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TO: **ALL CREDIT UNIONS**

FROM: **COMPLIANCE & REGULATORY AFFAIRS**

SUBJECT: **NCUA'S DERIVATIVES REGULATION AND GUIDANCE**

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Main Idea:	The NCUA has issued regulations and guidance about the use of derivatives by federally chartered and federally insured CUs to hedge against interest rate risk ("IRR"). Derivatives are financial contracts between the credit union and other entities. They are neither loans nor investments, but instead create relationships where one party is required to make payments to the other party when specified events, such as interest-rate fluctuations, occur. The new regulations and guidance can be summarized as follows: (1) Derivatives authority for FCUs - NCUA has amended its regulations to allow certain FCUs (after applying and being approved) to participate in a broader range of derivatives activities than had previously been allowed under the regulations. But NCUA will accept applications only from FCUs with assets of at least $250 million and composite CAMEL rating of 1, 2, or 3. (2) Derivatives authority for FISCUs - NCUA has opted, at this time, not to extend its derivatives regulations to state-chartered federally insured CUs ("FISCUs"), so FISCUs are allowed to engage in derivatives activities only to the extent that such activities are authorized under applicable state law. The League will consult with Virginia regulators

	regarding their position on allowing parity for Virginia-chartered CUs. NCUA's new regulations do require FISCUs to notify the applicable NCUA field director in writing at least 30 days before commencing any derivatives activities. (3) <u>Examination of derivatives programs (FCUs and FISCUs)</u> - NCUA has issued supervisory guidance clarifying that because of the "complexity of, and risks associated with, derivatives," NCUA will closely supervise the derivatives activities of *all federally insured CUs* (whether federally chartered or state-chartered), to make sure that any "safety and soundness" concerns related to those activities are identified during the examination process, and that such concerns are addressed using appropriate enforcement actions. NCUA has published supervisory guidance (in the form of Supervisory Letter 14-02) setting forth standards for the safe and sound utilization of derivatives activities. (A link to this supervisory guidance is provided below). (4) <u>Financial statement audit required if derivatives are used (FCUs)</u> – NCUA regulations generally do not require an FCU to obtain an independent financial statement audit unless its asset size is at least $500 million. Under the new derivatives regulations, however, any FCU that engages in derivatives activities must obtain such an audit even if its assets don't reach this threshold. FCUs that satisfy NCUA's eligibility requirements should review the new regulations and supervisory guidance to determine whether applying for derivatives authority is something that makes sense as part of an overall strategy for mitigating interest rate risk. All credit unions that decide to engage in derivatives activities, whether federally chartered or state-chartered, should carefully review NCUA's supervisory guidance and implement policies to assure that NCUA will not have any "safety and soundness" concerns with the derivatives activities.

Effective:	The rule became effective on 03/03/2014. FCUs that were previously approved for derivatives use under NCUA's pilot program must be fully compliant with the new regulations no later than 3/03/2015.
Regulation:	The new regulations addressing the extent to which FCUs are allowed to engage in derivatives activities were added to the NCUA regulations as a new "Subpart B" to Part 703, which regulates the investment activities of CUs. The new regulations run from 12 CFR 703.100 through 12 CFR 703.114, and there is a new appendix included as well. All are available online here, or you can find the individual sections by clicking on the following links: **Subpart B—Derivatives Authority** §703.100 Purpose and scope. §703.101 Definitions. §703.102 Permissible derivatives. §703.103 Derivative authority. §703.104 Requirements for derivative counterparty agreements, collateral and margining. §703.105 Reporting requirements. §703.106 Operational support requirements. §703.107 External service providers. §703.108 Eligibility. §703.109 Applying for derivatives authority. §703.110 Application content. §703.111 NCUA approval. §703.112 Applying for additional products or characteristics. §703.113 Pilot program participants with active derivatives positions. §703.114 Regulatory violation. - Appx to Subpart B—Examples of Derivative Limit Authority Calculations The requirement that FCUs obtain an annual financial statement audit if they engage in derivatives activities is found in the regulations at 12 CFR 703.106(b)(3) (available online here) and 12 CFR 715.5(a) (available online here). The new regulation requiring FISCUs to provide NCUA with advance notice prior to engaging in derivatives activities is at 12 CFR 741.219, which is available online here. NCUA's supervisory guidance explaining the standards that it will use to assess the derivatives activities of FCUs and FISCUs is available here
CUs Covered:	

	<u>FCUs</u>: FCUs must apply to NCUA for the right to engage in derivatives activity, and at present, the NCUA will consider applications only from FCUs with assets of at least $250 million and a composite CAMEL rating of 1, 2, or 3 to apply to use certain derivatives. The regional director has some authority to entertain applications for CUs below this asset threshold. <u>State-chartered CUs</u>: Per the NCUA: "While the final rule does not apply to federally insured, state-chartered credit unions, it does require those credit unions permitted to use derivatives under state law to notify NCUA 30 days before engaging in derivatives activities." State-chartered CUs are also required to submit to a "safety and soundness" examination of their derivatives activities by the NCUA, as described in the NCUA's supervisory guidance, which is described elsewhere in this release.
Background and Overview of Regulation:	<u>Purpose of regulation and guidance</u> - According to the NCUA, "[w]ith sound processes and controls in place, derivatives can be an effective tool to help credit unions hedge interest rate risk and better protect earnings and capital from adverse rate moves." (LCU 14-CU-04). The regulation addresses what derivatives activities are permissible and places limits on those activities; sets forth the procedures that an FCU must follow to apply for derivatives authority; addresses certain operational requirements; and identifies circumstances where FCUs must cease engaging in derivatives activities. <u>Illustration of how derivatives work</u> As explained above, derivatives are financial contracts between the credit union and other entities. They are neither loans nor investments, but instead create relationships where one party is required to make payments to the other party when specified interest-rate fluctuations occur. Here is a highly simplified example of a type of derivative known as an "interest rate swap": These contracts exchange fixed interest payments for floating-rate payments, or vice versa, without exchanging the underlying principal amounts. For example, suppose you owe $100,000 on a 10% fixed-rate home loan. You envy your neighbor who also is paying 10% on her $100,000 mortgage, but hers is a floating-rate loan, so if market rates fall, so will her loan rate. To the contrary,

	she is envious of your fixed rate, fearful that rates will rise, increasing her payments. A solution would be for the two of you to effectively swap interest payments using an interest-rate swap agreement. The way a swap works, you both would continue to actually make your own interest payments, but would exchange the net cash difference between payments at specified intervals. So, in this case, if market rates (and thus floating payments) increase, you would pay your neighbor; if rates fall, she pays you. The net effect is to exchange the consequences of rate changes. In other words, you have effectively converted your fixed-rate debt to floating-rate debt; your neighbor has done the opposite. . . . [If the neighbor's interest rate fell to 9 percent, the logistics would normally work like this:] . . . [T]he fixed-rate payer doesn't usually send the entire fixed interest amount (say 10% × $100,000 = $10,000) and receive the entire variable interest amount (say 9% × $100,000 = $9,000). Generally, only the net amount ($1,000 in this case) is exchanged. This example is taken from a McGraw Hill textbook and is obviously somewhat different (both in nature and degree) from the sort of interest-rate swaps that CUs might use, but it nonetheless illustrates the point: The person with the floating-rate loan has used the interest-rate swap to mitigate the risk of rising interest rates, whereas the person with the fixed-rate loan has taken some additional risk in exchange for the possibility of getting a lower interest rate. <u>Types of derivatives allowed</u> – According to NCUA, there are many categories of financial derivatives designed to hedge against many types of risk, including interest rate risk, foreign exchange risk, credit default risk, equity price risk, and commodity price risks. Under the NCUA's regulation, however, an FCU is not allowed to engage in any derivatives activities except those that are designed to mitigate interest rate risk. The only derivatives allowed are the "plain vanilla" derivatives that are specifically set forth in the regulation, which include the following: • Interest rate swaps

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- Interest rate caps
- Interest rate floors
- Basis swaps
- Treasury futures

<u>Limitations on derivatives activities</u>
Even the so-called “pain vanilla” derivatives that NCUA has authorized under the rule can get complicated, and financial sophistication is required even to understand exactly what the new regulation allows and prohibits. In general, the final regulation:

- Limits derivatives activities to sufficiently large and healthy FCUs, as described above;
- Limits the purposes and types of derivatives activities that FCUs may engage in, as described above;
- Limits the FCU’s overall derivatives exposure both by limiting the total amount of derivatives outstanding (by implementing a “notional limit”) and by having a limit that adjusts based on the actual performance of the derivatives (a “fair value loss limit”);
- Requires extensive planning, preparation, and resource allocation by an FCU before it can engage in derivatives activities, including:
    - Requiring the FCU to have sufficient internal expertise, appropriate resources, controls and systems (as outlined in the regulation) to maintain an effective derivatives program.
    - Requiring the FCU to articulate, prior to moving forward, exactly what derivatives it intends to use and exactly how those derivatives fit within its overall IRR mitigation strategy.
    - Requiring that upper management and the board of directors understand and maintain control over the derivatives activities.

The regulation allows FCUs to use external service providers “to support or conduct aspects of its derivatives program” but places strict limits on what those providers can do and requires FCUs to maintain “the internal capacity, experience, and skills, to oversee and manage” those providers.

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	In addition, the regulation requires the FCU, prior to engaging in any derivatives activities, to demonstrate its compliance with the regulation, as part of NCUA's two-stage application process, which NCUA describes as follows: In the first stage, the credit union will present to NCUA an IRR mitigation plan, which demonstrates how derivatives fit within that plan and how it will acquire the appropriate resources, controls and systems to implement a sound derivatives program. In the second stage . . . , NCUA will evaluate the credit union on its actual readiness to engage in derivatives transactions based on the personnel, controls, and systems it has put in place. Credit unions new to derivatives authority must operate safely for one year under limited authorities before moving to full authority. Once derivatives activities have been approved, the regulation prohibits expansion of such activities (including entry into new types of derivatives activities) without further approval. It also sets forth certain events that require immediate cessation of derivatives activities.
Further Research:	The NCUA's final rule, with the agency's section-by-section explanation of the rule, can be found online here. The NCUA's Letter to Credit Unions explaining the rule (LCU 14-CU-04) can be found here. The NCUA's guidance to its examiners about the rule (Supervisory Letter 14-02) is available here, and the questionnaires that examiners will be using are here (for FCUs) and here (for state-chartered CUs). Any FCU that is contemplating whether to apply for derivatives authority, can find a sample application in Appendix A to Supervisory Letter 14-2. (A link to Supervisory Letter 14-2 is included above). Any FISCU engaging in derivatives activities authorized under state law can find details about the NCUA reporting requirements in Appendix C to Supervisory Letter 14-2. (A link to Supervisory Letter 14-2 is included above). The derivatives-related materials in CUNA's *Compliance E-Guide* can be found online here.

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