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July 29, 2013

Mary Rupp, Secretary of the Board
National Credit Union Administration
c/o regcomments@ncua.gov

Re: Comments on Proposed Regulations – Derivatives

Ms. Rupp,

I am writing on behalf of Travis Credit Union (TCU) which serves our 12 county field of membership in Northern California. We have 177,000 Members and $2 billion in assets. Travis Credit Union appreciates the opportunity to provide comments to the National Credit Union Administration (NCUA) on its proposed derivatives rule.

This proposal is complex and raises a number of public policy issues as well as practical considerations. We believe that the Proposed Rule places clear and reasonable limitations on credit unions seeking to directly utilize derivatives to mitigate the portion of interest rate risk (IRR) attributable to credit unions' direct investments. We also believe, however, that NCUA could significantly enhance the Proposed Rule's effectiveness by providing guidance to credit unions seeking to mitigate the portion of IRR attributable to investments held by credit unions through mutual funds. Specifically, we recommend that NCUA provide guidance indicating that mutual funds marketed to credit unions may mitigate IRR by engaging in the limited derivative activities set forth in the Proposed Rule.

Summary of TCU's Comments

Our views are first summarized below and then subsequently discussed in greater detail in the remainder of our letter.

- TCU supports the agency's efforts to solicit comments on a proposal to authorize derivatives investments to manage IRR. The fact that the agency has issued a proposal for comments indicates that NCUA recognizes the importance of tools such as derivatives to hedge IRR.
- However, due to concerns that the scope and nature of many of the proposed limitations will make the use of even simple derivatives too cumbersome regardless of the credit union's level of participation, TCU does not support a number of the key provisions in the proposal.
- TCU does offer a number of suggestions to improve the rule to make it workable so that it can be implemented in an expeditious manner.
- TCU strongly opposes the imposition of application and/or supervision fees paid to the agency in order for credit unions to apply for or maintain derivatives programs or for ***any other*** financial activity that is directly authorized by statute or incidental to such authority.

- TCU does not support an asset eligibility threshold for derivatives participation.
- TCU is concerned that the investment limitations are too restrictive and urges the agency to provide for waivers and/or permit a Level III derivatives authority that would permit more flexibility for qualified credit unions.
- Credit unions should be able to rely on external service providers to a greater extent than the proposal would permit to meet expertise and experience requirements.
- An internal controls audit will be extremely costly for applicants and redundant since other audit requirements will provide NCUA with the information it needs to be assured a credit union will conduct its derivatives program in a safe and sound manner.
- 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.
- Credit unions that have participated in the pilot program on derivatives should be allowed to continue to do so, without having to reapply.

What Types of Investments Would NCUA's Proposal Cover and Why TCU Supports Simple Derivatives Authority

Some concerns have been raised about whether credit unions should even engage in derivatives, and these fears may be based on confusion within the credit union system about the nature of the derivatives that would be authorized under the proposal.

The proposed rule limits credit unions' authority to "plain vanilla" derivatives instruments known as interest rate swaps and caps. These are not the kinds of financial transactions, such as credit default swaps, that risky hedge funds employed in recent years and that contributed to the financial crisis. Rather, the simple derivatives investments that NCUA would authorize are transactions that actually performed well over the last five or so years.

TCU applauds the Proposed Rule's acknowledgement of the material risk that IRR poses to credit unions' direct investments, especially given the historically low interest rate environment of the last few years. The types of derivatives permitted by the Proposed Rule will provide credit unions with an effective tool for mitigating a portion of their overall IRR exposure.

TCU supports the use of simple derivatives by eligible credit unions as an important means to help manage risks associated with fixed-rate mortgage loans when rates begin to rise. In addition, as stated above, the use of simple derivatives could likewise help to minimize risks to the NCUSIF and the credit union system generally.

Under the proposal, the agency would establish Level l and Level II derivatives authority, with Level II giving credit unions more flexibility but with stricter requirements than under Level l.

The proposed derivatives rule requires credit unions to apply to NCUA for permission to conduct derivatives transactions. Credit unions' applications must demonstrate the need and ability to conduct derivatives transactions in compliance with the proposed rule. The proposal requests comments on eligibility criteria, such as asset thresholds and CAMEL levels. The proposal includes strict collateral and counterparty requirements, as well as provisions on expertise for staff, internal controls, the use of external service providers, and reporting.

The Derivatives Rule Must Be Well Balanced

It is understandable that NCUA in establishing a new program such as under the proposal would address eligibility requirements and related issues. However, key to the ability of derivatives authority to help credit unions manage their IRR is a regulatory framework that enables reasonable participation subject to appropriately calibrated requirements. We do not think the proposal strikes that balance and in fact if adopted as proposed, will virtually assure minimal use of derivatives, thus undermining the very purpose of the agency's own rule.

We urge the agency to revise the proposal as recommended below to address the concerns we are raising in a timely manner so that credit unions can move forward with these investment vehicles in sufficient time to help us be well positioned for rising interest rates, which are already creeping up in certain markets.

Application and Supervision Fees

TCU strongly opposes the imposition of application and supervision fees in order for credit unions to gain derivatives authority.

TCU also believes the amounts of the fees detailed in the proposed rule are higher than necessary to fund examination and supervision of credit unions with derivatives authority. We realize that the fees reflect the agency's estimate of its costs, which we address below, but NCUA has experience examining credit unions in the pilot program, which should facilitate the agency's efforts to examine and supervise credit unions with derivatives authority.

With proper safeguards, such as reasonable requirements in NCUA's final rule, these programs can be safely managed and risks to the National Credit Union Share Insurance Fund (NCUSIF) can be reduced. All federally insured credit unions, as paying participants of the NCUSIF, will benefit when credit unions reduce IRR through the use of derivatives, which in turn reduces risk to the fund. This risk reduction should be incentive enough for credit unions to gain derivatives authority.

We are concerned that the proposed fees would create additional unnecessary barriers for credit unions seeking derivatives authority. Separate from any fees, the requirements that NCUA proposes to place on credit unions applying for derivatives authority will be extremely costly and burdensome for many credit unions. Additional costs imposed by NCUA for supervision and application will multiply these burdens and lock a number of credit unions out of derivatives because the explicit fees coupled with the costs of the other requirements would exceed the benefits for those credit unions.

If derivatives reduce IRR, then NCUA should be encouraging credit unions to make appropriate use of permissible derivative options instead of erecting barriers to their use, such as fees to apply or for supervision.

TCU also opposes fees for application and supervision of derivatives authority because they would represent a change to the funding of regulation that is already in place. Credit unions should not be charged additional fees for adding services, investment activities or other products that have been duly authorized. An à la carte fee structure sets a precedent that, if applied to other products and services, could stifle innovation for credit unions by imposing additional burdens and costs that are simply not justified.

The proposed rule considers a Level l 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. While as stated above we cannot support fees in connection with derivatives authority, setting a range for fees would be even more problematic. Using ranges indicates NCUA does not have a precise measurement of its costs and more problematic, the more a credit union would utilize derivatives to manage risks, ironically the greater its fees would be.

In short, regarding additional fees, we feel that it is incumbent upon NCUA, as the regulator, to develop the expertise necessary to enable it to properly regulate the evolving business model of a credit union without imposing extra charges. This time it is derivatives, but next time it could be a payments system or other innovation. Quite frankly, NCUA should be able to keep up with credit unions through the normal course of its supervision program, without having to develop elaborate programs in a one-off fashion for which it must charge credit unions additional fees.

TCU's General Concerns Regarding Costs Associated with the Proposal

One of the biggest concerns with the proposal is the prohibitive compliance costs, in addition to any application and examination fees, that would be necessary to meet the requirements of the proposal.

While NCUA has provided some estimates of the regulatory and paperwork burdens associated with complying with the proposal, there was no cost analysis that we could see regarding projected costs for each new requirement and for the total requirements that credit unions would have to bear.

We also believe the agency's estimate of around $6 million to $11 million to develop an application and supervisory program should have been supported with analysis and a more thorough explanation. It is simply incredible to many credit union officials as to why it will cost so much to initiate this limited program involving simple derivatives that will ultimately save money for the credit union system by limiting risks to the NCUSIF.

We fear that the costs borne by credit unions conducting derivatives transactions under the proposed rule will vastly outweigh any potential benefit from the risk reduction derivatives may provide. Placing too many costly restrictions on credit unions creates barriers that keep the institutions from utilizing an important and necessary tool.

Another concern regarding costs is that under the proposal as currently structured, many of the requirements must be met ***even 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 may make many credit unions very reluctant to seek approval if they have to undertake major expenditures when they are not certain their application will be approved.

Also, any hedge will reduce a credit union's income and that should be factored in when NCUA establishes requirements that will inflict high costs.

Eligibility for Derivatives Authority

The proposal does not permit a credit union that has less than $250 million in assets to apply for derivatives authority. TCU opposes the $250 million asset threshold because it is arbitrary and ignores the needs of credit unions under that threshold. Credit unions below the asset threshold have IRR and may benefit from using derivatives to hedge these risks. If they meet the other derivatives rule requirements, they should be granted derivatives authority.

Admittedly, it may be difficult for credit unions below the threshold to find counterparties and to meet other requirements of the rule, but those that can meet the other requirements and can find counterparties should be given derivatives authority.

We agree that participating credit unions should be required to meet certain standards, but such standards should be based on safety and soundness and the ability to manage risks that may be associated with derivatives, not on an artificial eligibility requirement such as an asset level.

If credit unions under a certain asset level are prevented from using derivatives due to lack of counterparties then the asset threshold will not be necessary and does nothing more than create an additional complication to the rule. In any event, there are sufficient tests for eligibility that must be met without the asset threshold, which should be removed.

We suggest adding a section to the Proposed Rule addressing "Indirect Investments in Permitted Derivatives." We propose explicitly stating that, in addition to investing in all other permissible investments, mutual funds that possess an NCUA-approved level of financial sophistication, risk management and operational capabilities (and market to credit union investors) may invest in Permitted Derivatives to mitigate the inherent risks of those other permissible investments. For consistency with the Proposed Rule's limits on credit unions' mitigation of direct IRR using derivatives, we suggest applying the Proposed Rule's Level II limitations to mutual funds' mitigation of indirect IRR using derivatives.

We also suggest adding interest rate futures to the list of Permitted Derivatives that can help credit unions mitigate direct IRR and mutual funds mitigate indirect IRR. Interest rate futures are exchange-traded instruments that can be used to hedge interest rate exposure. They tend to be highly liquid, are most commonly cash-settled, and are highly regulated by the U.S. government through the Commodity Futures Trading Commission.

State-Chartered Credit Unions

Federally insured state credit unions (FISCUs) would be required to comply with NCUA's derivatives rule or the derivatives rule issued by the state where they are chartered but only if the state rule is more stringent than NCUA's. The effect of this requirement is that NCUA would set the minimum derivatives rules for all federally insured credit unions. We are seriously concerned that this is an overreach of NCUA's regulatory authority, which would have an adverse impact on the dual chartering system.

The proposed derivatives rule allows state regulators to develop any derivatives regulatory scheme as long as it is more restrictive than NCUA's derivatives rule. NCUA as an insurer may favor this approach as it simplifies derivatives rules across the broad spectrum of state regulatory authorities. However, it would stifle innovations and 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.

Every state regulator should be allowed to develop its own derivatives rule(s), and FISCUs should apply to their regulators for approval, unless the state regulator elects to have its credit unions apply to NCUA and follow NCUA's rule.

Investment limits

The proposed derivatives rule creates Level I and Level II authorities and limits, which are expressed as a percentage of net worth, for conducting derivatives transactions.

The amount of swaps that a credit union can purchase to hedge IRR is based on a credit union's net worth. 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. In light of this, an alternative to net worth should be available as a benchmark for credit unions in meeting investment limits. 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. An alternative could be to allow credit unions to match derivatives to segments of their portfolios that create IRR.

We also feel that duration should be extended to give credit unions more flexibility in matching derivatives to risks. The 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.

Valuations

TCU has concerns about the use of mark-to-market valuations relating to derivatives and urges NCUA to provide flexibility in the final rule regarding the use of mark-to-market, as permitted under the Federal Credit Union Act (12 USC 1782(a)(6)(C)(ii)). Mark-to-market loss in a derivatives portfolio is recognized under GAAP as unrealized loss, but it is often more than offset by a commensurate gain in the value of long-term fixed rate loans, although such gains are generally presented at book value. As such, a credit union's balance sheet may continue to be well hedged with very little, if any, net economic value (NEV) volatility even when it is carrying a large net unrealized loss on cash flow hedges.

We also think that requiring participating credit unions to calculate the fair market value of their derivatives exposure and monitor collateral on a daily basis will be unduly burdensome and cost prohibitive for many credit unions that could otherwise benefit from using derivatives. We agree with NCUA that valuating derivatives' exposure and collateral is essential to the proper management of derivatives, but we urge the agency to consider whether credit unions should be allowed to conduct these valuations on a less frequent basis, such as bi-weekly or monthly, depending on the extent of the credit union's involvement with derivatives.

Collateral

Under the proposal, participating credit unions would be required to collateralize their derivative investments with cash, treasury securities and certain agency debentures. We think this may be too limiting and participating credit unions should also be allowed to use agency mortgage-based securities and pass-through certifications that are fully guaranteed by one of the government sponsored enterprises (GSEs).

Expertise and Experience Requirements

NCUA should allow credit unions to meet experience requirements with employees, contractors, or through service providers when the qualified person is not in a position to profit from the transactions. Meeting the experience requirements would be relatively easy for a number of credit unions if costs were not an issue. Unfortunately, costs and the availability of experienced derivatives people may preclude many credit unions from engaging in derivatives.

Level I credit unions may be impacted the most by this problem for the simple reason that they have lower limits and thus, derive fewer benefits from the use of derivatives, making them more cost sensitive to the use of derivatives under the proposal.

However, we believe that Level I and Level ll credit unions should have the ability to rely on external service providers for any or all aspects of their derivatives programs. We urge NCUA to work with businesses that have the ability to help credit unions manage derivatives programs to develop turnkey alternatives that can be used to give credit unions manageable exposure to derivatives but also limit the risk and reduce costs.

Additional Levels of Investment Authority

The Level I and Level II investment limits for credit unions with derivatives may be sufficient for most credit unions. However, we urge NCUA to include in the final rule assurances that it will review these limits on an annual basis to ensure they are appropriate or to determine if they are in need of revision.

Moreover, we are very concerned that there are instances in which credit unions will have a greater need to use derivatives to mitigate IRR than even Level II would provide.

We urge NCUA to include a timely and meaningful waiver process or provide for a new Level III of derivatives authority for certain credit unions.

Similar to Level II, Level III would be appropriate only for those credit unions that can readily demonstrate their IRR and reasonably establish their ability to manage the additional authority.

Internal Controls Audit

It appears from the proposed rule that all credit unions will be required to have an internal controls audit to gain derivatives authority. This requirement is excessive and unnecessary for most credit unions. Most of the necessary requirements of an internal controls audit can be accomplished through the external audit process.

Some credit unions gaining derivatives authority will likely need to find new auditors that are familiar with derivatives. Experienced external auditors with derivatives experience should be able to perform an audit in a manner that is sufficient to give NCUA comfort that the proper internal controls are in place and that the applying credit union can safely engage in derivatives transactions.

Credit unions are likely to incur additional external audit expenses when securing an auditor with derivatives experience. Requiring an internal controls audit on top of this requirement for a credit union that conducts a few derivatives trades a year will be cost prohibitive and exclude many credit unions from seeking derivatives authority.

Legal Review

NCUA should revise the legal review requirement to ensure that it is commensurate with the plain vanilla type of derivatives the proposal would authorize. The agency should also detail its expectations for such review in line with the low risk profiles of the kind of transactions that will be permitted.

The proposed rule includes a legal review requirement, which includes attorney experience for a lawyer hired to conduct a legal review of the derivatives program and transactions. The attorney must have at least five years of experience reviewing derivatives transactions with the requisite skills and experience to evaluate International Swap Dealers Association (ISDA) agreements and compliance properly.

We agree that credit unions should hire attorneys with the proper skills and experience necessary to perform a derivatives review. However, the requirements NCUA would impose on the legal review are too burdensome. An attorney with the level of experience NCUA is proposing may be necessary to review a complicated derivatives transaction. However, NCUA is not proposing to allow credit unions to perform such complicated derivatives transactions. An ISDA agreement is boilerplate and unlikely to be modified by either party. Thus, a legal review is not necessary for every ISDA agreement, but only needed when new terms have been offered.

An experienced financial institution's regulatory attorney should have the skills to ensure that NCUA's requirements for the derivatives program are in place. In addition, we encourage NCUA to clarify the exact tasks that the derivatives attorney must perform relative to the derivatives program and each transaction. This is necessary for both credit unions and examiners so that all parties are clear as to the expectations of this requirement, which would help to eliminate chances for confusion as to what tasks are to be performed by the attorney.

Reporting

Credit unions should be able to outsource compliance with the reporting requirements. The proposed rules reporting requirements will require new infrastructure that will be expensive to develop and maintain. This infrastructure will possibly be underutilized by credit unions conducting a small number of derivatives transactions or with limited derivatives exposure. These and all other participating credit unions should be allowed to outsource reporting to a third party. We see little risk to credit unions by allowing a third party to provide reporting, which allows credit unions to leverage the skill of an outside party that can easily provide the necessary information to meet the needs of management and NCUA.

External Service Providers

The proposed rule limits the use of external service providers (ESP). Credit unions typically rely on ESPs for many services that might otherwise be cost prohibitive. ESPs are often owned by a single or a small number of credit unions, likely through credit union service organizations (CUSO). CUSOs allow credit unions to share resources while retaining control and ownership of the resource provider. The proposed derivatives rule allows a wholly-owned CUSO to perform functions required by the proposed derivatives rule but does not permit a CUSO owned by more than one credit union to perform such functions.

We urge NCUA to change this approach. A credit union should 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. We think that this requirement will weaken CUSOs and raise expenses for credit unions considering conducting derivatives activities.

We also want to reinforce that Level II credit unions should have the same ability to rely on ESPs as Level I credit unions. The proposed rule allows Level I credit unions to use ESPs to conduct far more activities than Level II credit unions. 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.

Pilot Program

NCUA should consider credit unions that participated in the pilot program and successfully used derivatives to mitigate IRR. NCUA has relied on these credit unions as a resource to gain regulatory experience with supervising derivatives activity. These credit unions should be grandfathered into the highest level consistent with their needs and expertise. Pilot program credit unions are the only credit unions that have conducted derivatives transactions and represent the least amount of risk to the credit union system regarding derivatives programs.

Pilot program credit unions should also be exempt from experience and training requirements. Presumably, these institutions have gained the best training through hands-on activities that were sanctioned by NCUA. Also, because they were allowed to participate in pilot derivatives, they must have been using derivatives in a safe and sound manner. Forcing pilot program credit unions to re-qualify and apply for derivatives authority would be redundant and needlessly burdensome.

Conclusion

This is a very important proposal, for many reasons. TCU strongly supports the agency's efforts to move forward with a derivatives rule. At the same time, we urge the agency to make the key revisions we are advocating in order to ensure the program will be as accessible as possible to mitigate IRR as broadly as possible. Since IRR is a top concern, the development of the proper parameters for the regulation of derivatives to mitigate that risk should also be a top priority for the credit union system.

Thank you for the opportunity to comment and for considering our views on the proposed rule for derivatives.

Regards,

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