



July 29, 2013

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

Chevron Federal Credit Union
P.O. Box 2069
Oakland, CA 94604-2069
510-627-5000 • 800-232-8101
jmooney@chevronfcu.org

James E. Mooney
President & CEO

RE: Comments on Proposed Rule – Derivatives

Dear Ms. Rupp:

On behalf of Chevron Federal Credit Union, I would like to thank the NCUA for its efforts to enable credit unions to use derivatives to hedge against interest rate risk. The proposed rule, we believe, provides the necessary flexibility to effectively deploy derivatives while providing sufficient safeguards against imprudent use. Accordingly, we are generally very supportive of the proposed rule.

There is, however, one aspect of the rule that we believe may have the unintended and pernicious effect of limiting the prudent use of derivatives. Our concern is discussed below, along with two possible alternatives that would effectively resolve this concern. We also share below some additional suggestions that we think would enhance the final rule.

I. PRINCIPAL CONCERN:

Our principal concern with the proposed rule pertains to the proposed methodology for measuring interest rate cap portfolios against regulatory limits. We also have some related concerns regarding limits for interest rate swaps.

Limits on Interest Rate Caps: The proposed rule states that interest rate caps are limited to an aggregate book value of 25% of net worth. We commend the NCUA for recognizing that the notional value of an interest rate cap is not the value at risk. However, this proposed methodology can result in varying levels of capacity depending on whether the interest rate caps have appreciated or depreciated. We believe a limit that does not vary in rising or falling rates would work best for credit unions.

The possible effects of rising and falling interest rates on hedging capabilities under the proposed rule are illustrated by the following hypothetical credit union:

Hypothetical Credit Union

Total Assets: \$2.5 billion
Net Capital Ratio: 10%
Purchase Premium on Interest Rate Caps: \$35 million

In accordance with GAAP, interest rate caps are recorded at market value on the balance sheet. If they qualify for hedge effectiveness per FAS 133, the mark-to-market is recorded through other comprehensive income, a balance sheet item. If they do not qualify for hedge effectiveness per FAS 133, the mark-to-market is recorded through the income statement. Book value is equal to market value. Due to the difficulties of achieving hedge effectiveness, Hypothetical Credit Union in this illustration is assumed to not qualify per FAS 133, but the issue is present regardless of whether hedge effectiveness is achieved or not.

- **In a falling interest rate scenario:** Hypothetical Credit Union's interest rate caps fall in market value to \$10 million, with a negative mark-to-market of \$25 million. **Interest rate hedging capacity: \$46 million.**
- **In a rising interest rate scenario:** Hypothetical Credit Union's interest rate caps rise in market value to \$60 million, with a positive mark-to-market of \$25 million. **Interest rate hedging capacity: \$9 million.**

As Proposed by NCUA

| | (millions) | |
|---|------------------|-----------------|
| | Falling Rates | Rising Rates |
| <u>Market value</u> | | |
| Purchase premium | 35 | 35 |
| +/- Mark to market (MTM) | -25 | 25 |
| Market value | <u>10</u> | <u>60</u> |
| <u>Net worth</u> | | |
| Net worth before MTM (10% of \$2.5 bil assets) | 250 | 250 |
| +/- MTM (no hedge accounting) | -25 | 25 |
| GAAP net worth | <u>225</u> | <u>275</u> |
| <u>NCUA Proposed Limit (25% of GAAP net worth)</u> | <u>56</u> | <u>69</u> |
| <u>Capacity (limit less market value)</u> | <u>46</u> | <u>9</u> |

The use of market value results in reduced capacity when interest rates rise and increased capacity when interest rates fall. This may produce the perverse result of limiting and potentially curtailing a credit union's interest rate hedging activity as interest rates rise – and the existing hedges are doing exactly the job they were intended to do. If a credit union uses up the capacity when rates are low, it will exceed the capacity level when rates rise. In such a scenario, a credit union seeking to hedge a growing balance sheet might need to divest some existing interest rate caps to remain within regulatory limits – at a time when such caps are most needed.

Alternative Resolutions: We wish to offer two possible alternatives that, if incorporated into the final rule, would provide stable interest rate cap capacity regardless of the direction interest rates might take.

Alternative #1: Use book value, which equals market value, for determining the limit, but allow 100% of net capital in excess of net worth “well-capitalized” level of 7%. This approach keeps the capacity level the same regardless of rising or falling interest rates. Even though the limit is different because net worth is different due to hedge mark-to-market, the capacity is the same. This example uses same assumptions as above.

| <u>Alternative #1</u> | (millions) | |
|--|---------------|--------------|
| | Falling Rates | Rising Rates |
| <u>Market value</u> | | |
| Purchase premium | 35 | 35 |
| +/- Mark to market | -25 | 25 |
| Market value | 10 | 60 |
| | | |
| <u>Net Worth</u> | | |
| Net worth before MTM (10% of \$2.5 bil assets) | 250 | 250 |
| +/- MTM (no hedge accounting) | -25 | 25 |
| GAAP net worth | 225 | 275 |
| | | |
| <u>CFCU Proposed Limit</u> | | |
| Threshold 7% of \$2.5 bil assets | 175 | 175 |
| Interest Rate Cap Limit (GAAP NW less threshold) | 50 | 100 |
| | | |
| <u>Capacity (limit less market value)</u> | 40 | 40 |

An advantage of this alternative is that it uses a safety and soundness measure as a threshold. A potential disadvantage is that future changes to regulatory capital could impact the threshold and therefore the capacity.

Alternative #2: Exclude the effects of hedge mark-to-market by using premium paid less reduction for the passage of time over a straight-line basis. This approach keeps the capacity level the same regardless of rising or falling interest rates. This example uses same assumptions as above.

| | |
|---|-------------------|
| <u>Alternative #2</u> | |
| <u>Net purchase premium</u> | <u>(millions)</u> |
| Purchase premium | 35 |
| Straight line amortization (passage of 3 yrs of 7 yr life) | -15 |
| Net purchase premium | <u>20</u> |
| | |
| <u>Net worth</u> | |
| Net worth before MTM (10% of \$2.5 bil assets) | 250 |
| | |
| <u>CFCU Proposed Limit</u> | |
| 25% of NW before MTM | 63 |
| | |
| <u>Capacity (limit less net purch premium)</u> | <u>43</u> |

The advantage of this approach is its simplicity. It is analogous to the purchase of insurance against a future event. The disadvantage of this alternative is that it is an exception from GAAP.

Limits on Interest Rate Swaps:

The proposed rule limits interest rate swaps to a notional value equal to 100% of net worth. However, notional value does not adequately reflect the risk or effectiveness of the derivative. It accounts for neither tenor nor rates. For example, a swap with one year remaining is very different from a swap with seven years remaining. Likewise, the pay and receive rates are not taken into consideration.

An alternative that incorporates tenor and rate and is similar in nature to limit on interest rate caps is to calculate the value of the interest rate swap with some safety assumptions, such as receiving zero but pay committed rate over remaining term of swap contract using the notional amount.

One advantage of this suggested approach is that the limits for interest rate caps and swaps can now be the same.

II. OTHER SUGGESTIONS:

We would also like to comment on three other areas in which we believe there are opportunities to enhance efficiency and cost without sacrificing safety and soundness.

Application Waiver for Qualified Existing Investment Pilot Participants:

We believe NCUA should consider an application waiver for credit unions that (a) have been operating independently under in the Investment Pilot Program for some significant period of time and (b) have received in their most recent examination a favorable CAMEL rating in asset liability management and overall management. The rule should stipulate that qualified credit unions may petition for such a waiver via letter to the NCUA. NCUA, in turn, may establish parameters for timely review of and

response to the petition. If denied, the petitioning credit union would be required to follow the standard application process to continue its use of derivatives.

NCUA has noted its concerns about the time and resources that may be needed to adequately review applications for authority to use derivatives. The suggested waiver would be one sensible way to address such concerns. The agency would thereby save time and effort in addressing credit unions with which it is already very familiar. An additional benefit: the qualified credit unions would also save time and money.

Legal Review: The proposal requires participating credit unions to obtain a legal opinion from qualified counsel before executing any derivatives transactions. Qualified counsel is defined as an attorney with at least five years of experience reviewing derivatives transactions.

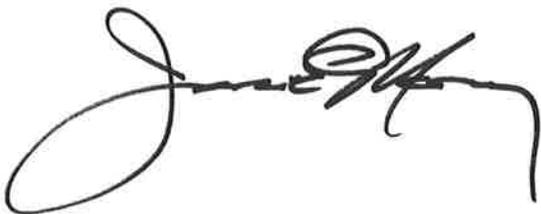
We recommend NCUA clarify that the legal opinion is required specifically for the International Swaps and Derivatives Association (ISDA) agreement and not every derivatives transaction.

Internal Controls Audit: The proposal states that an internal controls audit should be conducted by an external service provider with experience in auditing derivatives transactions.

We recommend that credit unions with professionally managed internal audit functions be permitted to satisfy the internal controls audit requirements by partnering with a qualified external service provider. Internal audit functions that adopt and are in conformance with the Institute of Internal Auditors' International Standards (Standards) for the Professional Practice of Internal Auditing should be considered professionally managed audit functions. The Standards require individuals overseeing internal audit functions to only undertake and assign persons to audits that collectively possess the knowledge, skills, and competencies to perform the audit appropriately. A credit union that has an auditor with the knowledge and skills to perform the internal controls audit should not be excluded from involvement in the audit.

Thank you for this opportunity to comment on the proposed rule.

Sincerely,

A handwritten signature in black ink, appearing to be "James H. [unclear]", written in a cursive style.