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National Association of Federally-Insured Credit Unions

December 23, 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 the National Association of Federally-Insured Credit Unions (NAFCU), I am writing in response to the National Credit Union Administration's (NCUA) notice of proposed rulemaking regarding derivatives. NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve nearly 122 million consumers with personal and small business financial service products. NAFCU appreciates the NCUA's commitment to modernizing the agency's derivatives rule, changing from a prescriptive approach to a more flexible, principles-based approach, all while maintaining safety and soundness measures. The proposal provides broader authority for permissible investments, maintains strong prudential controls, and removes more burdensome requirements such as the prescriptive product list and loss limits.

NAFCU supports the application threshold exemption and encourages the NCUA to explore the possibility of lowering the threshold for credit unions under $500 million in assets that meet certain requirements. In addition, NAFCU asks that the NCUA not specify acceptable collateral standards, as this could create duplicative and unnecessary due diligence efforts on credit unions. Also, NAFCU strongly encourages the NCUA to provide credit unions with all possible training opportunities and resources regarding implementation and management of derivative programs.

General Comments

NAFCU generally supports the proposed rule's amendments to the NCUA's derivatives rule. Given the low-interest rate environment, the NCUA should afford credit unions with every opportunity to hedge their interest rate risk (IRR) and strengthen their liquidity and capital positions with the use of derivatives. Credit unions continue to have risk management concerns over IRR. According to NAFCU's 2020 *Federal Reserve Meeting Survey*, over 43 percent of respondents expect increased levels of risk management concerning IRR over the next three years, representing an 11 percent increase from last year. Considering these increasing concerns, a more flexible, principles-based approach to a derivatives program is necessary.

Prescriptive restrictions included discrete limits on the types of derivative products purchased; requiring the NCUA's preapproval before engaging in derivatives; and regulatory limits on the amounts of derivatives a credit union could hold relative to its net worth. As proposed, the principles-based approach removes the discrete loss limits; eliminates the application requirements for complex credit unions with at least $500 million and a CAMEL management component rating of 1 or 2; and removes the prescriptive derivative product list and instead provides a list of required characteristics. Moreover, the proposal generally provides broader investment authority for transactions for the purpose of loan pipeline management, whereas the current investment authority is limited to interest rate lock commitments and forward sales commitments made in connection with a loan originated by a credit union.

The financial services industry has used derivatives for decades as a popular investment product to manage risk. For credit unions, however, regulation and approval of derivative plans has been slow. It was not until 1999 that the NCUA began approving pilot programs to manage IRR through derivatives and the insight gained through these pilot programs influenced the 2014 rulemaking. Understandably, the NCUA intentionally took a prescriptive approach to the 2014 final rule, citing most credit unions' lack of experience using derivatives for IRR management.

Over time, the NCUA gained knowledge and expertise, signaling a readiness to modernize the rule and move to a principles-based approach to allow more flexibility in managing IRR. As of June 2020, approximately 30 percent of all credit unions with an approved derivatives application have outstanding derivatives transactions. The NCUA has not reported any material issues or red flags since finalization of the 2014 derivatives rule. Additionally, the NCUA's proposed rule fits into a theme of recent efforts by other federal agencies to evaluate the use of derivatives. Recently, the Securities and Exchange Commission (SEC) adopted a final rule to update and modernize the use of derivatives by certain registered investment companies. The motivations behind the NCUA's proposed rule echo the SEC's rationale that modernization is necessary as agencies gain new information on the use and development of products in the industry.

Derivatives programs can be an extremely valuable tool for credit unions in managing balance sheet risks, primarily those related to fixed-rate mortgage loans. According to NAFCU's 2020 *Federal Reserve Meeting Survey*, over 70 percent of respondents reported that demand for first mortgages has increased in the last 12 months. Moreover, first mortgage loan originations in the four quarters through June 2020 were 76 percent higher versus the previous four quarters. Considering the increasing demand for mortgages throughout the last year, managing risks associated with fixed-rate mortgages will continue to be a priority. When employed correctly and safely, derivatives improve a credit union's risk management capabilities; however, the prescriptive approach is outdated and in need of modernization.

The proposed amendments will be beneficial to credit unions by enabling them to manage their inherent and idiosyncratic risks, rather than trying to adhere to the previously permissible options and risk limits. A more streamlined and modernized approach is appropriate at this time to alleviate the regulatory burden on credit unions while protecting safety and soundness. Derivatives used as an IRR mitigation strategy are a valuable tool for credit unions to employ to hedge against sharp changes in the economic landscape and market volatility. Providing that the COVID-19 pandemic endures, and the economic impacts may continue well into the future, this proposal is timely and assists those credit unions searching for IRR mitigation tools.

NAFCU Supports the Threshold Application Exemption

NAFCU supports the proposed application exemption for complex federal credit unions (FCUs) with at least $500 million in assets and a CAMEL rating of 1 or 2, as this exemption provides flexibility while accounting for the complexities of implementing a derivatives program. Credit unions must have the reasonable ability to acquire the necessary internal infrastructure and to execute and manage an effective derivatives program. Credit unions over $500 million in assets are also likely able to absorb the inherent valuation fluctuations. Further, as noted in the proposal, credit unions with a CAMEL rating of 1 or 2 have proven satisfactory management and board practices, serving as an additional safeguard against any risks to the safety of the National Credit Union Share Insurance Fund.

Although the proposal does not preclude credit unions under $500 million in assets from establishing a derivatives program, the institution must apply to the NCUA and have the demonstratable ability to manage a program, acquire the necessary infrastructure, and hold institutional knowledge. The proposal contemplates adjusting the proposed threshold if warranted and NAFCU urges the NCUA to consider lowering the exemption threshold. NAFCU generally opposes arbitrary asset-based thresholds, but absent a different metric for establishing this exemption, the NCUA should lower the exemption threshold for credit unions under $500 million in assets that possess the same requirements under the proposal. In setting the proposed threshold, the NCUA states that credit unions over $500 million generally have the required infrastructure to enter into derivative transactions; however, credit unions under this threshold may also have the requisite infrastructure in place. Managing IRR is important for credit unions of all asset sizes, and should an institution meet the same requirements as those over the exemption threshold of $500 million, then they should also be able to avail themselves of the exemption. The NCUA will receive the same notice and opportunity to establish a supervisory contact with the credit union. So long as the proper safeguards are in place, credit unions under $500 million should be afforded the ability to implement a derivatives program just as quickly as those over $500 million who are able to take advantage of the proposed application exemption.

The NCUA Should Not Specify Acceptable Collateral Standards

The NCUA should not specify acceptable collateral types, as establishing express standards will have unintended consequences. Under the current derivatives rule, there are no specific collateral standards; however, a credit union must have systems in place to effectively manage collateral, which entails a collateral management process to post, track, value, and report collateral. In addition to monitoring potential liquidity needs related to derivatives. The proposal seeks to list acceptable collateral for both exchange-traded and cleared derivatives. In the case of an exchange-traded or cleared derivative, the exchange or clearing house provides acceptable collateral standards, thus the proposal's creation of a collateral standard will create a parallel standard which may lead to confusion. Additionally, specifying acceptable collateral types may require due diligence efforts beyond the necessary level to ensure derivatives are collateralized pursuant to the counterparty agreements. Although the proposal states that the express collateral standards are generally consistent with clearing house and exchange standards, the inclusion of the specific standards creates duplicative due diligence efforts on the part of credit unions. Moreover, this duplication does not provide any additional security measures as credit unions are already reviewing the collateral when entering into the agreement with the counterparty and repeating this process is unnecessary. Absent any additional security measures or need for additional collateral information, the specific acceptable collateral list is unnecessary.

Should the NCUA specify acceptable collateral standards that differ from those set by exchanges or clearing housings, credit unions may have to manage two sets of acceptable standards. This may also be the case if an exchange or clearing house changes their standards after the NCUA's standards are set. Credit unions operating under the current rule are accustomed to the collateral standards set by the exchanges and clearing houses, and there is no need to create parallel and potentially contrasting standards. Not only does this require duplicative efforts on behalf of the credit union but this also creates additional work for the NCUA to align the collateral standards with that of the exchanges and clearing houses. Therefore, NAFCU asks that the NCUA not specify acceptable collateral standards and maintain the provision in the current rule. Should the NCUA adopt the approach to specifying acceptable collateral standards as proposed, NAFCU asks that the NCUA enumerate the standards as they are set by the exchanges and clearing houses and update those standards as necessary to ensure uniformity and minimize burdens.

Conclusion

NAFCU appreciates the opportunity to share its members' views on this matter. NAFCU supports the proposal's flexible, principles-based approach. NAFCU supports the application threshold exemption and encourages the NCUA to explore the possibility of lowering the application exemption for credit unions under $500 million in assets that meet certain requirements. In addition, NAFCU asks the NCUA to not specify acceptable collateral standards as this could create duplicative and unnecessary due diligence on credit unions. Lastly, the NCUA should make every effort to assist credit unions with implementing and managing derivatives programs by providing training and other resources. Should you have any questions or require additional information, please do not hesitate to contact me at (703) 842-2249 or kschafer@nafcu.org.

Sincerely,

Kaley Schafer
Senior Regulatory Affairs Counsel