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July 29, 2013

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

RE: Proposed Rule on Derivatives

Dear Mrs. Rupp:

On behalf of the National Association of Federal Credit Unions (NAFCU), the only trade association that exclusively represents federal credit unions, I am writing to you regarding the National Credit Union Administration's (NCUA) proposed rule regarding credit unions' authority to engage in derivatives. 78 FR 32191 (May 19, 2013).

General Comments

First and foremost, NAFCU would like to express our strong support for the proposed extension of derivatives authority for qualified credit unions. As the NCUA knows, NAFCU began discussing this issue with the NCUA well before the agency issued its first Advance Notice of Proposed Rulemaking (ANPR) on derivatives. Our main concern then, and now, was that credit unions do not have adequate alternatives for addressing interest rate risk. We believe strongly that derivatives, when used appropriately, should be available for qualified credit unions. Accordingly, we would like to express our appreciation to the NCUA for engaging in numerous discussions with NAFCU, credit unions and industry representatives on how to incorporate these instruments into credit unions' arsenal of risk management tools.

NAFCU also appreciates that the NCUA has proposed a comprehensive rule on derivatives. The proposed rule is clearly a result of not only extensive engagement with stakeholders and experts, but also considers the safety and soundness of the system. In this spirit, we would like to offer a number of comments that we believe would strengthen the rule.

Application and Costs

The proposed rule would require a credit union that seeks authority to engage in derivatives to submit an application with the NCUA. Among other things, the application must demonstrate how derivatives are part of the credit union's current or prospective interest rate mitigation strategy, the credit union's CAMEL rating, that the credit union's asset size is above $250 million and that the credit union has personnel with the required expertise for the particular level of authority it is seeking (Level I or Level II). In addition, for Level I authority, the credit union must pay $25,000 while a credit union seeking Level II authority would pay between $75,000 and $125,000. The proposed rule also contemplates an ongoing fee. The agency reasons that the fees are necessary to enable it to effectively supervise and examine derivatives programs.

As already discussed, NAFCU supports and has advocated for expanding credit unions' investment powers to include limited derivatives authority. However, NAFCU is greatly concerned about the proposed fee structure and strongly urges the agency to withdraw this aspect of the proposed rule. The proposed scheme represents a dangerous precedent. The agency, to the best of our knowledge, does not currently have any programs that require a credit union that engages in particular investments or other activities to pay the agency for its examination costs. We believe that imposing a fee on credit unions to engage in certain activities is a nonsensical approach to regulation.

The NCUA is a regulatory agency that is funded by the credit unions it supervises. Credit unions already are assessed a different operating fee based on asset size. NCUA pools the monies it receives from credit unions and uses those funds to create and manage an examination program. And, the monies that the NCUA collects have significantly increased over the past 5 years to cover a 58% increase in the agency's budget during that period. Thus, as an already well-funded agency, the NCUA need only look into its existing coffers to pay for a new examination program.

A user-fee pricing structure based solely on what credit unions offer is intrinsically flawed, as it runs directly afoul with the industry's long-established cooperative structure that embraces each credit union's uniqueness. As the agency designs and funds examination programs, it has to take into account that the fact that each credit union is unique. Some credit unions offer some products and services that others may not. Each credit union's portfolio of products and services *combined* makes up a critical part of its risk profile. NCUA's evaluation of a credit union is based on the CAMEL system: Capital adequacy; Asset quality; Management; Earnings; Liquidity-asset/liability management. All of those factors have to be looked at when determining examination cost.

As the NCUA has stated, it expends more examiner hours in some credit unions than may be appropriate to the low risk profiles of the institutions. A well-run and well-managed credit union will cost the NCUA less than a poorly run one even if that well managed credit union has "purchased" every item on the "menu." Thus, the mere fact that a credit union engages in derivatives activities does not mean that it poses a disproportionate risk to the National Credit Union Share Insurance Fund (NCUSIF). In fact, the opposite is far more likely - a particular credit union's proper use of this tool not only benefits the credit union itself but also reduces risk to NCUSIF.

Further, NAFCU notes that the NCUA does not provide any details about how it came to the proposed fee amounts. Even if the agency was to share this information, it would be nearly impossible to determine what constitutes "fair price."

The effect of the proposed scheme is to create a significant obstacle for many credit unions, particularly small credit unions, and it would undoubtedly serve as a disincentive to even explore entering into a new product line or management tool that reduces risk. Credit unions would be well aware that the benefits of using derivatives to mitigate risk would be reduced by the increased application and ongoing fees they would pay to the NCUA. NAFCU notes that many credit unions did not participate in the agency's derivatives pilot program because the program was riddled with numerous limits and obstacles. Unfortunately, many credit unions would similarly be repelled should the NCUA move forward with this aspect of the proposed rule.

The NCUA should to look for ways to create better efficiencies *within* the agency, to allow additional resources for new credit union activities. Accordingly, NAFCU believes that NCUA should withdraw this aspect of the proposal and better and more efficiently use existing mechanisms and resources to pay for all examination and supervision costs.

Proposed Limits

In order to ensure that a credit union does not overly expose itself to risk, the proposed rule would establish a set of transaction limits. Specifically, (1) interest rate swaps would be limited to a notational value of 100% of net worth for Level I authority and 250% for Level II authority; (2) interest rate caps to 10% of net worth for Level I authority and 25% for Level II authority; (3) interest rate swaps and caps would have a combined limit of 100% percent based on usage for Level I authority, while the NCUA will set a combined limit for Level II authority during the approval process; (4) aggregate fair value loss on swap positions would be capped at 10% of net worth for Level I authority and 25% for Level II authority; (5) maximum weighted average life (WAL) of all derivatives may not exceed 5 years for Level I authority and 7 years for Level II authority; and (6) a single derivatives position may not exceed 7 years for Level I authority and 10 years for Level II authority. Lastly, for Level II authority would have limits on single counterparty exposure.

NAFCU believes a credit union's board of directors, not the NCUA, should establish investment policies. While we would support a requirement that the credit union establishes limits, we do not believe that a regulator substituting itself for the credit union's board to establish specific limits is neither necessary nor advisable. It is important to note that only healthy credit unions, with strong capital and compliance positions, would be allowed to deal in derivatives. A credit union's qualification for derivatives authority, based both on these (and other) criteria, demonstrates that its board of directors should be allowed to do its job.

Further, the limits could easily take away a credit union's ability to use derivatives to hedge against interest rate risk during times when the credit union needs the authority most. A prescriptive, one-size-fits-all limit regime simply does not work, but it is especially unhelpful during such times. Simply put, NAFCU does not believe the agency should make investment decisions for credit unions.

Should the NCUA move forward with establishing predetermined limits, we ask that the agency consider adjusting the limits as discussed below.

Limits on Interest Rate Swaps

NAFCU believes the proposed limits to a notional value of 100% (Level I) or 250% (Level II) of net worth for interest rate swaps are far too low. We also do not believe that any limits on swaps should be tied to net worth. The proposed limits, given the fact that they would be tied to net worth, are far too low.

First, given that the risk the limits are seeking to address is the mismatch between assets and liabilities, we believe any limit should be tied to asset size. This would simply provide both the regulator and the credit union with a better picture. Thus, a credit union with high net worth does not overly extend itself, while a credit union with significant assets but limited net worth is not unduly restricted from using derivatives appropriately.

Second, if the NCUA does insist on using net worth to measure swap limits, we believe it must significantly increase the percentage. Based on our research and discussions with members, a more reasonable number would be at least 4 times the proposed limits for each level of the authority.

Limits on Interest Rate Caps

NAFCU agrees that the value at risk with interest rate caps is book value, not notional value. At the same time, we question whether the proposed methodology is appropriate.

NAFCU urges the NCUA to re-examine the appropriate methodology.

Weighted Average Life

The proposed WAL limits should be removed in their entirety. As the NCUA knows, derivatives with maturities of 10 years are both commonplace and desirable. A credit union that desires to transact multiple swaps with 10 years of maturity upon obtaining derivatives authority, however, will not be able to do so despite the fact that conducting these transactions is in the best interest of the credit union. Another credit union might execute a transaction in one year, not do so for the following years, and then find that it desirable to conduct transactions again for the credit union's benefit. In such a case, the WAL limit could similarly hinder the credit union from moving forward. Thus, we strongly urge the NCUA to remove the proposed WAL limits.

While we do not support any WAL limits, should the NCUA move forward on such limits, we ask that the agency develop a mechanism that would provide greater flexibility than the proposed rule. First, any WAL limits should be phased-in so that they would not apply for the first three to five years after the credit union executes its first transaction following the NCUA's approval of the credit union's application for authority to engage in derivatives. It is important that the time does not begin to run until after the first transaction (or set of transactions) rather than the date of agency approval. Second, if a credit union ceases to conduct derivatives transactions for a set period of time (to be determined based on the existing WAL in the credit union's derivatives portfolio, as opposed to a time period determined by the NCUA), WAL limits should be adjusted so that the credit union's ability to use derivatives transactions going forward is not unnecessarily hampered.

Single Maturity Limit

NAFCU does not oppose establishing a single derivatives position maturity limit. However, consistent with our discussion about the importance, availability and usefulness of derivatives transactions with 10-year maturities, we ask that the proposed limit for Level I authority is increased from 7 to 10 years. We do not believe that there should be a distinction, and the NCUA does not provide any justifications for making the distinction.

Proposed Asset-Size Threshold

The proposed rule would enable only credit unions with at least $250 million in assets to seek derivatives authority.

NAFCU strongly opposes this aspect of the proposal. As we have stated many times before, we strongly oppose any attempt by regulators or others to divide the credit union industry, especially by asset size. The NCUA is well aware that each credit union is unique, which means that regardless of its size, it may find interest rate risk challenges. While it may be true that most of the interest rate exposure in the industry is found in credit unions with above the proposed threshold, it is clear that this finding does not negate the fact there are many credit unions under the threshold with the exposure that derivatives can address. Further, it is entirely possible that another of NCUA's apparent finding that interest rate exposure among smaller credit unions is not as great can quickly change. The possibility is even greater since more credit unions may hold more mortgages following the soon-to-be effective "qualified mortgage" rule prescribed by the Consumer Financial Protection Bureau.

In addition, the proposed rule contains a number of other eligibility requirements (i.e., personnel expertise, showing of need for derivatives) that ensures that only credit unions that are serious about using derivatives responsibly would do so. Simply put, the NCUA should remove the proposed threshold requirement.

List of Permissible Derivatives

The proposed rule would limit the list of permissible derivatives to interest rate swaps and interest rate caps. NAFCU agrees that both derivatives are appropriate for credit unions.

NAFCU, however, requests that the NCUA add interest rate floors to the list of permissible derivatives. As interest rates rise, credit unions must have adequate risk management tools to manage risks associated with dropping rates. Interest rate floors, much like interest rate swaps enable a credit union to hedge against rising interest rate risk, would enable a credit union to protect itself against declining interest rates.

As the NCUA is aware, interest rates are rising and are projected to continue to rise. NAFCU believes that the NCUA should add floors to the list of permissible derivatives rather than wait until the decline of interest rates poses risks.

Acceptable Collateral

Under the proposed rule, acceptable collateral would be limited to cash, Treasury securities, fixed-rate non-callable agency debentures, and zero-coupon non-callable agency debentures.

NAFCU believes NCUA should add to the list of acceptable collateral to expressly include agency mortgage-backed securities and pass-through certificates to the extent that they are backed by the full faith and credit of the United States Government. These include agency-backed securities guaranteed by Fannie Mae, Freddie Mac, the Government National Mortgage Corporation (Ginnie Mae) and the Federal Home Loan Banks (FHLBs). Expanding the list of acceptable collateral would provide credit unions with needed flexibility to effectively use this important risk mitigation tool.

Counterparty Requirements

The proposed rule would limit permissible counterparties to swap dealers and major swap participants as defined by the Commodity Futures Trading Commission (CFTC), and more specifically to those swap dealers and major swap participants that have registered with the CFTC under its clearing requirements.

NAFCU urges the NCUA to expand the list of permissible counterparties to include the FHLBs. As the NCUA knows, credit unions in the pilot program had successful relationships with the FHLBs. Unfortunately, however, since the FHLBs are not required to register under the CFTC's regulations, credit unions would not be able to conduct business with them unless the NCUA provides for an exemption for FHLBs or otherwise includes FHLBs on the list of permissible counterparties.

Legal Review

Under the proposed rule, a legal review must be conducted by an attorney with at least five years of experience reviewing derivatives transactions. The attorney is expected to have the skills and expertise to properly evaluate International Swap Dealers Association agreements and compliance, and a legal opinion must be provided concluding that the credit union's agreements are in compliance with applicable laws and regulations relating to its derivatives program.

NAFCU is concerned that this requirement would create too much cost for credit unions. It is NAFCU's understanding that attorneys with the proposed qualifications are rare and that attaining their services is both difficult, especially for smaller credit unions, and extremely costly. In order to ensure that the legal costs do not serve as a barrier to entry, we ask that the NCUA revise this aspect of the proposed rule. Specifically, the NCUA should simply require that the credit union obtain legal review by an attorney with experience in multiple derivatives transactions.

NAFCU appreciates the opportunity to provide comments on the proposed rule Should you have any questions or would like to discuss these issues further, please contact me by telephone at (703) 842-2268 or by email at ttefferi@nafcu.org.

Sincerely,

Tessema Tefferi
Senior Regulatory Counsel