July 29, 2013

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

Re: Proposed Rule on Derivatives Activities

Dear Ms. Rupp:

Thank you for the opportunity to comment to the National Credit Union Administration ("NCUA") on the proposed rules that permit credit unions to engage in limited derivatives activities for the purpose of mitigating interest rate risk. Financial Standards, Inc offers expertise in derivatives and hedging, including providing educational programs for boards of directors, senior management and staff. The company also provides strategic expertise in drafting policies, providing assistance with derivatives modeling, hedge accounting under US GAAP, and providing independent mark to market valuations.

Financial Standards applauds the NCUA for promulgating guidance and regulation on eligibility of derivatives contracts used to hedge interest rate risk. We believe that the regulation makes clear the expectation to which credit unions can comply while addressing this important component of risk. This letter is responds to some of the specifics that may worth reconsideration when preparing the final regulation.

The Wall Street Reform Act of 2010

The Commodity Futures Trading Commission ("CFTC") has issued a number of new regulations requiring electronic execution, collateralization, central clearing and real time reporting of derivatives contracts. While the NCUA is the primary regulator, credit unions that use derivatives may also be subject to regulation by the CFTC. Financial Standards urges the NCUA to take into account some of the key elements in the CFTC regulations that will go a long way towards addressing safety and soundness concerns of the NCUA, chiefly systemic and counterparty risk.

For example, under the CFTC regulations, interest rate swap contracts will be executed on a swap execution facility ("SEF"), and then centrally cleared. The benefit to this new process is that pricing of plain-vanilla swaps is made more transparent. The other benefit is that the counterparty is not a financial institution, but the clearinghouse—a well-capitalized market utility. The main clearinghouses are the CME, ICE and IDCG, and are separately capitalized by the member futures commission merchants. The collateral position is monitored daily by the futures commission merchant ("FCM"), which is a member of the clearinghouse, and in almost all cases is also a swap dealer as defined in the proposed regulation. Credit unions would greatly benefit from the safety and soundness features that are built into this new regulatory arrangement.

In addition to the mandatory central clearing requirement, all derivatives positions must be collateralized. While collateral rules historically have been the authority of each of the clearinghouses, the CFTC plans to establish minimum collateral requirements. The new derivatives collateral rules promulgated by the CFTC are more specific than what is proposed by the NCUA. The collateral expectation is for initial margin and variation margin. The variation margin is based on mark to market, but the initial margin is the Value at Risk calculation based on a look back period (e.g. five years) and a replacement time frame of several business days. The initial margin covers the cost of the swap in the event of a failure on the part of a clearinghouse member and must be posted at inception of a swap transaction.

This new trade architecture addresses counterparty risk, and by requiring collateral for each trade, naturally limits the swap portfolio of an institution—as opposed to arbitrary limits based on capital and notional. We think that the NCUA's rulemaking would be improved by taking into account the requirements that are prescribed by the CFTC. However, we think that credit unions must also address the liquidity risk when posting initial and variation margin. Each credit union should have a program that measures expected collateral requirements based on changes in interest rates and how that will influence the availability of qualified assets that may be pledged.

Practical Approach to Derivatives Risk

We noticed that the NCUA has established bright lines for derivatives eligibility (e.g. asset size, percent of capital). We think that NCUA's approach to regulation should be more practical. Credit union management should make the case for using derivatives based on the hedged item. As an earlier commenter had stated, volatile interest rates, and especially the forecasted rising rate environment influence credit unions <u>of all sizes</u>. The Financial Accounting Standards Board's derivatives accounting standards require that hedge accounting is eligible when the hedging relationship is documented at inception, and on an ongoing basis hedge effectiveness is tested. We think that this standard may be an important element to the control process that the NCUA has recommended. As a practical matter, many of the hedging relationships undertaken by credit unions can be documented and tested in a way that is already required by auditors under US GAAP. Whether a

credit union may be eligible to use derivatives should be reliant on the economic benefit of the hedging relationship, and proper hedge documentation and effectiveness testing.

Need for Interest Rate Risk Policy and Framework
We agree that the NCUA should expect credit union management to demonstrate a material IRR exposure. We believe that credit unions should prepare a comprehensive risk management policy and include this information, along with the risk mitigation strategies employed to address the IRR exposure. Operational audits and examinations should test against the framework and specifications established in the policy. Financial Standards has experience in working with companies on developing interest rate risk policies that conform to audit standards.

Specialized Education Necessary
Having a policy and framework is not enough. We agree that specialized education is necessary to understand derivatives and to know what type of derivatives contracts are the most effective at addressing risk. We disagree strongly with the comment that "plain-vanilla" derivatives present little or no risk. An internal control requirement that all derivatives must have a documented hedging relationship is important to address the offsetting changes in fair value. Municipalities that have notoriously reported multi-million dollar losses did so when they held derivatives contract without a hedged item offset. Each hedge must have a hedged item, and derivatives contracts must be unwound when the hedge item matures or is terminated.

We think that many of the proposed regulations are warranted and timely, and we agree with NCUA's plan to require policies and training among directors and management. However, the CFTC regulations required by the Wall Street Reform Act of 2010 are relevant to the new derivatives marketplace and address the systemic and counterparty risk concerns that NCUA also has for its' regulated entities. The proposed NCUA regulations would benefit to harmonize with the expectations of the CFTC, thereby avoid confusion when complying with derivatives regulations.

Thank you for this opportunity to provide comments on these important regulations. If you have any follow up questions about the position stated herein, please feel free to contact our Washington DC office at 202-669-5351.

Sincerely,

Marti Tirinnanzi

Marti Tirinnanzi
President and CEO