14-CU-04 Derivatives Applications Open March 3

Summary

Prepared by NASCUS Legislative & Regulatory Affairs Department
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NCUA issued LTCU 14-CU-04 to provide federally insured credit unions the guidance NCUA has issued to its examiners as the new final derivatives rule takes effect. NCUA's final derivatives generally does not apply to federally insured, state-chartered credit unions (FISCUs) except to require FISCUs to notify NCUA 30 days before commencing engaging in derivatives transactions (FCUs must obtain pre-approval and are subject to the full limitations established in the final rule). The guidance contains a one page notice FISCUs may use to notify of intention to engage in derivatives activities.

Guidance to Examiners

NCUA notes that both FCUs and FISCUs are expected to operate derivatives in accordance with NCUA's safety and soundness expectations whether operating pursuant to NCUA's rule or to state authority. **On page 4 of the Supervisory Letter NCUA reminds its examiners that the guidance may be used as a reference for a safe and sound derivatives program, but may not be used as a reference for regulatory violations for a FISCU.** NCUA examiners examining a FISCU with derivatives activity are instructed to contact the state regulator to determine the nature of the state authority derivatives authority.

Derivatives Risks

NCUA instructs its examiners to be aware of the Interest Rate Risks, Liquidity and Credit Risks, and Operational Risks in credit unions engaged in derivatives transactions. NCUA notes that derivatives can significantly increase the leverage and price sensitivity on a credit union's balance sheet. This has the potential to rapidly increase interest rate risk exposure and threaten earnings and capital. Therefore, credit unions engaged in derivatives should incorporate the forward interest rate curve into their baseline assumptions and project performance over a prolonged horizon.

In addition, changes in forward interest rate curve could require credit unions to post additional collateral, increase margining or increased reserves. Credit unions must be certain to manage liquidity and sensitivity to credit risk in consideration of any existing derivatives positions.

Managing the Interest Rate and Liquidity and Credit Risks requires qualified personnel, policies, procedures and technology to support a safe and sound program. NCUA states that all credit unions must demonstrate the financial and managerial capacity to execute a safe and sound derivatives program.

Exam Procedures for FISCUs

NCUA's guidance for its examiners is divided into examination procedures for FCUs (Section II, pg. 7) and examination procedures for FISCUs (Section III, p. 14). With respect to FISCUs, NCUA states that its Field Supervisors will ensure an exam team has an expert to evaluate the FISCU's use of derivatives. When examining derivatives activity in a FISCU for insurance review purposes, NCUA examiners will:

- ensure the credit union uses only derivatives products that are authorized by the state regulator and are operating with parameters of state law and regulation
- determine the credit union's stated purpose and strategy for the use of derivatives and confirm what risk is being hedged
- assess whether the credit union's hedging strategy and risk limits are compatible and appropriate and whether the credit union can manage the activity financially and operationally
- assess the credit union's written policies and procedures for its derivatives program, determine that the policies and procedures are reviewed annually and updated as necessary, and verify that policies establish clear accountability and authority for all aspects of the program
- <u>if using a clearing organization</u> - determine credit union's compliance with regulatory requirements for exchange-traded and cleared derivatives by identifying the counterparty, evaluating the application of Commodity Futures Trading Commission (CFTC) rules for transactions that are cleared on a derivatives clearing organization, and assessing compliance with margining requirements set by the futures commission merchant
- <u>if not clearing transactions thru a clearing organization</u> - determine compliance with regulatory and contractual requirements for non-cleared derivatives, verifying that a master service agreement and credit support annex are compatible with protocol for standard bilateral agreements
- review the credit union's documentation of decisions to hedge, derivatives strategy, and demonstrated the economic effectiveness of the hedge
- evaluate credit union's management of collateral and margining requirements, including the need for daily monitoring
- analyzes and measures potential liquidity needs related to the derivatives program and evaluate the credit union's controls and management of liquidity exposures
- ensure credit unions maintain robust and detailed internal reporting to their board, asset liability committee, and senior management regarding the effectiveness, valuations, risk profile and compliance of the derivatives program
- evaluate experience and expertise of credit union staff with respect to asset/liability management, derivatives management and accounting/financial reporting with an emphasis on oversight of counterparty, collateral, and margin risk
- ensure appropriate separation of duties in the oversight of a derivatives program
- ensure proper third party due diligence and oversight
- ensure appropriate legal oversight with qualified counsel

<u>Additional Guidance</u>

NCUA provides reference to additional guidance including LTCU 12-CU-05 Interest Rate Risk Policy and Program Requirements, LTCU 10-CU-03 Concentration Risk, Chapter 6 §11 of the National Supervision and Policy Manual, Title VII of the Dodd-Frank Act, the CFTC's 17 CFR Parts 39, 140, and 190 Derivatives Clearing Organizations and International Standards.

NCUA also references 12 CFR Part 741.3, the OCC's quarterly report on trading revenue and bank derivatives activities, and the Bank for International Settlements' (BIS) statistics on derivatives markets.