NORTHWEST
FEDERAL CREDIT UNION

July 24, 2013

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

Dear Ms. Rupp:

On behalf of Northwest Federal Credit Union, I am writing in response to the Notice of Proposed Rulemaking - Derivatives. Northwest Federal appreciates the opportunity to provide our opinions on this proposed rule.

NWFCU's Commentary

We applaud the basic premise of this proposed action by the NCUA, that being to "provide credit unions with a meaningful tool to mitigate IRR". The use of derivative instruments in hedging strategies aimed toward management of interest rate risk represents a step forward for the credit union industry which we view as a progressive effort to provide additional tools to manage comprehensive balance sheet risk. Interest rate derivatives that are typically used for balance sheet management in community and regional sized financial institutions are generally straightforward instruments and are readily understandable. With that said, we believe that as with any other financial instruments, knowledge, experience and prudence is required for their safe and sound application.

We are proponents of prudential precautionary measures to insure the safe and sound utilization of derivatives for the purpose of hedging interest rate risk. However, in our opinion, a few such measures included in the proposed rule add unnecessary and unproductive complexity. In a number of cases, they also act to create artificial inflexibility which at a minimum substantially increases costs and ultimately acts to defeat the stated purpose of this rule.

We are of the opinion that access to tools such as interest rate derivatives are absolutely necessary for credit unions to remain competitive and to effectively manage risk. As the holdings of long term fixed rate mortgage assets have increased within the industry, the need to mitigate these risks has become much more acute. As recently as July 12, 2013 in her speech regarding new capital standards, Chairman Matz opined that "credit union failures are not isolated instances, because credit unions pool their risks". This clearly applies to interest rate risk as well and we only have to look to recent history for the impact pooled interest rate risk had on the savings and loan industry and to understand the necessity for the effective management of this risk. Accordingly, we respectfully present our views and comments relating to what we perceive as the most prominent and concerning aspects of the proposed rule in its current form. Our comments are as follows:

Eligibility - Section 703.103

We would first like to address proposed eligibility requirements. We believe that an eligibility requirement can be a prudent methodology in establishing the suitability of derivatives for use by any credit union. However, we are of the opinion that existing factors within each institution should be the determining factor for permissibility rather than a somewhat arbitrary asset size threshold. Rather than a hard and fast asset size disqualifier, factors and requirements delineated throughout the rule should be used as the criteria for assessing eligibility. While it would be expected that the majority of credit unions which choose to benefit from the use of derivatives would exceed the proposed asset threshold, we believe the standard for eligibility should be based on the institution's ability to safely and soundly implement the effective use of derivative instruments to mitigate risk. We believe that any institution having the required expertise to safely employ derivatives or which is willing to acquire it should be afforded the opportunity to do so.

Systems, Processes and Personnel Requirements - Section 703.108

Section 703.108 includes a very onerous provision relating to the derivatives experience and qualifications of management personnel. While some prior experience with derivatives is ideal, the ability to work with external advisors to gain such experience should be included as an option. Many credit union professionals have years or even decades of experience handling much more complex instruments than interest rate swaps and options. These derivative instruments are mathmatically simple to model and contain considerably fewer variables with which to be concerned than permissible assets such as MBS, CMOs and many others that bear no such experience requirement. In our view, the emphasis should be placed on the analytical and modeling capabilities of the institution and its personnel and advisors rather than on an arbitrary threshold that may or may not be indicative of the capabilities of the institution or its personnel to utilize derivatives in a safe and sound manner.

Section 703.108 also includes two requirements, compliance with which will prove to be very costly yet produce little practical benefit in our opinon. We believe the requirement for a separate internal control review for the derivatives program conducted by an external vendor is inappropriate. The internal control environment for a hedging program utilizing derivatives should be comparable to the internal control program for an institution's investment portfolio. And while there is no specific requirement for an external review of this functional area, internal control reviews are conducted via institutional internal audit procedures in common practice. Controls over the analytical, approval and executional aspects of both the investment portfolio and the derivatives portfolio should be very similar and therefore can be reviewed in concert.

Similarly, we are aware of very few of the personnel within the accounting firms that specialize in credit union audits who have the requisite experience as contemplated in section 703.108. If the requirement for two years experience in evaluating derivative transactions is retained, this will likely require the engagement of an outside expert and be outside the scope of a standard financial audit. The audit and attestation processes for accounting firms expressing an opinion on financial

financial statements is very structured and generally would not necessitate an auditor to perform detailed, exhaustive testing on derivative usage and controls. They would be required to evaluate hedge efficiency in accordance with ASC 815 but, in our understanding, this generally would not require an exhaustive evaluation of the practice, usage and controls as the proposed rule seems to imply. Accordingly, retaining this requirement would be beyond the scope of a credit union's annual audit, would clearly increase the audit's cost and would fall outside the standard reporting scope of the auditor's opinion letter or the requisite notes to the financial statements themselves. Furthermore, derivatives in and of themselves constitute only one half of a hedging transaction. Therefore, viewing and reporting on only one half of any hedging transaction in isolation is inappropriate and will lead to inaccurate accounting and economic results.

Section 703.102 – Permissible derivative transactions

As proposed, this rule would permit credit unions to utilize only interest rate swaps and interest rate caps. While this represents a sizeable portion of the typically used instruments, it is unduly restrictive. We believe this very narrowly defined permissibility limitation will create unnecessary inefficiencies as swaps and caps are not appropriate in some scenarios and are not cost effective in others. We liken this approach to providing a carpenter a tool box with which to construct a house, but which contains only a hammer and a screwdriver. These tools work well for certain jobs, but when a saw is needed, a hammer or screwdriver will not suffice to effectively perform the task at hand.

We believe the menu of permissible instruments should be broadened. With respect to options, we believe there are at least two additional instruments that require inclusion under this rule. Clearly interest rates to not always go up. Therefore, excluding the use of *interest rate floors* creates a significant handicap in a falling rate environment. This is certainly not an issue in the current interest rate environment, but at some future time it will become an issue if not adequately addressed in this rule. The other instrument that has significant utility in balance sheet management is *swaptions* or options on swaps. Swaptions provide the purchaser the right but not the obligation to enter into an interest rate swap at a future point in time and at specified terms. These instruments have very well defined and limited risk profiles in their native construct, but provide the opportunity to enter into a future interest rate swap if it is favorable at that future time for the owner of the swaption to do so.

Another constraint we consider impractical within this section is that of the exclusion of amortizing swaps. In many cases, the asset or liability to be hedged, would itself, be amortizing thereby making an amortizing swap the appropriate structure for maximum hedge efficiency. This restriction should be eliminated.

Collateral Requirements – Section 703.105

This section restricts collateral to U.S. Treasuries, Agency bullets and zero-coupon Agency debt. Exclusion of asset backed Agency and GSE debt does not appear prudent. All securities are subject to market price fluctuation and collateral value maintenance should be included in all bilateral collateral agreements with counterparties. Accordingly, amortizing assets such as MBS securities pose little additional risk. Presumably, limiting collateral in this fashion would have the effect of limiting it for both parties to the swap. This could have an unintended liquidity consequence for credit unions which have limited portfolios of Treasuries and non-callable Agencies.

Specific Limitations on Trade Structures - Section 703.109

This section applies a limitation of 100 percent of net worth on the aggregate notional value of interest rate swaps. In our opinion, this is an ill advised and counterproductive limitation. Unlike investment securities, the notional value of a derivative instrument is only a benchmark for its underlying mathmatical calculations. Notional value should not be evaluated in isolation as its value can not be determined without consideration of the other components of a swap's structure. This holds true for the other primary variable embedded in a swap structure, that of its duration. Both of these variables must be known to calculate the value of the swap which is the critical issue in any hedging scenario. Notional value and term can readily be adjusted to achieve the desired end result. And the end result which should be the goal for any rule should be the swap's economic value in correlation to that of the asset or liability being hedged. In practice, the risk associated with an appropriately structured hedge, regardless of the derivative instrument utilized, is that hedge's inefficiency. Therefore, we would recommend recrafting the limits currently relating to swap notional value and maturities to reflect limits on the actual risk generated by hedge inefficiency. We believe an appropriate limit for such risk would be 10% to 20% of net worth provided that risk level, if experienced, would not reduce net worth to below 8.0%

As previously noted, limitations on mark-to-market losses on the derivative half of any hedge is inappropriate. This rule as proposed places specific limits on mark-to-market losses on aggregated swap positions. No mention is made regarding mark-to-market gains. Therein lies the fallacy of attempting to limit risk on a single side of a hedged position. With a loss on the derivative portion of the hedge a corresponding gain on the asset or liability being hedged would be expected. Conversely, when a derivative is "in the money" the second half of the hedged transaction would be expected to have a loss that is unrecognized. Thus, we believe that it is inherently inappropriate and fundamentally misleading to place limits on only one side of any hedged position.

Participation Fees

From our perspective the purpose of this rule should be to provide access to tools that can assist in mitigating risk for individual credit unions and for the industry as a whole. Furthermore, we believe that participation in the usage of these tools should be encouraged by the structure of this rule. Therefore, we believe that the levying of fees to participate in hedging activities will actual dissuade participation by many institutions. Fundamentally, we believe the practice of hedging should be embraced by this regulation as it will reduce industry risk and logically the introduction of significant fees is counterproductive to that end.

In summary, we belive the Agency's efforts to introduce this rule are needed and welcomed. We are concerned with what we view as some unnecessary complexities, inefficiencies and added costs introduced by the attempt to place hard and fast rules on the uses of derivative instruments. Accordingly, we would encourage additional study of the areas we have noted and would welcome the opportunity for further discourse on these issues.

We appreciate your consideration of our comments.

Sincerely,

Greg Gibson
Chief Financial Officer and
Chief Operating Officer