SCHOOLSFIRST
FEDERAL CREDIT UNION

July 23, 2013

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

Re: Comments on Proposed Rule - Derivatives

Dear Ms. Rupp:

I am writing on behalf of SchoolsFirst Federal Credit Union, which serves school employees and their families in Southern California. We currently have more than 550,000 Members and $9.7 billion in assets. SchoolsFirst FCU appreciates the opportunity to once again provide comment and feedback on the NCUA Board's Advanced Notice of Proposed Rulemaking with regards to the regulation, requirements and terms, within the proposed rule on Derivatives Authority.

It is exciting to hear that NCUA is willing to allow additional tools to combat the interest rate risks facing credit unions today. Once modified in support of credit union concerns, the program overall will be of great assistance and benefit to credit unions in being able to navigate through today's economic challenges.

However, there is hesitation and some concern with the current proposed control requirements which appear excessive, considering the plain vanilla types of derivatives being authorized, which are limited to interest rate caps and interest rate swap transactions. It is overly burdensome to require a host of experiential and system requirements along with limitations on transaction amounts, administration fees, and the overall costs to implement and operate such a program. Currently, credit unions are authorized to conduct transactions of equal or even greater risk than swaps and caps (e.g., CMOs); however, the risk control requirements for those investments are not as cumbersome and extensive as those being proposed here.

There is an overall cost impact to credit unions in order to comply with some of the proposed requirements. Some of these costs include, acquiring additional qualified derivatives personnel, attaining legal review, conducting an internal controls audit and acquiring external service providers, just to name a few. It appears the costs associated with implementing such strict controls may outweigh the potential benefits of protecting the credit union's overall balance sheet.

Although we can certainly understand there will be some cost involved with participating in such an impactful program, it is unclear why the NCUA believes that only credit unions that elect to engage in these types of investments should be the ones to bear the expense when, ultimately, the purpose of investing in derivatives is to protect the National Credit Union Share Insurance Fund (NCUSIF) from losses caused by a credit union failing due to improperly managed interest rate risk. We propose including these charges as part of the overall operating fees NCUA assesses annually to all credit unions as opposed to creating a separate fee for only participating credit unions.

We respectfully provide further opinion and recommendations to address the following items:

- Levels of Authority
- Collateral Requirements
- A Credit Union's Board of Directors
- Senior Executive Personnel
- Qualified Derivatives Personnel
- Separation of Duties

2115 N. Broadway • Santa Ana, CA • 92706-2613
PO Box 11547 • Santa Ana, CA • 92711-1547
800.462.8328 | schoolsfirstfcu.org

- Internal Controls Audit
- Legal Review
- External Service Providers
- Limits - Interest Rate Swaps & Interest Rate Caps
- Limits - Maturity
- Regulation Violation
- Indirect Investments in Permitted Derivatives

Levels of Authority

Although the levels are tiered, the two levels currently proposed are much too restrictive in cost and implementation to conduct this program effectively. Levels should simply be based on asset size, which in itself, address the requirements with respect to the experiential and system requirements.

While we understand the need to establish requirements and guidelines due to the potential risks associated with such a program, the current proposed controls will impact credit unions tremendously. We request that NCUA give consideration to allowing more flexibility and less restrictions, if not to all, then to at least the largest asset size credit unions, who currently have more experienced staff and sophisticated systems in place.

We propose creating a "Level III" for credit unions over $5 billion in asset size which will allow the credit union to navigate and maximize the full potential benefits of a derivatives program, which is the ultimate goal. We propose for the larger credit unions more flexibility due to their higher CAMEL rating (1 or 2) and overall assets and stability. The larger size credit unions will have the cumulative expertise already on hand along with a more sophisticated internal controls system in order to implement and manage this program accordingly. **In addition, we would like to stress that other non-credit union financial institutions do not have such strict restrictions, which promotes a further competitive disadvantage for credit unions as a whole.**

Collateral Requirements

We can understand the importance of collateral requirements in order to safeguard credit unions from market disruptions or counterparty defaults; therefore, eligible collateral should be broadened to all permissible investments per 703, and not limited to just the liquid assets stated within the proposal. The requirements should be flexible to ensure it adheres to current market practices with threshold amounts and mandatory triggers per collateral type.

A Credit Union's Board of Directors

While we agree with the need to ensure a well-managed derivatives program is in place and that the board of directors has a full understanding of the program and respective functions, the current proposed requirement for annual training for the board of directors will create some redundancy with the financial literacy requirements currently in place. Instead, we propose a comprehensive initial training for all new and existing board members to ensure knowledge and complete understanding of the program. If there are any updates or changes to program, the Board should be provided this information and/or training on an as needed basis.

Senior Executive Personnel

We understand the responsibility of our senior executive officer is to oversee the day-to-day operation of the derivatives program; however, we do not see the need to notify NCUA when this position becomes vacant or replaced. This would only cause more disruption to the overall flow and efficiency of the program. At the present time, per regulation 703, credit unions aren't required to notify NCUA and we recommend following the same guidelines.

Qualified Derivatives Personnel

Further clarification is needed as to what constitutes "qualified" personnel, including which positions would fall within these requirements, the number of personnel required, and type of duties. In addition, given the simplicity of these plain vanilla derivatives, we recommend NCUA does not establish a prerequisite of previous experience since all other FCU-permissible investments do not require.

Separation of Duties

Although we understand the desire for separation of duties for this program, it will be problematic for credit unions with a smaller asset size. Credit unions may not be able to physically separate the duties without the excessive cost of acquiring additional staff and training. We propose more flexibility to be able to determine what duties need to be separated to ensure there is not a risk or liability exposure for the credit union. Supporting documentation can be provided to reflect and support the decisions in determining the duties and positions assigned.

Internal Controls Audit

We recommend in lieu of having an external service provider audit our internal controls separately, we incorporate this audit into the annual CPA audit. This audit would review the coverage of the accounting, legal, operating and risk controls. In addition to streamlining this process, this would also minimize additional costs involved with contracting a separate audit when this could be incorporated into the annual CPA audit.

Legal Review

We are requesting for more clarity and specifics on the legal opinion requirement. Based on the current proposal, the requirement to obtain a legal opinion prior to engaging in derivatives transactions is ambiguous. The requirement does not specify whether a legal opinion must be obtained prior to *each* transaction or prior to the program being implemented. This requirement is potentially very costly if the intent of the requirement is to obtain a legal opinion prior to the engagement of each and every transaction. In addition, time is lost through the process of obtaining and awaiting approval from legal review.

We propose not requiring a legal review since other investments do not require this process.

External Service Providers

Credit unions should be allowed to contract without any restrictions as long as there is a cost benefit for the credit union. We would like to propose that NCUA consider allowing credit unions to outsource the complete day-to-day activity with the oversight and management of a senior officer. We understand that derivatives transactions are unique and pricing transparency is considerably more limited, that in mind, the credit union will continue to retain responsibility and full control over the derivatives management and decision making process.

In addition, we recommend that there should be no difference in permissible use of contractual services and support between the two Levels. Although, we understand that Level II has more authorization to take higher risks, a restricted use of external service providers should not be enforced based on the notion that Level II credit unions would have greater in house risk management capabilities. The experience and knowledge will be more robust in Level II credit unions, but the additional work and time required to focus on the day-to-day derivatives activities remains the same for both Levels. Therefore, we propose to mirror the requirements of Level I in obtaining external service providers.

Limits - Interest Rate Swaps & Interest Rate Caps

We would like to propose to modify the limits on the amount of derivatives exposure a credit union may take.

Limits should not be based on net worth but by concentration risk limits established by the Board of Directors. Asset size and balance sheet structure should be the main considerations, and to the extent the Board of Directors is willing to hedge, e.g. Fixed Rate Mortgages. A net worth limit is truly a lagging indicator in comparison to asset size, which would be a more leading indicator.

The purpose of utilizing derivatives transactions is to hedge either an asset or liability, in which the fair value loss on derivatives should be offset by the asset/liability you are hedging; therefore, a limit should only be established if there isn't a correlation between the designated asset/liability and the hedge items. We propose NCUA also consider other comprehensive income movements, which effect equity, and should be excluded from the capital ratio calculation to the extent the asset/liability, has correlation to the hedge. If correlation within the asset is performing, the capital ratio should not be affected due to accounting rules, which require us to recognize losses thru OCI. This accounting rule would create an inconsistency in our equity calculation and would not accurately reflect the true position of the credit union.

We propose that credit unions not be required to submit a corrective action plan to the NCUA when the aggregate fair value loss exceeds the established limits. Instead, credit unions should be able to report limits outside their policy the same as any other investments currently allowed under Part 703 of NCUA's Rules and Regulations.

Limits - Maturity

The current proposed limits for Level I are not adequate to hedge real estate mortgages. These limits on maturity and average life of all derivatives in a credit union's portfolio, minimizes the advantage of being allowed to participate in derivatives activities. These restrictions will force most credit unions into Level II. With the higher costs proposed in application fees for this level, many credit unions may not be able to participate in this program due to the incapacity to absorb the associated fees. We propose to have the limits increased on Level I to allow credit unions to maximize hedging strategies.

Regulatory Violation

We understand the need to comply with the rules and requirements identified and confirmed in the initial application for approval. However, in the event there is a discovery violating these requirements, and approval is not given by NCUA on the corrective action plan, credit unions are mandated to cease entering into new derivatives. This will impact the derivatives strategy the credit union has employed up to that point and will unwind the effectiveness of the hedge which contradicts the initial purpose of this proposal to mitigate IRR exposure.

We propose more flexibility with regards to program violations. The consequence should be based on the violation itself, in lieu of ceasing all new derivatives transactions and disrupting the program, especially if the violation is not directly related to derivatives transactions.

Indirect Investments in Permitted Derivatives

In addition to FCU permissible investments, we propose mutual funds that are approved by NCUA based on criteria such as risk and operational capabilities, are allowed to invest in Permitted Derivatives to mitigate the fundamental risks of those other permissible investments. Allowing mutual funds to safely mitigate indirect IRR using the same Permitted Derivatives would maximize the purpose and goals within the proposed rule. Credit unions would greatly benefit by being armed with the tools to effectively manage IRR, the safety and soundness of credit unions and the NCUSIF would be enhanced and the regulatory burden incurred by NCUA and credit unions would be minimized.

Summary

In conclusion, we request that NCUA review and reconsider the current requirements under the proposed rule based on the items we have addressed above. In addition, we would like to reiterate the recommendation that derivatives be permissible investments under Part 703 and that a credit union's Board of Directors should have the authority to allow their credit union to independently engage in

derivatives transactions for the purpose of offsetting IRR. We still contend that a credit union board should be able to adopt a derivatives policy (similar to the investment policy) that delegates authority to management, but includes restrictions or limits to manage the process and have sufficient board oversight.

Thank you for the opportunity to comment on this ANPR and for considering our perspective on financial derivatives transactions. We have enclosed our last comment letter regarding derivatives authority, from April of 2012, as reference. Both comment letters will provide our overall perspective.

Sincerely,

Francisco Nebot
Senior Vice President, Chief Financial Officer
SchoolsFirst Federal Credit Union

Cc: Credit Union National Association (CUNA)
California/Nevada Credit Union League (CCUL)