SHUTTS & BOWEN LLP

100 Years of Service

FRANÇOIS G. HENRIQUEZ, II
PARTNER
(305) 415-9076 Direct Telephone
(305) 347-7821 Direct Facsimile

E-MAIL ADDRESS:
fhenriquez@shutts.com

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Via email to: regcomments@ncua.gov

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

Re: Proposed Rule – Derivatives

Dear Ms. Rupp:

Shutts & Bowen LLP is pleased to have the opportunity to comment on the National Credit Union Administration ("NCUA") Proposed Rule regarding derivatives as set forth at 78 F.R. 32,191 (May 29, 2013) (the "Proposed Rule"). In addition to commercial banks, community banks, trust companies, foreign banks, insurance companies, broker-dealers, investment advisors, private equity funds and industry trade groups, Shutts & Bowen provides legal and regulatory advice and transactional representation to boards and management of federally insured credit unions throughout the United States.

If adopted by the NCUA Board (the "Board"), the Proposed Rule would permit credit unions, subject to regulatory approval, to engage in limited derivatives activities for the purpose of mitigating interest rate risk. We support NCUA's direction in providing credit unions with additional tools and means to manage their balance sheets safely. We understand that the Proposed Rule addresses those circumstances in which a credit union seeks independent authority to engage in derivatives transactions. However, we encourage the Board to continue to consider and authorize mechanisms and programs under which credit unions can take advantage of derivatives-based interest rate risk mitigation strategies through external service providers.

With respect to the Proposed Rule, we respectfully offer the Board the following comments:

Section 703.102 – Permissible derivative transactions

Under the Proposed Rule, credit unions may only purchase interest rate caps or enter into interest rate swap transactions.
COMMENT:

The definition of "permissible derivative instruments" under the Proposed Rule should be expanded to include interest rate floors, collars, swaptions, and exchange traded futures. Although current markets are preoccupied with the threat of rising interest rates, NCUA should anticipate the interest rate risk credit unions could face in declining interest rate environments by providing credit unions with a broader array of balance sheet management tools. To operate a derivatives program that includes interest rate caps and swaps, a credit union must maintain certain systems, processes, and personnel requirements mandated by the Proposed Rule. These are the same systems, processes, and personnel the credit union would need to engage in transactions involving interest rate floors, collars, swaptions, and exchange traded futures.

Section 703.103 – Eligibility

Among other things, the Proposed Rule would limit Level I and Level II derivatives authority to those credit unions that have assets of at least $250 million as of their most recent call reports.

COMMENT:

While the discussion section of the Proposed Rule as published demonstrates that interest rate exposure is significantly greater among credit unions with assets of $250 million or greater, there are always exceptions. A credit union with assets below $250 million that can otherwise demonstrate compliance with the other requirements of the Poposed Rule should be granted derivatives authority, if only on a waiver basis.

Section 703.105 – Collateral requirements for operating a Level I or Level II program

The Proposed Rule limits acceptable collateral to cash, Treasury securities, fixed-rate non-callable agency debentures, and zero-coupon non-callable agency debentures.

COMMENT:

To improve credit unions' negotiating position with counterparties by conforming collateral requirements to the standard ISDA Credit Support Annex, acceptable collateral under the Proposed Rule should include agency mortgage-backed securities and pass-through certificates.

Section 703.108(a)(3) – Systems, processes, and personnel requirements for operating a Level I or Level II derivatives program

Under the Proposed Rule, to engage in derivatives transactions with Level I authority, a credit union must have knowledgeable and experienced employees that have at least three years of direct transactional experience in the trading, structuring, analyzing, monitoring, or auditing of financial derivatives transactions at a financial institution, a risk management advisory practice, or a financial regulatory organization. (Section 703.110(f) would increase this experience requirement to five years to engage in Level II derivatives authority.)

COMMENT:

By placing a quantitative measurement on a qualitative attribute, the Proposed Rule's requirement of three (or five) years' experience results in a test that, in addition to being arbitrary and vague, fails to ensure its objective. Moreover, auditing derivatives transactions does not necessarily fit an individual for trading derivatives any more than the converse. Rather, credit unions seeking to engage in derivatives authority should be required to engage personnel that have training and experience that are commensurate with the credit union's activities and the position's accountabilities.

Section 703.108(b)(5) – Systems, processes, and personnel requirements for operating a Level I or Level II derivatives program

Before executing any derivatives transactions, a credit union must receive a legal opinion from qualified counsel. Under the Proposed Rule, "qualified counsel" means an attorney with at least five years of experience reviewing derivatives transactions.

COMMENT:

Again, the quantitative measurement of a qualitative attribute results in a test that is arbitrary, vague, and fails to ensure its objective. An attorney who has only one year's experience but has reviewed 20 transactions may well be substantially more qualified to render the required legal opinion than an attorney who has reviewed only one transaction a year for the past five years. The Board need only require that any legal opinion be rendered by an attorney who is competent with respect to the applicable derivatives transactions.

Section 703.109(d) – Specific Level I limits and requirements

Under the Proposed Rule, the aggregate fair value loss of all swap positions into which a credit union with Level I derivatives authority has entered cannot exceed 10 percent of net worth.

COMMENT:

We understand the objective of the Proposed Rule to be to allow credit unions to execute effective strategies for hedging interest rate risk. As a general rule, to the extent a hedge is effective, the market conditions that give rise to a gain or loss on the asset or liability being hedged result in a corresponding loss or gain on the associated derivative. Accordingly, the 10 percent net worth limit should be clarified to ensure that it is based on the net aggregate valuation of both the swap and the hedged item.

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Again, we appreciate the opportunity to comment on the Proposed Rule and hope our comments are useful to the Board.

Very truly yours,

Shutts & Bowen LLP

François G. Henriquez, II

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