League of Southeastern
Credit Unions & Affiliates

July 29, 2013

Ms. Mary Rupp
Secretary of the Board
National Credit Union Administration Board
1775 Duke Street
Alexandria, VA 22314-3486

Re: Proposed Rule: Derivatives / 12 CFR Parts 703, 715, and 741 / RIN 3133-AD90

Dear Ms. Rupp,

This letter represents the views of the League of Southeastern Credit Unions (LSCU) on the National Credit Union Administration Board's (NCUA) proposal to permit credit unions to engage in limited derivatives activities for the purpose of mitigating interest rate risk. This proposal applies to federal credit unions and any state chartered credit unions currently permitted under applicable state law to engage in derivatives transactions. By way of background, the League of Southeastern Credit Unions (LSCU) is one of the largest credit union advocacy organizations in the country, representing approximately 285 state and federal credit unions throughout Alabama and Florida.

While we consider it positive that the National Credit Union Administration is seeking comment on a proposal to allow eligible credit unions to use simple derivatives to hedge against interest rate risks, our organization and its affiliates are concerned with the proposal as presented. Some of our concerns include the proposed fee structure, overly restrictive eligibility requirements, and restrictions on personnel managing credit union derivatives programs.

Credit Union Participation Fees

The most glaring issue in the proposal right now is whether credit unions that choose to participate in the program should bear the costs of the applications, supervision, and examinations associated with it. One of the concerns about the possible fees is that such a requirement would set a precedent for a new fee structure from NCUA for future initiatives or services that a credit union is permitted to engage in if it is concluded that the activity presents greater risk to the National Credit Union Share Insurance Fund. LSCU strongly advocates expansion of credit union investment powers including limited derivatives authority. We therefore appreciate that NCUA continues to seek opportunities for credit unions in these areas. We are just not convinced that this fee driven approach is the most efficient method to adopt at this time.

At this point the program costs are expected to vary based on the number of applications received which NCUA initially estimates will be between 75 to 150 credit unions in 2014. To address the disparity between credit union sizes, The NCUA developed separate eligibility requirements for two levels of applicants based on the program estimates. Level I credit union application fees would start at $25,000, and Level II application fees would vary from $75,000 to $125,000, depending on the complexity of the application. The NCUA expects the overall program costs to range from $6.25 million to $10.75 million in 2014. These estimates reflect one-time start-up costs and costs of qualifying, processing and supervising a variable number of credit unions seeking derivatives authority. Thereafter, based on the absence of one-time fees and costs, the NCUA projects the program costs to decline in 2015 to between $2.05 million and $3.85 million.

Establishing a "pay-to-play" regulatory arrangement for credit unions that seek to, and subsequently are permitted to, engage in derivatives activities would be a first for our industry and would set a significant precedent for other activities that credit unions might seek to engage in the future. LSCU considers this approach 'suspect' and we have significant concerns that it will likely create unnecessary obstacles to participation for many credit unions, as well as potentially dividing the credit union movement into separate paying and non-paying camps. We view this as a bad precedent and not beneficial to the credit union industry in the long run.

Credit Union Eligibility Requirements

Currently, derivatives are among the instruments specifically prohibited by NCUA but the agency has been evaluating pilot programs for limited derivatives use since 1999. That evaluation process has evidently satisfied the Board to the point that certain credit unions are to be permitted to effectively manage a limited derivatives program in order to hedge interest-rate risk in a safe and sound manner, provided they have sufficient experience, management capacity and infrastructure in place before implementing such a program. The Board also feels comfortable allowing the use of external service providers in limited ways when credit unions meet particular conditions and observe particular restrictions. We support the coordination between the NCUA and representatives of state credit union supervisors to develop the proposed rule. We further support applying the rule to both federal credit unions and federally insured state-chartered credit unions that are permitted to engage in derivative transactions under state law is a reasonable approach.

LSCU is concerned however, that eligibility requirements currently proposed are too restrictive. We view the requirement that excludes credit unions that have less than $250 million in assets from applying for derivatives authority as unnecessary. Many institutions below this threshold could effectively manage their own derivatives program and those that are not prepared for the rigors of such a program will forego participation. Therefore, an asset sized threshold such as this serves as an obstacle to potential credit unions. We oppose its inclusion in the rule.

While the term "derivatives" covers a broad spectrum of financial instruments in today's financial market, NCUA is only proposing to authorize a very limited version of the program via the use of very plain, US Dollar-denominated (USD) interest rate swaps and purchased-only interest rate caps. These instruments are widely transacted in today's capital markets, have deep and transparent pricing and afford end users with strong liquidity and execution.

As proposed, participating credit unions would only be able to purchase interest rate caps or enter into interest rate swap transactions that are for the purpose of managing interest rate risk; not leveraged; based on domestic rates; denominated in US dollars; not used to create structured liability offerings for members or nonmembers unless exception applies; settled within three business days of entering into the transaction; and interest rate swaps that do not have fluctuating notional amounts. This is a very limited approach to managing interest rate risk and we would like to see a more expansive program made available to credit unions capable of managing the related responsibilities. LSCU also notes that concerns have been raised about restrictions set on notational value at 100% of net worth for a Level I credit union and 250% for a Level II credit union. A side-by-side comparison of the limits and requirements for a Level I and Level II program, for example also show that for Level I program, interest rate caps are restricted the aggregate book value of 10% of net worth compared to a Level II, in which the interest rate caps are limited to an aggregate book value of 25% of net worth. Why were 10%/25% chosen as the optimum net worth totals for NCUA use? More detail is needed.

With regard to interest rate swaps, the NCUA Board is proposing to authorize only standard "pay-fixed/receive-floating" and "pay-floating/receive-fixed" interest rate swaps. It is currently anticipated that most interest rate swaps users would enter into "pay-fixed/receive-floating" transactions to hedge against rising interest rates. This "plain vanilla" interest rate swap affords some protection against the most common interest rate exposure experienced by credit unions with material interest-rate risk (IRR) sensitivity—namely, a balance sheet with an asset portfolio that does not reset to external rate changes as quickly as its liabilities. We question whether these restrictions are necessary to address the notational value. There is no reference as to whether the swaps have a distinct schedule or one that has a pre-established determinant. If a notational value is established by specific schedule, the restriction seems counterproductive and its removal should be considered.

Use of CAMEL Ratings

We agree with the NCUA's plan for the use of specific CAMEL code ratings in the application process. Under either the Level I or Level II derivative authority the credit union's most recent composite CAMEL code rating assigned by NCUA would need to have been a 1, 2 or 3 with a management component of 1 or 2. We believe this approach would serve as an effective indicator of a credit union's capabilities with regard to managing the application, expertise, and systems requirements associated with operating a derivatives program.

Policy & Procedure Requirements and Personnel Qualifications

We have reviewed the requirements deemed necessary to participate in a derivatives program. The requirements include the need for a participating credit union to develop comprehensive, written policies and procedures that address minimum program requirements. Also, the credit union's board of directors would be obligated to review those policies and procedures annually as well as updating them when necessary. Also present in the program rules proposal are requirements that involve collateral and counterparty activities that each credit union must meet when operating either a Level I or Level II program. We support the creation of internal policies and procedures upon which credit unions will rely to manage their programs. We are concerned however, that these may become too cumbersome for many credit unions so we encourage the NCUA to provide more detail as to the expected content.

There are also present in the NCUA's proposal requirements that certain experience and competency levels that must be present at each credit union seeking approval to engage in derivatives activities. Included in the proposal are requirements that the board of directors must annually receive training regarding general understandings of derivatives and knowledge to provide strategic oversight of the credit union's derivative program and senior executive officers must possess sufficient understanding and experience to understand, approve and provide oversight for the program. This experience includes such things as being qualified to understand and oversee appropriate accounting and financial reporting for derivatives transactions in accordance with GAAP.

There are also operational requirements for management to address that create additional expense for the credit union's derivatives involvement. For example, before "executing any transactions under this subpart of the rule, a credit union must obtain a legal opinion from qualified counsel that states that the credit union's ISDA agreements are enforceable and that the institution has complied with all applicable laws and regulations relating to their operation of a derivatives program. A qualified counsel is defined as a licensed attorney with at least five years of experience for derivatives transaction review purposes. The costs that will be incurred for this type engagement will prove to make entry into a derivatives program a non-starter for many credit unions. In addition, the effectiveness of a requirement that a credit union must itself ensure that counterparties are authorized to enter into such transactions is questionable. For smaller credit unions with limited resources, it's just not feasible.

After reviewing the proposals experience requirements, we recommend NCUA revisit this part of the proposal. The many requirements present in this part of the proposal appear to be much too onerous and inflexible for credit unions wishing to participate. We are also concerned that credit unions of limited means capable of participating will be discouraged by these added obligations.

Use of External Service Providers

LSCU encourages the NCUA revisit this part of the proposal to provide that all Level I or Level II credit unions applying to participate in the derivative authority program be permitted to contract with external service providers to engage in a broader variety of services than those specified in the proposal. The facilitation of a credit union's derivative authority program application and the data/information management of the day to day derivatives program are just two services a third party vendor could be contracted to provide for credit unions.

The Program Application Process

After reviewing the proposal, we believe the process available for credit unions to apply for Level I or Level II authority should be further streamlined. A FCU credit union would be required to submit their request to the Field Director and a FISCU would submit their request to the state supervisory authority. We recognize the need for multiple approval paths based on agency authority and jurisdiction. However, with rates already rising, already 100 basis points on some parts of the curve, thought should be given to the creation of an expedited approval path before the approval of a program request provides limited relief from interest rates that have already increased.

Technical Amendments

LSCU is supportive of the NCUA's efforts to address outdated and erroneous regulations currently under its authority. We consider the final rule on technical amendments a positive step forward by the NCUA which will benefit credit unions operating under its rules. We are concerned however, about the transfer of certain consumer protection laws to the Consumer Financial Protection Bureau (CFPB). Based on the performance of the CFPB so far in communicating, analyzing, and finalizing a variety of issues in a timely manner, we are concerned that the CFPB has so far displayed limited ability to conduct these activities with the efficiency enjoyed by credit unions in the past. We are willing to take a wait and see approach in the hopes that past CFPB performance in this area is not indicative of future results.

Conclusion

We are aware and appreciate the fact that the derivatives program proposal is not cast in stone and our comments are welcomed on all aspects of the rule. NCUA Board Chair Debbie Matz is quoted as stating "Working with credit unions to manage interest-rate risk exposure is a top priority for NCUA and the negative impact on balance sheets when rates rise, especially if they rise rapidly, will significantly reduce the earnings and net worth of exposed credit unions". We look forward to working with the NCUA on ways to aid our affiliated credit unions in preparing for the demands of rising interest rates and their related challenges. The NCUA Board's proposal to allow eligible credit unions to purchase simple types of derivatives with certain safeguards to hedge interest-rate risk is a positive beginning.

Thank you for the opportunity to comment on this proposal. If you have any questions regarding our views, please feel free to call me or contact our Director of Regulatory Compliance Scott Morris at (205) 437-2165.

Sincerely,

Patrick La Pine
President and CEO