PENNSYLVANIA CREDIT UNION ASSOCIATION

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July 29, 2013

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

RE: Comments on Proposed Derivatives Rule - 12 CFR Parts 703, 715, and 741

Dear Ms. Rupp:

The Pennsylvania Credit Union Association (PCUA) appreciates the opportunity to comment on the National Credit Union Administration's (NCUA) proposed derivatives rule 12 CFR Parts 703, 715, and 741, which will permit credit unions to engage in limited derivatives activities to help mitigate interest rate risk. PCUA is a statewide advocacy organization which represents a majority of the over 500 credit unions located in the Commonwealth of Pennsylvania.

PCUA consulted with its Regulatory Review Committee and State Credit Union Advisory Committee (the Committees) in order to provide comments on the derivatives proposal. The Committees consists of credit union CEOs and senior management staff. Members of the Committees also represent credit unions of all asset sizes. The comments contained in this letter reflect the input of the Committees and PCUA staff.

PCUA supports authority for credit unions to engage in derivatives transactions as a means to mitigate interest rate risk (IRR). However, PCUA and the Committees are very concerned that the restrictions and fees included in this proposal are much too constrictive for a credit union to find any value in participating in such limited derivatives transactions. Further, the Committees and PCUA oppose the proposed application and supervision fees.

Application/Supervision Fees
To the best of our knowledge and belief, the proposal marks the first time that NCUA has sought to impose an application or ongoing supervisory fee. The proposal does not articulate the statutory authority for such a fee structure. Before imposing the fee scheme, NCUA should establish its legal authority for doing so.

The Committees anticipate that the proposed fees will deter credit unions from utilizing the derivatives authority. The application fee, combined with the compliance prerequisites to engage in derivatives front-loads the expenses. An application fee, even as low as $25,000, would be a deterrent for any credit union interested in participating in derivative transactions, despite asset size or derivatives expertise.

The credit unions that comprise the Committees have sophisticated and in-depth experience at investing for their credit unions, as well as, balance sheet management. Consequently, they view the proposed derivatives authority as an appropriate investment tool that does not present undue risk to a credit union.

Further, appropriate IRR mitigation reduces risk to the National Credit Union Share Insurance Fund (NCUSIF). Accordingly, PCUA and the Committees maintain that the application and supervisory fees create an unnecessary barrier to exercising what could be an effective risk mitigation strategy.

PCUA and the Committees are troubled by the precedent that could be set by the imposition of application or supervisory fees. NCUA's rationale for the proposed fees is to recover costs associated with examination time, staff, or contractors to supervise those credit unions that engage in derivatives transactions. The authority for derivatives transactions is limited to risk mitigation. It is hard to grasp what additional costs NCUA might incur for supervision where the purpose of the underlying regulation is risk mitigation.

Second, PCUA and the Committee are concerned by the potential of future application of NCUA's cost rationale to other activities. For example, all credit unions do not engage in member business lending or invest in or conduct business with credit union service organizations (CUSOs). NCUA , from time-to-time, has cautioned credit unions about managing risk connected to those activities. We would oppose any effort by NCUA to apply a fee structure to those activities

In sum, the Federal Credit Union Act and the various state credit union laws establish the permissible powers and activities for credit unions. When those laws are enacted or amended, society renders a public policy decision on the appropriate levels of risk as well as the appropriate powers for a credit union. Federal and state regulators alike must budget and train their staff consistent with the powers established by federal or state law. Ad hoc efforts to impose fees to cover or recover perceived costs undermine the value of a credit union charter.

Permissible Transactions

Section 703.102 limits permissible derivatives to interest rate caps and interest rate swaps. The scope of the permissible transactions in this proposal is too narrow. The Committees are advocating for NCUA to add forward swaps to this proposal as well, because these transaction are just as "plain vanilla" as interest rate swaps and caps. With the proposed stringent requirements on credit union personnel to have three years or more experience with derivatives, there would be no doubt that employees would be familiar with the forwards swaps. Additionally, the Committees oppose the requirement to settle the transaction within three business day of entering the transaction. Three days does not give credit unions the flexibility to account for the rise and fall of interest rates to mitigate risk. The credit union should have discretion concerning settlement.

Eligibility

Section 703.103 defines the eligibility requirements for a credit union to apply for Level I and Level II derivatives authority. The Committees agree that NCUA should set certain standards in order for credit unions to be eligible to participate in derivatives transactions to protect the safety and soundness of credit unions and the NCUSIF. But, the arbitrary asset threshold eligibility requirement in this proposal does not parallel a credit union's ability to engage in certain financial transactions. This limitation should be removed and the eligibility requirement should be based on the complexity and nature of the credit union's balance sheet as well as the ability or experience of management to engage in such transactions.

Section 703.100(a)(2) permits federally insured state-chartered credit unions to engage in derivative transactions under applicable state law. Pursuant to Pennsylvania's Credit Union Code, the Pennsylvania Department of Banking and Securities (the Department) would have latitude to impose additional safety and soundness requirements on derivatives transactions. With that in mind, PCUA and the Committees

urge NCUA to moderate the compliance requirements for derivative transactions consistent with the comments below.

Proposed Requirements

The Committees agree that the proposed requirements for both Level I and Level II derivatives authority, are much too restrictive. The compliance costs to credit unions would be astronomical if this proposal were to go into effect as is. These requirements are a major barrier that few, if any, credit unions would want to comply with just to participate in simple derivatives transactions.

Collateral Requirements

Section 703.105 restricts the collateral requirements to only certain highly liquid instruments, such as cash, Treasury securities, fixed-rate non-callable agency debentures, and zero-coupon non-callable agency debentures. The Committees suggest that the final rule include agency mortgage-backed securities as acceptable collateral. These instruments are highly liquid, fully guaranteed, and convenient to credit unions because their own portfolios could be used as collateral.

Reporting

Section 703.107 requires senior executives to deliver, at least monthly, a comprehensive derivatives report to the board of directors. The proposed level of detail is inconsistent with the risk posed by the plain-vanilla permissible transactions. A report that must include itemization of the credit union's individual positions and the cost of executing new derivatives transactions devalues the use of the derivatives program. The asset-liability management policy and the investment policy should already detail much of what proposed section 703.107 requires. We view any requirements beyond a policy that sets the investment limits as redundancy.

Systems, Processes, and Personnel

The proposal addresses the requirements for certain systems, process, and personnel for credit unions that wish to participate in derivatives transactions. Specifically, the requirement for an internal controls review has the Committees the most concerned with compliance. Section 703.108(b)(3) requires a credit union to have an internal controls audit completed by external individuals qualified to evaluate the attributes of the derivatives program. The Committees are requesting clarification as to the reason why an internal employee could not complete this function. If it is mandatory to obtain a second review from derivative specialist, the compliance costs would indeed be prohibitive. Derivative activity is not so difficult such that a credit union's internal audit team is adequate to ensure appropriate internal controls.

Section 703.108(1) requires board members to complete training on derivatives and understand how derivatives fit into the business model and risk management program. This training is to continue annually. The Committees assert that NCUA seeks to place undue responsibility on the board of directors for derivative activity in terms of training and ongoing review of the investments. The board's role should be limited to setting policy and providing for an adequate system of internal control. The yardstick for measuring the board's performance should be the business judgment rule as articulated by the state law where the credit union is headquartered.

Section 703.108(b)(5) requires credit unions to receive a legal review from qualified counsel before executing any derivatives transactions. The requirement for when a legal opinion is required must be

clarified. If the final rule commands that the opinion to be rendered by counsel with securities experience in the specific investment, that ramps up the compliance costs and will deter credit unions from exercising the authority.

External Service Providers

Section 703.108(e) prohibits the services and external services provider can provide to support or conduct certain aspects of the derivatives program. The Committees agree external service providers (ESPs) could potentially be very costly to credit unions engaging in derivatives transactions. The Committees have asked for clarification of the specific activities ESPs can engage in such as examples and what the differences are between support and conduct.

Limits

Sections 703.109 and 703.110 establish the specific Level I and Level II derivatives limits and requirements. The maximum permissible weighted average life (WAL) on all derivatives is limited to 5 years under Level I and 7 years under Level II. The Committees maintain that these years are arbitrary. While it is understandable that NCUA wants to take a conservative approach to WAL, in order for credit unions to use derivatives effectively to mitigate IRR, the swap should offset a particular duration segment of the credit union's balance sheet. In this low interest rate environment, what has typically been presumed as average life will most likely be longer for credit unions. The Committees urge NCUA to remove the WAL restriction and have the proposal focus more on the credit union's balance sheet.

Conclusion

In closing, the ability for credit unions to use derivatives transactions as a tool to help mitigate interest rate risk is highly supported. But, the application fee and ongoing examination fees sets a horrible precedent. If this authority takes hold, there is serious concern by credit unions that NCUA will impose application or additional examination fees on any other activity that it deems to be difficult. Overall, the eligibility requirements combined with the ongoing compliance chores such as internal control, policies, legal opinions and other requirements will deter credit unions from using derivatives an investment tool that they would like to use to manage IRR. The Committees urge you to please take these points in to consideration when drafting the final rule.

Very truly yours,

PENNSYLVANIA CREDIT UNION ASSOCIATION

James J. McCormack
President/CEO

cc: PCUA Board
Regulatory Review Committee
State Credit Union Advisory Committee
M. Dunn, CUNA