Credit Union National Association
CUNA

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December 28, 2020

Ms. Melane Conyers-Ausbrooks
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

Re: Derivatives; RIN 3133–AF29

Dear Ms. Conyers-Ausbrooks:

On behalf of America's credit unions, I am writing to the National Credit Union Administration (NCUA) in support of the proposed rulemaking on Derivatives. The Credit Union National Association (CUNA) represents America's credit unions and their 120 million members.

Summary of Proposed Rulemaking

The NCUA finalized the current Derivatives rule in 2014.[1] The scope of the 2014 final rule was intentionally prescriptive, given most federal credit unions' (FCU) lack of experience using Derivatives for interest rate risk (IRR) management and the NCUA's need to increase its specialized expertise to manage and supervise the use of such instruments and the accompanying application process included in the rule. The prescriptiveness of the final rule enabled the NCUA to safely expand Derivatives authority while also ensuring that FCUs which engaged in Derivatives did not pose an undue safety and soundness risk to themselves, the broader credit union industry, or the National Credit Union Share Insurance Fund (NCUSIF). As such, the 2014 final rule included a number of restrictions on Derivative authorities, including discrete limits on the types of Derivative products an FCU could purchase, requiring FCUs to receive NCUA preapproval before engaging in Derivatives, and regulatory limits on the amounts of Derivatives an FCU could hold relative to its net worth.

Given the observable safe and effective management of Derivatives by credit unions since the 2014 final rule, the NCUA believes it is appropriate to modernize the Derivatives rule

[1] 79 Fed. Reg. 5,228 (Jan. 31, 2014).

to expand the Derivatives authority for FCUs[2] and shift the regulation toward a more principles-based approach.

We appreciate the agency listening to the suggestions and concerns of the industry regarding Derivatives, including those in a CUNA comment letter on the agency's Regulatory Reform Agenda.[3]

We support the proposed rule. We believe the proposal retains key safety and soundness components, while providing more flexibility for FCUs to manage their IRR through the use of Derivatives. We believe the changes will streamline the regulation and expand credit unions' authority to purchase and use Derivatives for the purpose of managing IRR.

Proposed Rulemaking

Subpart B to Part 703

Purpose and Scope (§ 703.101)

This section continues to make it clear that an FCU may enter Derivatives under this rule for the exclusive purpose of managing IRR. Further, while the majority of this section would remain unchanged, the NCUA is proposing to eliminate the requirement related to mutual funds. By removing this prohibition, the NCUA would permit FCUs to invest in mutual funds that enter into Derivative transactions to manage IRR.

The NCUA would like to make it clear that mutual funds permissible for FCUs under the general investment authority will only be permitted to engage in Derivatives to manage IRR. A mutual fund may not engage in Derivatives that do not manage IRR. For example, a mutual fund that purchases Derivatives related to equities, credit, or commodities would not be permissible for an FCU under the general investment authority.

We support removal of the existing prohibition regarding mutual funds. We believe such use of mutual funds is another tool to help FCUs manage IRR.

Requirements Related to the Characteristics of Permissible Interest Rate Derivatives (§ 703.103)

The NCUA is proposing that FCUs may use Derivatives to manage IRR, provided such Derivatives have the following characteristics, all of which are in the current Derivatives rule:

- Denominated in U.S. dollars;

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[2] To use Derivatives, federally insured, state-chartered credit unions (FISCU) must have (explicit or case-by-case) authority from their state regulator. 85 Fed. Reg. 68,487, 64,487 n.3 (Oct. 29, 2020).
[3] CUNA Comment Letter to NCUA re Regulatory Reform Agenda (Nov. 20, 2017), *available at* https://www.cuna.org/uploadedFiles/Advocacy/Actions/Comment_Calls,_Letters_and_Testimonies/2017/Letters/NCUA%20RegReformAgenda11202017.pdf.

- Based off Domestic Interest Rates or dollar-denominated London Interbank Offered Rate (LIBOR);
- A contract maturity equal to or less than 15 years, as of the Trade Date; and
- Not used to create Structured Liability Offerings for certain individuals.

The NCUA is proposing to continue to limit permissible indices for Derivatives to Domestic Interest Rates. In addition, any Derivatives transaction must be denominated in U.S. dollars. These restrictions are consistent with the use of Derivatives to manage IRR, as an FCU's IRR is correlated to changes in domestic interest rates.

Consistent with the current Derivative rule, the NCUA is proposing to keep the current contract maturity limit (15 years). As with the current rule, the NCUA believes this will continue to allow FCUs to effectively hedge various points of the yield curve for longer-term assets like mortgages, while preventing an excessive exposure to very long Derivative maturities.

In addition, the NCUA is proposing to continue to prohibit Derivatives to create Structured Liability Offerings for members or nonmembers. The NCUA continues to believe this activity is inconsistent with FCUs managing IRR.

We support maintaining the characteristics described above, as we agree they are consistent with a principles-based approach while maintaining guardrails for safety and soundness and are consistent with the requirement for Derivatives to be used for managing IRR.

Further, the NCUA is proposing to remove reference to specific product types. The proposed rule will allow for all of the specific product types identified in the current rule, as well as additional product types that meet the above characteristics. We also support this proposed change. We believe the current rule identifying specific product types is too restrictive and inconsistent with a principles-based approach, which will allow for additional product types that are in line with the established characteristics noted above.

In addition, the NCUA is proposing to remove all limitations that appear in § 703.103 in the current rule. We strongly agree with the agency that Derivative limits are inconsistent with a principles-based approach, especially when the activity is to manage IRR. The current rule has limits on the weighted average remaining maturity notional and fair value loss limits, both of which would be removed by the proposal. We agree it is important that the NCUA continue to review Derivative exposure when examining an FCU's Derivative program.

Reporting Requirements (§ 703.105)

The NCUA is proposing to retain certain parts of the reporting requirements in the current Derivatives rule. The current rule requires that credit unions provide their board of directors, senior executive officers, and, if applicable, asset liability committee a comprehensive Derivatives report.

The proposal would retain the required frequency of reporting (at least quarterly to the board of directors, and at least monthly to the senior executive officer and applicable asset liability committee). The proposal would also retain the requirements outlining what must be included in these reports. This includes identification of any areas of noncompliance with any provision of this rule or the credit union's policies; an itemization of the credit union's individual transactions subject to the rule; the current values of such transactions; each individual transaction's intended use for IRR mitigation; and a comprehensive view of the credit union's risk reports, including IRR calculations with details of the transactions subject to the rule.

The NCUA believes that retaining these reporting requirements is essential to credit unions maintaining strong internal controls related to Derivative transactions, given the principles-based approach of this proposed rule.

We agree that proper reporting is critical to ensure the agency, as well as the credit union, understand the scope and degree to which the credit union is engaging in Derivatives. While we believe the items to be included within the reports continues to appear appropriate, we ask the agency to examine the frequency of such reporting. Specifically, the agency should look at whether at least quarterly reporting to the credit union's board of directors and at least monthly to the credit union's senior executive officer and applicable asset liability committee is necessary, or whether an extended timeframe would suffice.

Operational Support Requirements; Required Experience and Competencies (§ 703.106(a))

The NCUA believes that a credit union's board of directors and senior executive officers need sufficient experience and knowledge to effectively oversee a Derivatives program. Therefore, the NCUA is proposing to retain many of the experience and competency requirements from the current rule.

The proposal would retain the requirement that a credit union's board of directors receive training before a credit union engages in its first Derivative transaction. The NCUA, however, is proposing to remove the requirement that a credit union's board members receive annual Derivatives training. The NCUA is substituting the required annual training with an annual briefing from the FCU's senior executive officers. We support this proposed change.

The NCUA believes that a credit union must have qualified personnel to manage the asset/liability risk management functions when a Derivatives program is in place. The NCUA is retaining the staff qualifications from the current rule to support the complexity of Derivatives for trade execution, financial reporting, accounting, and the operational processes related to Margin requirements.

We support retention of these requirements, which are largely consistent with the requirements of the existing Derivatives rule. We agree that the transparency of the Derivatives program with the board of directors is a critical part of the credit union's internal controls and communication. Further, we support retaining the requirement that a credit union's senior executive officers be able to understand, approve, and provide oversight for a Derivatives program.

Operational Support Requirements; Required Review and Internal Controls Structure (§ 703.106(b))

The NCUA is proposing to retain the current requirements for transaction review and internal controls. For internal controls reviews, the NCUA is proposing to reduce the number of required internal controls reviews a credit union must conduct. The current rule requires internal controls reviews for the first two years from when a credit union commenced its Derivatives program. The NCUA is proposing to reduce this to only the first year after a credit union engages in its first Derivative transaction.

We support reducing the number of required internal controls review to just one. We agree with the agency that at least a single review, together with the required reporting and operational provisions in this proposal, is prudent in supporting a safe and sound Derivatives program.

The NCUA is retaining the requirement that a review of the policies and procedures must be completed annually by the board of directors. The NCUA believes that effective policies and procedures which are reviewed annually are critical to maintaining and supporting a Derivatives program.

We support this requirement. As we noted above, in order to ensure a Derivatives program is properly administered it is crucial that the credit union's board of directors have at least a general understanding of the credit union's Derivatives activities.

Notification and Application Requirements (§ 703.108)

The NCUA is proposing to eliminate the application process for FCUs with at least $500 million in assets that have a CAMEL rating of 1 or 2. However, the NCUA is proposing that an FCU provide the applicable Regional Director a written notification within five business days after entering into its first Derivative transaction. We believe the five-day notification requirement is reasonable, as it will allow the NCUA to schedule a supervision contact or an examination if necessary.

We strongly support elimination of the application process for FCUs with at least $500 million in assets that have a CAMEL rating of 1 or 2. We agree with the agency's determination that credit unions with at least $500 million in assets—which will be subject to the NCUA's risk-based capital requirements and will be deemed "complex"—generally have the required infrastructure to enter into Derivative transactions without preapproval. Further, we support eliminating the application process for only those credit unions with a CAMEL rating of 1 or 2. We agree that such a CAMEL rating demonstrates that these credit unions have at least satisfactory management and board practices relative to the credit union's size and, in general, have effectively identified, measured, monitored, and controlled risks at the credit union.

Under the proposal, a credit union that does not meet the notification criteria (those with less than $500 million in assets and/or a CAMEL rating of 3, 4, or 5) must submit an application to the applicable Regional Director for Derivatives authority that contains content generally consistent with the current rule. We support this proposed approach.

Regulatory Violation or Unsafe and Unsound Condition (§ 703.109)

The NCUA is retaining the provisions for regulatory violations when a credit union no longer meets the requirements of this subpart or its internal polices, in that such a credit union must immediately stop entering into any new Derivative transactions. We agree with retaining this provision, as it is important from a safety and soundness perspective that any regulatory violations be addressed prior to an FCU entering into new transactions.

Currently, under section 703.114, if an FCU determines that a regulatory violation has occurred, the FCU must stop entering into new Derivative transactions and then alert the appropriate field director of the violation. Under the proposal, the appropriate Regional Director would determine whether a regulatory violation has occurred. If the applicable Regional Director determines that the credit union is operating in an unsafe or unsound condition, the Regional Director may prohibit the credit union from engaging in Derivatives transactions.

We agree with the objective of this section, which is to ensure regulatory violations are identified and reported, and that credit unions do not operate in an unsafe and unsound condition as it pertains to their Derivatives program. We do not necessarily oppose this proposed approach. However, we ask the agency to monitor this change to ensure it continues to achieve the intent of this section. Further, in instances where the Regional Director determines a violation has occurred, it is critical that he or she provide the FCU written notice that includes the reason for such determination.

Conclusion

On behalf of America's credit unions and their 120 million members, thank you for considering our comments in response to the proposed changes to the Derivatives rule. If you have questions about our comments, please do not hesitate to contact me at (202) 508-6743 or LMartone@cuna.coop.

Sincerely,

Luke Martone
Senior Director of Advocacy & Counsel