



PO BOX 1950
WEST LAFAYETTE, IN 47996
765.497.3328 // 800.627.3328



July 29, 2013

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

Dear Ms. Rupp:

On behalf of Purdue Federal Credit Union and the members of the Asset Liability Committee (ALCO), I am writing in response to the Notice of Proposed Rulemaking – Derivatives. I thank you for this opportunity.

Issues for Comment

The proposed rule for use of off balance sheet derivatives for constructing hedging strategies is a welcomed and prudent opportunity for Purdue Federal Credit Union, and the industry, to manage interest rate risk. Without the ability to hedge using derivatives, credit unions are forced to either take undue amounts of interest rate risk or manage their balance sheets in sub-optimal ways not fully benefiting their membership. Derivative use can clearly reduce the industry's aggregate NEV sensitivity to increases in interest rates and add to the stability of the NCUSIF. This can especially be true for outlier "what-if" scenario analysis involving large and rapid increases in interest rates. The potential economic capital loss could be considered "catastrophic" for some institutions. Lessons learned from recent history make prudent risk management, even for low probability events, necessary.

The Purdue Federal ALCO applauds the NCUA for its efforts in drafting the derivatives notice of proposed rulemaking, providing credit unions the opportunity to engage in derivative activity for managing interest rate risk. I provide the following suggestions for consideration.

Section 703.102 – Permissible derivative transactions, please consider the following:

As part of its regulatory approved strategy, a credit union may only purchase interest rate caps or enter into interest rate swap transactions. While both can be an effective option, I ask that consideration be given to more broadly define "permissible derivative instruments" to include interest rate floors and options on swaps (swaptions).

Interest Rate Floors - Interest rate risk can and does manifest itself in credit union balance sheets for changes in interest rates in either direction. For example, Purdue Federal sells member mortgage loans, creating mortgage servicing rights (MSR assets) that are sensitive to falling interest rates. Interest rate floors are simple derivatives that have been used for years in other industries to hedge MSR sensitivity to falling interest rates. While exposure to falling rates is less burdensome to the share insurance fund, interest rate mitigation tools are essential to effectively manage both falling and rising interest rates.

Swaptions - A swaption is an option granting its owner the right but not the obligation to enter into an underlying swap. Some credit unions may want to protect themselves in the future should rates move up. Swaptions are a great way to hedge interest rate risk with limited downside risk. Should rates fall, Purdue Federal could write off the swaption premium and not deal with the market value loss of the underlying swap that was never executed.

(g) Interest rate swaps that do not have fluctuating notional amounts.

There is no additional risk in swaps with amortizing principal. Amortizing swaps could be useful in managing specific mortgages.

Section 703.103 – Eligibility

(a) A credit union may apply for Level I or Level II derivatives authority if it meets the following criteria:

(a)(3) It has assets of at least \$250 million, as of its most recent call report.

Asset size restrictions should not prevent credit unions from using derivatives. The market will most likely dictate those credit unions that will be able to contract with counterparties.

Section 703.105 – Collateral requirements for operating a Level I or Level II program

(b) Acceptable collateral is limited to cash, Treasury securities, fixed-rate non-callable agency debentures, and zero-coupon agency debentures.

Acceptable collateral should also include mortgage-backed pass-through securities. Pass-throughs are highly liquid securities and therefore easy to price. The addition of this collateral type will also broaden the collateral that Purdue Federal and the credit union industry can post with out-of-the money positions.

(e) A credit union must set threshold amounts to zero.

The Dodd-Frank protocol has not been finalized. The final ruling should incorporate requirements that also adhere to the Dodd-Frank regulations.

(g) The minimum transfer amount must be less than or equal to \$250,000.

The Dodd-Frank protocol has not been finalized. The final ruling should incorporate requirements that also adhere to the Dodd-Frank regulations.

Section 703.108 – Systems, processes, and personnel requirements for operating a Level I or Level II derivatives program

(a) Required experience and competencies. A credit union operating a derivatives program must internally possess the following experience and competencies:

(b) (3) *Qualified derivatives personnel.*

To engage in derivatives transactions with Level I authority, a credit union must have knowledgeable and experienced employees that, except as provided in § 703.110(f) of this subpart for Level II authority, have at least three years of 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.

It will be very difficult for Purdue Federal and credit unions as a whole to obtain employees with a minimum of three years of direct transactional experience. In addition, it is not financially prudent to hire this talent for what will likely be a few trades. This restriction will be problematic for Purdue Federal, if for instance, we hire this type of experience solely for derivatives, execute a few trades and then have the person leave the organization. The proposal does not provide a practical way to stay within compliance for such a situation.

As an alternative I ask that experience include capital market responsibilities and knowledge of back office work and derivative analytics. Plain vanilla interest rate swaps and caps are not very complicated to transact. The qualifications can be achieved by hiring experienced personnel or obtaining guidance through third-party consultants. The rule should allow practical ways for credit unions to access expertise from the marketplace.

(b)(3) *Internal controls review.* A credit union must have an internal controls audit at least annually that ensures the timely identification of weaknesses in internal controls,

modeling methodologies, and the risk oversight process. This internal controls review must be performed by external individuals qualified to evaluate the attributes of a derivatives program. An internal controls audit must incorporate an evaluation of the effectiveness of internal controls relevant to measuring, monitoring, reporting, and limiting risks. The scope of the internal controls review must also include coverage of the accounting, legal, operating, and risk controls

Internal control audits are specialized in scope and different from financial statement audits already required by Purdue Federal. I believe this is an excessive burden and financially a very expensive requirement of the ruling. Derivative activities are much less complicated than other credit union activities, for which internal control audits are not required. Credit unions should be given the option to have an internal auditor review the internal controls, modeling methodologies, and oversight process.

(e) Use of external service providers

(e)(1) The external service provider, including affiliates cannot

(e)(1)(ii) Be a principal or agent in any derivatives transaction involving the credit union

The NCUA should specifically define “agent”. I assume the term “agent” is defined as a broker when it executes investment purchase transactions on my behalf when I deliver such orders, whereas a “dealer” is defined as a broker that acts in behalf of its own account.

(b)(5) *Legal review.*

Before executing any transactions under this subpart, a credit union must receive a legal opinion from qualified counsel stating that the credit union’s ISDA agreements are enforceable and that the credit union is complying with applicable laws and regulations relating to operating a derivatives program. Qualified counsel means an attorney with at least five years of experience reviewing derivatives transactions. A credit union must also ensure any counterparty is authorized to enter into such transactions.

Five years of experience from a qualified counsel is rather excessive for contracts that are fairly boilerplate and commonly used in the market place.

Section 703.109 – Specific Level I limits and requirements

A credit union with Level I derivatives authority must comply with the following specific limits and requirements:

(a) A credit union approved only to enter into interest rate swaps must restrict the aggregate notional amount of its interest rate swap transactions to 100 percent of net worth.

Limits set solely based upon an absolute notional amount will discourage the use of proper hedging strategies, which I understand the OCC clearly states in its guideline. As interest rate swaps age, they decrease in duration and lose some of their hedging benefit, potentially requiring additional hedges and again, making a notional exposure amount illogical. It is my understanding that alternatives exist.

If NCUA is determined to set limits based on notional amounts, I suggest that the maturity be considered. In addition, notional limits should not be placed as a percent of net worth. The institution that has a lower capital ratio will most likely be the one that needs hedging the most. The concept of hedging is to reduce risk and usually the higher the credit union's capital, the greater its options should be to use borrowings or to manage risk in general.

A simple formula for calculating a limit would be desired, so one method suggested to me is calculating the aggregate notional limit by risk weighting the notional amounts based upon the maturity bucket in which it lies. For example, interest rate swaps that lie within one year of maturity could be weighted by 5 percent and those that are greater than 15 years could be set at a risk weighting of 200 percent.

The chart below is an example. The credit union's \$10 million in interest rate swaps that have maturities less than one year would have a risk weighted notional amount of \$0.5 million, while the \$10 million in swaps greater than 15 years would have a risk weighted notional of \$20 million. In this example, although the credit union has \$60 million notional amount of interest rate swaps, the risk weighted notional is \$45 million. This risk weighted notional amount as a percent of assets appears very straight forward and can easily identify a limit.

Risk weighting notional amounts in this way appears conducive to call report preparation and should be transparent across institutions. Also, risk weighting notional amounts will allow NCUA to rank order institutions with derivative powers by risk weighted notional exposure. Using actual notional amounts will not allow for such ranking. Comparing institutions based on risk weighted notional should simplify regulatory oversight.



As an additional measure, the weighted average life notional for this portfolio falls in the 3.5 year category and its market value change given 100 basis points is within 4 percent of net worth.

Assets	500,000,000		
Net Worth	50,000,000		
Maturity Bucket Years	Notional	Risk Factor	Risk Weighted Notional
Less than 1 year	10,000,000	0.05	500,000
1 - 3	10,000,000	0.20	2,000,000
3 - 6	10,000,000	0.45	4,500,000
6 - 10	10,000,000	0.80	8,000,000
10 - 15	10,000,000	1.00	10,000,000
More than 15 years	10,000,000	2.00	20,000,000
Total	60,000,000	0.5553	45,000,000
Percent of Assets			9%

A suggested risk weighted notional limit for interest rate swaps of Level I credit unions is 15% of the credit union’s assets.

- (b) A credit union approved only to purchase interest rate caps must restrict the aggregate book value of its interest rate cap transactions to 10 percent of net worth.
- (c) A credit union approved to transact interest rate swaps and purchase interest rate caps may not exceed a combined limit of 100 percent of the aggregate amount of each limit the credit union used under paragraphs (a) and (b) of this section. For example, a credit union may hold 80 percent of the limit for interest rate caps and 20 percent of the limit for interest rate swaps, but cannot hold 100 percent of the limit for each.

This aggregate limit combining caps and interest rate swaps could be problematic. As an example, suppose that a Purdue Federal holds caps at a limit of 10 percent of net worth and interest rate swaps at a limit of 90 percent. If the cap gains value to an amount equal to 30 percent of net worth, the market value gain could be reflected in the book value of the cap. Given this scenario, the Purdue Federal would be forced to sell its position in interest rate swaps.

The limits set forth for interest rate caps are acceptable, but should not be combined with notional limits of interest rate swaps. As stated, these limits

should be set as a percent of assets.

(d) The aggregate fair value loss of all swap positions into which the credit union has entered cannot exceed 10 percent of net worth.

Limits on mark-to-market changes independent of the asset or liability being hedged are inappropriate and will negatively impact effective hedging strategies. Theoretically, if there is a loss on the derivative there should be a gain on the asset. Therefore, the market valuation limit should take into consideration the asset or liability being hedged.

The 10 percent net worth limit should be based as an exposure to the aggregate mark-to-market limit, including gains on the hedged item.

(e) The maximum permissible weighted average life on all derivatives positions may not exceed five years and the maximum permissible maturity for any single derivatives position may not exceed seven years.

Maturity and average life restrictions are arbitrary and inappropriate for effective hedging strategies, especially because in-the-money trades are collateralized. At the very least, maturities should be allowed at 20 years with no weighted average life restrictions.

With assistance from ALM First, Purdue Federal uses key rate duration calculations in measuring the investment portfolio. This measurement places price sensitivity on the correct part of the yield curve which is as important as hedging parallel rate moves; in essence, this effectively hedges a change in the slope of the yield curve.

The majority of the duration of a mortgage asset sits out in the 10-to-15- year part of the curve. Restricting the maturity of a hedge will unnecessarily expose a credit union to changes in the slope. As an example, if Purdue Federal has a 14 percent duration series of cash flows that needs to be hedged, this restriction will force hedging with two times the notional of a 7 percent duration hedge. From a parallel perspective, the asset would appear to be hedged. But if the yield curve steepens, the hedge would not be effective as the shorter hedge's price appreciation multiplied by two will not equal the market value loss in the longer end of the curve.

The use of key rate duration analytics allows specific client hedging needs to be measured, and the ability to therefore hedge the more appropriate part of the yield curve required. The restrictions are not conducive to proper hedging practices and Purdue Federal would not be able to construct



effective hedges with economics that work in the best interest of the balance sheet and our members. The following table illustrates a partial duration analysis. The majority of interest rate sensitivity is clearly in the longer maturity parts of the yield curve.

	Current Balance	Total Duration	Partial Duration			
			3 - 9 Month	1 Year - 2 year	3 Year - 5 Year	7 Year - 30 Year
Assets						
Single Family Mortgage Loans	50,000	5.50%	0.27%	-0.21%	1.82%	3.62%
Commercial Mortgage Loans	6,000	4.50%	0.09%	0.68%	1.27%	2.46%
Total	56,000	3,020	138	(62)	988	1,956
Liabilities and Hedges						
3 month FHLB Advance	56,000	0.25%				
2 year FHLB Advance	-	1.90%				
5 year Interest Rate Swap	20,000	4.85%			970	
10 year Interest Rate Swap	20,000	9.10%				1820
Total	56,000	2,790	-	-	970	1,820
Net	-	230	138	(62)	18	136
		Hedged Duration:	0.41%			

Level 1 maturity requirements should be the same as Level II. As stated above, proper hedging strategies will require the use of longer duration hedges. Level I credit unions should be put in a position with the rule properly hedge, but just use fewer of them.

Section 703.110 – Specific Level II and requirements

A credit union with Level II derivatives authority must comply with the following specific limits and requirements:

- (a) For a credit union approved only to enter into interest rate swaps, NCUA will establish the aggregate notional amount of its interest rate swap transactions at an amount not to exceed 250 percent of net worth.
- (b) For a credit union approved only to purchase interest rate caps, NCUA will establish the aggregate book value of its interest rate cap transactions at an amount not to exceed 25 percent of net worth.

- (c) For a credit union approved to transact interest rate swaps and interest rate caps, NCUA will establish the appropriate cumulative limit not to exceed individual limits in paragraphs (a) and (b) of this section.
- (d) The aggregate fair value loss of all swap positions into which the credit union has entered cannot exceed 25 percent of net worth.
- (e) The maximum permissible weighted average life on all derivatives positions may not exceed seven years and the maximum permissible maturity for any single derivatives position may not exceed ten years.
- (f) The qualified derivatives personnel described in § 703.108(a)(3) must have at least five years of 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. In addition to the activities the qualified derivatives personnel are required to conduct in Section 703.108(a)(3), they must also price options and undertake statement of financial condition simulations under multiple interest rate scenarios.

The comments above on section 703.109 apply here. As stated, proper hedging strategies require the use of longer duration hedges, so I recommend allowing maturities out to 20 years. Level I credit unions should be given practical methods to properly use the simple hedge's written in the rule, and eventually graduate to Level II and be allowed to use a greater amount.

For Level II credit unions, the same formula as expressed in section 703.109 appears a reasonable approach; however, the allowable risk weighted notional limits should be expanded to be equal to 25 percent of assets.

- (g) The exposure by notional amount to any single derivatives counterparty cannot exceed 100 percent of net worth for interest rate swaps and the book value may not exceed ten percent of net worth for interest rate caps.

This limit should be altered to the suggested limit referenced in Section 703.109.

Application Fees

I strongly suggest some alternative approach to regulating derivative use than the idea of instituting a fee structure for those credit unions that apply for derivative authority. This opposition also applies to ongoing fees for continued supervision and examination. Derivatives are a common practice



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for financial institutions outside the credit union industry, and its introduction is not dissimilar to other products throughout credit unions' history, such as CMOs or commercial loans. To introduce a fee with this rule sets a very poor precedent for ongoing funding of NCUA supervision responsibilities.

Derivatives Costs

The rule as proposed places such a financial burden upon a credit union like Purdue Federal, the likely outcome would prohibit any use of derivatives to manage balance sheet interest rate risk. As expressed throughout this document, the ruling as proposed creates excessive expense for derivative use. I would expect NCUA has an interest to help credit unions best manage risks to the balance sheet and that should include rules that best position Purdue Federal to compete in the market place. Excessive regulation and costs do not contribute to building Purdue Federal as a long term option for members.

I thank NCUA for putting the work into the proposed ruling and trust the comments will assist in drafting a final rule that many well run credit unions can use long term. I welcome any opportunity to assist further as you review comments.

Sincerely,

A handwritten signature in black ink that reads "Brian D. Musser".

Brian D. Musser
VP of Finance/CFO



This credit union is federally insured by
the National Credit Union Administration