DERIVATIVES PROCEDURES AND THE NCUA APPLICATION
CUNA CFO Conference | May 19, 2015

Presented by:
Emily Moré Hollis, CFA
Founding Partner
Agenda

- Application
- Checklist
- Back office
- Derivative budget
- Timeline
- Conclusion
Application

• Application process is in two stages:
  – Credit union presents a complete application except for International Securities Dealers Administration (ISDA) agreements and Dodd-Frank compliance paperwork.
  – NCUA will then evaluate the credit union on its actual readiness to engage in derivative transactions based on the personnel, controls, and systems it has in place.
Application - From the Regulation

• Interim approval
  – NCUA’s goal is to respond in 60 days

• Acquisition of infrastructure to comply with the rule
  – Acquire all of the personnel and systems

• Notice of readiness
  – Once the credit union is ready, it must notify the NCUA

• Final approval
  – NCUA’s goal is to respond in 60 days

• Credit union may choose to submit an application after acquiring all of the necessary resources

• NCUA’s goal is to respond within 120 days for final approval
Application - Actual

- **Approval**
  - NCUA’s goal is to respond in 60 days
  - NCUA visits credit union on site

- **Notice of readiness**
  - ISDA agreements are negotiated and Dodd-Frank compliance
  - Once the credit union is ready, it must notify the NCUA

- **Final approval**
  - NCUA’s goal is to respond in 60 days
Notification Process

NCUA analysts will be looking for meaningful business plans

i.e. on products

Does the application indicate what products and characteristics the credit union will be using and what the hedging objectives are?

Interim approval questionnaire: ~18 points
Final approval questionnaire: ~30 points
Notification Process:
Federally Insured State Chartered Credit Unions

FISCU Notification to NCUA:

- Must notify NCUA field director in writing at least 30 days before it begins engaging in derivatives, or;
- If already using derivatives, must notify NCUA field director before next transaction.

i.e. on products evaluation;

Does the application indicate what products and characteristics the credit union will be using and what the hedging objectives are?

Interim approval questionnaire: ~18 points
Final approval questionnaire: ~30 points
Application

• Pursuant to section 703.11 of the NCUA regulations, Sample Credit Union requests your approval of derivative authority that would enable the Credit Union to enter into non-speculative interest rate swaps, caps, floors and Treasury future contracts for the purpose of hedging interest rate risk for its balance sheet. We are sending this document as a notice of readiness excluding executed ISDA agreements and Dodd-Frank compliance documents.

• The request for authority must be clear in terms of what exactly the credit union is applying for and what the credit union is not applying for.
Application (continued..)

• “Sample Credit Union requests authority for the following:”
  – Interest rate swaps
  – Interest rate caps
  – Interest rate floors
  – U.S. Treasury note futures (2, 3, 5, and 10 year contracts)
  – Amortizing notional on interest rate swaps, caps and floors
  – Forward start on interest rate swaps
  – Basis swaps
  – Amortizing notional on interest rate swaps, caps and floors

• Make sure to also detail what the credit union is not applying for –
  “Sample Credit Union is not applying for:”
Application Attachments

• A board resolution showing that the Board of Directors has approved the use of derivatives
• A signed contract with external service provider to perform functions as listed in the document
• Derivative exposure report
• Daily margin monitor
• Board approved policies
• Board approved procedures
• Sample monthly NEV report with derivatives
• Sample monthly NEV report without derivatives
Application Attachments (continued..)

• Internal control framework or process flow chart that documents the roles and responsibilities for all the activities needed to support derivative program, including the separation of duties
• Sample cost / benefit analysis showing alternatives to other interest rate mitigation strategies
• Sample accounting hedge review
• Signed contracts with XXX to perform hedge accounting functions
• Credit union’s latest ALM reports
Application Attachments (continued..)

• Sample monthly derivative analytics report
• The following items are in process and credit union will submit a letter of readiness when completed:
  • Signed ISDA contracts with dealers
  • Dodd-Frank compliance paperwork
Application

1. An interest rate risk mitigation plan that shows how derivatives are one aspect of the federal credit union’s overall interest rate risk mitigation strategy, and an analysis showing how the federal credit union will use derivatives in conjunction with other on-balance sheet instruments and strategies to effectively manage its interest rate risk;

2. A list of the products and characteristics the federal credit union is seeking approval to use, a description of how it intends to use the products and characteristics listed, an analysis of how the products and characteristics fit within its interest rate risk mitigation plan, and a justification for each product and characteristic listed;
Application (continued..)

3. Policies and procedures that the federal credit union has prepared in accordance with §703.106(d) of this subpart;

4. How the federal credit union plans to acquire, employ, and/or create the resources, policies, processes, systems, internal controls, modeling, experience, and competencies to meet the requirements of this subpart. This includes a description of how the federal credit union will ensure that senior executive officers, board of directors, and personnel have the knowledge and experience in accordance with the requirements of this subpart;
Application (continued..)

5. A description of how the federal credit union intends to use external service providers as part of its derivatives program, and a list of the name(s) of and service(s) provided by the external service providers it intends to use;

6. A description of how the federal credit union will support the operations of margining and collateral; and

7. A description of how the federal credit union will comply with GAAP.
Application Content

1. An interest rate risk mitigation plan that shows how derivatives are one aspect of the federal credit union’s overall interest rate risk mitigation strategy, and an analysis showing how the federal credit union will use derivatives in conjunction with other on-balance sheet instruments and strategies to effectively manage its interest rate risk;
   • Should be based upon NEV analytics
   • Should mention inclusion of all available tools, such as borrowings, asset / liability rebalancing, selling of mortgages
2. A list of the products and characteristics the federal credit union is seeking approval to use, a description of how it intends to use the products and characteristics listed, an analysis of how the products and characteristics fit within its interest rate risk mitigation plan, and a justification for each product and characteristic listed;

- Interest rate swaps
- Interest rate caps
- Interest rate floors
- Interest rate futures
Application Content – Description Example

• Example
  – A standard swap is an agreement between two counterparties in which cash flows are exchanged as they are received for a fixed time period (“tenor”), with the terms initially set so that its present value is zero. The most common instance of this is an ISDA standard interest rate swap, in which counterparties exchange the difference between the coupon and interest cash flows of fixed-rate for floating-rate payments.
  – Maturities will be 15 years and less and amortizing features as well
Application Content

3. Draft policies and procedures that the federal credit union has prepared in accordance with §703.106(d) of this subpart;
Derivatives Policy

- Purpose and content
- Statement of policy
- Structure, responsibilities, and authority
- Reporting
- Derivative limits and guidelines
- Counterparties and limits
- Collateral requirements
- Internal controls
- Noncompliance
- Derivative policy exemptions
Levels

• Credit union must operate in two levels:
  – Entry level for one year with maximum fair value loss of 15% of net worth and weighted average remaining maturity notional of 65% of net worth
  – Standard level of maximum fair value loss of 25% of net worth and weighted average remaining maturity notional of 100% of net worth

• Certain credit unions with experience may be granted standard limit authority at the time of application
# Weighted Maximum Fair Value Loss

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<th>Options</th>
<th>Swaps</th>
<th>Futures</th>
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<td>100%</td>
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<td>Adjusted Notional (Step #2)</td>
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<td>8.50</td>
<td>5.00</td>
<td>7.74</td>
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</table>

Weighted Average Remaining Maturity Notional (WARM) (Step#4) 68,112,000 (77.4% of Step #3)

Notional Limit Authority (65% of net worth) 65,000,000

Under (Over) Notional Limit Authority - (3,112,000)
Sample Flowchart

Chief Executive Officer

Ensures Personnel Are Qualified

EVP/Chief Financial Officer

Makes Derivatives Execution Decision

Controller

Oversees Derivatives Accounting

Director of Finance

Oversees ALM

Report Non-Compliance to NCUA

Board of Directors

Reviews Derivative Benefits/Risks Annually

Reviews Derivative Policies Annually

Ensures Training of Staff & Officials

Oversees Policies & Procedures

Transfers Funds & Security

Performs Analytics/Risk Reporting
Application Content

4. How the federal credit union plans to acquire, employ, and / or create the resources, policies, processes, systems, internal controls, modeling, experience, and competencies to meet the requirements of this subpart. This includes a description of how the federal credit union will ensure that senior executive officers, board of directors, and personnel have the knowledge and experience in accordance with the requirements of this subpart;
Board

• Board must complete derivatives training before a credit union could begin a derivatives program and annually thereafter
• Board must have sufficient knowledge to effectively oversee and effectuate a derivatives program
• The Board should have adequate understanding of:
  – Caps
  – Swaps
  – Procedures
  – Accounting
  – Legal issues
  – Cost
  – Risk / return
Staff

• Credit union staff must have commensurate experience in the following areas:
  – ALM
  – Accounting and financial reporting
  – Derivatives trade execution and oversight
  – Counterparty, collateral and margining
  – Enhanced capacity to analyze and understand the credit union’s IRR
Staff: ALM Requirements

- Staff must be qualified to understand and oversee asset liability risk management including the appropriate role of derivatives.
The Staff ALM Requirement Includes -

• Identifying and assessing risk in transactions, developing asset liability risk management strategies, testing the effectiveness of asset liability risk management, determining the effectiveness of managing interest rate risk under a range of stressed rates and statement of financial condition scenarios, and evaluating the relative effectiveness of alternative strategies

• Staff must also be qualified to understand and undertake or oversee the appropriate modeling and analytics related to scope of risk to earnings and economic value over the expected maturity of derivatives positions
‘What-ifs’ and Derivative Analytics

• The credit union will on at least an annual basis, conduct alternative ‘what-if’ scenarios. These ‘what-ifs’ will stress-test the major model assumptions to determine how the balance sheet performs in these alternative scenarios and to solidity true interest rate risk prior to derivative modeling. Management will then understand the full impact of the tested assumptions on the balance sheet and its risk position. These tests will be sensitivity and scenario analyses such as non-parallel shifts in the yield curve, forward NEVs including a rapid rise of interest rates, key rate duration analytics, and adjusting non-maturity deposit cash flows and sensitivities, and prepayment speed stress tests.
‘What-ifs’ and Derivative Analytics (continued..)

• Once results are analyzed, various derivative strategies will be modeled to clearly capture the affect and cost of the trades.
Application Content

5. A description of how the federal credit union intends to use external service providers as part of its derivatives program, and a list of the name(s) of and service(s) provided by the external service providers it intends to use;
External Service Providers

- Asset liability management
- Accounting and reporting
- Counterparty exposure management
- Collateral management
- Liquidity risk
- Trade execution
- Transaction management
- Financial statement auditing
- Legal services
External Service Provider (ESP)

• Credit union may use ESP to support or conduct aspects of its derivatives program provided that the ESP:
  – is not counterparty
  – is not principal or agent
  – does not have discretion

• Credit union must internally and independently conduct ALM and liquidity risk management
  – May obtain assistance from ESP produced software and modeling tools

• Credit union must have the internal capacity and experience to oversee and manage ESP

• Credit union must document the specific use of ESP in its process and responsibility framework
6. A description of how the federal credit union will support the operations of margining and collateral

- Our credit union will contract with ALM First to monitor changes in market value for our derivatives holdings with each counterparty on a daily basis. When the change in market value exceeds the threshold for the transfer of collateral, ALM First will notify us on that business day. We will directly post and maintain collateral with counterparties according to our policies.

- Our credit union plans on using agency bullets, Treasuries, cash, and mortgage pass-through securities as acceptable collateral from the dealer and as securities to pledge to the dealer.

- Our credit union plans on safekeeping collateral at the Federal Reserve of Dallas. We do not plan to use an exchange, but will be negotiating bi-lateral agreements directly with the dealers.
Application Content (continued..)

7. A description of how the federal credit union will comply with GAAP.
CHECKLIST
Checklist: Application

- Execute derivatives agreement with ESP if applicable
- Training for staff and Board of Directors (board resolution)
- Credit union board approval for the use of derivatives
- Prepare a risk mitigation plan which includes derivatives and show how derivatives are one aspect of its overall interest rate risk mitigation strategy
- Hedge review
- Policies and procedures
- Flowchart
Checklist: Application (continued..)

• Solidify who will conduct hedging accounting
• Derivative analytics reports
• Operations reports (margin monitors, exposure reports)
• Submit an application to the state supervisory authority with NCUA’s concurrence (60 days for approval)
Checklist: Final Application

• Execute ISDA agreement(s) with counterparty
  (Dealers require 3 years of audited financials and unaudited quarterly reports for the current year.)
    – Master
    – Schedule
    – Credit Support Annex (CSA) (Must be bilateral)
• Dodd-Frank Compliance
• Notify regulators of readiness
Checklist: Post-trade

• Monthly NEV analysis
• Daily monitoring of swap pricing and meeting margin requirements
• Quarterly comprehensive derivatives report to the board
• Monthly reports to the senior officers:
  – Areas of noncompliance
  – Limits
  – List of individual positions and aggregate current fair values and notional amounts
  – Net economic value with derivatives included and excluded
  – Evaluation of effectiveness of the hedge relationship and reporting in compliance with GAAP
• Monitor hedge effectiveness at least quarterly
Checklist: Other

• Obtain annual independent audit of financial statements
• Obtain CFTC Interim Compliant Identifier (CICI) at www.ciciutility.org
• Match swap dealers on www.markit.com
BACK OFFICE
# Back Office

## POSITION SUMMARY

**December 31, 2013**

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<tr>
<th>Description</th>
<th>CounterParty</th>
<th>Outstanding Notional</th>
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<th>Maturity Date</th>
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## Back Office

### PRICE

**December 31, 2013**

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DERIVATIVE BUDGET
Derivative Budget – Assume two trades at $20 million

HEDGING EXPENSES

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<th>Expense</th>
<th>Amount ($)</th>
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<td>CICI/LEI Registration</td>
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<tr>
<td>ISDA Amend *</td>
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<tr>
<td>Hedge Accounting</td>
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<td>Legal Counsel w/ IRD experience *</td>
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<td>External Service Provider</td>
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<tr>
<td><strong>Total Expenses - Year One</strong></td>
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<td><strong>Total Expenses - Year Two</strong></td>
<td><strong>40,500</strong></td>
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Cost in Basis Points for $20 Million 20.25
Cost in Basis Points for $40 Million 10.13

**Annual cost savings vs. borrowings (75 bps)** 150,000

* Expensed in the first year only
TIMELINE
Timeline

• **+6 Weeks**: Training for CU staff and Board
  • Training should include the following:
    – Swaps training
    – Caps training
    – Hedge accounting training
    – What-ifs preparation
    – Regulatory compliance
    – Counterparty credit analysis

• **+5 Weeks (11 weeks total)**:
  – Board will vote on hedge policy and procedures
  – Staff will work on application

• **+1 Week (12 weeks total)**:
  – Credit Union will apply to NCUA for derivative approval
Timeline

• **+6 Weeks (18 weeks total):**
  – Credit Union will have an on-site NCUA exam regarding derivatives prior to approval

• **+10 Weeks (28 weeks total):**
  – Credit Union should receive notification of approval or denial of derivative application.

• **+14 Weeks (32 weeks total):**
  – Negotiate ISDA agreements with dealers
  – Dodd-Frank compliance applications
  – Send readiness letter to NCUA

• **+1 day (32 weeks total):**
  – Upon receiving approval of application, credit union can initiate trades immediately.
Conclusion

- Regulatory approval process takes at least four months
- Federal credit unions should expect a visit from the NCUA
- Board approval is the first step
- Federal credit unions apply to the NCUA, state chartered credit unions apply to their respective state regulator
- Final approval is pending completion of ISDA agreements