Questions and Answers:
Proposed Rule on Derivatives Authority

Q.1: What are derivatives? What kinds of derivatives is NCUA proposing to allow for credit unions?

The Commodities Futures Trading Commission (CFTC) broadly defines a derivative as: "A financial instrument, traded on or off an exchange, the price of which is directly dependent upon (i.e., "derived from") the value of one or more underlying securities, equity indices, debt instruments, commodities, other derivative instruments, or any agreed upon pricing index or arrangement (e.g., the movement over time of the Consumer Price Index or freight rates). They can be used to hedge risk or to exchange a floating rate of return for fixed rate of return. Derivatives include futures, options, and swaps."

While the term "derivatives" covers a broad spectrum of financial instruments in today's market, NCUA is only recommending authorizing the use of plain-vanilla, US Dollar-denominated (USD) interest rate swaps and purchased-only interest rate caps. These instruments are widely transacted in today's capital markets, have deep and transparent pricing and afford end users with strong liquidity and execution. The Bank for International Settlements reports that interest rate swaps are the largest component of the global over-the-counter (OTC) derivatives market.

With regard to interest rate swaps, the NCUA Board is proposing to authorize only standard "pay-fixed/receive-floating" and "pay-floating/receive-fixed" interest rate swaps. It is currently anticipated that most interest rate swaps users would enter into "pay-fixed/receive-floating" transactions to hedge against rising interest rates. This "plain vanilla" interest rate swap affords some protection against the most common interest rate exposure experienced by credit unions with material interest-rate risk (IRR) sensitivity—namely, a balance sheet with an asset portfolio that does not reset to external rate changes as quickly as its liabilities. Most credit unions use non-maturity and other short-term shares to fund longer duration assets, creating an inherent re-pricing mismatch for which pay-fixed/receive-floating interest rate swaps can provide some effective mitigation.

Q.2: Why is the NCUA Board proposing this new derivatives rule now for credit unions?

NCUA is concerned about the risk posed by rising interest rates and intends to enhance the financial tools and strategies available to manage that risk. With short-term interest rates at historic lows, there is a significant risk of rising interest rates potentially affecting the operations of financial institutions, including credit unions. Many credit unions are carrying substantial amounts of long-term, fixed-rate assets such as mortgages on their books but are funding those assets with short-term liabilities, such as money market accounts, that are rate-sensitive deposits.

For the subset of eligible credit unions that hold almost 80% of the credit union system's assets, certain types of simple, plain-vanilla derivatives can be an effective risk mitigation tool. When used properly, derivatives can be a prudent and useful hedging strategy against future interest-rate shocks. Responsibly used derivatives can help protect credit union balance sheets and in turn protect the National Credit Union Share Insurance Fund (NCUSIF) from potential losses at those credit unions should interest rates rise dramatically rather than gradually over time.

The NCUA Board has documented its concern about potential interest-rate risk for credit unions. The Board issued two Advanced Notices of Proposed Rulemaking to explore the use of derivatives as a possible hedging authority against interest rate risk. The first was at the June 2011 Board meeting; the second was at the January 2012 Board meeting where the Board also finalized the interest-rate risk management rule that was prompted by the same underlying concern about credit unions' exposure to rising interest rates.

NCUA's Part 703 of the Rules and Regulations has long prohibited the use of derivatives because of concerns about complexity and risk. However, NCUA has had some experience monitoring derivatives use. NCUA has authorized a number of pilot programs for derivatives since 1999. These programs were conducted to determine the feasibility of allowing broader use of derivatives for the sole purpose of hedging interest-rate risk.

Recognizing that derivatives can be beneficial in helping credit unions to mitigate IRR, the Board believes it is appropriate to allow credit unions to use derivatives for the limited purpose of IRR mitigation.

Q.3: What are the potential benefits to a credit union's balance sheet and asset-liability management from using simple interest rate swaps and caps to hedge interest-rate risk? What are the possible downsides?

To best answer these questions, it's useful to understand the risk mitigation benefits that each of these tools can offer. Essentially, swaps and caps can be used to offset interest rate mismatches that exist between a credit union's assets and liabilities. Many credit unions "borrow short to lend long." This creates exposure to rising rates (meaning income falls as rates rise). For example, a credit union that funds long-term fixed-rate mortgages with short-term non-maturity shares (e.g., money market accounts) may have considerable interest rate risk in rising-rate scenarios. This is because their average cost of funds will rise faster than their average yield on assets. Caps and swaps can be a source of additional income to offset this effect and therefore serve as a kind of IRR insurance.

The opportunity cost to the credit union for a cap is the premium paid up front if the protection from rising rates is never needed. (The loss is limited to the premium paid.) Conversely, the opportunity cost for a swap is the higher fixed funding cost (dependent on term and swap rates) until the indexed floating rate rises and exceeds that level.

Bottom line: When used properly, both of these tools can be effective in hedging the risk arising from the interest rate gap between longer-term fixed-rate assets and non-maturity deposits.

Q.4: What factors must be in place to allow a credit union to run a derivatives program with NCUA approval? What credit unions may qualify as eligible to use derivatives?

Under the proposed rule, there are a number of financial, operational and experiential requirements a credit union applicant must meet to be eligible.

The minimum eligibility requirements for a credit union to be approved include:

1. Satisfactorily demonstrating how derivatives function within a credit union's interest-rate risk mitigation strategies.
2. Assignment by NCUA of current CAMEL code composite rating of 1, 2, or 3.
3. Assignment by NCUA of current "M" management component of 1 or 2.
4. Total asset size of at least $250 million.

A credit union seeking derivatives authority could submit an application for one of two levels of authority.

Level I and Level II authority differ on the permissible amounts of transactions as well as the application, expertise, and systems requirements associated with operating a derivatives program.

- Level I derivatives authority contains lower permissible transaction limits, but also entails a more streamlined application process and less restrictive requirements with respect to experience, personnel, and systems.
- Conversely, Level II allows for higher transaction limits set by NCUA up to a specific ceiling, but entails a more comprehensive evaluation, greater regulatory requirements, a higher application fee, and the necessary personnel and systems to be in place before a credit union may apply. A credit union must also show why the limits under Level I are insufficient to mitigate its interest-rate risk.

The rule requires a credit union applying for either Level I or Level II authority to operate according to written policies and procedures. A credit union's board of directors would be required to review these policies and procedures annually and update them when necessary.

To ensure a derivatives program is well-managed and achieves the goals of the credit union, the board of directors, senior executive officials, and qualified derivatives personnel must have the knowledge and expertise to carry out their respective functions. NCUA is also proposing to require financial statement audits for any credit union with derivatives authority.

Q.5: What regulatory safeguards has NCUA built into the proposed rule to make sure simple derivatives are only used in a safe and sound manner by credit unions?

Previously, NCUA prohibited derivatives because they are complex financial instruments that potentially introduce significant degrees of risk to a credit union. Accordingly, this level of risk calls for a more robust asset/liability management (ALM) capability that is supported by a higher degree of sophistication, analytical rigor and risk management expertise.

The rule's safeguards include:

- Limits on eligibility to those credit unions that are rated as financially sound and well-managed.
- Certain mandatory governance provisions, internal controls, operational capabilities, and risk management program proficiencies to be resident in the credit union.
- Limits on maximum transaction amounts including position limits for both swaps and caps, limits on use of external service providers to support derivatives functions and demonstration that those relationships, collateral management guidelines and counterparty limits will be effectively managed.

In total, there are 19 separate requirements detailed in the rule to provide a framework for a safe and manageable derivatives program.

Q.6: Would credit unions be able to contract with external service providers to manage their approved derivatives program—such as a vendor or a credit union service organization (CUSO) with proven derivatives expertise?

External service providers (ESPs) can play a vital role in the overall success of a derivatives program. The Board, however, is concerned that overreliance on ESPs in the complex area of derivatives may lead to additional risk to the credit union. The Board is proposing to allow credit unions to utilize ESPs in limited ways, provided that credit unions meet certain conditions and restrictions.

The Board is proposing differing levels of ESP involvement for credit unions with Level I and Level II authority. Credit unions with Level I authority may contract with ESPs to conduct more functions than credit unions with Level II authority. (See the chart below.) Credit unions with Level II authority must have a higher degree of internal capacity with infrastructure and experience to obtain a higher level of authority.

	Level I		Level II	
Function	Support	Conduct	Support	Conduct
Asset Liability Management	X		X	
Accounting and Reporting		X		X
Credit Risk	X		X	
Counterparty Exposure Mgmt		X	X	
Collateral Management		X	X	
Liquidity Risk	X		X	
Trade Execution		X		X
Transaction Management		X	X	
Financial Statement Auditing		X		X
Legal Services		X		X

Q.7: NCUA is proposing what appear to be very strict guidelines before granting derivatives authority to eligible and interested credit unions. Why is that necessary?

NCUA has intentionally proposed conservative restrictions on derivatives authority because derivatives introduce complexity and risk that require commensurate degrees of financial sophistication, risk management and operational capabilities. After observing limited derivatives use in pilot programs during the past decade, the NCUA Board concluded that certain financial derivatives can be effectively utilized as part of a credit union's overall interest-rate risk management process, but that strong controls are warranted.

Q.8: If my credit union is a state charter, and state law already allows state-chartered credit unions to engage in derivatives transactions, how would the proposed rule affect my credit union? Conversely, if my state does not allow for state charters to engage in derivatives, is my credit union prohibited from applying for them?

This proposed rule applies to any federally insured state-chartered credit union (FISCU) that is permitted by its state law to engage in derivatives. It does not grant any FISCU authority to engage in derivatives if applicable state law does not expressly allow it. It does, however, require those FISCUs with derivatives authority under state law to meet the requirements of this proposed rule. In addition, if aspects of a state's derivatives regulation are more restrictive than this rule, FISCUs in that state must follow the more restrictive provisions of the state rule. A State Supervisory Authority (SSA) would review an application submitted under this proposed rule and forward its decision to the applicable NCUA personnel for concurrence. If the state does not allow its charters to engage in derivatives, the credit union is not eligible to apply to NCUA.

Q.9: How will the application process work for federal charters and state charters?
Assuming that the NCUA Board finalizes a version of the proposed rule (which may incorporate changes from the open comment period), NCUA will issue guidance on the application process. State-chartered credit unions will be required to submit complete application packages to their respective SSA, and then they will be forwarded to NCUA for review.

The proposed rule provides that NCUA will approve or deny a credit union's application within 90 days for Level I authority and 120 days for Level II authority. These time limits begin when an NCUA Field Director (Regional Director or ONES Director) determines it has a complete application from an FCU or a decision from the SSA for FISCU applicants.

Q.10: If a credit union's application is rejected, would the credit union have a right to appeal?

The proposed rule permits a credit union whose application was denied by a Field Director to appeal to NCUA's Supervisory Review Committee within 60 days from the date of denial.

Q.11: How would derivatives affect the financial reporting results of a credit union?

Currently, NCUA only requires financial statement audits for credit unions with assets of $500 million or more. The Board, however, is proposing to require financial statement audits for any credit union with derivatives authority. This is a new requirement only for those credit unions with assets between $250 million and $500 million.

US Generally Accepted Accounting Principles (GAAP) Codification Topic 815 Derivatives and Hedging Overview (ASC 815) requires that an entity recognize all derivatives as net assets in the statement of financial position and measure those instruments at fair value with changes recognized in the current period's Statement of Income and Expense. However, if certain hedge accounting criteria are met, the credit union may designate the underlying hedged instrument for either fair value or cash flow hedge accounting.

The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation. In either case, new financial disclosures would be required.

Q.12: How would this program affect capital and liquidity requirements?

Credit unions engaged in derivatives activity must consider the capital and liquidity implications of derivatives transactions and portfolios. Infrastructure enhancements, such as personnel, interest-rate risk monitoring and reporting tools, and the use of ESPs, may reduce operating income and impact capital growth projections. Credit union management must also understand the capital implications of the derivatives portfolio under a variety of adverse interest rate scenarios.

Similarly, derivatives activity requires subtle enhancements to liquidity monitoring and planning. Anticipated payments for cap premiums and swap transactions need to be included in liquidity risk analysis. Additionally, the credit union must monitor potential collateral needs and understand associated liquidity risk implications.

The Dodd-Frank Wall Street Reform and Consumer Protection Act put forth similar expectations for banking organizations.

Q.13: How much would this proposed derivatives program cost NCUA to run? Would NCUA's annual budget increase to fund it? If so, by how much?

The NCUA Board is considering instituting a fee structure for those credit unions that apply for derivatives authority. As discussed above, NCUA's application review process and ongoing enhanced supervision is labor-intensive and resource-intensive. Rather than pass this cost on to the credit union industry as a whole, the Board is considering whether or not to pass some of these costs directly to the credit unions seeking approval.

From the outset, NCUA would expend resources to train staff, develop or acquire necessary analytical tools, and develop approval and supervisory processes. NCUA would need to recruit additional staff with derivatives expertise.

The extent of these resource needs would depend on a variety of factors:

1. Number of credit union participants
2. Level of derivatives authority
3. Rate and timing of application inflow

NCUA is requesting comment on whether or not credit unions that are granted derivatives authority should be responsible for additional supervision fees.

Q.14: Where can I review the proposed rule? How do I comment?

NCUA posts all open Board actions on our website following the conclusion of the Board meeting. The proposed rule includes instructions on how to submit public comments and the period during which the Board can accept them. The Board encourages all interested parties to submit their comments, as it enhances the regulatory process. In particular, the Board seeks comments in response to specific questions it has posed in the preamble to the rule. The proposed rule is posted on www.ncua.gov under the Regulations, Publications and Reports section. Click on the above section and proposed regulations are under the Regulations & Legal Resources sub-section. Instructions for commenting are contained in the beginning of the proposed rule.

Q.15: Who at NCUA can answer questions on the proposed rule?

Justin M. Anderson or Lisa Henderson, Staff Attorneys, Office of General Counsel, at (703) 518-6540; Rick Mayfield, Senior Capital Markets Specialist, Office of Examination and Insurance, at (703) 518-6360.