CUNA REGULATORY ADVOCACY

CUNA REGULATORY COMMENT CALL

February 2, 2012

Financial Derivatives Transactions to Offset Interest Rate Risk (Independent Authority)

EXECUTIVE SUMMARY

- The National Credit Union Administration (NCUA) has issued another advance notice of proposed rulemaking (ANPR) on financial derivatives to offset interest rate risk (IRR). This ANPR elaborates further on an earlier ANPR from June 2011 regarding whether and how the agency should modify its regulations to permit a natural person federal credit union (FCU) to engage in derivatives to hedge IRR.
- Specifically, this ANPR seeks comment on the eligibility of applicant FCUs for independent derivatives authority (without program oversight by a third-party provider) and other requirements.
- NCUA is interested in comments regarding whether a FCU should demonstrate that it has an IRR or risk management need that would be met through the use of derivatives. Further, the agency seeks comment in these areas: minimum performance levels; minimum levels of experience and expertise with derivatives; types of permissible derivatives, such as interest rate swaps and caps; exposure limits; risk management; and collateral requirements.
- Currently, NCUA allows a limited number of FCUs, on a case-by-case basis, to engage in some derivative transactions to hedge IRR through an investment pilot program. Six FCUs currently participate in the pilot program through a third-party provider and two FCUs have independent authority
- Comments for this ANPR are due to NCUA by April 3, 2012; **please submit your comments to CUNA by March 3.**
- After comments are received on this ANPR, NCUA will decide whether to issue a proposed rule for further comments to modify its regulations on financial derivatives to hedge or offset IRR.
- Please e-mail your comments to Regulatory Counsel Dennis Tsang at dtsang@cuna.com and Deputy General Counsel Mary Dunn at mdunn@cuna.com, or contact us at (800) 356-9655 ext. 6733 with any questions.
- For further details, please click here for this ANPR in the Federal Register.

BRIEF DESCRIPTION OF ANPR

Background

NCUA is interested in more information regarding potential requirements for FCUs that would receive independent derivatives authority to hedge IRR under this ANPR. In June 2011, NCUA issued an ANPR[1] regarding whether and how to modify its regulations to permit a natural person FCU to engage in derivatives to hedge IRR (either with program oversight by a third-party provider or independently). For more information about the previous ANPR, please see CUNA's comment letter and our summary of the ANPR and relevant derivatives background for credit unions in our comment call.

Eligibility Requirements

Under this ANPR, NCUA believes that FCUs that would have independent derivatives authority to hedge IRR should meet eligibility requirements based on at least three factors: 1) the need to demonstrate a relevant, material IRR exposure, 2) financial performance (e.g., CAMEL ratings, net worth), and 3) ability to manage derivatives, such as minimum experience requirements for FCU staff on analysis and ongoing derivatives risk management.

Permissible Derivatives

Also, NCUA believes the only permissible derivatives to hedge IRR would be: 1) interest rate swaps, and 2) interest rate caps. Other types of derivatives may be used for speculative purposes and could increase risks for FCUs. Credit unions typically use two types of "plain vanilla" derivatives that do not have embedded or special features to hedge IRR.

Outside Experts

NCUA believes that FCUs that seek independent authority for derivatives should not rely exclusively on the derivatives experience of an outside party. Instead, a FCU should be required to demonstrate sufficient internal knowledge of derivatives, possibly with an onsite review prior to the FCU receiving independent derivatives authority.

Exposure Limits

Further, NCUA is considering whether to establish exposure limits to reduce volatility in the value of a derivatives portfolio, such as a restriction on a FCU's authority to transact derivatives if losses exceed a certain limit or threshold. Such exposure limits may be based on the notional or mark-to-market value of the derivatives transaction. Under the current investment pilot program, a FCU that uses a third-party provider is subject to exposure limits based on the notional value of the derivatives portfolio, as a percentage of the FCU's net worth.

Market and Counterparty Risks

A derivatives transaction has many risks, including market risk and counterparty risk. Market risk is the fluctuation of the mark-to-market value of a derivatives position. Counterparty risk (also known as "default risk" or "credit risk") is the risk that losses will occur due to a counterparty's failure to fulfill its obligations. NCUA believes that a FCU

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[1] 76 Fed. Reg. 37030 (June 24, 2011).

should, on an ongoing basis, monitor counterparties and their creditworthiness, as well as credit risk mitigation features with its derivatives (e.g., margin requirements, daily valuations of collateral, and performance of third parties).

Collateral Requirements

NCUA believes that effective collateral management can substantially mitigate counterparty risk. A FCU should include the following collateral management standards in its derivative contracts.

- Bilateral collateral - both parties to a derivatives contract agree to post collateral to cover mark-to-market gains and losses.
- Tri-party custody - posted collateral is delivered to a third party acting as custodian.
- Zero thresholds - parties are required to post collateral at any level of loss over a minimum amount specified in the derivatives contract; and
- Restrictions on the type of assets used as posted collateral to instruments permitted for investment by a FCU.

QUESTIONS TO CONSIDER REGARDING THIS ANPR

General Questions

1. Does your credit union currently use derivatives to hedge IRR? Why or why not?

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2. Do you have any general recommendations regarding NCUA's regulations on derivatives to help improve the process to hedge IRR? Do you have any recommendations on the accounting and financial reporting on derivatives?

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3. Do you support the ability of federal credit unions (FCUs) to independently engage in derivatives to hedge IRR (without program oversight by a third-party provider)?

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4. Other general suggestions or comments?

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Specific Questions from NCUA on Independent Derivatives Authority

1. Should NCUA require an FCU to demonstrate a material IRR exposure or another risk management need before the FCU receives independent derivatives authority?

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2. Before NCUA permits a FCU to independently engage in derivatives transactions, should a FCU satisfy certain minimum performance levels (e.g., CAMEL ratings, net worth classifications)? If so, what should the minimum performance levels be?

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3. Does your credit union agree that a FCU should be required to demonstrate a minimum level of derivatives experience and expertise before it receives independent derivatives authority (e.g., a minimum of three years of derivatives transactions for a FCU with a less complex balance sheet, or additional experience if

a FCU has a more complex balance sheet, such as with prepayments or call options)?

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a. Should a FCU that seeks independent derivatives authority be able to rely on a third-party for derivatives experience and expertise? To what extent?

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4. Regarding permissible derivatives, should a FCU only be able to use interest rate swaps and caps to hedge IRR? Should interest rate swaps be limited to pay-fixed/receive-floating instruments? What other limits should be established to ensure that a FCU does not engage in derivatives that are greater than its IRR exposure?

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5. Should NCUA or the FCU's board establish exposure limits? Should there be limits on the aggregate amount of each type of derivatives instrument in the portfolio, or on the aggregate amount of derivatives with any counterparty? Should limits be based on the notional amount of derivatives, its mark-to-market value, or both?

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6. Are there ways to mitigate counterparty risk besides posting collateral? Are there additional or alternate collateralization conditions that should be required?

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