

# OLDEN LANE

December 16, 2020

Ms. Melane Conyers-Ausbrooks  
Acting Secretary of the Board  
National Credit Union Administration  
1775 Duke Street  
Alexandria, Virginia 22314-3428

Re: Comments on Derivatives Proposed Rule: RIN 3313-AF29

Dear Acting Secretary Conyers-Ausbrooks,

We are pleased to offer this Comment Letter in support of the proposed changes to the National Credit Union Administration's ("NCUA") treatment of derivatives embodied in Subpart B of Section 703. The three most significant elements of the proposal include:

- The elimination of the preapproval process for "complex" federal credit unions with more than \$500 million in assets and a Management CAMEL component rating of 1 or 2,
- Permitting all other federal credit unions to apply to use derivatives, and
- Eliminating the regulatory limits on the derivatives a federal credit union may purchase.

We view the proposed changes as an important form of regulatory relief that will allow credit unions to better utilize derivatives as part of an overall interest rate risk (IRR) mitigation strategy. We agree that, as a general matter, the proposed changes "will make it easier and more efficient for FCUs to manage IRR with Derivatives while maintaining the necessary safety and soundness controls."<sup>1</sup>

Olden Lane operates a SEC registered broker-dealer active in the share certificate market and the market for credit union secondary capital. We also control an SEC registered investment advisor that assists credit unions with capital planning and balance sheet management. We regularly help credit unions to properly identify appropriate objectives for capital and in connection with the proper maintenance of safety and soundness. As an advisor to many credit unions, we offer this Comment Letter to provide additional context and to suggest certain considerations which might strengthen the Rule as proposed.

Olden Lane has the following suggestions, which are discussed in greater detail below:

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<sup>1</sup> *Derivatives*, National Credit Union Administration, 85 FR 68487 (Oct. 29, 2020), available at <https://www.govinfo.gov/content/pkg/FR-2020-10-29/pdf/2020-23968.pdf> ("hereinafter *Derivatives Release*").

1. The proposal's changes with respect to mutual fund investment should be clarified to allow credit union management the discretion to make determinations regarding the efficacy of any such investment, in line with the credit union's overall IRR management and the proposal's principles-based approach.
2. Technical changes should be considered to ensure that the proposed prohibition on Structured Liability Offerings is not overly broad as to eliminate certain products that would be otherwise permissible and potentially advantageous to certain credit unions and their members.
3. Consideration should be given to adopting a sliding scale for the maximum collateral threshold level proposed.
4. The agency should provide additional clarification that the proposed liquidity review procedures may be appropriately linked to a credit union's overall liquidity management internal monitoring and reporting procedures.
5. The framework for those credit unions still requiring an application, the proposal would benefit from a time limit once an application has been submitted to the Regional Director for review.

This proposal concerns one of the most important topics for today's credit union. Assessing IRR within an asset-liability management (ALM) framework is a central consideration of nearly every financial decision made and action taken by credit union executives. By embarking on an effort to modernize, liberalize and harmonize the rules concerning derivatives, the NCUA is encouraging more credit unions to take advantage of some of the best available hedging tools and techniques. Importantly, the proposal seeks "to eliminate the application requirement for Derivatives authority except for certain FCUs that do not meet limited conditions."<sup>2</sup>

At the outset, it is important to address the gorilla in the room. While more widely employed than ever before, derivatives still carry a stigma in some circles.<sup>3</sup> For example, many can recall Warren Buffett's famous statement, in the 2002 Berkshire Hathaway Letter to Shareholders, that "derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal."<sup>4</sup> Fewer, however, appreciate that in the very same letter, the Oracle of Omaha confessed: "Indeed, at Berkshire, I sometimes engage in large-scale derivatives transactions in order to facilitate certain investment strategies."<sup>5</sup> These two statements from the legendary investor can be reconciled as a balance – between a healthy respect for the risk of derivatives, on the one hand, and an appreciation for their importance in helping to implement and achieve an investment or hedging strategy, on the other.

At Olden Lane, we view this derivatives proposal in a similar light. The NCUA's proposal signals a maturation in its own thinking regarding the use of derivatives by credit unions. As the NCUA concedes, the 2014 rules were "intentionally prescriptive" to account for the lack of experience had with derivatives and to accommodate the NCUA's own "need to increase its specialized expertise to manage and supervise

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<sup>2</sup> *Id.*, at 68489.

<sup>3</sup> *See, e.g.* Statement of Chairman Rodney Hood (Oct. 15, 2020), available at <https://www.ncua.gov/newsroom/speech/2020/ncua-chairman-rodney-e-hood-statement-proposed-rule-derivatives> ("I know the very word 'derivative' can have a negative connotation and carries a high-risk stigma.").

<sup>4</sup> Berkshire Hathaway Inc. 2002 Annual Report, Chairman's Letter, at 15, available at <https://www.berkshirehathaway.com/2002ar/2002ar.pdf>.

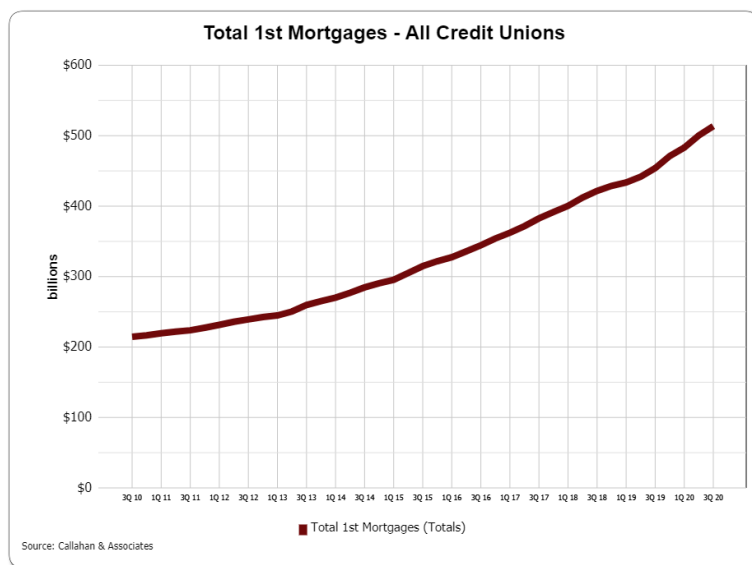
<sup>5</sup> *Id.*, at 14.

the use of such instruments.”<sup>6</sup> During the derivatives regime that has been in place since 2014, however, the NCUA Board and staff “have gained critical knowledge and experience through oversight of credit unions actively using Derivatives.”<sup>7</sup> It is to the agency’s credit that, based on its experience, it now looks to streamline the derivatives regime to provide regulatory relief in a safe and sound manner. Proposing these changes as credit unions confront the ongoing economic fallout of the COVID-19 pandemic is particularly timely. We believe, as Chairman Hood does, that

“enhancing the ability of federal credit unions to better protect themselves against market risks is critically important at all times. In fact, managing balance sheet risks through a time of disruption and uncertainty underscores how important it is for credit unions to have tools, like financial derivatives, at their disposal to help guard against volatile economic periods that can hurt liquidity, earnings and capital.”<sup>8</sup>

Aside from the benefit of some experience with derivatives over the past several years, the market is quite different than it was in 2014. First, interest rates are at historic lows. Secondly, as Q3 2020 data suggest and Charts 1 and 2 below illustrate, at \$513 billion and 44% of the industry’s loan book, first mortgages now account for more of credit union loan books – in both absolute and relative terms – than ever before.<sup>9</sup>

**Chart 1.**



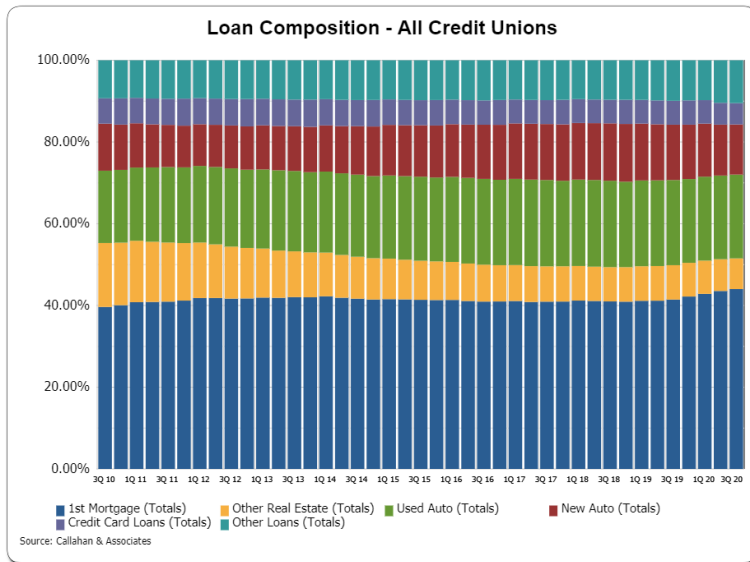
<sup>6</sup> Derivatives Release, *supra* note 1 at 68487.

<sup>7</sup> *Id.*, at 68488.

<sup>8</sup> See Statement of Chairman Rodney Hood, *supra* note 3.

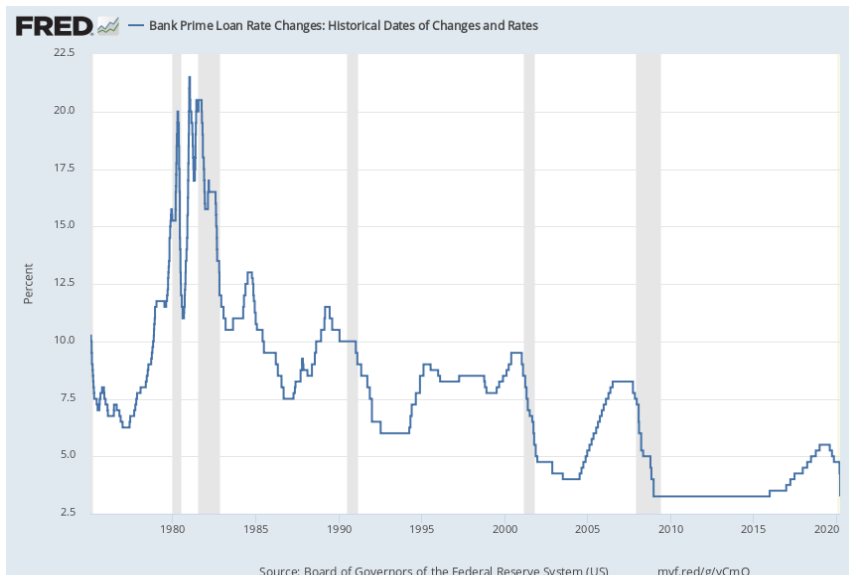
<sup>9</sup> See Statement of Board Member Todd M. Harper (Oct. 15, 2020) (hereinafter “Harper Statement”), available at <https://www.ncua.gov/newsroom/speech/2020/ncua-board-member-todd-m-harper-derivatives-rule-update-notice-proposed-rulemaking> (“With the growth in long-term mortgage lending within the credit union system, the industry now has half of its assets in long-term real estate loans, and the vast majority of those loans are at fixed rates.”).

**Chart 2.**



Against this backdrop, the timing of this regulatory proposal is of additional importance, as it allows credit unions to better prepare for any sustained increase in interest rates on the horizon. It is important too to appreciate that this generation of credit union leaders and regulators have never confronted a sustained period of interest rate increases. As Chart 3 below illustrates, reaching record high levels in the early 1980s, interest rates entered a three-decade stretch of decline. While there were sporadic short periods of increase, there have been no periods of sustained rate increase since the early 1980s.

**Chart 3.**



Accordingly, any resulting income pressure on credit unions due to the high levels of IRR was short-lived, with relief as rates eased. As one expert describes,

“credit unions did not feel the full and potentially devastating effects of these episodes. This means that despite a much better understanding of IRR and more powerful analytical tools, financial institutions have not been tested in a prolonged period of rapidly rising interest rates that have been sustained at a high level.”<sup>10</sup>

Nevertheless, credit unions have improved their understanding and measurement of IRR over the past several years. The most notable improvements have been in the quality of ALM, which describes the forward-looking process involving the joint and simultaneous management of assets and liabilities to measure, monitor and control the effects of changing interest rates on income, asset values, liquidity and regulatory capital.<sup>11</sup> The primary objective of an ALM analysis is to provide an early warning of possible financial problems resulting from the effects of changing interest rates on a credit union’s existing balance sheet and income performance. Typically, such problems manifest themselves when the cost of liabilities increases faster than the returns on assets in a rising rate environment.<sup>12</sup> While not an immediate cause for concern, a falling rate environment also brings risks, as asset returns may decline faster and more than liability costs.<sup>13</sup> As a credit union anticipates either rising or falling rates, proper ALM allows for preventive action to be implemented.

Derivatives are one of the more important instruments of such prevention, as they offer one of the most capital-efficient methods of hedging to control risk. At its core, hedging is the action of adjusting, reducing or mitigating the adverse impact of potential market fluctuations. Additionally, hedging strategies are best implemented under a robust risk management process which adjust risk to a desirable tolerance. Today, the use of derivatives by credit unions remains quite modest. As of the June 30, 2020 Call Report, 23 credit unions had outstanding derivative transactions in interest rate swaps and interest rate caps, totaling approximately \$10.3 billion in notional amount.

Nonetheless, we agree with NCUA Board Member Todd Harper’s observation that this proposal adds “a timely and useful interest-rate risk-management tool, without the upfront administrative burden, and could provide greater flexibility for tailoring risk mitigation strategies that can immediately benefit federal credit unions seeking to increase hedge effectiveness.”<sup>14</sup>

### **Interest Rate Risk Management**

To meet the demands of their members and communities, credit unions make loans, take deposits, and borrow funds with different maturities, interest rates, and repricing characteristics. IRR is the risk to the bank’s current or projected financial condition and resilience arising from movements in interest rates.<sup>15</sup> Because credit unions are in the business of transforming short or indeterminate-term deposits into longer-term loans, they are inherently exposed to some degree of interest rate risk. A well-designed IRR

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<sup>10</sup> John R. Brick, *Asset-Liability Management: Theory, Practice, Implementation and the Role of Judgment*, Filene Research Institute, (2014), at 6.

<sup>11</sup> *Id.*, at 12.

<sup>12</sup> *Id.*, at 13.

<sup>13</sup> *Id.*

<sup>14</sup> See Harper Statement, *supra* note 9.

<sup>15</sup> See Doug Gray, *Interest Rate Risk Management at Community Banks*, Federal Reserve Bank of Kansas City (Q3 2012), available at <https://communitybankingconnections.org/articles/2012/Q3/interest-rate-risk-management>.

management program allows a credit union's management team and board of directors to appropriately identify, measure, monitor, and control these exposures.<sup>16</sup>

IRR describes an adverse outcome that will result from changes in interest rates. Typically, a credit union's Asset Liability Management Policy defines IRR as the risk that increases or decreases in prevailing interest rates could adversely impact the credit union's earnings stream and equity position and disrupt anticipated cash flows. While IRR can arise from various sources, four key types of interest rate risk are common to the balance sheets of credit unions:

- **Mismatch/Repricing Risk:** The risk that assets and liabilities reprice or mature at different times, causing a narrowing between the margins on interest income and interest expense.
- **Basis Risk:** The risk that changes in underlying index rates used to price assets and liabilities do not change in a correlated manner, causing margins to narrow.
- **Prepayment/Extension Risks:** The risk that asset repayments accelerate at a time when interest rates are low, resulting in diminished interest income and the need to reinvest repaid funds in lower-yielding assets.
- **Yield Curve Risk:** The risk that nonparallel changes in the yield curve will disproportionately affect asset values or cash flows. Typically, credit unions with significant mortgage asset holdings would be exposed to greater yield curve risk than those with mortgage assets comprising a lower percentage of assets.<sup>17</sup>

With respect to managing IRR, an effective credit union Asset Liability Management Committee (ALCO) typically monitors both short-term (1-12 month) and longer-term (13-24 month) interest rate risk exposure. Gap reports are commonly used in the industry to assess IRR exposure by analyzing a credit union's repricing and cash flow imbalances. Often, two separate reports are produced – a repricing analysis and an effective gap analysis. The only difference between the two analyses is in the way non-maturity deposits are analyzed. While the repricing gap analysis assumes the non-maturity deposits reprice immediately, the effective gap analysis utilizes both account-specific decay assumptions and the effective maturity dates of the deposits to project monthly estimates of deposit outflows. Gap analyses are additional aids for understanding a credit union's potential IRR exposure and provide context for both the economic value of equity modeling and net interest income simulation. Together with a credit union ALCO's outlook for the timing of future deposit rate changes, the repricing and effective gap analyses provide a useful tool to help gauge the credit union's potential IRR.

IRR can be managed by employing internal hedging techniques like matching and smoothing or external hedging instruments such as forward rate agreements and derivatives.

To provide proper context, each technique is briefly described below.

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<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

### *Matching and Smoothing*

Matching is the process where liabilities and assets with a common interest rate are paired off or “matched”. This method is popular with financial institutions such as credit unions because it is often easier to find matches among the expanse of their assets and liabilities. “Smoothing” describes the process of maintaining a balance between fixed rate and floating rate borrowings. A rise in interest rates will make the floating rate loan more expensive but this will be compensated for by the less expensive fixed rate loan. Smoothing and matching are less precise measures. Adding to the inexactness is the idea that a credit union is often a price taker, catering to the needs of its borrowing and depositing members.

### *Forward Rate Agreements (FRA)*

A credit union can enter into a forward rate agreement with a counterparty that fixes the rate of interest for borrowing at a certain time in the future. If the actual interest rate proves to be higher than the agreed upon rate, the credit union is responsible to pay the difference to the counterparty. Likewise, if the actual interest rate is lower than the agreed upon rate, the counterparty will pay the difference to the credit union.

### *Interest Rate Futures*

Interest rate futures can be used to hedge against interest rate changes between the current date and the date at which the interest rate on the referenced lending or borrowing is set. Borrowers typically sell futures to hedge against an increase in interest rates, while lenders buy futures to hedge against a decline in interest rates. Interest rate futures are notional fixed-term deposits, usually for three-month periods starting at a specific time in the future. The buyer of a futures contract is buying the (theoretical) right to deposit money at a particular rate of interest for three months.

### *Interest Rate Options*

An interest rate option is perhaps the simplest derivative contract. For a fixed payment up front called a premium, the buyer is granted the right, but not the obligation, to deal at an agreed upon interest rate (strike rate) at a future maturity date. On the option’s expiration date, the buyer must decide whether to exercise its right. The buyer of an option to borrow will not exercise it if the market interest rate is below that specified in the option agreement. Conversely, an option to lend will not be worth exercising if market rates have risen above the rate specified in the option agreement by the time the option has expired.

Bespoke over-the-counter interest rate options have become extremely liquid and transparent over the past several years and can be purchased from major financial institutions, with specific values, periods of maturity and rates of agreed interest. As a result, interest rate options offer more flexibility than FRAs. They also tend to be more expensive.

### *Interest Rate Caps, Floors and Collars*

An interest rate cap is a hedging technique used to cover interest rate risk on longer-term borrowing (usually 2 to 5 years). A cap is a contract providing the purchaser the right to set a maximum level for interest rates payable. If interest rates rise above the agreed upon level, compensation is paid to the cap purchaser. Under these arrangements, a borrowing credit union can benefit from interest rate declines but can limit the amount of interest paid should interest rates rise. Likewise, an interest rate floor is an option which sets a lower limit to interest rates. It protects the floor buyer from losses resulting from a

decrease in interest rates. The floor seller compensates the buyer with a payoff when the reference interest rate falls below the floor's strike rate. Under a collar arrangement, a borrower can buy an interest rate cap and sell an interest rate floor simultaneously. This structure limits the cost for the company as it receives a premium for the option it sells.

### *Interest Rate Swaps*

Interest rate swaps are derivatives contracts whereby two counterparties agree to exchange interest rate payments, without an exchange of principal. Swaps can be used to hedge against an adverse movement in interest rates. Interest rate swaps typically involve one counterparty paying a fixed rate of interest in exchange for a floating rate, which has historically been LIBOR. In its simplest form, an interest rate swap is no different than buying/selling a US Treasury note and financing it at LIBOR rather than the prevailing repo rate. This is perhaps the most popular hedging vehicle for large holders of mortgage assets. Not only does it provide a hedge against outright interest rate exposure, but it also offers an opportunity to limit some credit exposure since swaps are often tied to LIBOR, which has an inherent credit component. Swaps also offer the flexibility to amortize notional amounts to better match the expected cashflows of underlying mortgage assets.

The balance of this letter will address the merits of specific parts of the proposed rule both substantive and technical.

### **Elimination of Significant Requirements**

As a general matter, the proposed changes aim to make the regime “less prescriptive and more principles based.”<sup>18</sup> This makes good sense, as it is an approach to regulation that allows credit unions to tailor the use of derivatives to their individualized needs. At the same time, it will enable regulators to attune their oversight to the individual cases of those they oversee. With that in mind, we support the NCUA proposal to eliminate (1) the pre-approval process for FCUs that are complex and maintain a Management CAMEL component rating of 1 or 2, (2) the permissibility of specific products, and (3) the regulatory limits on the amounts of derivatives that an individual credit union may purchase. In sum, these three categories of elimination rewards deserving credit union managements by providing additional flexibility in hedging design, while maintaining appropriate oversight and protections for safety and soundness. At the same time, the proposal extinguishes a confusing Section 701.21(i).

The NCUA also proposes removing the current prohibition on credit unions investing in registered investment companies or collective investment funds, under 703.14(c), where the fund’s prospectus permits the investment portfolio to contain derivatives. This section of the proposed rule appears to be written imprecisely. The proposal implies that the intent is to allow credit unions to make investment in funds that employ derivatives provided that the credit union is making the investment as part of its IRR management. Yet, the proposed test observes the intent of the mutual fund in employing derivatives.

Instead, the proposal describes “[m]utual funds that enter into Derivative transactions to manage IRR.”<sup>19</sup> An inquiry into the investment intent of mutual funds is unlikely to be as straightforward as the proposal suggests. Typically, a mutual fund prospectus will provide an investment manager with more expansive

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<sup>18</sup> Derivatives Proposal, *supra* note 1, at 68488.

<sup>19</sup> *Id.*, at 68489.



discretion in the use of derivatives across a fund’s portfolio. In addition, the test proposed by the NCUA does not express a preferred outcome where the management of interest rate risk is among a broader set of reasons for the fund to employ the instruments. Instead of a test that requires the NCUA to uncover the intent (if not, the sole intent) of the investment manager of a mutual fund, we suggest that the NCUA begin and end its test at the credit union waterfront. If, in the estimation of a credit union’s management, an investment in a mutual fund that employs derivatives is called for as part of a proper IRR management program, we do not believe that an inquiry into the intent of the derivative use in the underlying fund should be necessary or required. In the same spirit as the above-referenced elimination of the limitation on specific products, we believe that the management of a well-managed credit union are best to determine the efficacy of an investment in a specific registered investment company or collective investment fund for itself.

### **Requirements of Permissible Interest Rate Derivatives**

More than eliminating existing requirements, the new proposed rule offers a cogent principles-based framework by which FCUs could responsibly deploy derivatives as part of an overall IRR management program.

The proposal establishes four conditions for permissible derivatives:

1. Denominated in U.S. dollars,
2. Based on Domestic Interest Rates,
3. A contract maturity of 15 years or less, and
4. A prohibition on Structured Liability Offerings for members or nonmembers.

The first three of these conditions are simple, straightforward, sensible, and consistent with a responsible regime to manage interest rate risk. In this regard, we are in accord with the NCUA statement that the characteristics cited above are “consistent with a principles-based approach while maintaining guardrails for safety and soundness and consistency with requirement for Derivatives to be used in managing IRR.”<sup>20</sup>

More nuance is required, however, in addressing the prohibition on Structured Liability Offerings. As proposed, a Structured Liability Offering would mean “a share product created by a Federal credit union with contractual option features, such as periodic caps and calls, similar to those found in structured securities or structured notes.” We believe that this blanket prohibition is too broad, as it might eliminate certain products that would be otherwise permissible and potentially advantageous to certain credit unions and their members.

For example, in the last decade, a growing cohort of investors have employed bank-issued, market-linked certificates of deposit as (1) an alternative to a direct investment in the underlying market, (2) part of an overall strategy or (3) a portfolio risk management tool. For these investors, the market-linked certificates of deposit offer the potential to address standard wealth management objectives, including capital preservation, conservative growth and income generation.<sup>21</sup>

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<sup>20</sup> *Id.*, at 68491.

<sup>21</sup> According to the *Wall Street Journal*, U.S. investors hold more than \$22 billion of bank-issued market-linked certificates of deposit in their portfolios, with annual sales of these structures running as high as \$15 billion. See

While today's market is dominated by bank issuers, the Federal Credit Union Act permits federal credit unions to issue similar products, subject to certain conditions. Today there is a significant opportunity for credit unions to sponsor a market-linked share certificate programs to (i) offer existing members the potential for market-based returns and (ii) attract new members.

Such certificates could be issued by a credit union with the final payout based upon the change in a benchmark index over a predefined term. As the market increases, so does an investing member's potential earnings. For credit union members, a product with a return tied to stock market performance offers the attractive potential for higher returns, provided the member can responsibly take the risk. Importantly, market-linked share certificates would be NCUA insured, and, therefore, would carry no risk to principal (at maturity). These certificates would also lack a management fee and would be flexible enough to be used for individual retirement savings, college savings, or individual or joint investors.

From the perspective of a credit union issuer, such a program would offer meaningful potential to increase the share of wallet from existing members and a meaningful opportunity to attract new members. Of course, in the wake of the pandemic, these benefits could be more important than ever. Today, the opportunity cost for dollars deposited in a credit union is quite high, as members are limited to fixed-income style returns in a yield starved environment. In addition, a new market-linked share certificate product line could offer significant opportunity for an issuing credit union to gather longer dated contingent liabilities – an increasing need in light of the recent growth in the mortgage books of most credit unions.

The Federal Credit Union Act (FCUA) expressly provides that a federal credit union shall have power “to receive from its members. . . payments, representing equity, on. . . share certificates which may be issued at varying dividend rates and maturities . . . subject to such terms, rates, and conditions as may be established by the board of directors, within limitations prescribed by the Board.”<sup>22</sup> In addition, the FCUA's accompanying Rules and Regulations permit a credit union to purchase European options to fund the payment of equity-linked share certificates where the payment is tied to an equity index, subject to certain conditions.<sup>23</sup> Among the most notable conditions, the aggregate amount of equity-linked share certificates cannot “exceed 50 percent of the Federal credit union's net worth.”<sup>24</sup>

Olden Lane believes that the suggested prohibition on Structured Liability Offerings be appropriately tailored to avoid any suggestion that a market-linked share certificate program in the fashion described above would be somehow impermissible.

### **Requirements for Counterparty Agreements, Collateral and Margining**

We are generally in agreement with the NCUA's changes with respect to Master Services Agreements, margin requirements and collateral. Responding to some of the NCUA's questions directed to the public,

1. we see no issue with the single standard for both exchange-traded and cleared transactions and non-cleared transactions,

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Jean Eaglesham, Sarah Krouse and Ben Eisen, *Wall Street Re-Engineers the CD – and Returns Suffer*, WALL STREET JOURNAL (Sep. 6, 2016).

<sup>22</sup> See Federal Credit Union Act § 1757(6)(B).

<sup>23</sup> See 12 CFR 703.14(g).

<sup>24</sup> 12 CFR 703.14(g)(11).

2. we are in favor of the requirement that Master Services Agreements be reviewed by counsel with appropriate expertise to ensure that the agreement reasonably protects the credit union's interests,
3. we suggest that, instead of the proposed \$250,000 maximum level, the NCUA might consider a maximum threshold amount on a sliding scale depending on the asset size of an individual credit union, and
4. we support the proposed revisions to the concept of eligible collateral, including subjecting exchange-traded and cleared derivatives to the requirements and expanding the acceptable collateral types. We do not expect unintended consequences as a result of subjecting exchange-traded and cleared derivatives to the rules and we agree that the changes are sufficient to "restrict the forms of collateral to the most liquid and easily valued instruments so they can be easily negotiated even in times of market illiquidity."<sup>25</sup>

### **Reporting Requirements**

In keeping with the focus on the safety and soundness of credit unions engaging in derivatives transactions, the proposed regime establishes a comprehensive set of reporting requirements related to derivatives. We support the requirement of a quarterly report to the credit union board and a monthly report to senior executive officers and the asset liability committee. We also support the requirements that these reports contain the detail the NCUA currently requires in Section 703.105. As with any significant transactions of a credit union, derivatives transactions should be subject to strong internal controls.

Finally, we agree that it is appropriate for a derivative management report to be furnished to the Regional Director and made available to the credit union's examiner following a regulatory violation or a violation of the credit union's policies, especially as the Part 746 appeals process remains available to the credit union following such a determination.

### **Operational Support Requirements**

As the transparency of a derivatives program to the credit union's board is a critical part of proper internal controls, we are encouraged by the NCUA's reasonable approach to the required experience and competence levels for credit union boards and management. Importantly, the proposal calls for directors to be trained before a credit union engages in its first derivatives transaction, with such training to include a general understanding of derivatives and the specific knowledge required to provide strategic oversight of the credit union's particular derivative transactions. We also support the move from ongoing annual training to an ongoing annual briefing and the NCUA's emphasis on the necessary transparency and disclosure in an ongoing basis. Again, this signals the willingness of the NCUA to consider removing requirements when the burdens might outweigh the benefits. Finally, we appreciate the NCUA's attempt to link the derivatives expertise of the credit union's personnel with its overall asset-liability management processes and personnel.

The "Required review and internal controls structure" articulated in the proposed 703.106(b) is among the strongest parts of the proposal. Improving upon the existing structure, the proposal calls for credit

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<sup>25</sup> Derivatives Release, *supra* note 1, at 68493.

unions engaging in derivatives transactions to review each transaction before execution to document the circumstances that lead to the decision to execute the transaction, specify the strategy to employ and demonstrate its economic effectiveness and to engage in a review of internal controls within the first year of an initial derivatives transaction. In addition, there are requirements for a review of collateral management and a newly proposed liquidity review. We suggest that the NCUA consider clarifying that the proposed liquidity review procedures may be appropriately linked to a credit union's overall liquidity management internal monitoring and reporting procedures.

Finally, we also support the separation of duties expressed in the proposed 703.106(b)(6), as we believe that they represent best practices and are a necessary component of a safe and sound derivatives program.

### **External Service Providers**

We support the proposal's retention of the three current restrictions on the use of External Service Providers (ESPs). While ESPs can serve an important function in assisting credit unions in the understanding, execution and monitoring of derivatives transactions, we agree wholeheartedly that credit unions "must have the internal capacity, experience and skills to oversee and manage any ESP it uses."<sup>26</sup> In light of the proposed removal of the derivatives application process, we appreciate the need for clarity around the requirement that credit unions remain responsible to employ qualified personnel in accordance with the operational support requirements of the revised Section 703.106. This requirement, and the ongoing requirements to properly diligence, evaluate and select appropriately skilled outside advisors provide important protections for credit unions.<sup>27</sup> Finally, we appreciate too the NCUA's clarification that a credit union may house its asset/liability management and liquidity risk management models with an ESP provided the credit union has oversight and control of both functions.

### **Notification and Application Requirements**

The crux of the proposal's regulatory relief is embedded in the proposed Section 703.108, which seeks to eliminate the existing application process for credit unions with at least \$500 million in assets and a CAMEL Management component rating of 1 or 2. Employing the CAMEL Management component as part of the permissive test does add an unwelcome layer of subjectivity. Nonetheless, it offers a satisfactory means to determine that a credit union has the management and board practices necessary to responsibly execute derivatives transactions. In response to the proposal's specific inquiry with respect to whether \$500 million is the proper size to exempt credit unions from the application process, we support the \$500 million threshold. We believe that it is an appropriate level of demarcation based on the typical level of infrastructure, expertise and resources of credit unions of that size. It seems reasonable that such a credit union will be required to inform its Regional Director within five business days of executing its first derivatives transaction. Such a notification seems appropriate to allow the NCUA to better monitor, supervise and examine the credit union.

Next, we turn to the cohort of credit unions unable to meet the asset size and CAMEL Management component test of the proposed Section 703.108(a) and seeking approval to engage in derivatives

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<sup>26</sup> *Id.*, at 68495.

<sup>27</sup> See generally *Letter to Credit Unions 07-CU-13*, National Credit Union Administration (Dec. 2007), available at <https://www.kaufcan.com/wp-content/uploads/2008/12/07-cu-13.pdf>.

transactions. With respect to this group, we are generally in agreement with the proposal's retention of an application process. We also agree with the proposed changes which bring the section more in line with the NCUA's new principles-based philosophy. We do wish, however, that the NCUA would consider a time limit on its ability to review a derivatives application once it has been submitted and deemed complete by the Regional Director. And, while we support the Regional Director's ability to seek additional information as the proposed Section 703.108 (b)(8) provides, we do have some concern that a regulation with no time bar and an open-ended invitation to request additional information could needlessly slow credit unions seeking in good faith to gain access to derivatives responsibly and as part of a risk reducing strategy. In our experience, such a review without a time limit can be frustrating to a credit union's proper planning.

### **Alterations to Definitions**

As part of the proposed framework, the NCUA seeks to revise several definitions, add others, and remove others still.

With respect to the proposed revisions to existing definitions, the NCUA proposes eight changes, most of which are technical in nature. For example, we agree that the change to "Counterparty" will improve both precision and readability. We also support the changes to "Interest Rate Risk" and "Net Economic Value," as they are designed to harmonize the terms with their treatment in the Interest Rate Risk chapter of the NCUA Examiner's Guide. Likewise, we view the proposed changes to "Margin", "Master Service Agreement", "Senior Executive Officer", "Threshold Amount" and "Trade Date" as clarifying and technical.

As part of the proposal, the NCUA suggests adding four new definitions: (1) Domestic Counterparty, (2) Domestic Interest Rates, (3) Earnings at Risk, and (4) Written Options. Again, we support these additions. The Domestic Counterparty and Domestic Interest Rates definitions are integral to ensuring that FCUs can only enter derivatives transactions with U.S. counterparties and to ensure that derivatives transactions are limited to those with interest rates derived in the United States and denominated in U.S. dollars. Likewise, the Written Options definition is necessary to enforce a prohibition on a credit union entering derivatives contracts requiring it to pay an in-the-money option holder at maturity – which is certainly in line with the philosophical underpinnings of the proposal. Again, we reiterate the comment that such prohibition be appropriately tailored to allow certain hedging transactions of a market-linked share certificate program of the type described above.<sup>28</sup> Finally, the Earnings at Risk definition adds additional clarity to the types of ALM modeling that the new regime seeks.

Finally, the proposal seeks to eliminate twenty-two (22) definitions from the existing regulations, noting that the definitions "lose their relevancy due to the proposal's shift to a principles-based approach from the more prescriptive approach in the current rule."<sup>29</sup> We agree with the deletions and embrace the effort to cull the regulation for superfluous terms.

### **Conclusion**

We view this proposal as an important form of regulatory relief that will allow credit unions to better utilize derivatives as part of an overall IRR mitigation strategy. Against a backdrop of historically low

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<sup>28</sup> See generally Discussion at "Requirements of Permissible Interest Rate Derivatives", above.

<sup>29</sup> Derivatives Release, *supra* note 1, at 68490.

interest rates and historically high mortgage balances on the balance sheets of credit unions, we believe that the proposal is particularly timely. Again, we applaud the Board for its hard work on this issue and its thoughtful and forward-thinking effort. We are grateful too for the opportunity to comment on the proposed amendments. Finally, we look forward to the adoption of the Proposed Rule.

Should you have any questions regarding our comments, please feel free to contact the undersigned at 908 679-9037 or [mmacchiarola@oldenlane.com](mailto:mmacchiarola@oldenlane.com).

All the best,

/s/Michael C. Macchiarola  
Chief Executive Officer  
Olden Lane LLC