July 29, 2013

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

RE: Proposed Rule on Derivatives (12 CFR Parts 703, 715 and 741)

Dear Ms. Rupp,

On behalf of Digital Federal Credit Union, thank you for the opportunity to comment on the National Credit Union Administration's (NCUA) Proposed Rule on Derivatives. Overall, we applaud the NCUA's efforts to provide credit unions with additional tools to employ in the mitigation of interest rate risk.

While we are encouraged by the NCUA proposing access to derivative tools for credit unions, there are a number of areas of the Proposed Rule that require additional consideration. The proposal includes considerable restrictions, oversight requirements and certain costs that we believe will limit the practical utilization of these tools by credit unions. The following are our comments and observations that we believe could improve the usability of this proposed regulation.

Levels of Authority

In addition to the "Level I" and "Level II" derivatives authority outlined in the Proposed Rule, we would like the NCUA to consider another level of authority for Management Investment Companies (MICs) to offer mutual funds to credit unions that utilize derivative transactions (i.e. Level 0).

This approach would require the MICs to obtain NCUA approval as opposed to individual credit unions receiving authority. A credit union's ability to invest in these mutual funds (having derivative authority) would not allow the credit union any other NCUA derivative investment authority without going through the application process.

MICs are regulated under the Investment Company Act of 1940, the Securities Act of 1933 and the Securities Exchange Act of 1934. From this perspective, the MICs would fall under the regulatory scope of the Securities Exchange Commission. The existing regulatory framework of MICs includes considerable oversight at the time of registration, as well as frequent ongoing

reporting requirements. As we understand it, these existing reporting requirements are more onerous and frequent than a credit union's requirements under the Proposed Rule.

Once NCUA approved, the MICs' intention would not be to create a mutual fund with investments entirely in derivatives. Rather, the MICs' intention would be to utilize derivative tools to manage the interest rate risk within the mutual fund. This approach could provide a vehicle with derivatives for credit unions with assets less than $250 million. For example, as opposed to credit unions investing in individual securities with embedded interest rate risk, credit unions could utilize this mutual fund as an alternative investment tool.

We understand that in the past there was a mutual fund that was part of the Pilot Program which experienced challenges. We would welcome the opportunity to better understand these challenges and discuss with you the concerns and lessons learned from the mutual fund to properly create this additional level of derivative authority as described.

Permissible Transactions

In addition to the "permissible derivative transactions" provided for in the proposal, we suggest the inclusion of interest rate floors and swaps options (swaptions). We believe such derivative transactions also protect credit unions against the most common interest rate exposure.

- Interest rate floors complement interest rate caps. While interest rate floors would not seem like a viable option to credit unions based on the current rate environment, they have similar mechanics to caps. Waiting until the point when interest rate floors are needed could result in a time delay and could impact the ability to effectively manage interest rate risk.

- Swaptions provide a tool to manage interest rate risk without the obligation to enter into the transaction (swap) unless changes in the rate environment support it. This provides a tool for credit unions to enable if rates move up, while limiting the downside risk during the option period to the cost of the option. Similar to an insurance policy, the premium would be written off over the term of the option (policy). There would be downside risk if the option is exercised, but no more than if the original swap was entered into at the time of the option.

Swaps with amortizing notional amounts are specifically excluded as part of the proposal (§703.102 (g)). The basis for this exclusion is not clear in the proposal. Credit union balance sheets typically include a variety of amortizing loans as well as investments that have amortizing principal balances. Providing the ability to utilize swaps with amortizing notional amounts could provide an enhanced interest rate risk tool. Based on a declining balance being the primary difference with swaps containing a static balance, we do not believe there is any additional risk.

Collateral requirements

We believe the Proposed Rule for acceptable collateral (§703.105 (b)) is confusing. Why include the first sentence if the "acceptable collateral" is spelled out in the second sentence. While it appears the intention here is to address only collateral being pledged to the credit union, not collateral pledged by a credit union, sub-part (i) adds to the confusion (*A credit union may agree to provide additional collateral to a counterparty in a credit support annex so long as the credit union complies with all other collateral provisions in this subpart).*

Daily pricing of derivative positions and calculating fair value exposure (§703.105 (c)) is excessive and has the potential to add considerable costs to the process. We recommend utilizing a more flexible approach that allows management to adjust the frequency of evaluating the position based on market conditions and level of collateral protection. This would allow management to consider the collateral cushion and stability of the respective markets in determining the frequency of evaluating fair value exposure. As factors change, management would be expected to make reasonable adjustments to the assessment timeframes.

Daily, a credit union must be collateralized for all transactions to at least 100 percent of the transactions, based on the risk of the collateral (§703.105 (d)). We would recommend this be modified consistent with our comments related to (c) above. Additionally, it is not clear what "*based on the risk of the collateral*" means. This could be interpreted to imply that if the collateral is not risky, the transaction could be less than 100 percent collateralized. We do not think this is what the NCUA intended.

Qualified Derivative Personnel

While we believe qualified staff is critical to safely and effectively manage a derivative program, the Proposed Rule emphasizes years of experience as a requirement to transact derivatives. The three and five years of experience requirements (§703.108 (a)(3)) appear to be arbitrarily selected and open to considerable interpretation. We do not believe a specific number of years of experience provide a safe and effective derivative program. For example, an individual performing one transaction a year over the past three years will have less experience than an individual performing one transaction a month over the past three years. Do both qualify under the proposal?

We believe experienced personnel with comprehensive understanding of derivative transactions and the associated risks are critical to a successful program. Comprehensive understanding should include the ability to execute the transactions, analyze the accounting treatment and valuation assumptions, manage the counterparty exposure, and manage the collateral throughout the life of the derivative transaction. Such an understanding, along with guidance through third-party consultants, should be adequate to effectively manage risk and properly execute all derivative transactions allowed under the Proposed Rule.

Internal Controls Audit

The Proposed Rule requires an annual external service provider's internal controls opinion audit (§703.108 (b)(3)). We believe the derivative transactions allowed under the Proposed Rule are "plain vanilla" and therefore should not require an internal controls audit opinion. We believe this type of engagement is excessive, and expensive, considering the limited authority being proposed. Additionally, to maintain approval for a credit union, this internal control opinion audit would need to be performed regardless of the volume of derivative transactions.

We believe credit unions should incorporate review(s) of the internal control functions of their derivative transactions similar to other areas of the credit union. The scope and frequency of the review(s) would be based on the credit union's risk assessment of derivative transactions similar to other transactions made by the credit union. Credit unions engage in other complicated transactions which do not require a specific external service provider's internal controls opinion audit. We encourage the NCUA to reconsider the Proposed Rule requirement of an internal controls audit.

Legal Review

We understand the importance of obtaining a legal opinion from qualified counsel before executing any derivative transaction, although we believe the proposed five year minimum qualification of such counsel is excessive and open to considerable interpretation (§703.108 (b)(5)). Similar to the example we mentioned above for credit union qualified derivative personnel, we believe experienced counsel with comprehensive understanding of derivative transactions, applicable laws and regulations, and International Swap Dealers Association agreements is appropriate and adequate.

Management of the credit union perform due diligence on their legal counsel, and other third party vendors, evaluating the relationship and reliability of such third parties. We believe legal counsel for derivative transactions should be evaluated and determined by management of the credit union based on their due diligence.

External Service Providers

The proposal includes specific requirements for "Level I" and "Level II" derivatives authority regarding areas where external service providers are prohibited to conduct certain activities (§703.110 (h)). While the proposal for "Level I" seems reasonable, the proposal for "Level II" is much more restrictive. We would recommend that the model for "Level I" be the standard utilized for "Level I" and "Level II", as well as any higher levels (i.e. "Level III") considered based on comments received.

As part of the application process, NCUA will have the opportunity to assess the appropriateness of external service providers being utilized. As we understand the proposal, external service providers are allowed for specified areas, but not guaranteed. Concerns related to an external service provider can be addressed as part of the application process.

Application Fees, Supervision and/or Examination Fees

We are opposed to the introduction of application and supervision fees to individual credit unions for derivative transactions, or any other product or service. While new to credit unions and the NCUA, derivatives are a common tool available throughout the financial services industry. We do not believe derivatives warrant special assessments for permission to use and/or subsequent regulatory oversight. If the NCUA wishes to implement such an approach, it should not be done selectively. This type of evaluation should incorporate the entire menu of regulatory authorities available to credit unions and be address as part of a separate proposal.

In closing, we thank you once again for this opportunity to comment on the Proposed Rule on Derivatives. We look forward to additional communication related to permitting credit unions to engage in derivatives activities for the purpose of mitigating interest rate risk.

Sincerely,

James F. Regan
President and Chief Executive Officer

Laurie M. LaChapelle
Vice President of Finance