From: John McKenzie
To: _Regulatory Comments
Subject: Indiana Credit Union League Comments on Proposed Rule – Derivatives
Date: Monday, July 29, 2013 5:03:21 PM

Mr. Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Comments on Proposed Rule – Derivatives

Dear Mr. Poliquin:

The Indiana Credit Union League (ICUL) appreciates the opportunity to submit the following comments on the National Credit Union Administration Board's (NCUA) proposed rule to allow federally insured credit unions to invest in simple derivatives transactions as a tool for managing interest rate risk (IRR). The ICUL member credit unions represent 97% of assets and members of Indiana's credit unions, with those memberships totaling more than two million consumers.

<u>We support the intent of the proposed rule to allow credit unions to use derivatives as a tool to manage IRR, and we support adequate safeguards but feel that this proposed approach goes too far in some areas</u>. Credit unions have been hearing from the examiners that IRR is an area of concern for NCUA. Derivatives will be an important tool for some credit unions with expertise once rates start to increase. However, we do have some significant concerns with the proposed rule. We believe that, as proposed, many of the proposed limitations will make the use of even simple derivatives too cumbersome regardless of the credit union's level of participation. In particular, we are opposed to the following:

- The imposition of application and/or supervision fees paid to the agency in order for credit unions to apply for or maintain derivatives programs.
- The imposition of application and/or supervision fees for any other financial activity that is directly authorized by statute or incidental to such authority.
- An asset eligibility threshold for derivatives participation.
- The investment limitations- which we believe are too restrictive on the duration limits.
- The limitations related to a credit union's ability to rely on external service providers to meet expertise and experience requirements.
- The requirement of an internal controls audit to participate due to the cost for applicants. We believe other audit requirements already in place are adequate for credit unions choosing to invest in derivatives.
- The application of the proposed rule to state-chartered credit unions rather than permitting them to engage in derivatives activities as authorized by state law implemented by state regulators.
- The use of mark-to-market valuations relating to derivatives since the offsetting increase in the market value of longer term loans is not reflected in

the same way.

- Limiting collateral for derivative investments to cash, treasury securities and certain agency debentures.
- The legal review requirement that includes attorney experience. Specifically that a lawyer hired to conduct a legal review of the derivatives program and transactions have at least five years' experience reviewing derivatives transactions with the requisite skills and experience to evaluate International Swap Dealers Association (ISDA) agreements and compliance properly.
- the limitation on use of external service providers to perform functions required by the proposed derivatives rule to a wholly-owned CUSO.

The following provides additional information on ICUL's positions regarding the proposed rule.

We do not oppose NCUA establishing eligibility requirements and ongoing program requirements for credit unions wanting to utilize derivatives. We are concerned that the proposed rule goes too far and creates both very expensive and complex application and compliance requirements that will result in few credit unions utilizing this as an option. Also, the asset threshold of $250 million is too restrictive. There are significant benefits to the share insurance fund from credit unions utilizing derivatives. As proposed, the restrictions are so limiting that many credit unions will deem the cost to outweigh the benefits and will choose not to use this valuable IRR mitigation tool. This will expose the share insurance fund.

As stated above, we strongly oppose the imposition of application and supervision fees in order for credit unions to gain derivatives authority. We are also concerned that the fees proposed in the rule, when added to the significant expense associated with compliance, will be a further deterrent to credit unions from participating in this program. We also do not feel that NCUA has provided sufficient supporting information to justify the need for the fees proposed.

One argument used to justify the fees is that some credit unions that do not participate in derivatives transactions will not want to shoulder the costs of any losses that participating credit unions may incur as a result of their derivatives authority. There are many services that not all credit unions participate in (mortgages, member business lending, investments in more complex securities, etc.) for which there are not special application or supervision fees. We believe that any authorized activity should not come with special application or supervision fees. We are concerned that once this is implemented, it will be too easy to just continue to apply the same logic to future regulatory enhancements. NCUA should be encouraging credit unions to utilize the authorities available to mitigate risk, reducing exposure to the share insurance fund, not adding unnecessary expense that will act as a barrier to utilizing these authorities.

We are very concerned with the compliance costs, in addition to any application and examination fees, that that a credit union would incur to meet the requirements of the proposal. As with many proposals, NCUA has provided some estimates of the regulatory and paperwork burdens associated with complying with the proposal. However, there was no cost analysis as to the impact of this additional regulatory burden. It is our belief that the cost of the additional compliance requirements will be significant. NCUA discusses the benefits of credit unions utilizing derivatives as an IRR management tool, but at the same time establishes requirements that will add additional costs to the point that the benefits of this tool for IRR management are offset by the expense. This will result in fewer credit unions recognizing this as a tool worth the time, effort and expense to implement.

Another concern regarding costs is that under the proposal many of the requirements must be met even before a credit union applies for derivatives authority. Many credit unions will find it difficult to make the decision to incur these expenses when they are not certain their application will be approved.

We oppose the $250 million asset threshold because it is arbitrary and ignores the needs of credit unions under that threshold.   Many credit unions with assets less than $250 million have IRR and would benefit from the availability of derivatives as a risk management tool. If they demonstrate the ability to meet the requirements of the regulations, they should be granted derivatives authority.

We do not believe the derivatives rule should apply to federally insured state chartered credit unions (FISCUs) but rather it should be up to state law or regulation to determine if derivatives should be available to this group of credit unions. We view this as another overreach by NCUA to usurp state law and increase its control of state chartered credit unions. A state may decide to apply NCUA's rules rather than develop its own, but that should be a decision made at the state level, not by NCUA.

We have concerns about the use of mark-to-market valuations relating to derivatives. 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. The gains on the loans are not applied in the same manner since the loans are listed at book value. We would ask that NCUA provide as much flexibility in the final rule regarding the use of mark-to-market, as permitted under the Federal Credit Union Act.

We also believe the daily requirement to calculate the fair market value of derivatives exposure and monitor collateral is unduly burdensome and cost prohibitive for many credit unions. This is yet another barrier to credit unions participating in derivatives that could benefit and better manage the IRR with this tool. We encourage NCUA to consider whether credit unions should be allowed to conduct these valuations on a less frequent basis, such as bi-weekly or monthly.

We oppose limiting participating credit unions' collateral options for their derivative investments to cash, treasury securities and certain agency debentures. We believe that consideration should be given to additional options such as agency mortgage-based securities and pass-through certifications that are fully guaranteed by one of the government sponsored enterprises.

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 existing external audit process.

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 to include 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 do not believe an attorney with the level of experience NCUA is proposing is needed to review the types of plain vanilla derivative transactions authorized by the proposal. 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.

Credit unions should be able to outsource compliance with the reporting requirements. As proposed, the infrastructure a credit union will need to put into place to meet the reporting requirements is overkill, especially for credit unions that only need to do a few derivative transactions. These new reporting infrastructures will be expensive to develop and maintain. All participating credit unions should be allowed to outsource reporting to a third party.

NCUA should allow credit unions to meet experience requirements with employees or contractors, or through service providers when the qualified person is not in a position to profit from the transactions. We believe that Level I and Level ll credit unions should have the ability to rely on external service providers (ESPs) for any or all aspects of their derivatives programs.

However, the proposed rule limits the use of ESPs. These ESPs provide an alternative for credit unions to offer many services they otherwise would not be able to offer due to cost or other complex compliance requirements. The proposed derivatives rule allows a wholly-owned CUSO to perform functions required by the proposed derivatives rule. We strongly believe that NCUA should allow credit unions 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 as it relates to the use ESPs.

Weencourage NCUA to move forward with a derivatives rule, but want to reinforce the need to make significant revisions as discussed above to make sure the program will be accessible to as many credit unions as can benefit from mitigating IRR. Thank you for the opportunity to comment on the NCUA’s proposed rule on derivatives authority for credit unions. If you have any questions concerning this letter, please contact me at (317) 594-5320.

Sincerely,

John McKenzie
President, Indiana Credit Union League

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