share Insurance Fund.

Since credit unions such as BECU strive to limit fees charged to their members, we have a greater dependency on margin management than other financial institutions. Certain derivative transactions can therefore be an important tool for credit unions to use in mitigating their interest rate risk. We also support reasonable restrictions limiting the use of derivative transactions to mitigation of risk rather than for speculative purposes. NCUA's desire for a "targeted approach" and reasonable limitations on collateral, counterparties, and exposure represent a common sense approach to assuring that derivative transactions are used for the proper purposes without introducing undue additional risk.

Because interest rate risk is a concern, we have reviewed the Proposal carefully and provide the following comments. In general, we believe there is a significant misalignment between all of the hurdles, costs and burdens for exercising this risk mitigation tool and the usefulness of the relatively common, "plain vanilla" transactions permitted by the Proposal. In more detail, our comments address the following aspects of the Proposal: (i) the application process itself; (ii) the organizational realignment and level of experience that must be in place in order to engage in derivatives transactions; (iii) the requirement for outside legal review; and (iv) the proposed fee arrangements for both the application process and ongoing authority to engage in derivative transactions.

Application Process

The Proposal appears to make the application for the *authority* to engage in derivative transactions overly difficult and thus a disincentive for credit unions to apply. For example, in order to even apply for the authority to use this mitigation tool, a state-chartered federally insured credit union must:

- Demonstrate how derivatives are one part of its IRR mitigation strategy
- Demonstrate how it plans to acquire, employ, and/or create the required resources, policies, processes, systems, internal controls, modeling, and competencies
- Demonstrate that its senior executive officers and board of directors understand the role derivatives play in the credit union's balance sheet management and the risk inherent in derivatives activities.

NCUA acknowledges that derivatives by themselves are merely one such tool to mitigate interest rate risk. As a result, the above requirements appear relatively excessive due to the level of detail required. In particular, the requirement to include an IRR mitigation strategy (and then demonstrate how derivatives are one part of that strategy) could be extremely detailed and still not answer all the potential scenarios that result in risk to the credit union. We therefore request NCUA to clarify what it means when it requires credit unions to demonstrate how derivatives are a part of their IRR mitigation strategy. Absent such clarification, we believe that the requirements could be a disincentive for credit unions to utilize this particular tool. Since NCUA acknowledges that the benefits of derivatives are to reduce risk, the proper usage of this tool should be encouraged, not discouraged.

Regarding the second requirement, most credit unions have never had experience with derivatives. Nonetheless, the Proposal would have credit unions devote substantial resources to planning and documenting resources even before applying to engage in derivative transactions, without any assurance of when, or even if, the authority will be granted. (The Proposal requires state-chartered federally-insured credit unions like BECU to go through this process twice; first with its state regulator and then again with the NCUA.) We recommend that NCUA develop a streamlined application process that would document a credit union's general plans to support derivatives transactions, allowing the credit union to provide more documentation later (perhaps within six months of receiving approval). We also strongly recommend that NCUA consult with state regulators to develop a separate approval process for state-chartered, federally insured credit unions. Such a streamlined, "conditional" approval process may limit some of the uncertainty associated with the application for authority.

Similarly, the third requirement seems to indicate that a credit union must undertake an education process with its executive officers and board of directors prior to even applying for derivative transaction authority. BECU is unclear about the NCUA's expectations for the level of education that senior officers and board of directors must have prior to the application process or how a credit union would satisfactorily demonstrate the required level of understanding. We suggest that the rule should clarify what the NCUA focus will be when reviewing an application for senior officers' and board of directors' experience levels.

Organizational Realignment/Level of Experience

It appears that the Proposal requires credit unions to significantly alter their current organization structure before obtaining the authority to engage in derivative transactions. For example, the Proposal requires that different personnel (i) execute derivative transactions, (ii) account for and confirm those transactions, (iii) manage asset and liability risk, and (iv) manage credit, collateral and liquidity associated with the transactions. Ordinarily some of these activities, even if performed by different individuals, would all report to a common management supervisor, e.g. the head of the credit union's treasury department. Requiring that each of these functions have separate management reporting structures would create a burdensome organizational realignment on current credit union management. We recommend that the rule clarify that a separate reporting structures is not required.

The Proposal requires that the board of directors receive initial and annual training regarding a general understanding of derivatives, including the risks and benefits, and must have the knowledge to provide strategic oversight of the credit union's derivatives program, which includes how derivatives fit within the credit union's risk mitigation tool. While it is certainly important that the credit union's directors be provided with some education about the nature of derivatives and the credit union's interest rate risk mitigation strategy, annual education requirements for the entire board seems overly burdensome, particularly given the very limited nature of permitted transactions and the other restrictions in place that mitigate transactional risk. Board members should have some understanding of how derivative transactions can mitigate interest rate risk and the risks associated with such activities, but the level of expertise needed to understand simple interest rate swaps or interest rate caps hardly justifies an annual training requirement.

The Proposal also requires that senior executive officers and management staff have the requisite skill set before engaging in derivatives transactions. Again, some level of knowledge and understanding is necessary, but it is difficult for all senior executive officers to acquire the necessary detailed experience, particularly when credit unions have historically been prohibited from engaging in derivatives transactions. Even some senior executive officers with direct responsibility for the derivative program are unlikely to be able to acquire experience with derivative transactions before the credit union actually engages in such transactions. The rule should clarify that senior executive officers responsible for directing the program acquire the appropriate level of education, but refrain from requiring any set level of prior experience in derivative transactions.

In addition, the required experience for staff employed in the derivative program is too broad. Given the requirement for separation of duties, not all staff involved in the credit union's derivative program should need to have experience in all of the job functions described in § 703.108(3). For example, staff responsible for actual execution of the derivative transactions should not need to demonstrate that they could oversee appropriate accounting and financial reporting for such transactions. In addition, we are uncertain about the type of training NCUA will require in order for staff to demonstrate particular competencies. The uncertainty of the necessary level of training and experience only increases the burden for a credit union seeking to apply for derivative transaction authority.

Legal Review

The Proposal requires that the credit union obtain a legal opinion from qualified counsel before executing any derivative transactions. This requirement seems to require both an opinion of the enforceability of the derivative transaction agreements and a separate opinion that the credit union is complying with all applicable laws and regulations related to the derivatives program. BECU does not support having to obtain a legal opinion regarding its compliance program. Attorneys, despite having the requisite skill set, are not necessarily willing and able to provide formal legal opinion letters about such matters. If those opinion letters are intended to be Third Party Opinion Letters on which the NCUA can rely, the opinions will be both expensive and heavily qualified, even as to enforceability of transaction agreements. The unwillingness of an attorney to provide a satisfactory legal opinion letter should not prevent the credit union from engaging in the transaction if its own internal counsel and/or experienced staff and management properly analyze the legal and compliance requirements. Further, if the NCUA intends that the credit union obtain a separate opinion for each of what should be very similar transactions, subsequent opinion letters will not likely add any appreciable risk mitigation. NCUA should be encouraging the responsible use of derivative transactions to mitigate interest rate risk, but not unnecessarily placing obstacles in the way of their use.

Fees

BECU believes that requiring credit unions to pay additional fees for review of an application for authority is inappropriate. NCUA does not currently charge credit unions for other applications that apply only to a limited number of credit unions. For example, the NCUA does not charge a separate application and review fee for considering a waiver of certain MBL requirements even though not all credit unions ask for MBL waivers. NCUA should be encouraging the use of appropriate risk mitigation tools to decrease the risk to the NCUSIF. An application fee seems an unnecessary disincentive for credit unions seeking to acquire the expertise and education necessary for use of this tool. Indeed, the application cost seems excessive in light of the fact that credit unions will be allowed to use only plain vanilla derivatives. These costs would be in addition to all of the other costs and burdens imposed on the credit union to develop the policies, procedures, training, education, organization and other resources needed to even apply for the authority.

The Proposal asked for comments on whether NCUA should charge an annual licensing fee to the credit unions that are approved to engage in derivatives transactions or charge credit unions that have purchased derivatives for examination time spent evaluating their derivatives activity. BECU does not believe such fees or charges are appropriate. NCUA already must oversee and examine diverse credit unions with varying degrees of risk, size, and complexity. NCUA has not demonstrated that the proposed derivative authority provides a greater risk to the insurance fund than many other activities for which there is no separate annual fee or examination charge. Furthermore, for those state-chartered, federally insured credit unions that already have the authority to engage in derivatives transactions, NCUA has the ability to mitigate its cost of examination and supervision by working in conjunction with the state regulator.

As a final matter, BECU wishes to briefly discuss an issue that most likely will be fully discussed by appropriate credit union trade associations. As a federally insured state-chartered credit union ("FISCU"), BECU is concerned about NCUA's apparent intent to preempt the field of derivatives authority through this Proposal. The Washington State Credit Union Act and its implementing regulations (RCW 31.12.436 and WAC 208-436-010) allow state-chartered credit unions to engage in investment activities (including derivatives transactions) subject to state approval and regulation. NCUA's Proposal preempts that existing authority and thus subjects BECU to NCUA requirements. Such preemption by NCUA runs contrary to Section 611 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which allows state regulation of bank derivative activity conditioned only upon the state's lending limit laws.

Conclusion

While we applaud NCUA's leadership in this matter, we question the net risk mitigation benefits provided by the proposed transactions and limitations. BECU recommends that in order for many credit unions to take advantage of the rule, either the costs and burdens should be lessened or NCUA should consider allowing credit unions to enter into more complex transactions that would certainly be manageable given the proposed control parameters.

Thank you for your consideration of these comments.

Sincerely,

Kathy Elser

Kathy Elser, Senior Vice President and CFO
BECU, a Washington state-chartered credit union