



May 29, 2013

## **Derivatives Investment Authority**

### **Executive Summary**

The National Credit Union Administration (“NCUA”) Board issued a proposed rule that amends its investment rule to allow federal credit unions (“FCU”) and federally insured state-chartered credit unions (FISCU), authorized by their state laws, to use derivatives to mitigate interest rate risk (“IRR”). The proposed rule limits credit unions’ authority only to derivatives instruments known as interest rate swaps and caps. The proposal contemplates Level I and Level II derivatives authority, with Level II authority giving credit unions more flexibility but with stricter requirements. Credit unions must apply to the NCUA for permission to conduct derivatives transactions, which requires credit unions to demonstrate the need and ability to conduct derivatives transactions in compliance with the proposed rule. Comments are due to NCUA by July 29, 2013.

### **Application and Supervision Fees**

NCUA is considering instituting a fee structure for those credit unions that apply for derivatives authority. This is the first time that NCUA has proposed charging credit unions fees in this manner and might set a precedent for application and examination fees for other credit union activities.

NCUA states that the agency’s application review process and ongoing supervision is labor and resource intensive. Further they state “[r]ather than pass this cost on to the credit union industry as a whole, the Board believes it may be prudent to pass this cost directly to the credit unions seeking approval.” NCUA is considering a Level I application fee with amounts starting at \$25,000 and a Level II application fee with amounts ranging from \$75,000 to \$125,000, based on the complexity of the application. The fees would be updated in periodic guidance based on the evolving costs of processing applications.

### **Background**

NCUA has conducted a very limited derivatives pilot program since 1999 and has issued two Advance Notices of Proposed Rulemakings (“ANPR”) where the agency has solicited feedback from credit unions on their needs and uses of derivatives. This proposed rule is the result of NCUA’s experience from the pilot program, information gathered through the ANPR process, and other research. The agency believes that derivatives give credit unions a useful tool to mitigate IRR, while reducing risk to the National Credit Union Share Insurance Fund.

Although there are many definitions of derivatives, NCUA proposes a definition that focuses on the derivatives authority the rule will give credit unions. NCUA defines derivatives and its proposed derivatives program as:

A derivative is an instrument whose price is dependent on or derived from one or more underlying assets. A derivatives transaction involves a contract between two parties, called counterparties, that exchange value based on the fluctuation of the underlying asset or index. A counterparty is the other party to the derivatives transaction and can include swap dealers and major swap participants, which are terms to identify entities that operate primarily in the derivatives market. These transactions may involve collateral and a collateral custodian, which is an entity that holds the collateral for the two contracting parties.<sup>1</sup>

Again, there may be more expansive definitions but the one above describes NCUA's derivatives program.

NCUA's proposed derivatives rule is very limited and requires credit unions to meet several requirements before the agency will grant authority. These requirements may prove too strict and/or cost prohibitive. The authority is split into Level I authority and Level II authority. Level II authority gives credit unions higher limits and the ability to purchase instruments with longer durations. Level II authority also has more stringent requirements for approval and additional in-house expertise to run a derivatives program.

The first hurdle to gain derivatives authority is to meet NCUA's proposed eligibility requirements, which are:

- Demonstrating how derivatives will be used in a credit union's IRR program.
- A composite CAMEL code rating assigned by NCUA of 1, 2, or 3, with a management component of 1 or 2.
- Have assets of at least \$250 million, as of its most recent call report.

In addition to meeting eligibility requirements, NCUA also places extensive requirements on a credit union's derivatives program, which must be met before a credit union will be granted derivatives authority and be allowed to use derivatives. Some of these requirements include:

- Annual board reviewed policies and procedures
- Board training (initial and annual)
- Staff expertise
- Reporting
- Internal controls and financial statements audit

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<sup>1</sup> 78 Fed. Reg. 32191 (May 29, 2013)

- GAAP reporting
- Legal review by an experienced derivatives attorney
- Hedge review

**Definitions**

We encourage credit unions to review NCUA’s definitions in the proposal and to provide comments if these definitions are not accurate, clear, or do not meet the needs of the derivatives program. The proposed definitions can be found in §703.2 and §703.101, pages 32206 and 32207 of the Federal Register respectively. The proposal adds a separate definition section in §703.101 that pertains only to the derivatives program. These sections contain common definitions used by the derivatives industry.

**Eligibility for Derivatives Authority**

There would be two levels of eligibility detailed in §703.103 of the proposed rule. The table below provides a basic synopsis of the differences between Level I and Level II eligibility.

Level I	Level II
<p>To apply for Level I authority a credit union must:</p> <ul style="list-style-type: none"> <li>• Show, in its application, how derivatives are part of the credit union’s IRR mitigation strategy. IRR mitigation may be of current or prospective IRR.</li> <li>• Have a composite CAMEL code rating assigned by NCUA of 1, 2, or 3, with a management component of 1 or 2.</li> <li>• Have assets of at least \$250 million, as of its most recent call report.</li> </ul>	<p>In addition to all of the eligibility criteria under Level I in this chart, a credit union seeking Level II authority must also be able to demonstrate in its application why the limits for Level I authority are not sufficient to meet the credit union’s IRR mitigation needs.</p>

**IRR Mitigation**

A credit union must articulate how derivatives authority will complement existing risk mitigation tools. This is different from a requirement to demonstrate IRR, which could come too late for derivatives authority to address the risks. NCUA had discussed IRR as a requirement to being granted derivatives authority, but appears to have addressed credit unions’ concerns by allowing credit unions to be approved for derivatives authority before actual IRR exists.

## **CAMEL Requirements**

The proposed rule also requires a credit union's most recent composite CAMEL code rating, assigned by NCUA, to be a 1, 2, or 3, with a management component rating of 1 or 2.

## **Asset Threshold**

A credit union must have \$250 million or more in assets to be eligible for derivatives authority. NCUA states that IRR is more prevalent in credit unions with assets over this threshold level, which is the reasoning for setting the threshold at this amount. NCUA also indicates that most credit unions with assets below this threshold do not have sufficient resources to conduct a derivatives program. Also, credit unions with assets below the threshold might not have access to counterparties.

Currently, NCUA only requires financial statement audits for credit unions with assets of \$500 million or more. Under this proposal credit unions with assets under \$500 million with derivatives authority will be required to provide financial statement audits that express an opinion as to whether the financial statements fairly present the credit union's financial position and the results of the operations and its cash flows in conformity with GAAP.

## **NCUA Requirements to Gain Derivatives Authority**

The proposed rule details a long list of requirements that credit unions must meet to be authorized to conduct derivatives transactions. Some of these requirements must be met before approval and others are ongoing requirements.

## **Policies and Procedures**

Credit unions applying for Level I or Level II authority must have written policies and procedures in place that are reviewed annually by a credit union's board of directors. These policies and procedures must, at a minimum, address managerial oversight, scope of activities, approved counterparties, risk management, legal issues, accounting standards, limits, counterparty exposure, margin requirements, and reporting requirements. NCUA's policy requirements are detailed in proposed §703.104.

## **Collateral Requirements**

The proposed rule places collateral requirements on Level I and Level II credit unions. These requirements limit collateral to highly liquid instruments. The proposal states that the collateral requirements are stricter than required by the Federal Credit Union Act. The requirements include that:

- Collateral arrangements must be bilateral and collateral may not be held by counterparties except at a legally separate affiliate;
- Derivatives positions must be priced daily;

- Daily a credit union must be collateralized for all transactions to at least 100 percent of the transaction based on the risk of collateral; and
- Thresholds must be set to zero.

Please review proposed §703.105 for the entire list of requirements.

### **Counterparty Requirements**

The counterparty requirements are found in §703.106 and are the same for Level I and Level II approved credit unions. The proposed rule limits credit risk by limiting permissible counterparties to swap dealers and major swap participants as defined by the Commodity Futures Trading Commission (“CFTC”). NCUA stated that more than 70 domestic swap dealers have provisionally registered with the CFTC under its clearing requirements.

NCUA is also proposing to require credit unions to conduct a credit risk analysis of any potential counterparty. This means that a credit union must carefully assess the likelihood of default and timely repayment of derivatives obligations. In addition, a credit union must be aware of the financial strength of its counterparties, as well as the counterparty’s capital buffers to absorb losses and access liquidity. It is not clear how much of this can be assigned to a third-party.

### **Reporting**

At least monthly, a credit union’s senior executive officers must deliver to the credit union’s board of directors, separately or as part of the standard funds management or asset/liability report, a comprehensive derivatives report. The report must include:

- Identification of any areas of noncompliance with any provision of this subpart or the credit union’s policies;
- Utilization of the limits in §703.109 or §703.110, as applicable, and the limits in the credit union’s policies;
- An itemization of the credit union’s individual positions and aggregate fair and book values;
- A comprehensive view of the credit union’s statement of financial condition, including, but not limited to, net economic value calculations for the credit union’s statement of financial condition done with derivatives included and excluded; and
- The cost of executing new derivatives transactions. A credit union can express this cost through a comparison with observed market quotes and/or offering levels from other counterparties. Observed market quotes can include swap rates or external service provider modeled cap prices.

## **Personnel**

In §703.108 NCUA details experience requirements for credit union staff and the board.

- The board must receive initial and annual training to provide general understanding of derivatives.
- A credit union's senior executive officers must have sufficient knowledge and experience to understand, approve, and provide oversight for the derivatives activities commensurate with the complexity of the derivatives program. These individuals must have a comprehensive understanding of how derivatives fit into the credit union's business model and risk management process. A credit union must notify NCUA when a senior executive separates from the credit union.
- Qualified Derivatives Personnel. To engage in derivatives transactions with Level I authority, a credit union must have knowledgeable and experienced employees that have at least three years of direct transactional experience in the trading, structuring, analyzing, monitoring, or auditing of financial derivatives transactions at a financial institution, a risk management advisory practice, or a financial regulatory organization. Staff must also have the demonstrated expertise in the statement of financial condition analysis described in proposed §703.107(d). Level II authority requires employees with at least five years of experience. Qualified derivatives personnel must have the ability to perform the following requirements:
  - Asset/liability risk management.
  - Accounting and financial reporting.
  - Trade execution and oversight.
  - Credit, collateral, and liquidity management.

## **Internal Controls Structure**

NCUA details a specific internal controls structure for credit unions with derivatives authority.

Separation of Duties:

The proposed rule requires that as part of its derivatives management and internal controls structure, a credit union maintain separation of duties for the functions of: derivatives execution and oversight; accounting for and confirmation of derivatives transactions; ALM; and credit, collateral, and liquidity management.

#### Framework:

A credit union with derivatives authority will be required to maintain, in its written derivatives policy, a written and schematic description of the derivatives decision process. This framework description must show how decisions on derivatives are made, starting with the board's decision to use derivatives to mitigate IRR, to the senior executives formulating a derivatives plan and choosing the counterparties and derivatives, to the execution of the derivatives transaction and the monitoring and accounting through the life of the transaction.

#### Internal Controls Audit:

A credit union with Level I or Level II derivatives authority must, at least annually, have an internal controls audit conducted by an external service provider. The credit union must ensure the external service provider is experienced in auditing derivatives transactions, including, but not limited to, valuation methods and risk management modeling techniques, and is familiar with the credit union's IRR model and the related assumptions and inputs to test for reasonableness.

#### Financial Statement Audit:

As mentioned above, all credit unions with derivatives authority will be required to have a financial statement audit that conforms to GAAP. Only credit unions with \$500 million or more in assets are required to meet this requirement now.

#### Legal Review:

A credit union must obtain a legal opinion from qualified counsel before executing any derivatives transaction. Qualified counsel means an attorney with at least five years of experience reviewing derivatives transactions. The attorney must be familiar with International Swaps and Derivatives Association ("ISDA") agreements that consist of a master agreement, a schedule, confirmations, definition booklets, and a credit support annex.

#### Hedge Review:

This review entails identifying and documenting the circumstances leading to the decision to hedge, specifying the derivatives strategy, and demonstrating that the derivatives transaction is protecting against the loss it was intended to mitigate. Two conditions must be met: a credit union with derivatives authority is using derivatives for their intended purpose, the mitigation of IRR; and the credit union has a well thought out and documented plan of how and why it will hedge particular IRR on its balance sheet.

#### Transaction Management:

Credit unions are required to have support systems in place to provide accurate and timely transaction processing. Under this requirement, credit unions should be able to document a derivatives transaction, including the price paid, collateral requirements,

identification of the counterparty, life of the transaction, and reason for the hedge. Under the reporting section of the proposed rule, these items must be included in the monthly report to the credit union's board of directors.

#### Asset Liability Management (ALM):

A credit union must manage the risk from derivatives transactions itself, within a clearly stated ALM strategy, while testing and demonstrating the effectiveness of these transactions in reducing IRR exposure. As well as testing past effectiveness, a credit union must assess the likely effectiveness of its derivatives transactions in reducing IRR exposure going forward under a range of stressed rate and statement of financial condition scenarios. The credit union will also need to consider a variety of alternative strategies to reduce IRR in order to perform this function successfully.

#### **External Service Providers**

The use of external service providers ("ESP") is especially important to credit unions. NCUA will allow credit unions to utilize ESPs in their derivatives programs, but the extent they can be used varies with the level of derivatives authority approved for a credit union. The proposed rule classifies a number of activities into two categories of permissible use of contractual services and support. The functions in each classification vary between Level I and Level II authority. The two classifications are:

**Support:** A credit union is required to conduct the functions in this category. ESPs can provide assistance and input, but a credit union is prohibited from allowing an ESP to conduct the function or activity in lieu of the credit union.

**Conduct:** A credit union may contract with an ESP to conduct a function or activity in this category as part of the management and internal controls structure. While a credit union is responsible for managing an ESP's work quality and must have full understanding of all ESP activities and work products, it is not required to maintain in house capacity for the function or activity. The table below summarizes the permissible uses of ESPs outlined in the proposed rule.

Below is a chart provided by the NCUA that details how external service providers can be used for Level I and Level II credit unions.

Level I	Level II
<p>A credit union with Level I derivatives authority may contract with external service providers to:</p> <ul style="list-style-type: none"> <li>• Support: <ul style="list-style-type: none"> <li>○ Evaluating credit risk management.</li> <li>○ Evaluating liquidity risk.</li> <li>○ Asset/liability risk management.</li> </ul> </li> <li>• Conduct: <ul style="list-style-type: none"> <li>○ Accounting reporting.</li> <li>○ Counterparty exposure management.</li> <li>○ Collateral management.</li> <li>○ Trade execution.</li> <li>○ Transaction management.</li> <li>○ Financial statement auditing.</li> <li>○ Legal services.</li> </ul> </li> </ul>	<p>A credit union with Level II derivatives authority may contract with external service providers to:</p> <ul style="list-style-type: none"> <li>• Support: <ul style="list-style-type: none"> <li>○ Asset/liability risk management.</li> <li>○ Evaluating credit risk.</li> <li>○ Counterparty exposure management.</li> <li>○ Evaluating liquidity risk.</li> <li>○ Collateral management.</li> <li>○ Transaction management.</li> </ul> </li> <li>• Conduct <ul style="list-style-type: none"> <li>○ Accounting reporting.</li> <li>○ Trade execution.</li> <li>○ Financial statement auditing.</li> <li>○ Legal services.</li> </ul> </li> </ul>

As detailed in the chart, Level I credit unions can rely on ESPs to conduct more of the required duties. Level II credit unions will be required to have more capacity to perform required duties in-house.

NCUA has indicated that they are concerned that overreliance on ESPs to meet derivatives requirements may lead to additional risk to credit unions. They are also concerned that conflicts can arise when external parties do not share the same fiduciary responsibility as the credit union and when parties have financial objectives and incentives that are inconsistent.

The proposed rule prohibits credit unions from using ESPs that are principals or agents to derivatives transactions involving the credit union. NCUA is aware that some credit unions have ESP relationships with firms that provide services and act as agents or principals for securities trades. Credit unions can make responsible use of contractual services provided by independent ESPs, as part of an effective derivatives and balance sheet management process. NCUA believes that responsible use of ESPs requires a credit union to have the internal capacity, experience, and skills to oversee and manage any ESP activities. Credit unions are required to closely supervise ESPs. Credit unions must retain responsibility and control over the derivatives and balance sheet management process and decision making. Credit unions are responsible for managing ESP work products and must have a full understanding of ESPs' activities.

**Authorities and Limits**

Level I and Level II credit unions have different authorities and limits for conducting derivatives transactions. The authorities and limits are expressed as a percentage of net worth. Below is a chart provided by NCUA that compares Level I and Level II authorities and limits.

Level I	Level II
<ul style="list-style-type: none"> <li>• Interest rate swaps are limited to a notional value of 100% of net worth.</li> <li>• Interest rate caps are limited to an aggregate book value of 10% of net worth.</li> <li>• The combined limit of interest rate swaps and interest rate caps is limited to 100% of the aggregate limits based on usage.</li> <li>• Aggregate fair value loss on all interest rate swap positions cannot exceed 10% of net worth. <ul style="list-style-type: none"> <li>○ A credit union with Level I authority that exceeds this limit may not enter into any new derivatives transactions and must submit a corrective action plan to NCUA (or NCUA and the applicable SSA, in the case of a FISCU).</li> </ul> </li> <li>• Maximum weighted average life of all derivatives transactions may not exceed 5 years.</li> <li>• A single derivatives position maturity may not exceed 7 years.</li> </ul>	<ul style="list-style-type: none"> <li>• Interest rate swaps are limited to a notional value of 250% of net worth.</li> <li>• Interest rate caps are limited to an aggregate book value of 25% of net worth.</li> <li>• NCUA will set the combined limit of interest rate swaps and interest rate caps during the approval process.</li> <li>• Aggregate fair value loss on all interest rate swap positions cannot exceed 25% of net worth. <ul style="list-style-type: none"> <li>○ A credit union with Level II authority that exceeds this limit may not enter into any new derivatives transactions and must submit a corrective action plan to NCUA (or NCUA and the applicable SSA, in the case of a FISCU).</li> </ul> </li> <li>• Maximum weighted average life of all derivatives transactions may not exceed 7 years.</li> <li>• A single derivatives position maturity may not exceed 10 years.</li> <li>• Single counterparty notional exposure cannot exceed 100% of net worth for interest rate swaps and single counterparty book value may not exceed 10% of net worth for interest rate caps.</li> </ul>

Derivatives exposure limits are measured differently for interest rate caps and interest rate swaps. The NCUA stated that they chose relatively simple measurement tools and acknowledge they may not fully capture all risks associated with derivative exposure. The proposed limit on interest rate caps is measured by the exposure of book value to net worth. NCUA stated that notional value was considered but decided book value was a more appropriate measurement because it accurately captures the risk associated with interest rate caps without unreasonably limiting a credit union's ability to mitigate IRR.

The proposed limit on interest rate swaps is measured using notional exposure and fair value loss. Both measurements use the credit union's net worth as the basis. Also, fair value loss limits trigger a suspension of derivatives transactions and the submission of a corrective action plan if the credit union reaches certain levels of losses.

The proposed rule prohibits a credit union with Level I derivatives authority from having individual derivatives transactions that exceed a maturity of seven years. Further, the weighted average life of all derivatives in the credit union's portfolio cannot exceed five years. Level II derivatives authority allows transactions to have a maturity up to ten years and a weighted average life of all derivatives in its portfolio of seven years. These longer maturities reflect the increased requirements for and supervision of a credit union with Level II authority.

NCUA stated that it intends for derivatives to be one part of an overall IRR mitigation strategy. We would appreciate your comments on whether these limits are sufficient for credit unions to use derivatives to hedge IRR, especially in light of the costs associated with implementing and maintaining a derivatives program.

### **Regulatory Violation**

The proposed rule provides a system of corrective action if a credit union with derivatives authority fails to comply with the rule, has safety or soundness concerns identified by NCUA, or fails to employ the resources, policies, processes, and competencies that it identified in its application for approval. If NCUA determines a credit union has failed any of these aspects, the credit union must immediately cease entering into any new derivatives transactions and must also present a corrective action plan to NCUA and the SSA, in the case of a FISCU, within 30 days of notice by the NCUA.

### **Questions and Comments**

The CUNA Examination & Supervision Subcommittee has met with NCUA staff, including Larry Fazio, Director of NCUA's Office of Supervision and Insurance and Owen Cole, Office of Capital Markets & Planning Director to discuss the derivatives proposal. CUNA will continue to meet with NCUA staff to address credit unions' concerns with the proposed derivatives rule. The CUNA Examination & Supervision Subcommittee plans to meet to discuss the derivatives proposal again in June.

CUNA welcomes and encourages comments on all aspects of the derivatives proposed rule.

1. Are eligibility requirements too restrictive or not restrictive enough?

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2. Should credit unions have a broader authority to use derivatives besides managing IRR?

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3. Do you agree with the CAMEL requirements?

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4. Are the policy requirements too restrictive?  
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5. Are the collateral requirements too prescriptive?  
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6. Should NCUA add the ability to use more counterparties?  
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7. Is the reporting too restrictive?  
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8. Does NCUA place too many requirements on personnel qualification, including a credit union's board?  
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9. Does NCUA provide enough information detailing the use of external service providers?  
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10. Should Level I and Level II credit unions be allowed to use external service providers more extensively?  
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11. Are the limits enough for credit unions to mitigate IRR?  
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12. Should NCUA charge an annual licensing fee to the credit unions approved to engage in derivatives?  
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13. Should NCUA charge credit unions that engage in derivatives for examination time spent evaluating their derivatives activity?  
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14. How would NCUA isolate and determine the staff hours involved in supervision of derivatives activity?  
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15. Would an annual licensing fee or additional charge act as a deterrent to qualified credit unions from using derivatives to mitigate IRR?

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NCUA is accepting public comments until July 29, 2013; please send any comments to CUNA by July 22, 2013.

Please send comments to CUNA Deputy General Counsel and Senior Vice President [Mary Dunn](#) by July 22, 2013. Click [here](#) to access the proposed rule in the Federal Register.