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July 29, 2013

National Credit Union Administration
c/o Mary Rupp, Board Secretary
1775 Duke Street
Alexandria, VA 22314-3428

BY EMAIL: regcomments@ncua.gov

RE: Sandler O'Neill: Comments on Proposed Rule – *Derivatives*

Members of the Board:

Sandler O'Neill + Partners, L.P., is pleased to comment on the NCUA Board's May 29, 2013 Notice of Proposed Rulemaking ("NPR") – *Derivatives*, published at 78 FR 32191 for comment no later than July 29, 2013. In the NPR the Board requests public comments regarding whether and how to modify its rule on investment and deposit activities to permit natural person credit unions ("credit unions") to engage in limited derivatives activities for the purpose of mitigating interest rate risk.

Sandler O'Neill is a full-service investment banking firm and broker-dealer focused on the financial services sector.¹ We address the Board as a firm of financial professionals who work closely with some 1,000 financial firms, among them banks, thrifts, and credit unions ("financial institutions"). Our Balance Sheet Advisory Services ("BSAS") group provides modeling expertise and advice to financial institutions on managing their balance sheets. Our Interest Rate Products Desk ("Rates Desk") advises financial institutions on structuring and executing transactions, as well as counterparty risk mitigation and ongoing management of interest rate products, including derivatives.

Overview

The Federal Credit Union Act authorizes the purchase and sale of financial derivatives for the purpose of mitigating interest rate risk.² By regulation, the Board has generally prohibited credit unions from engaging in financial derivatives transactions to offset interest rate risk except pursuant to Pilot Programs the Board has approved for credit unions or third-party providers that meet certain prudential standards. Credit unions

¹ For further information on Sandler O'Neill + Partners, L.P., and the authors of this letter, see <http://www.sandleroneill.com>.

² 12 U.S.C. § 1757(17); NCUA General Counsel Opinion No. 99-0229 (February 23, 1999).

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generally do not need to obtain NCUA approval for participation in an approved third-party Pilot Program.³

The NPR proposes to replace the Pilot Programs and provide participating credit unions one year to comply with the requirements of the new framework, including an application for authority to continue using derivatives to mitigate interest rate risk. At the end of that year, the rule would immediately prohibit a noncompliant credit union from entering into new derivatives transactions and require submission of a corrective action plan within 30 days.

Taken as a whole, the requirements of the proposed framework would be tantamount to an almost complete prohibition of credit union use of derivatives to mitigate interest rate risk. The application fees alone – starting at \$25,000 and \$75,000 for Level I and II authority – would deter most credit unions from applying, and together with unquantified enhanced annual examination fees would render cost-prohibitive the use of derivatives to mitigate interest rate risk. Among the credit unions we know of greater than \$500 million in assets, virtually every one would need to hire one derivatives specialist, and the vast majority would need to hire two, in order to satisfy the separation-of-duties requirement.

Add to these requirements others of the rule such as obtaining a legal opinion for each and every derivatives transaction entered into, and what comes into focus is a proposed rule incapable of achieving its stated purpose. It strikes us that the Board may believe financial derivatives to be a greater threat to credit unions than interest rate risk.

Financial Derivatives in Context

Used to hedge various risks, financial derivatives are a key set of tools that financial institutions, including credit unions, should have at their disposal. Specifically, the January 6, 2010 interagency *Advisory on Interest Rate Risk Management* makes clear that financial institutions, including credit unions, are expected to measure exposure to interest rate risk and to take appropriate steps to mitigate it.⁴

Notable in that guidance is a greater supervisory emphasis on increasing capital to address interest rate risk: “If an institution determines that its core earnings and capital

³ See generally 12 C.F.R. § 703.19. Our information is that the only currently approved advisor under the Pilot Program is advising fewer than 10 credit unions, which we do not believe is indicative of credit union interest in using derivatives to mitigate interest rate risk.

⁴ Released on January 7, 2010, the interagency guidance is available on the FFIEC’s website at <http://www.ffiec.gov/press/pr010710.htm>. The NCUA supplemented this guidance with a final rule titled “Interest Rate Risk Policy and Program,” 77 FR 5155 (February 2, 2012), and notes that the current proposed rule on derivatives builds on the 2012 final rule on interest rate risk. 78 FR at 32192.

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are insufficient to support its level of IRR, it should take steps to mitigate its exposure, increase its capital, or both.” Of course, earnings are the only source of capital growth for credit unions, so that to the extent the Board renders using derivatives to hedge that risk prohibitively expensive, the Board would handicap credit unions further compared to their bank counterparts, particularly in the current low-rate environment.

On June 10, 2013, Sandler O’Neill conducted a webinar for credit unions on the use of derivatives to mitigate interest rate risk. Interest was strong, with 70 credit unions participating, despite the fact that most had no realistic expectation of being permitted to utilize derivatives to mitigate interest rate risk. Had they such prospects, interest would undoubtedly have been even stronger. For context, consider a first-quarter 2010 conference call we conducted for several hundred financial institutions on ways to mitigate the risk of rising market interest rates. On that call, Sandler O’Neill’s interest rate risk management professionals identified 14 different strategies available, 8 of which require the use of financial derivatives in the form of a cap or a swap.

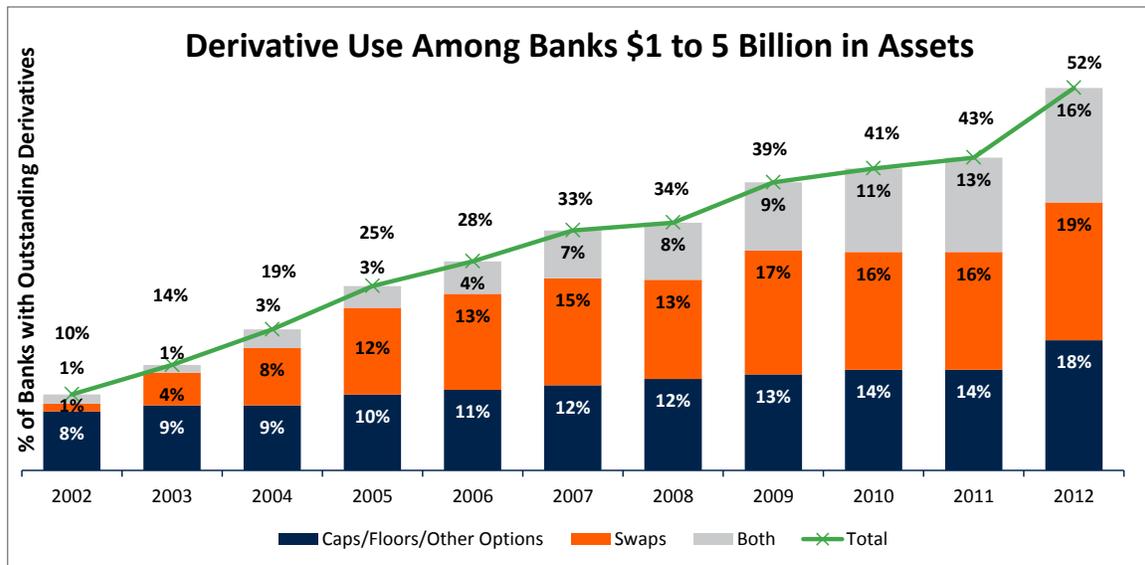
In many cases, the use of financial derivatives is the most efficient means of managing interest rate risk, particularly in protecting capital and earnings. For example, if a financial institution wishes to reduce its exposure to rising market interest rates but is limited to on-balance-sheet strategies, it will likely confront equally unacceptable options. Specifically, such a financial institution must either generate one-time losses as it unwinds and restructures assets and/or liabilities, or it must give up earnings by selling higher-earning assets to avoid booking net losses. A financial institution such as a credit union might be able to affordably avoid this dilemma by using a cap or a swap.

Managing the Risks of Financial Derivatives

We acknowledge that financial derivatives have specific risks in addition to those associated with other instruments such as borrowings and bonds. However, we do not believe these risks are any more unusual than the risk involved in purchasing certain types of securities. Pre-purchase analysis that assesses risk as part of an ongoing framework for managing it is an established supervisory expectation for the use of all financial instruments. For this reason, we believe the only basis for singling out instruments such as caps, floors and swaps is the relative unfamiliarity of some financial institutions with them. Moreover, we believe the best means of addressing this state of affairs is supervisory encouragement of greater familiarity with and prudent use of such instruments.

The significant growth in the use of derivatives by banks illustrates this linkage between familiarity and use, which almost certainly would not have occurred had banks been required to run the gauntlet the Board’s proposal would create for credit unions. The graph on the following page charts the growth in derivative use by banks between \$1 billion and \$5 billion in assets over the 10-year period beginning in 2002. It paints a portrait of banks that did not recklessly rush into derivatives but, rather, began utilizing

derivatives in a measured way as they educated themselves about the risks and benefits of their use. We believe credit unions would follow in their footsteps, if given the chance.



Source: SNL Financial

Two risks are specific to financial derivatives: (i) counterparty risk, the risk that a counterparty defaults on its obligation, resulting in losses; and (ii) accounting risk, the risk of not properly applying Accounting Standards Codification (“ASC”) 815,⁵ leading to income statement volatility resulting from restatement.

We offer the following three observations by way of addressing these two risks.

First, in a change from the pre-Lehman-meltdown world, it is now possible to get full bilateral collateral terms on a derivative contract. For example, Sandler O’Neill’s Rates Desk, which advises financial institution clients on the use of these instruments, generally will not advise placing a trade with a counterparty that is unwilling to collateralize the exposure it presents to our client. This requirement dramatically reduces counterparty risk, reduces the risk-based capital charge,⁶ and greatly simplifies

⁵ ASC 815 codifies guidance originally issued as Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, June 1998.

⁶ Basel III provides a strong regulatory capital incentive for counterparties to clear derivative trades through central counterparties to reduce allocated risk weighting of the exposure. Central counterparties will likely require full collateralization of exposure.

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accounting since it minimizes the need to incorporate Credit Valuation Adjustment ("CVA")⁷ into the mix.

This is an important recent development in the market that largely renders moot the discussion of whether credit unions will be required to clear trades pursuant to the Dodd-Frank Act or elect an "end user exemption." In fact, in speaking with large derivative counterparties such as swap dealers, we have heard from most that they expect collateral requirements imposed under Credit Support Annexes ("CSAs") on uncleared trades to be at least as stringent as those applied to cleared trades by clearing firms. Thus, we believe that the enhanced use of collateralization will reduce counterparty risk, either as is currently the case under a bilateral CSA or under clearing requirements implementing the Dodd-Frank Act.

If trades are not cleared, credit unions will need to have the ability, either directly or through outsourcing, to monitor the value of their positions and collateral so they can verify margin calls against them and know when they should be calling for margin (on cleared trades the clearing agent does this). Such assistance is a basic service that Sandler O'Neill's Rates Desk provides on all derivative trades for which we act as advisor.

Second, we observe that imposing rules-based limitations on derivative exposure based on notional amount, "book value," and/or market value loss, as suggested in the table on page 32203 of the NPR, is arbitrary and misleading, and does little to advance the fundamental regulatory objective of understanding, evaluating, and limiting the risk posed to a credit union at an enterprise level as a result of using these instruments.

We address each of these limits as follows:

Factors other than the notional amount affect the risk profile of a financial derivative transaction. Certainly, policy limits on the use of financial derivatives should be implemented and approved by a credit union's board of directors. However, we believe that a policy emphasizing limitation of the notional amount of interest rate derivatives – such as the proposed limitation on swap notional amount of 100% of net worth – is inadequate because it does not address the vastly different risks posed by various types, structures, and maturities of derivatives, and by differences in collateral and other terms that could materially alter the amount of counterparty risk taken in such transactions.

The example on the following page illustrates these differences by comparing the market risk and counterparty risk of two hypothetical interest rate swaps with the same notional amount but different durations and collateral received.

⁷ CVA is an adjustment made to the market value of a derivative contract to take into account the unsecured credit risk of the counterparty.

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Swap 1

Notional Amount: \$10,000,000

Type of Swap: Generic Pay-Fixed vs. 3-Month Libor

Maturity: 2 Years

Collateral Terms: Full Bilateral/Cash or US Treasurys

Duration: 1.9 years

Unrealized Gain if Rates Rise 3%: **\$570,000** (1.9 * 3% * \$10,000,000)

Unsecured Counterparty Exposure: **\$0** (fully collateralized)

Swap 2

Notional Amount: \$10,000,000

Type of Swap: Generic Pay-Fixed vs. 3-Month Libor

Maturity: 10 Years

Collateral Terms: None

Duration: 9.2 years

Unrealized Gain if Rates Rise 3%: **\$2,760,000** (9.2 * 3% * \$10,000,000)

Unsecured Counterparty Exposure: **\$2,760,000** (no collateral received)

Despite having the same notional amount, these two interest rate swaps represent materially different risks because of their different maturities/durations and collateral terms. Thus, a policy emphasizing notional amount limits as a percentage of capital would do little to further the objective of ensuring proper risk controls over the use of financial derivatives.

The proposed limitations based on the "book value" of interest rate caps strike us as ambiguous at best, and at worst counterproductive of the agency's goal of encouraging the use of derivatives to reduce interest rate risk. We note that the accounting concept of "book value" is generally not used with reference to derivatives. Under U.S. GAAP all derivatives are carried at fair value, with changes in FV recorded in some combination of earnings and other comprehensive income, depending on accounting treatment. The concept of "book value" applies to instruments that are accounted for under U.S. GAAP based on an historical cost model, which does not apply here. So the very use of this term creates significant ambiguity regarding the definition of "book value," which will cause credit unions to shun these instruments less they inadvertently violate a poorly defined limit.

Assuming that by "book value" the Board means the initial premium outlay (cost) of the cap, less any "amortization" of caplet expense as prescribed under hedge accounting (if applied), this type of limit could result in credit unions limiting their hedge activity to "disaster" protection. The reason for this is that the initial cost of a cap is a function of the notional amount *and* the "strike rate" on the cap (the level of interest rates that would trigger payments received on the cap). The larger the notional amount for a given strike

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rate, the higher the upfront cost in actual dollars. The lower the strike rate (and thus the more rate protection provided), the more expensive the cap and thus the higher the upfront expense. Thus, if hard limits are imposed on upfront expense, they will cause credit unions to reduce the notional amount hedged and/or increase the strike rate on these options, thus reducing the benefits of the hedge unless rates rise exponentially. In each case, the credit union may be forced to leave a significant portion of its interest rate risk unhedged due to arbitrary limits on the size of the initial premium outlay.

Limitations based on the fair value loss of hedging derivatives are ill conceived. If the intent of the proposal is to limit potential losses in the event of counterparty default, then it would need to limit the size of unrealized *gains* on hedges, since those gains would be forfeited in the event of counterparty default (net of the value of collateral received) as the instruments are written off, resulting in charges to capital. For this reason, the proposed limitation on unrealized *losses* is perplexing.

Consider the conditions under which a fair value “loss” would be recorded, and whether that loss should prompt regulatory concerns. A “loss” on the derivative would occur if interest rates moved counter to the direction being hedged, so if a credit union were hedging against rising rates but interest rates actually fell, there would be an unrealized loss on the hedge. However, this does not in any way imply risk to the credit union but, rather, the contrary in two ways.

First, if the credit union were hedging the change in value of its assets (for example, the securities portfolio or a mortgage pipeline destined for sale), a fall in market interest rates triggering a decline in the fair value of the hedge would cause an offsetting gain in the value of the asset being hedged, which would likely be recorded in earnings under U.S. GAAP, mitigating losses on the hedge. Second, if the credit union were hedging against a decline in future earnings due to rising interest rates, a declining interest rate environment might cause a decline in the fair value of the hedge, but would likely result in an improvement in underlying earnings.

In either case, setting policy limits based only on the impact of interest rate movements on the hedge instruments without examining the offsetting impact on the risk being hedged will serve as a very significant deterrent to hedging risk because it defines and limits future outcomes in terms of “wins” and “losses,” with “wins” perversely defined as outcomes in which the risk being hedged actually materializes.

Third, the complexity of accounting for financial derivatives created by FASB Statement 133 and associated Derivatives Implementation Group (“DIG”) issues has significantly lessened since 2005 as a result of five notable developments.

- There is now an established set of hedge-accounting trades/designations common to financial institutions that are generally accepted across external audit firms, minimizing if not eliminating the risk of adverse interpretation and

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- restatement in connection with these specific trades.
- The use of the "short-cut" method of hedge accounting, which had been the most common cause of earnings restatement, has fallen out of favor, leading to very few accounting mishaps in the last seven years.
 - The FASB's update of derivative accounting,⁸ if adopted as proposed, would greatly simplify the ongoing testing/documentation process that has tripped up financial institutions in the past (as well as eliminate "short-cut" treatment altogether).
 - A number of specialized consultants and software providers now offer very affordable "long-haul" hedge accounting services, which have been vetted with all the major accounting firms.
 - The FASB's recent acceptance of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a "benchmark" interest rate for hedging interest rate risk in cash flow hedges further reduces accounting risk.

As a result, we contend that accounting risk in connection with the use of financial derivatives can be substantially reduced by following a well-established path, using either qualified internal resources or third-party providers.

Forward-Settling Hedges

The Board proposes to set a three-day settlement requirement for derivatives transactions to prevent market speculation while permitting risk mitigation. While we laud the desire to limit credit unions' ability to use derivatives to speculate on future interest rate movements, we fundamentally disagree with the conclusion that permitting forward-settling hedges encourages speculation. Our experience in working with banks on hedging strategies, and our fundamental understanding of derivative accounting, directly contravene this view. Financial institutions can just as easily speculate on interest rate movements using "spot" or forward-settling swaps, caps and floors.

The limiting factor on speculation is accounting. Small- to mid-sized (below \$250 billion in assets) banks generally use derivatives only if they can qualify for hedge accounting under U.S. GAAP. Non-qualification results in those derivatives being marked to market through earnings as if they were trading positions, posing a risk of earnings and capital volatility that financial institutions generally are unwilling to bear. In order for a forward-settling derivative to qualify for hedge accounting and avoid that earnings and capital volatility, the financial institution must be able to match the derivative against a highly probable future event that is exposed to interest rate risk, such as a rollover of funding or a sale of assets.

⁸ Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities (Topics 825 & 815)*, May 26, 2010.

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Thus, in our experience, the use of forward-settling derivatives is limited to legitimate hedging applications that “work” under accounting rules, such as mitigating the future refinancing risk of rolling over specific certificates of deposit, FHLB advances, and other funding generally maturing within the next two years or so, or hedging the future sale of mortgage loans for which the mortgage rate was “locked” in advance. Given this practical reality, a prohibition against forward-settling hedges would do nothing to reduce credit unions’ ability to speculate on interest rates, but would eliminate a very important tool for hedging future earnings risk due to funding rollover and asset sales.

External Service Providers

Finally, we wish to address the risk the Board perceives in the use of external service providers that are principals or agents to derivatives transactions involving the credit union. The Board’s rationale for the proposed restrictions on the use of external service providers is the complexity of derivatives, conflicts of interest, and the lack of a fiduciary duty to credit union customers.

We believe a more nuanced approach than the Board proposes is appropriate for several reasons:

- As discussed above, the derivatives the Board proposes to permit credit unions to employ in mitigating interest rate risk are less complex than assumed.
- Principals acting as counterparties to a derivatives transaction with a credit union will have potentially greater conflicts of interest than agents because their capital, rather than a fee, is at stake.
- Not all external service providers are created equal due to varying levels of expertise and differing regulatory requirements.

More broadly, because commercial realities are that it takes two sides to make a market, the Board should concern itself less with prescribing behavior for credit unions through self-defeating regulations and more with addressing such management shortcomings as may occur through supervision, including monitoring, examination, and enforcement when needed. To do otherwise is to regulate to the lowest common denominator at the expense of the many credit unions capable of responsibly using derivatives to mitigate interest rate risk in a cost-effective manner that leverages the expertise of external service providers.

Conclusion

Rather than being subject to the Board’s Pilot Programs or the proposed rule, credit unions should be permitted to use financial derivatives to mitigate interest rate risk, subject to the same pre-purchase due diligence required for other capital markets

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trades, including understanding how market conditions impact an instrument's value, as long as:

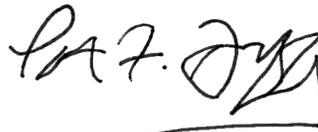
- The credit union secures counterparty protection in the form of collateral, either through a bilateral CSA or clearing.
- The credit union has the ability to monitor ongoing collateral requirements, or outsources such monitoring to a qualified third party.
- The credit union has established policy limits related to the amount of market risk, both gross and net of collateral, it is permitted to carry in financial derivatives, and can demonstrate the ability to measure and monitor that risk, either by using internal resources or by outsourcing that expertise to a qualified third party.
- The credit union can demonstrate a thorough understanding of the basics of how derivatives accounting will impact the balance sheet, income statement, and capital.
- The credit union has the resources and knowledge to apply well-established hedge accounting to commonly executed transactions, or outsources such accounting to a qualified third party.
- The credit union can adequately demonstrate that the proposed transaction reduces rather than increases the risk to the institution.

We would be pleased to discuss points presented in this letter, as well as such other matters as the Board or its staff may desire. Reachable at jlongino@sandleroneill.com or 212-466-7936, Mr. Longino is available to coordinate dialogue with the Sandler O'Neill team.

Sincerely,



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Principal



Peter Duffy
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Joseph Longino
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