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We thank the National Credit Union Administration (NCUA) for the opportunity to comment on the proposed rule RIN 3133–AD90 "Derivatives" (hereinafter, "Proposal") and we applaud the NCUA's efforts to enhance interest rate risk management alternatives on behalf of the credit union industry. Generic interest rate derivative instruments serve an important role by rebalancing accumulated risk positions, inherent within any financial institutions' business practice. The natural product appetites of any local market most often result in organically mismatched balance sheet interest rate risk (IRR) profiles. Therefore, the inclusion of derivatives within the eligible "toolkit", alongside more standard methods of IRR management, should be deemed a worthwhile exercise.

While we appreciate the framework put forward within the Proposal, we would ask for further consideration regarding a few of its components. In the following letter, we provide commentary on those components, as well as potential alternatives with corresponding rationale. The letter addresses these items in the following order:

1. Permissible Derivative Instruments
    a. Instrument Types
    b. Maturities/Size Limitations
2. Counterparty Limit Expectations
    a. Eligible Counterparties
    b. Credit Support Agreements
    c. Counterparty Credit Monitoring
3. Experience Requirements
    a. Internal Staff Requirements
    b. External Service Providers
4. Authority Levels and Application/Examination Fee
    a. General Commentary

Thank you for entertaining our comments and we would welcome the opportunity to discuss in further detail.

Respectfully,

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Permissible Derivative Instruments

The Proposal details those derivative instruments that would be both permissible and appropriate for use by credit unions. We agree with the NCUA's initial "targeted approach" to eligible instruments; as the universe of derivative structures is diverse and could lead to attempts at risk mitigation in more esoteric products. We also agree with granting permission only for hedging instruments designed to reduce, not speculate on, risks relating to interest rate movements. Other risk exposures, such as credit, introduce an entirely new set of instruments, pricing models, and associated complications (i.e. accounting considerations) that can prove problematic.

Therefore, the first limitation to standard "plain-vanilla" interest rate swaps is appropriate. The Proposal reads:

> *"With regards to interest rate swaps, the Board is proposing to authorize only standard 'pay-fixed/receive-floating' and 'pay-floating/receive-fixed' interest rate swaps"*

This would provide a suitable hedging vehicle to institutions with net balance sheet risk exposures to rising rates (liability sensitive). For example, a credit union predominantly funded by money market shares supporting 15 year fixed rate mortgage loans will see both net interest income (NII) and net economic value (NEV) decline in a rising rate scenario. Conversely, a credit union predominantly funded by longer term share certificates supporting short adjustable rate mortgage loans will experience net interest income (NII) and net economic value (NEV) declines in a falling rate scenario. Chairman Matz and others have frequently warned about the potentially negative economic consequences to credit unions (and by extension, the NCUSIF) associated with funding longer duration mortgage assets with interest sensitive liabilities. We believe plain vanilla interest rate swaps if properly utilized could help mitigate this risk.

Additionally, we would agree that it is unnecessary to introduce more complex structures such as forward starting interest rate swaps, etc. (although they can provide potential solutions to unique problems within the current environment) as it would only complicate the goal of broad interest rate risk management.

The Proposal continues by granting permission to utilize interest rate caps as a hedging vehicle. We would agree that the use of interest rate options can be appropriate at different points in the rate cycle by creating, unlike interest rate swaps, the asymmetric hedging profile that is sometimes warranted (unlimited upside yet limited cost). However, the Proposal stops short of including interest rate floors as an eligible instrument as well. Although we appreciate the argument that the prevailing risk exposure within the industry is to rising rates, **we would argue that floors can serve an important purpose for institutions that are net exposed to falling interest rates (no matter how small the count of those institutions may currently be)**. Additionally, we would urge alignment with the other eligible instruments the NCUA is proposing, specifically the inclusion of "pay floating/receive fixed" interest rate swaps. As this instrument provides protection to falling rates, we would offer that an asymmetric form of falling rate protection (i.e., interest rate floors) should be included as well.

The Proposal addresses maturity and aggregate size limitations for both Level I and Level II authority, citing the following swap restrictions for a single transaction and the weighted average life (WAL) of the derivative portfolio:

	Single Transaction	Derivative Portfolio	Notional % Net Worth	Fair Value Loss % Net Worth
Level I	7 years	5 years	100%	10%
Level II	10 years	7 years	250%	25%

It is appropriate to explore these limitations within the context of a "hypothetical" balance sheet and its corresponding asset/liability profile. We illustrate below a fairly typical credit union with a liability sensitive net economic value position and a net worth of approximately $30mm:

Net Economic Value Analysis

Rate Shift	Net Economic Value	% Chg Equity from Level
+400	$ 24,150,321	-43.1%
+300	$ 29,338,318	-30.9%
+200	$ 34,312,140	-19.2%
+100	$ 38,968,329	-8.2%
Level	$ 42,465,350	0.0%
-100	$ 42,342,600	-0.3%

The decline in net economic value is roughly $18mm between Level and the up 400 bps (parallel shock). The Level I classification limitations for this particular sample institution would be $30mm notional with a weighted average portfolio duration of 5 years. Assuming the institution had implemented the full permissible amount of a pay fixed – receive float interest rate swap, the following results would be achieved:

Net Economic Value Analysis **5 Year Duration Example**

Rate Shift	Net Economic Value	% Chg Equity from Level	Swap Market Value	Post Swap Net Economic Value	% Chg Equity from Level
+400	$ 24,150,321	-43.1%	$ 5,203,460	$ 29,353,781	-30.9%
+300	$ 29,338,318	-30.9%	$ 4,010,494	$ 33,348,812	-21.5%
+200	$ 34,312,140	-19.2%	$ 2,748,351	$ 37,060,491	-12.7%
+100	$ 38,968,329	-8.2%	$ 1,412,961	$ 40,381,290	-4.9%
Level	$ 42,465,350	0.0%	$ -	$ 42,465,350	0.0%
-100	$ 42,342,600	-0.3%	$ (1,495,127)	$ 40,847,473	-3.8%

One can see that given the restrictions on term (duration) and notional amount of the derivative, a portion of the risk position can be hedged but a significant exposure still remains. While we appreciate the desire to limit the potential for fair value loss as a percentage of net worth (which directly influences the term and duration thresholds), we would argue that these loss positions are transitory. If an institution implements an interest rate swap and holds it to maturity, the fair value will begin at zero and end at zero.

If one of the two constraints were relaxed (i.e., weighted average portfolio maturity), one could more effectively mitigate the risk position illustrated previously. For example, if the institution could implement a 10 year total duration exposure, the following results could be achieved:

Net Economic Value Analysis **10 Year Duration Example**

Rate Shift	Net Economic Value	% Chg Equity from Level	Swap Market Value	Post Swap Net Economic Value	% Chg Equity from Level
+400	$ 24,150,321	-43.1%	$ 8,792,680	$ 32,943,001	-22.4%
+300	$ 29,338,318	-30.9%	$ 6,926,444	$ 36,264,762	-14.6%
+200	$ 34,312,140	-19.2%	$ 4,854,792	$ 39,166,932	-7.8%
+100	$ 38,968,329	-8.2%	$ 2,554,596	$ 41,522,925	-2.2%
Level	$ 42,465,350	0.0%	$ -	$ 42,465,350	0.0%
-100	$ 42,342,600	-0.3%	$ (2,837,914)	$ 39,504,686	-7.0%

While we appreciate the efforts to distinguish between various levels of delegated authority, we would reinforce the need to balance the limitations within the context of the overriding goal – mitigating risk within the credit union industry and the corresponding implications for the NCUSIF. We reserve our thoughts regarding the two Levels of authority for the latter half of the comment letter; **however we would urge the NCUA consider widening the constraint to allow for more effective risk mitigation.**

Counterparty Limit Expectations

We applaud the NCUA in their efforts to limit permissible counterparties to swap dealers and major swap participants defined by the Commodity Futures Trading Commission. This should exclude counterparties with operations or capital positions inadequate to the aim of minimization of credit exposure within these transactions.

Additionally, we appreciate the NCUA's stance on maintaining bilateral Credit Support Agreements (CSA) requiring daily pricing of collateral, zero thresholds, and low minimum transfer amounts. However, we are somewhat surprised by the limitation on eligible collateral within these agreements, only allowing for cash, Treasuries, non-callable agency debentures and zero coupon non-callable agency debentures. Given that each respective collateral type would carry its own haircut, one could argue that the conceived "liquidity concession", as one moves from non-callable agency debentures to agency mortgage backed security passthroughs (MBS), would be offset. Most CSA's provide a haircut of between 5 and 8% on debentures and agency MBS passthroughs respectively. **We believe the inclusion**

of Agency MBS passthrough securities as eligible collateral would also provide institutions a wider set of assets eligible for posting in the event of a margin call, thereby fostering broader balance sheet liquidity efforts.

Finally, we appreciate the conceptual link between counterparty monitoring and the new credit quality due diligence standards. These expectations alongside the bilateral CSA arrangements discussed above should provide an appropriate means to significantly reduce credit risk related to these transactions.

Experience Requirements

The Proposal sets forth personnel requirements from the board of directors to "qualified personnel". We are encouraged by the emphasis placed on board and executive management education but have serious concerns relating to both Level I and II qualified personnel requirements. The threshold of 3 and 5 years experience respectively in "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" could prove overly burdensome.

Experienced derivative personnel currently employed within the credit union industry is scarce. As a result, most credit unions will likely have to add employees for the sole purpose of satisfying this requirement. Potential employees, with this unique skill set, are valuable and therefore often compensated accordingly. As a result, we are presented with a dichotomy: the purpose of the rule is to grant credit unions the authority to utilize derivative transactions to mitigate balance sheet risk (and potentially systemic credit union industry risk) yet the prescribed experience requirements present an obstruction to the goal.

Additionally, the Proposal goes on to restrict the use of external service providers (ESP) as it relates to satisfaction of these experience requirements. The Proposal permits ESP assistance in the derivative process, relating to tasks such as asset liability management or counterparty credit risk exposure management. Given both the experience and ESP restrictions, we are fearful that most of the industry will find these as insurmountable barriers which will hinder the overall purpose of the ruling effort, enhanced risk mitigation authority.

If the NCUA determines that the need to hedge against rising rates is pressing, it may be beneficial to consider a more immediate solution than hiring or organically developing derivative personnel at the credit union level – which may take several years and considerable expense to achieve. **We suggest that the Proposal provide for stronger relationships between ESP's and credit unions and that such relationships, where formalized, could help satisfy the experience requirements, at least in the near term.**

Assume a derivatives professional would cost approximately $100,000+/annually in salary (required to attract from other employment opportunities). If instead, a credit union were to work with an ESP for $50,000/annually and the derivative experience of the ESP were to be adopted by the credit union for the interim period, the existing management team would have gained the required experience by a more efficient means. We understand the NCUA's desire to have management as the ultimate responsible party. However, we are fearful that market circumstances (potential for curve elevation – either steepening or parallel) and the Proposal in its current form (perhaps too cumbersome to implement rapidly), will result in extremely slow adoption and result in unnecessary and unmitigated interest rate risk exposure remaining within the industry. This potential ESP route could provide the bridge necessary, at reasonable cost in contrast with alternatives, to "teach a man to fish" inside the industry.

Authority Levels/Examination Fees

Finally, while we appreciate the NCUA's approach to segregating derivative participants into differing levels of experience and authority, we would argue that the overriding goal of risk reduction within the industry (via the derivatives market) is being impeded by the restrictions set within the Proposal. **Perhaps there should be one set of authority and permissible instruments, as long as the other themes such as collateral arrangements, counterparty approval/monitoring, and evidence of the hedging need are strong**. Given the comments shared earlier within the letter, a uniform standard of permissible authority can likely be achieved that is controlled, yet also proportional to the risk at hand.

Additionally, we understand the need to fund the NCUA's oversight for the product set. However, this "a la carte" approach to regulatory oversight would appear to be another deterrent to user adoption. One might also argue that the risk mitigating activities of the industry as a whole could have benefits to those that do not have a need to participate in the product, perhaps by insulating the NCUSIF from possible future losses. **That said, we ask for further consideration regarding the overall examination cost structure proposed and how it might be reshaped to encourage user adoption more broadly.**

Conclusion

We reiterate our support for the NCUA in its broader effort to expand credit union authority relating to derivative instruments. The Proposal represents a strong foundation from which to build upon an appropriate final ruling. The consistent theme within the majority of our comments stems from the following concept: balance the need for risk mitigation within the industry against the backdrop of careful delegation of authority. We would urge the NCUA to be cognizant of any potential components within the Final Rule that would act as a disincentive to user adoption and perhaps instead look for efficient methods (including but not limited to a broadened use of ESP's) to educate and empower the industry for the task at hand.

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