**Board of Governors of the Federal Reserve**

*Authority and Issuance*

For the reasons set forth in the Common Preamble, the Board of Governors of the Federal Reserve System is adding the text of the common rule as set forth at the end of the Common Preamble as § 248.16 to part 248, 12 CFR chapter II.

## PART 248—PROPRIETARY TRADING AND CERTAIN INTERESTS IN AND RELATIONSHIPS WITH COVERED FUNDS (Regulation VV)

■ 3. The authority for part 248 continues to read as follows:

**Authority:** 12 U.S.C. 1851, 12 U.S.C. 221 *et seq.,* 12 U.S.C. 1818, 12 U.S.C. 1841 *et seq.,* and 12 U.S.C. 3103 *et seq.*

### § 248.16 [Amended]

■ 4. Section 248.16 is added as set forth at the end of the Common Preamble.

**Federal Deposit Insurance Corporation**

*Authority and Issuance*

For the reasons set forth in the Common Preamble, the Federal Deposit Insurance Corporation is adding the text of the common rule as set forth at the end of the Common Preamble as § 351.16 to part 351, chapter III of Title 12, Code of Federal Regulations.

## PART 351—PROPRIETARY TRADING AND CERTAIN INTERESTS IN AND RELATIONSHIPS WITH COVERED FUNDS

■ 5. The authority for part 351 continues to read as follows:

**Authority:** 12 U.S.C. 1851; 1811 *et seq.;* 3101 *et seq.;* and 5412.

### § 351.16 [Amended]

■ 6. Section 351.16 is added as set forth at the end of the Common Preamble.

**Commodity Futures Trading Commission**

*Authority and Issuance*

For the reasons set forth in the Common Preamble, the Commodity Futures Trading Commission is adding the text of the common rule as set forth at the end of the Common Preamble as § 75.16 to part 75, chapter I of Title 17, Code of Federal Regulations.

## PART 75—PROPRIETARY TRADING AND CERTAIN INTERESTS IN AND RELATIONSHIPS WITH COVERED FUNDS

■ 7. The authority for part 75 continues to read as follows:

**Authority:** 12 U.S.C. 1851.

### § 75.16 [Amended]

■ 8. Section 75.16 is added as set forth at the end of the Common Preamble.

**Securities and Exchange Commission**

*Authority and Issuance*

For the reasons set forth in the Common Preamble, the Securities and Exchange Commission is adding the text of the common rule as set forth at the end of the Common Preamble as § 255.16 to part 255, chapter II of Title 17, Code of Federal Regulations.

## PART 255—PROPRIETARY TRADING AND CERTAIN INTERESTS IN AND RELATIONSHIPS WITH COVERED FUNDS

■ 9. The authority for part 255 continues to read as follows:

**Authority:** 12 U.S.C. 1851.

### § 255.16 [Amended]

■ 10. Section 255.16 is added as set forth at the end of the Common Preamble.

Dated: January 14, 2014.

**Thomas J. Curry,**

*Comptroller of the Currency.*

By order of the Board of Governors of the Federal Reserve System, January 14, 2014.

**Robert deV. Frierson,**

*Secretary of the Board.*

Dated at Washington, DC this 13th day of January 2014.

By delegated authority from the Board of Directors of the Federal Deposit Insurance Corporation.

Federal Deposit Insurance Corporation.

**Robert E. Feldman,**

*Executive Secretary.*

Dated: January 17, 2014.

By the Securities and Exchange Commission.

**Elizabeth M. Murphy,**

*Secretary.*

Issued in Washington, DC, on January 15, 2014, by the Commodity Futures Trading Commission.

**Melissa D. Jurgens,**

*Secretary of the Commodity Futures Trading Commission.*

**Note:** The following appendices will not appear in the Code of Federal Regulations.

**Commodity Futures Trading Commission (CFTC) Appendices to Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities With Regard to Prohibitions and Restrictions on Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds—Commission Voting Summary and Statements of Commissioners**

*Appendix 1—Commodity Futures Trading Commission Voting Summary*

On this matter, Acting Chairman Wetjen and Commissioner Chilton voted in the affirmative, and Commissioner O'Malia concurred.

*Appendix 2—Statement of CFTC Acting Chairman Mark P. Wetjen*

I support the interim final rule adopted by the CFTC and the other Volcker Rule agencies. The Commission believed it was important to join the other agencies in ensuring community banks are protected, as Congress directed, from restrictions in the Volcker Rule intended to lower the risk of large financial institutions.

*Appendix 3—Statement of Concurrence by CFTC Commissioner Scott D. O'Malia*

I support the interim final rule adopted by the Commission and the OCC, Federal Reserve Board, FDIC, and SEC (''Agencies''). When an unintended consequence of a regulation is discovered, it is imperative that it be expeditiously corrected to avoid unintentional harm to affected parties. Broken rules must be fixed, and I applaud the work of the Agencies to quickly respond to the public's concerns and comments regarding the holding of TruPS CDOs by community banks affected by the Volcker Rule.

[FR Doc. 2014–02019 Filed 1–30–14; 8:45 am]

BILLING CODE 6210–01–P; 6741–01–P; 6351–01–P; 8011–01–P; 4810–33–P

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## NATIONAL CREDIT UNION ADMINISTRATION

## 12 CFR Parts 703, 715, and 741

**RIN 3133–AD90**

## Derivatives

**AGENCY:** National Credit Union Administration (NCUA).

**ACTION:** Final rule.

**SUMMARY:** This final rule permits credit unions to engage in limited derivatives activities for the purpose of mitigating interest rate risk. This rule applies only to Federal credit unions. The final rule addresses permissible derivatives and

characteristics, limits on derivatives, operational requirements, counterparty and margining requirements, and the procedures a credit union must follow to apply for derivatives authority.

**DATES:** This final rule is effective March 3, 2014.

**FOR FURTHER INFORMATION CONTACT:** Justin M. Anderson, Staff Attorney, Office of General Counsel, at the above address or telephone (703) 518–6540; or Tom Fay, Senior Capital Markets Specialist, Office of Examination and Insurance, at the above address or telephone (703) 518–1179.

**SUPPLEMENTARY INFORMATION:**



## I. Notice of Proposed Rule Making

In May 2013 the NCUA Board (Board) issued a proposed rule to permit Federal credit unions (FCUs or credit unions) to engage in derivatives transactions for the purpose of mitigating interest rate risk (IRR). The proposal also required federally insured, state-chartered credit unions (FISCUs) permitted by state law to engage in derivatives to follow the requirements of NCUA's rule. The proposed rule required a credit union seeking derivatives authority to meet minimum eligibility criteria and included two levels of authority, Level I and Level II. The two levels had different permissible limits of derivatives and regulatory requirements. To obtain Level I or Level II authority, the proposed rule required a credit union to apply to NCUA or, in the case of a FISCU, its state supervisory authority (SSA). In addition, the proposed rule described requirements on derivatives processes, systems, and personnel; experience requirements; and restrictions on the use of external service providers (ESPs). The proposed rule also addressed credit unions in NCUA's pilot program and regulatory violations. Finally, the Board specifically requested comment on the possibility of requiring credit unions that apply for derivatives authority to pay an application and/or supervision fee. The Board issued the proposed rule with a 60-day comment period.

## II. Summary of Comments

The Board received 75 comments on the proposed rule: 28 from FCUs; 16 from FISCUs; 13 from state credit union leagues; 9 from credit union service organizations or third-party vendors, including investment advisors and brokers; 3 from trade associations; 3 from SSAs; 2 from law firms; and 1 from a Federal Home Loan Bank.

In general, commenters supported permitting credit unions to engage in derivatives transactions. However, all commenters opposed at least one aspect of the proposed rule. While most provisions of the rule elicited comments, commenters focused on fees, permissible derivatives, limits, processes, and experience requirements.

Most commenters believed the proposed requirements imposed high costs and regulatory burdens on credit unions. Virtually all of the commenters, however, believed that credit unions would be able to use derivatives as a meaningful IRR mitigation tool if the Board did not include application or supervisory fees and reduced the regulatory requirements. The Board addresses comments on the proposed rule in more detail in the following section.

## III. Section-by-Section Analysis of the Final Rule

*(a) General*

The Board has made several changes in the final rule based on public comments. Most notably, the Board has condensed and simplified the rule and reduced the overall regulatory burden. The Board also decided not to include, in this final rule, fees associated with using derivatives. The final rule also addresses swap clearing regulations issued in early 2013 by the Commodities and Futures Trading Commission (CFTC). The following is a brief summary of the final rule:

- The rule allows limited derivatives authority comprising of plain vanilla interest rate derivatives for balance sheet management and risk reduction.
- Derivatives exposure is limited by two related measures, a measure of notional amount of derivatives outstanding and a fair value loss limit. The limits are designed to work in tandem, with the notional limit a prospective limit on a credit union's derivatives activity and the fair value loss limit based on the actual performance of the derivatives held by a credit union.
  - ○ The limit on notional amount of derivatives outstanding takes into account the type of derivative and the time to maturity, two key components that determine an instrument's sensitivity to interest rate changes. This innovation provides significant flexibility under the rule and improves the relationship between the notional limit and the fair value limit.
  - ○ The fair value threshold, if breached, will require a participating credit union to cease new derivative investments, provide notification and develop a corrective action plan.
- Credit unions are required to apply for derivatives authority. Generally the application process will be conducted in two-stages. 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 of the approval process, 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.
- The rule outlines the appropriate resources, controls and systems required for an effective derivatives program.

The Board believes the changes between the proposed and final rules will significantly lower the cost and burden for credit unions to use derivatives as part of their IRR mitigation strategy.

*(b) Changes to Part 703*

The proposed rule divided part 703 into two subparts, subpart A and subpart B. Subpart A consisted of the current part 703, with minor modifications, and subpart B consisted of rules and requirements related the use of derivatives. The Board did not receive any comments on the changes to Part 703, but is amending the definition of ''derivative'' in both subparts for accuracy. The Board has not made any other changes to the structure of Part 703.

In addition, the Board notes that the requirements of new subpart B do not apply to derivatives transactions that are permitted under § 703.14, which include European call options, interest rate lock commitments, certain embedded options, and certain options associated with the sale of loans on the secondary market.

*(c) Purpose and Scope (§ 703.100)*

The purpose and scope section of the proposed rule indicated that the rule applied to FISCUs that are permitted to engage in derivatives by state law. The purpose and scope section also outlined which sections of the rule applied specifically to the different levels of derivatives authority (Level I or Level II, as defined in the proposed rule). Based on public comment and other changes to the rule, the Board has significantly revised this section.

(1) Applicability to FISCUs (§ 703.100)

The proposed rule required any FISCU permitted by state law to engage in derivatives to follow NCUA's rule, including the application process and regulatory limits. Approximately one-quarter of the commenters addressed this requirement. All but one commenter argued that NCUA is encroaching on states' rights and should not regulate FISCUs' derivatives use. Commenters maintained that such regulation is the province of the states, and that NCUA did not provide sufficient support for Federal regulation of derivatives transactions.

After consideration of the comments, the Board has removed this requirement from the rule. Given the absence to date of any problems specific to FISCUs' derivatives use, FISCUs may follow applicable state law (including a state parity provision) or other SSA authorization, rather than this final rule.

NCUA will closely supervise all federally insured credit unions that engage in derivatives, and will address any safety and soundness concerns through use of applicable enforcement actions. Given the complexity of, and risks associated with, derivatives activity, NCUA will be publishing supervisory guidance in this area. This guidance will address standards for the safe and sound operations of a derivatives program, including expectations for comprehensive policies and procedures, counterparty and collateral management practices, internal control, accounting, and reporting systems, personnel with appropriate levels of expertise, and asset-liability management modeling capabilities. As insurer, NCUA's supervisory guidance will apply to all federally insured credit unions. The final rule also requires that a FISCU engaging in derivatives—whether pursuant to authority granted under state law (including a state parity provision) or other SSA authorization—must notify the applicable field director in writing at least 30 days before it begins engaging in such transactions. This provision will open a dialog between the FISCU and NCUA about the objectives of each new derivatives program. It will also facilitate efforts between NCUA and SSAs to coordinate off-site monitoring and on-site supervision.

(2) Registered Investment Companies

The Board also wants to clarify application of this rule to § 703.14(c), which reads as follows:

(c) *Registered investment company.* A Federal credit union may invest in a registered investment company or collective investment fund, as long as the prospectus of the company or fund restricts the investment portfolio to investments and investment transactions that are permissible for Federal credit unions.

The Board notes that this final rule will not allow FCUs that are approved for derivatives to invest in a registered investment company or collective investment fund that has derivatives. The Board does not believe it is appropriate for FCUs to invest in entities that may use derivatives for non-hedging purposes. The Board notes that derivatives are complex instruments that can pose significant risk.

The Board has taken steps to mitigate that risk for credit unions using derivatives, but does not have authority to do the same with respect to registered investment companies and collective investment funds. The Board is concerned that such entities using derivatives may put credit unions, and therefore the NCUSIF, at risk. Thus, NCUA has included a clarifying provision in the final rule stating that FCUs are not permitted to invest in registered investment companies or collective investment funds that allow derivatives to be in their investment portfolios. The Board also notes that the purpose of this rule is to permit credit unions to use derivatives for the very limited purpose of mitigating IRR. It never intended for this rule to be a vehicle for credit unions to take on additional risks through a registered investment company or a collective investment fund.

*(d) Definitions (§ 703.101)*

The proposed rule included several new definitions. The Board received three comments asking for clearer definitions of ''plain vanilla derivatives,'' ''leveraged derivative,'' and ''weighted average life.'' In addition to clarifying several of the definitions, the Board has added new definitions to correspond with other changes in the rule. The Board has also deleted definitions of terms that are no longer used in the rule.

*(e) Permissible Derivatives and Characteristics (§ 703.102)*

The proposed rule permitted credit unions that have derivatives authority to use interest rate swaps and interest rate caps. The proposal further limited the use of interest rate swaps and interest rate caps to those that are non-leveraged, based on domestic rates, denominated in U.S. dollars, are not used to create structured liability offerings, and settled within three days. The proposal further limited the use of interest rate swaps to those that did not have a fluctuating notional amount.

More than half of the commenters maintained that the list of permissible derivatives was too restrictive to allow credit unions to adequately hedge against IRR. Many of these commenters believed NCUA should allow interest rate floors as a means of hedging against falling rates. Other commenters suggested the list of permissible derivatives should include swaptions, basis swaps, forward settling swaps, swaps with amortizing features, interest rate collars, and interest rate futures. These commenters cited IRR mitigation and low levels of complexity as reasons for permitting these additional derivatives and characteristics.

The Board has considered all of the derivatives and characteristics suggested by commenters, and has expanded the list of permissible derivatives and characteristics in the final rule. In reviewing each suggested derivative, the Board compared the product's utility in mitigating IRR to the derivative's overall complexity and risk. After careful deliberation, the Board is permitting credit unions to apply for the following derivatives and characteristics:

| Derivatives | Derivative characteristics |
|---|---|
| • Interest rate swaps | • Amortizing notional amounts for swaps, caps, and floors. |
| • Interest rate caps. | |
| • Interest rate floors | • Forward start date for swaps (90-day maximum). |
| • Basis swaps. | |
| • Treasury futures. | |

The following is a description of each new derivative or characteristic that the Board has included in this final rule. The following discussion does not include plain vanilla interest rate swaps and interest rate caps, which the Board discussed in the proposed rule:

(1) Interest Rate Floors. An interest rate floor requires payment to the holder when an underlying interest rate (the ''index'' or ''reference'' interest rate) falls below a specified contract rate (the ''floor rate'').

(2) Basis Swaps. A basis swap is an interest rate swap in which the parties exchange two floating rate indices. For example, Party A enters into a five-year agreement with Party B in which Party A makes quarterly payments to Party B of the U.S. dollar Prime rate multiplied by $10,000,000 (the notional amount), and Party B makes quarterly payments to Party A of the Three-Month U.S. dollar LIBOR rate times $10,000,000. The Board believes that basis swaps can be a useful hedging tool and are commonly used when one party is active in two money markets and wishes to limit the exposure to the risk that the spread between the two interest rates fluctuates.

(3) Amortizing Notional Amounts. An amortizing notional amount is a characteristic of an interest rate cap, interest rate floor, or interest rate swap where the notional amount of the derivative decreases over time according to a predetermined, fixed schedule. The Board agrees the use of amortizing derivatives can potentially enhance hedge effectiveness, provided the amortizing schedule is set at the time of the derivative transaction. For example, a $5 million five-year interest rate swap where the notional amount is reduced $1 million each year after year one. However, the Board is not permitting derivatives with amortizing notional amounts in which the notional amount is indexed to another financial instrument. For example, a credit union cannot enter into an interest rate swap where the notional amount declines based on the amount and frequency of repayments of a reference mortgage pool or portfolio. In such circumstances, the reference index is known but the amounts are unknown and can vary throughout the term of the contract. This adds significant uncertainty to the performance of the derivative, resulting in modeling and pricing complexity that is inconsistent with the objectives of this final rule.

(4) Treasury Futures. A Treasury future is an IRR management tool and a contractual obligation to either buy (take delivery of) or sell (make delivery of) U.S. Treasury notes on a specified date in the future. The final rule restricts permissible Treasury futures to those that deliver Treasury notes (Treasury notes with maturities of up to 10 years, as compared to Treasury bonds which have maturities greater than ten years).

(5) Forward Starting. A forward start date is a characteristic of an interest rate swap that allows the start date of the exchange of interest rate payments to begin at some date in the future. The Board is permitting forward start dates of up to 90 days from the date the credit union executes the transaction. The Board believes that longer forward start dates can impose undue risk on a credit union.

As discussed in more detail below in the section on applications, a credit union must demonstrate that it has the need for, and capacity to manage, the type of derivatives and associated characteristics it is seeking. Accordingly, in its application for derivatives authority, a credit union must specify which type(s) of derivative(s) it is requesting, include a description of each type of derivative it seeks to use, a discussion of how the type of derivative(s) fits within its IRR mitigation plan, and a justification and statement of use for each type of derivative.

The Board notes that this requirement is different from the proposed rule, which permitted any approved credit union to use interest rate swaps or interest rate caps without specifically applying for these types of derivatives. With an expanded list of permissible derivatives and characteristics in the final rule, the Board believes it is necessary and prudent for credit unions to specify how each requested type of derivative fits in the credit union's unique asset-liability structure and IRR mitigation plan. The Board believes this system in the final rule appropriately balances an expanded list of permissible derivatives and safety and soundness.

The Board notes that a credit union may subsequently apply for additional types of derivatives or characteristics that it does not seek in its original derivatives authority application. The final rule includes procedures for applying for authority to use additional types of derivatives.

The Board believes the types of derivatives and characteristics in this final rule will provide credit unions with effective tools to hedge IRR. NCUA's analysis of other derivatives and characteristics suggested by commenters, in particular swaptions and interest rate collars, did not warrant inclusion of these derivatives transaction types at this time. The Board determined that the other types of derivatives suggested by commenters added higher levels of complexity and risk without adding to a credit union's IRR mitigation strategy. The Board believes the expanded list of derivatives it has included in the final rule will allow a credit union to successfully use derivatives as part of its IRR mitigation strategy.

The Board reiterates that derivatives are only one tool for credit unions to mitigate IRR and are not the only way credit unions should be managing this risk. The Board believes that the expanded list of derivatives and characteristics in the final rule will provide credit unions with additional, meaningful tools to mitigate IRR. The Board notes that as part of its annual review of one-third of all regulations, it will reconsider the requirements of this rule within 36 months from its effective date.

Finally, the Board notes that all derivatives under this final rule must have the characteristics adopted in this final rule, unless a credit union receives NCUA's approval for a differing characteristic.

In addition to the characteristics in the proposed rule, the Board is also including one new item and revising another. First, the final rule includes a requirement that all derivatives used by credit unions meet the definition of a derivative under generally accepted accounting principles (GAAP). This requirement will ensure that credit unions are using derivatives in such a way to be recognized as such under GAAP, and preclude transactions that result in a form of lending or borrowing.

Second, the Board is increasing the maximum maturity to 15 years. In the proposed rule, the Board set a maximum maturity limit for Level I authority of seven years and at ten years for Level II. The Board believes this change will allow credit unions to effectively hedge various points on the yield curve and allow for longer-term assets, like mortgages, while at the same time preventing an excessive exposure to very long maturities. As discussed below, the Board has imposed a new maturity weighted notional limit on the aggregate derivative portfolio, which will account for the risk of derivatives with longer maturities.

*(f) Derivatives Authority (§ 703.103 and Appendix A)*

(1) Structure

The final rule reflects the Board's determination that all credit unions using derivatives should adhere to one set of regulatory requirements. In the final rule, the Board has eliminated the

''Level I'' and ''Level II'' derivatives authority structure in the proposed rule. This structure permitted eligible credit unions to apply for either Level I or Level II authority; each level had different permissible limits and regulatory requirements. Many commenters believed that some of the regulatory requirements outlined in the proposed rule were overly burdensome and could restrict credit unions from effectively using derivatives.

Based on these comments, the Board determined that this structure does not efficiently administer a derivatives regulatory framework. Therefore, the Board has eliminated the two level authority structure and has adjusted many of the regulatory requirements. The Board believes the final rule is less prescriptive and more efficient for credit unions, but also retains the necessary safety and soundness provisions.

The final rule introduces ''entry'' and ''standard'' limit authorities. The two authorities differ only by the permissible limits under which a credit union must operate. The limits are as follows:

| | Entry limits (% of net worth) | Standard limits (% of net worth) |
|---|---|---|
| Total fair value loss | 15 | 25 |
| Weighted Average Remaining Maturity Notional (WARMN) | 65 | 100 |

When initially granted its authority, a credit union must first operate under the entry limits for one year before it can increase the volume of its activities under the standard limits. A credit union that has engaged in derivatives for a continuous period of one year (beginning on the trade date of its first derivatives transaction) will automatically progress from the entry limit to the standard limit, unless it has received written notice from NCUA of relevant safety and soundness concerns. It is not necessary for a credit union to submit an additional application to progress from the entry limits to the standard limits. The Board notes that relevant safety and soundness concerns are ones that undermine the credibility of the credit union's management of its derivatives program or expose the credit union to undue risk. NCUA will make this determination on a case-by-case basis, taking into account the overall condition of the credit union and the severity of the safety and soundness concerns.

The Board believes the one-year entry period will allow credit unions to obtain experience with derivatives to ensure their programs are safe and sound. This period also provides NCUA with an opportunity to examine a credit union's actual use of derivatives before that credit union begins using the higher limits in the standard limit authority. While credit unions in NCUA's derivatives pilot program must apply to maintain their derivatives authority under this final rule, most of them will meet the one year of activity threshold and may immediately use standard limit authority after they are approved. The following discussion provides a description of the fair value and notional limits.

(2) Description of Fair Value Loss and Notional Limits (§ 703.103 and Appendix A)

The proposed rule included a notional limit for interest rate swaps, a book value limit for interest rate caps, and a combined notional and book value for all derivatives positions. In addition, the Board also proposed a fair value loss limit for interest rate swaps and a maturity limit based on weighted average positions for all derivatives.

Approximately half of the commenters suggested ways the Board could improve the limit structure. Commenters focused on the measurements for interest rate swaps and interest rate caps, and on the problematic aspects of a mixed attribute limit methodology that combines a notional limit for interest rate swaps with a book value for interest rate caps.

Some commenters suggested using total assets as a notional limit versus a net worth percentage and recommended increasing the maximum maturity limits to account for longer duration assets, like mortgages. Other commenters suggested adjusting the notional amounts of derivatives for time to maturity to account for a lower degree of risk for shorter maturity transactions. Finally, with respect to the fair value loss limit, commenters requested NCUA include the changes in fair value in the underlying hedged item (i.e. the corresponding asset or liability) along with the derivative for the regulatory limit.

First, the Board has eliminated the proposed maximum weighted average maturity limits. Instead, it has adopted a single maximum maturity limit for all derivatives transactions of 15 years.

Second, the Board has replaced limits on individual derivative instruments with a consolidated fair value loss limit and weighted average remaining maturity notional (WARMN) limit for all derivatives transactions. The Board believes this approach holds risk exposures at a more constant degree regardless of maturity, and is more reasonable and effective to implement and monitor.

(i) Considerations for Notional and Fair Value Loss Limits

The Board recognizes that notional amounts, in and of themselves, do not constitute the economic risk exposure of derivatives. Rather, they serve as the reference principal amount upon which parties in a derivatives transaction calculate periodic payments. The notional amount of a derivative contract does not directly represent the actual amounts exchanged or the overall exposure to credit and market risk. In addition, the Board is aware that not all derivatives have the same price sensitivity to changes in interest rates and using a simple gross notional limit could be unduly restrictive.

The Board faced a similar challenge in determining how to implement a fair value loss limit for transactions that are presumed to be used as IRR hedges, where the change in the fair value of the hedged item (asset or liability) could potentially offset the change in the value of the derivative, which is not considered in the fair value loss limit.

However, derivatives can create incremental financial and operation risk. Thus, at this time, the Board believes that a well-constructed limit on total derivatives activity is a critical piece of an effective regulatory framework for derivatives.

The Board seeks a limit framework that is as simple as possible, while providing sufficient authority for credit unions to achieve meaningful reductions in their IRR and recognizing derivatives should not be the sole mitigation strategy for extraordinary levels of IRR. Therefore, the final rule limits derivatives exposure with two related measures, a measure of the notional amount of derivatives outstanding and a fair value loss limit.

The limits are designed to work in tandem, with the notional limit a prospective limit on a credit union's derivatives activity and the fair value loss limit based on the actual performance of the derivatives held by the credit union.

• Fair Value limit. The fair value loss limit for derivatives transactions in the final rule is 15 percent of net worth for ''entry'' authority, and 25 percent of net worth for ''standard'' authority. These limits are for all derivatives positions outstanding on the date a credit union reports its transactions. The fair value limit, if breached, requires a participating credit union to cease new derivatives transactions, provide written notification to NCUA, and develop and submit a corrective action plan to NCUA.

The proposed rule had established fair value loss limits for swaps only while limits for cap premiums were considered as part of the notional limit. The Board believes that simplifying the framework to have one fair value limit for all derivatives positions is an effective approach in governing credit union's derivatives activity.

Many of the commenters suggested that the Board consider a methodology that takes into account the offsetting effect of the hedged item. Commenters maintained that this approach would better align with the strategy of using derivatives for risk mitigation where the associated gain (loss) from the hedged item would have an offsetting gain (loss) to the derivative. The Board considered this approach and has concluded that doing so would add too much complexity. As such, the limit methodology is based upon the derivatives positions only. The Board believes this approach is more transparent and more straightforward to monitor, measure, and control.

Credit unions calculate the fair value loss by totaling the fair value gains and losses on all of its outstanding derivatives positions. If this sum results in an aggregate net loss, the credit union must compare the loss amount, expressed as a percentage of net worth, to the applicable fair value loss limit. Appendix A of the final rule defines what constitutes a gain or a loss and provides an example of how the fair value loss amount should be reported for each of the permissible derivative types (swaps, options, and futures).

Unlike the proposed rule, the final rule requires credit unions to calculate the aggregate gain (loss) for options. As noted above, the proposed rule only required this calculation for swaps. An option's gain or loss is the difference between the option's fair value and its corresponding unamortized premium on the date the credit union reports its transactions. The Board recognizes that credit unions may amortize the upfront premium paid to purchase a cap or floor over the life of the option. In order to determine a gain or loss on an option, credit unions should use the unamortized balance on an option at the reporting date to determine the gain (loss) amount.

• Weighted Average Remaining Maturity Notional (WARMN) limit. This limit on the notional amount of derivatives outstanding takes into account the type of derivative and time to maturity, two key components that determine an instrument's sensitivity to interest rate changes. This innovation provides significant flexibility under the rule and improves the relationship between the notional limit and the fair value limit. The WARMN calculation is designed to correspond to the net worth at risk (15% and 25% for entry and standard limits) in an interest rate shift of 300 basis points. While the WARMN limit corresponds to a fixed percentage of net worth (65% and 100% of net worth for entry and standard limits), the maturity weighting method provides for higher gross notional amounts for shorter duration derivatives portfolios, but lower gross notional amounts for longer duration derivatives portfolios.

The Board received several comments on the effectiveness of applying a notional limit to a derivatives program. Commenters expressed concern that a simple notional limit does not represent the true economic risk of a transaction, and requested that if it proceeded with this type of limit the Board consider weighting the notional exposure by time (maturity) and its respective price sensitivity. By doing so, it would make a notional limit more consistent with the actual price risk of the underlying transaction (shorter maturity derivatives could have higher permissible notional amounts than longer maturity ones).

The Board acknowledges that the notional amount of a derivatives contract does not directly represent the amount of risk in a transaction and other factors, such as the derivative type and its tenor, are key risk drivers. For example, interest rate floors and interest rate caps will have lower sensitivity to interest rate movements given the inherent structure of the instruments. To better account for the varying price sensitivities between interest rate options and interest rate swaps, the Board incorporated adjustment factors into the limit calculation methodology that keep these different product types roughly comparable from a risk exposure standpoint.

The notional limit methodology has been adjusted to take into account the impact of average life and maturity on a transaction's price sensitivity (its risk). The methodology scales exposure limits based on years and uses a ten-year maturity as the basis for assigning relative weights. The notional limit in the final rule has been designed to provide credit unions with a constant level of total risk assumption capacity. This allows for increased notional capacity for derivatives that have shorter terms and as they approach maturity by weighting notional amounts based on the underlying derivatives' remaining time to maturity. This better accounts for the risk and permits greater flexibility to replace maturing hedges. NCUA established the maximum transaction limits after taking into account the projected price sensitivity of options and swaps in the current market and stressed for an instantaneous, parallel, and sustained shock in the yield curve of 300 basis points. This allows for significant price moves over time and creates room within which credit unions can actively manage exposures.

The Board has adopted a conservative approach for calculating the WARMN by prohibiting the netting of offsetting transactions for limit measurement purposes (i.e. pay-fixed swap transactions which were offset with receive-fixed swap transactions must show the total notional amount of both transactions). Rather than netting offsetting transactions, the rule requires all transactions to be cumulatively aggregated. The notional limit in the final rule applies to all derivative transactions. Credit unions must calculate the WARMN limit to determine compliance as detailed in Appendix A of the final rule.

The following are definitions and a calculation example as follows:

(A) Interest rate swaps—The total of all notional amounts regardless of whether a pay fixed, receive fixed, or basis transaction are used. Netting or offsetting of transactions when done for risk reducing purposes are to be reported gross for the calculation of adjusted notional for limit purposes. Transactions with amortizing notional amounts must use the current notional amount as per the amortization schedule at the reporting date.

(B) Interest rate options—The total of all notional amounts for caps and floors are reduced by two-thirds (factored down to 33 percent of the total). Reducing the gross notional amounts for caps and floors by two-thirds approximates the reduced price sensitivity of options compared to interest rate swaps.

(C) Futures—U.S. Treasury note futures will use the underlying contract size for notional limits. For example, a 5-year Treasury note futures contract with an underlying contract size of $100,000 will use $100,000 of notional as a five-year maturity.

An illustration with definitions and calculations is included in Appendix A of the rule.

The Board believes the limit structure described above balances ease of calculation for credit unions with a meaningful and accurate measure of risk associated with using derivatives.

*(g) Collateral, Margining, and Counterparty Management (§ 703.104)*

Two sections in the proposed rule addressed collateral and counterparty requirements for credit unions operating a derivatives program. The collateral requirements in the proposed rule specified the permissible types of collateral, the respective margining, and the minimum transfer requirements. In the section addressing counterparties, the proposed rule included requirements on who is a permissible counterparty and the requirements for the credit union to manage the counterparty credit risk.

Approximately half of the commenters addressed either or both of the proposed requirements for collateral or counterparties. All of the commenters that addressed the collateral requirements suggested a more expansive list of permissible collateral types. Some commenters suggested permissible collateral include agency pass-through residential mortgage-backed securities, callable agency debentures from government sponsored enterprises (GSEs), and collateralized mortgage obligations. Other commenters suggested that NCUA's collateral requirements align with the Chicago Mercantile Exchange's eligible collateral requirements for cleared swaps.

For collateral requirements, some commenters believed the requirement to support pricing collateral daily would be too costly and unnecessary and should be less stringent. Others urged NCUA not to impose margining rules at this point, but rather wait until relevant rules required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) *http://www.hblr.org/2013/04/margin-costs-of-otc-swap-clearing-rules/_ftn11* are promulgated.

Only a few commenters addressed the issue of counterparties. These commenters believed the rule should be expanded to include additional counterparties, like Federal Home Loan Banks.

Based on comments and the implementation of CFTC swap clearing regulations, the Board has amended the sections on collateral and counterparties to address swap clearing, expansion of the permissible types of collateral, and streamlining the requirements for credit unions.

(1) CFTC Swap Clearing

Since the promulgation of the proposed rule, the CFTC finalized rules that provide credit unions with an End-User Exception or Cooperative Exemption from swap clearing. The CFTC's final rules on derivatives clearing requirements were required by the Dodd-Frank Act. Title VII of the Dodd-Frank Act imposes comprehensive changes in the regulatory framework for derivatives and includes amendments to the Commodity Exchange Act (CEA) and the Securities Exchange Act of 1934. This new section makes it unlawful for any person (including financial institutions) to engage in a swap that the CFTC has determined requires clearing unless the person submits the swap for clearing to a derivatives clearing organization (DCO) or an exception applies. Clearing changes the traditional relationship between counterparties by placing a clearinghouse intermediary between counterparties.

The two CTFC exceptions are the End-User Exception, which applies to small financial institutions with total assets of $10 billion or less and the Cooperative Exemption, which applies to entities with assets greater than $10 billion where the entity is a cooperative. The CFTC's definition scope includes credit unions. Therefore, all credit unions have the exceptional right, as cooperatives, to elect to either clear swaps or engage in a traditional bilateral agreement. The Board notes that the clearing structure only applies to swaps as of the date of this rule.

For cleared derivatives transactions, each party to the swap submits the transaction to a DCO for clearing. This reduces counterparty risk for the original swap participants in that they each bear the same risk attributable to facing the intermediary DCO as their counterparty. In addition, DCOs exist for the primary purpose of managing credit exposure from the swaps being cleared and therefore DCOs are effective at standardizing transactions and mitigating counterparty risk through the use of exchange-based risk management frameworks.

Finally, swap clearing requires both counterparties to post collateral (i.e. initial margin) with the clearinghouse when they enter into a swap. The clearinghouse can use the posted collateral to cover defaults in the swap. As the valuation of the swap changes, the clearinghouse determines the fair market value of the swap and may collect additional collateral (i.e. variation margin) from the counterparties in response to fluctuations in market values. The clearinghouse can apply this collateral to cover defaults in payments under the swap.

(2) Changes in the Final Rule

The Board has merged the two proposed sections addressing collateral and counterparties and made conforming changes in the final rule. First, the Board has included in the final rule that any credit union using exchange traded or cleared derivatives must comply with the applicable exchange or DCO regulations on these types of derivatives. Second, for non-centrally cleared derivatives, the Board has retained many of the requirements in the proposed rule, but has also made several changes to address comments it received.

(i) Collateral and Margining

Exchange traded or cleared swap transactions are subject to the clearing member's requirements, which is regulated by the respective exchange or DCO's eligible collateral requirements. The current eligible collateral by these exchanges are within the investment authority granted under the Federal Credit Union Act for credit unions. Margining requirements are also promulgated by the exchanges and DCO's, and would be consistent with an initial margin and daily variation margining with no minimum transfer amounts.

For non-centrally cleared transactions, the Board has retained all of the proposed requirements. However, the Board has expanded the list of permissible collateral types to include GSE issued agency residential mortgage-backed securities and GSE debentures. The Board agrees with commenters that these types of collateral may be useful for credit unions and do not pose significant liquidity risks when used for this purpose. The Board recognizes, however, that the counterparty may limit the eligible collateral list to less than the permissible authority. Margining for non-cleared transactions as part of a bilateral credit support annex must still have a minimum transfer amount of $250,000.

(ii) Counterparties

With respect to counterparties, the Board addresses the different arrangements a credit union may have given clearing requirements, the ability of credit unions to use exchange-traded derivatives, and applicable exemptions that credit unions can use for non-centrally cleared derivatives. The Board included in the final rule that credit unions must use CFTC registrant swap dealers, introducing brokers, and futures commission merchants whether using cleared or non-cleared derivatives clearing or non-clearing. However, the Board has eliminated major swap participants (MSP) as permissible counterparties. The Board notes that MSPs are substantial holders of derivatives positions and may not be in the market of dealing derivatives to other parties. Swap dealers and introducing brokers, however, regularly act as counterparties in the ordinary course of business as dealers to derivatives transactions. The Board believes swap dealers and introducing brokers are a sufficient universe of counterparties for credit unions to execute transactions, consistent with the safe and sound operation of a derivatives program.

*(h) Reporting Requirements (§ 703.105)*

The proposed rule required senior executive officers of a credit union with Level I or Level II authority to report to the credit union's board of directors at least monthly on the following topics: Noncompliance, utilization of limits, itemization of the credit union's positions, the credit union's financial condition, and the cost of executing new transactions. Less than a quarter of the commenters addressed the issue of reporting requirements. All of these commenters disagreed with the requirement of monthly reporting, instead favoring quarterly reporting.

After further evaluation, the Board is amending this section by requiring that senior executive officers, and, if applicable, the credit union's asset liability committee, receive derivatives reports from credit union staff on a monthly basis and the credit union's board of directors receive derivatives reporting from the credit union's senior executive officers at least quarterly. The Board is retaining the requirements of what must be included in these reports from the proposed rule, with a few minor technical amendments. The technical amendments conform to the other changes the Board has made throughout the rule. The Board believes these changes are less burdensome, while ensuring the proper credit union officials receive the reports that are necessary to oversee the credit union's derivatives program.

*(i) Operational Requirements (§ 703.106)*

The proposed rule contained requirements relating to a credit union's personnel, internal controls structure, transaction management, and asset liability management (ALM). The Board has made several changes to this section to simplify and consolidate the requirements, and make this section of the rule less burdensome while retaining elements necessary to ensure a safe and sound derivatives program.

(1) Personnel

(a) Board of Directors and Senior Management

The proposed rule set minimum knowledge and experience requirements for a credit union's board of directors and senior management. Specifically, the rule required that a credit union's board of directors complete derivatives training before a credit union could begin a derivatives program and annually thereafter. The proposed rule also required that senior executive officers have sufficient experience and knowledge to oversee the credit union's derivatives program.

Most commenters did not address the experience requirements for a credit union's board of directors and senior executive officers. However, a few commenters felt the training and experience requirements for credit union board members are excessive and unwarranted. These commenters requested that the Board eliminate this requirement, arguing that the board members do not need annual training on this topic.

The Board believes that a credit union's board of directors and senior executive officers need to have sufficient experience and knowledge to effectively oversee and effectuate a derivatives program. Therefore, the Board is retaining the proposed requirements. However, the Board is deleting the provision that requires a credit union to provide notification to NCUA when positions become vacant and documentation evidencing knowledge and experience for any new senior executive officer. This deletion is a reduction in regulatory burden that the Board believes will help credit unions administer a derivatives program more efficiently, without sacrificing safety and soundness.

(b) Qualified Derivatives Personnel

The proposal also required a credit union to have qualified derivatives personnel. The rule required the qualified derivatives personnel to have three or five years of direct transactional experience with derivatives based on the level of authority for which a credit union was approved. The qualified derivatives personnel are responsible for ALM, accounting and reporting, trade execution, and credit and collateral management.

The majority of the commenters that addressed the qualified derivatives personnel requirement argued against the proposed experience requirements. Commenters believed the proposed experience requirements would result in large expenses to a credit union in its attempt to attract and retain qualified individuals. Some commenters argued that the experience requirements were arbitrary, unrealistic, and unattainable. As alternatives, commenters suggested shorter experience requirements or allowing credit unions to substitute capital markets experience in place of derivatives experience. Some commenters also suggested that the final rule allow greater use of external service providers as an alternative to having qualified derivatives personnel (relaying on external service providers is addressed in additional detail in the section on ESPs).

After careful consideration, the final rule does not require a credit union to have one or more employees with a specific number of years of experience. Rather, the final rule addresses the overall experience of the credit union staff overseeing the credit union's derivatives program. To that end, the Board has replaced the specific years of experience requirement with a general requirement that a credit union have staff with commensurate experience in the following areas: ALM; accounting and financial reporting; derivatives trade execution and oversight; and counterparty, collateral, and margining.

With respect to the qualified derivatives personnel having experience with ALM and transaction management, the Board has retained the requirements on these topics from the proposed rule. The Board believes that the addition of an effective derivatives program should include enhanced capacity by the credit union staff to analyze and understand the credit union's IRR.

In particular, a derivatives program will require enhanced capacity to estimate the credit union's earnings and economic value based on the market's expectation of future interest rates and any potential changes from these expectations. While a projection of income over a short period of time is customarily used by credit unions for financial planning, the Board believes that the longer maturity and increased complexity of permissible derivatives contracts will require credit unions to project their earnings over longer periods of time. In addition, because interest rate derivatives are priced using the forward interest rate curve, and the value of these contracts changes when there is a shift in the market's expectation of future interest rates, credit unions need to incorporate the forward interest rate curve into their baseline assumptions. It is important for the credit union to consider its earnings and economic value in the context of these forward rates, and how changes from these forward rates would affect the institution's projected financial performance. Moreover, analyses of the effects of changing interest rates should include both parallel and non-parallel changes in rates over the maturity spectrum (both a flattening and steepening of the yield curve).

The Board believes these changes reduce the overall expense and burden on the credit union, while ensuring that credit unions have adequate experience to manage a derivatives program. As discussed below, before a credit union can begin using derivatives, NCUA will ensure that the credit union has staff with the experience necessary to comply with this section. While credit unions are not required to obtain staff with a specific length of experience, the Board notes that it may be necessary for a credit union to hire outside staff to comply with this section of the rule.

(2) Internal Controls Structure

The proposed rule required credit unions engaging in derivatives to maintain adequate internal controls, including proper separation of duties, a written and schematic description of the derivatives decision process, an internal controls review, a financial statement audit, legal review, and a hedge review.

Few commenters addressed the internal controls structure requirements. However, the comments the Board did received argued that experience requirements for attorneys to conduct a legal review and the requirement for an internal controls review conducted by an external auditor were overly burdensome, costly, and unnecessary.

Based on comments and a reevaluation of the rule, the Board has significantly condensed and simplified the internal controls structure requirements. The Board has retained the requirement for a credit union to maintain a process and responsibility framework that visually demonstrates the derivatives decision process. The Board has also retained the required separation of duties without amendment.

In response to commenters, however, the Board is amending the section on internal controls review to indicate that a credit union must only obtain this review for the first two years of its derivatives program. The Board believes that an internal controls review is only needed for the first two years of a derivatives program, as that will be the time when the credit union is implementing and expanding its internal controls.

The final rule also provides that this review may be conducted by a credit union's internal auditor, if it has one. The Board believes that if credit union has an independent auditor on staff, it is not necessary for the credit union to bear additional expense to produce this review.

The Board has also moved the requirement for a legal review to the section addressing collateral and counterparties. The proposed rule required a credit union to obtain counsel with at least five years of experience with derivatives transactions. Based on public comment, the Board is not including this experience requirement in the final rule.

Finally, the Board is retaining the proposed requirements for a financial statement audit and a hedge review. However, the Board is eliminating the requirement that the person conducting the financial statement audit have at least two years of experience with derivatives. The Board has reconsidered this requirement and does not believe it is necessary for a financial statement auditor to have a specific number of years of experience with derivatives. However, the Board believes a credit union should use a person or persons that have relevant experience accounting for these instruments.

(3) Policies and Procedures

The proposed rule required credit unions to maintain and operate according to written, comprehensive policies and procedures. The proposal required that these policies and procedures cover the following topics: The scope of activities; risk management; accounting and reporting; limits; and oversight and responsibilities. In addition, the proposed rule required a credit union's board of directors to review the policies annually and update them when necessary.

One commenter maintained that credit union board members should not be required to review the policies and procedures for a derivatives program. This commenter did not provide a justification for the comment. The Board continues to believe that a credit union should operate according to written policies to govern the credit union's staff operations of the derivatives program. However, the Board does not believe the final rule needs to be as prescriptive as the proposed rule. The Board, therefore, has eliminated the list of specific items a credit union must have in its policies and procedures and moved this section to the section addressing operational requirements.

In the final rule, the Board requires credit unions to have policies and procedures that address everything in the rule, except for sections relating to applications, pilot program credit unions, regulatory violation, and eligibility. In addition, the Board is retaining the requirement that a credit union's board of directors reviews these policies at least annually, and updates them when necessary. The Board continues to believe that it is important for a credit union's board of directors to update the credit union's policies and procedures as the condition of the credit union and its market position change.

*(j) External Service Providers (ESPs) (§ 703.107)*

The proposed rule restricted who a credit union could use as an ESP and indicated what activities an ESP could conduct or support for the credit union. The proposal defined ''support'' as having the credit union conduct the function with assistance from an ESP and ''conduct'' as allowing an ESP to conduct a function with the credit union's oversight. Credit unions approved for Level I derivatives authority were permitted to have ESPs conduct more activities than credit unions approved for Level II derivatives authority. The proposed rule contemplated that credit unions with Level II authority would have less reliance on ESPs and be able to conduct more activities independently, in-house.

Several commenters argued that the restrictions on the use of ESPs were too great. These commenters argued that ESPs are an efficient and inexpensive means to safely and soundly conduct a derivatives program. These commenters sought to use ESPs for most of the functions needed to successfully carry out a derivatives program, as opposed to employing high cost internal derivatives personnel.

The Board agrees that, if properly managed, ESPs can be an efficient and cost effective way to carry out many of the functions of a derivatives program. Based on the comments and NCUA's staff evaluation, the Board is amending the section of the rule addressing ESPs.

Most notably, the Board is eliminating a majority of the provisions that describe the activities an ESP can conduct and support. The final rule permits a credit union to use ESPs for most functions, provided the credit union complies with the other requirements related to ESPs. However, the Board is retaining the requirement that a credit union must internally and independently conduct ALM and liquidity risk management. The Board believes these two functions are fundamental to a credit union's understanding of derivatives and how they fit into its IRR mitigation strategy. The Board notes that while a credit union must conduct these functions internally it may obtain assistance from ESPs, for example use of ESP produced software and modeling tools. The Board believes this change makes the final rule clearer and easier for credit unions to follow, and also makes it less burdensome and costly for credit unions to administer a derivatives program.

The Board is also retaining the restrictions on who cannot be an ESP. The Board believes these restrictions are necessary to preclude conflicts of interest. The Board is also retaining requirements that a credit union have the internal capacity and experience to oversee and manage any ESP and that the credit union documents the specific use of ESPs in its process and responsibility framework. While the Board believes ESPs can be a safe and sound way to conduct many functions, the Board reiterates that NCUA considers anything produced by an ESP as the product of the credit union. Therefore, it is necessary that the credit union have the internal capacity and expertise to ensure the work done by ESPs is accurate and sufficient for its purposes. Also, NCUA staff will use the process and responsibility framework in conjunction with a credit union's application to determine if the use of ESPs is proper and if the credit union can effectively manage the use of ESPs.

*(k) Credit Union Eligibility (§ 703.108)*

The proposed rule required a credit union applying for either Level I or Level II authority to provide an IRR mitigation plan; have a CAMEL rating of 1, 2, or 3, with a management component of 1 or 2; and have assets of at least $250 million. In addition, any credit union applying for Level II had to demonstrate why the limits under Level I are insufficient.

As noted above, the eligibility requirements were one of the most commented on topics. Approximately half of the commenters addressed this issue. All but one commenter argued that the Board should reduce or eliminate the asset threshold in the proposed rule. These commenters argued that an asset threshold of $250 million is arbitrary and would exclude credit unions that need, and are capable of engaging in, derivatives transactions. Also, one commenter did not believe that the rule should contain a restriction on credit union participation based on CAMEL ratings. This commenter argued that some lower CAMEL rated credit unions may need, and be able to successfully manage, a derivatives program.

The Board continues to believe that a $250 million asset threshold and a CAMEL rating based eligibility requirement will ensure that well-managed credit unions that need derivatives to mitigate IRR are able to obtain this authority. However, the Board recognizes that there may be some credit unions with assets under $250 million that need and are capable of effectively managing a derivatives program.

The Board, therefore, is retaining the eligibility requirements in the proposed rule, but is including a provision in the final rule that provides an NCUA field director with the authority to permit a credit union that has assets under $250 million to apply for derivatives authority. The field director will only permit a credit union that does not meet the asset threshold to apply if he or she concludes that the credit union needs derivatives to manage its IRR and can effectively manage a derivatives program. Further, a field director may set additional stipulations or conditions related to the application of a credit union that is below the $250 million asset threshold. The Board believes this provision gives field directors flexibility to determine if a credit union that does not meet the asset threshold can benefit from and effectively manage derivatives. A field director may not, however, permit a credit union that does not meet the CAMEL code eligibility requirements to apply for derivatives authority. The Board believes it is crucial for a credit union to be well run and in sound financial condition to take on the additional complexity of derivatives.

*(l) Application Process, Content, and Review (§ 703.109–§ 703.111)*

The proposed rule included a detailed procedure for credit unions to apply for one of the two levels of authority. The proposed application process required credit unions to submit an IRR mitigation plan. In addition, credit unions were required to obtain all necessary personnel, systems, and infrastructure before the credit union could apply for Level II authority.

Approximately ten percent of the commenters addressed the application process. The majority argued against the upfront costs associated with applying for Level II derivatives authority. These commenters believed that a requirement to have systems, processes, and personnel in place before receiving approval was inefficient and could lead to a waste of institution resources. Several other commenters were in favor of a more streamlined application process. These commenters believed that the propensity for rising interest rates in the near term warrants a quicker application process.

In response to commenters, the Board has replaced the requirement that credit unions obtain all necessary personnel and infrastructure before NCUA grants approval with a more streamlined application process. The changes are highlighted below.

(1) Applying for Derivatives Authority

The Board is retaining the requirement that a credit union seeking derivatives authority must submit a detailed application to the appropriate field director.

(2) Application Content

The Board is retaining the required application content items, but has expanded on each to ensure clarity in the final rule. The Board has also included a requirement that the credit union include a list of the types of derivatives and characteristics it is applying for and a business justification for each. The Board believes the clarifying changes it made in this section will make it easier for credit unions to submit a complete and accurate application, which will help NCUA expedite its review.

(3) NCUA Approval

Consistent with amendments to the section on derivatives authority, the Board is amending this section to increase the efficiency of NCUA's application review process, as well as allow credit unions to receive an approved application before procuring all necessary resources.

In lieu of requiring a credit union to obtain all necessary personnel and systems before receiving final approval, the Board is amending the application review process. This process is made up of the following steps:

(i) Interim Approval

First, a credit union must submit a detailed application to NCUA. This application must include all of the information in the application content section, which NCUA may further clarify through guidance. While the Board has eliminated a deadline for NCUA to review and approve or deny an application, the Board notes that NCUA's goal is to respond to every application within 60 days.

(ii) Acquisition of Infrastructure To Comply With the Rule

A credit union that receives approval of its application must then acquire all of the personnel and systems that are necessary to comply with this final rule. The Board recognizes that each credit union will have its own approach to establishing its infrastructure and that this acquisition period may vary from credit union to credit union.

(iii) Notice of Readiness

Once a credit union has acquired and implemented all of the necessary elements to comply with this rule, it must notify NCUA that it is ready to begin using derivatives.

(iv) Final Approval

After NCUA receives a notice of readiness, it will review the credit union's derivatives program to ensure the credit union is in compliance with this final rule. The Board notes that a credit union may not begin using derivatives until it receives this final approval. NCUA's goal is to provide approval or denial within 60 days from the date it receives the notice of readiness. In rendering a decision, NCUA may conduct an onsite review to verify the credit union is ready and able to start using derivatives. In addition, NCUA may permit a credit union it denies to remedy any deficiencies in its program and reapply. However, reapplication is solely at the discretion of the applicable field director and reapplication efforts do not ensure that a denied credit union will receive authority if deficiencies persist.

Finally, the Board notes that a credit union may choose to submit an application after acquiring all of the necessary resources. In this situation, it is not necessary for the credit union to submit a separate notice of readiness. NCUA's goal is to approve or deny these applications within 120 days from the date it receives the credit union's complete application and request for final approval. Again, the Board notes that this process will only apply to a credit union that has acquired all of the necessary resources and is ready to begin using derivatives when it applies.

The Board believes this new application structure is more efficient and streamlined and allows a credit union to receive interim approval of its application before expending resources to acquire the infrastructure necessary to operate a derivatives program in compliance with this final rule.

*(m) Application for Additional Derivatives and Characteristics (§ 703.112)*

Consistent with changes made to the permissible derivatives section, the Board has included in the final rule a description of how a credit union applies for additional derivatives and characteristics which it did not request in its initial application. This section requires that a credit union seeking an additional derivative type or characteristic submit an application to the applicable field director. The application must include a list of the additional derivatives and characteristics that the credit union is applying for, and justification and explanation of the need for each of the additional derivatives and/or characteristics. NCUA's goal is to issue a decision on a credit union's application for additional derivatives or characteristics within 60 days from date of receipt of the credit union's request. The Board believes this application system will allow NCUA to grant authority for additional derivatives only to credit unions that need and can manage these additional derivatives and characteristics, while providing credit unions with additional variations of derivatives transactions to mitigate their IRR. Similar to appeal rights granted in the final rule relative to entry level applications, if NCUA denies an application for additional derivatives and characteristics, a credit union may appeal any denial to the Board within 60 days of the denial from the field director.

*(n) Pilot Program Participants (§ 703.113)*

The proposed rule required that any credit union in NCUA's derivatives pilot program comply with the requirements of the rule within 12 months from its effective date. Any credit union that fails to comply within 12 months must stop entering into new derivatives transactions and, within 30 days, present a corrective action plan to the appropriate field director, explaining how it will come into compliance or safely unwind its program.

Several commenters addressed the issue of pilot program participants being required to apply for derivatives authority. All of these commenters argued that pilot program participants should be grandfathered into the rule without going through the application process. Commenters maintained that NCUA has been evaluating these credit unions for a considerable amount of time and, therefore, a separate application review process is not needed.

The Board believes the requirement for a pilot program credit union to apply for authority helps to ensure a continued safe and sound program in compliance with the final rule. Therefore, the Board is adopting the proposed section on pilot program credit unions without amendment.

*(o) Regulatory Violation (§ 703.114)*

The Board included a section in the proposed rule that provided a system of corrective action for a credit union with derivatives authority that fails to comply with the rule or has safety and soundness concerns. This corrective action system included a cessation of new transactions and a corrective action plan from the credit union to the applicable field director. The Board did not receive any comments on this section of the rule. However, the Board is amending this section to further explain the steps that a credit union must take if it fails to meet the requirements of this final rule or its approved strategy.

(1) Suspension

A credit union that no longer complies with the requirements of the final rule must immediately suspend all new derivatives activities. However, a credit union may terminate existing transactions. In addition, NCUA may permit a credit union to enter into new offsetting transactions if part of a corrective action strategy. The Board recognizes that it may be necessary for a credit union to terminate existing positions as a way to immediately come into compliance with the limits in the rule. Further, the Board believes that offsetting transactions are another means of coming into compliance with the limits in the rule. Offsetting transactions involve entering into another derivatives transaction that operates in the opposite way as a current position. For example, if a credit union has a pay-fixed swap, the offsetting position would be a receive-fixed swap with similar terms. These transactions essentially offset the risk of each other if constructed effectively. However, because this strategy involves entering into new transactions for credit unions that are already exceeding one of the rule's limits, the Board believes it is important for NCUA to approve these actions.

A credit union seeking to use offsetting transactions must make this request in its notice to the appropriate field director. As explained in the final rule, a credit union must notify NCUA within three days from the date of the regulatory violation. In addition to including a request for offsetting transactions, if applicable, the notice must also provide a description of the violation and the immediate steps the credit union is taking. This notice will allow NCUA to begin working with the credit union to develop a corrective action plan for remedying the violation.

Within 15 days from the date the credit union provides a notice of violation, it must submit a corrective action plan to NCUA. This corrective action plan, to which NCUA must agree, must describe in detail how the credit union will remedy the violation. A credit union that submits a satisfactory corrective action plan must comply with that plan until it has remedied its violation. A credit union may enter into any new derivatives transactions while it is under a corrective action plan. The Board believes this structure will help to protect the NCUSIF and the credit union from continuing and compounding violations.

(2) Revocation

In addition to a suspension of activities, NCUA may also revoke a credit union's authority granted under this final rule. Revocation will require the credit union to immediately cease any new derivatives transactions and may require the termination of existing positions. The Board notes that NCUA will only require the termination of existing positions if it determines that doing so would not pose a safety and soundness concern. The Board believes it is necessary for NCUA to have the power to revoke authority for credit unions that demonstrate that they are not capable of successfully managing a derivatives program safely and soundly.

(3) Appeals

A credit union may appeal NCUA's revocation of its authority or NCUA's determination to require the termination of existing positions. The Board believes the finality of both of these actions and the impact they will have on the credit union and its members warrants additional scrutiny through an appeals process to the Board. Further, as a credit union may not enter into any new derivatives transactions during the pendency of an appeal, the Board does not believe the time associated with the appeals process will raise any additional safety and soundness concerns.

*(p) Fees*

In the proposed rule the Board specifically requested comment on including a fee structure for those credit unions that apply for derivatives. The Board considered having a fee structure that included an application and/or a supervision fee just for those credit unions utilizing derivatives.

Most of the commenters addressed the imposition of application and/or supervision fees. All of these commenters argued that NCUA should not charge a separate fee, in any form, for derivatives authority. Some commenters questioned the actual agency costs associated with derivatives, while other commenters believed the suggested fees would establish a negative precedent. All of the commenters on this subject argued that the fees suggested by the Board would make derivatives cost prohibitive, and that, by reducing risk to the share insurance fund, credit unions with derivatives would actually be saving the agency and the industry money.

In response to those comments, the Board is not instituting a fee structure for derivatives. While the Board notes that derivatives authority is cost and labor intensive for the agency, it does not believe singling out derivatives for an authority-based fee is appropriate at this time.

*(q) Changes to Part 715*

The proposed rule included an amendment to part 715, which clarifies that all credit unions engaging in derivatives must have a financial statement audit, regardless of asset size. As noted above, the Board is retaining this requirement in the final rule. Therefore, the Board is also adopting the proposed changes to part 715 without amendment.

*(r) Changes to Part 741*

The proposed rule contained changes to Part 741 to reflect application of the rule to FISCUs. The final rule will not apply to FISCUs, so the Board is only amending this section to require that any FISCU engaging in derivatives provide NCUA with written notice at least 30 days before it begins engaging in derivatives transactions.

## IV. Regulatory Procedures

*a. Regulatory Flexibility Act*

The Regulatory Flexibility Act requires NCUA to prepare an analysis of any significant economic impact any proposed regulation may have on a substantial number of small entities (primarily those under $50 million in assets).[1] The final rule allows credit unions to enter into certain derivatives transactions to reduce IRR. Since the final rule requires credit unions seeking derivatives authority to have at least $250 million in assets, it will not have a significant economic impact on a substantial number of small credit unions.

*b. Paperwork Reduction Act*

The Paperwork Reduction Act of 1995 (PRA) applies to rulemakings in which an agency by rule creates a new paperwork burden on regulated entities or increases an existing burden.[2] For purposes of the PRA, a paperwork burden may take the form of a reporting or recordkeeping requirement, both referred to as information collections. The proposed changes to part 703 impose new information collection requirements. As required by the PRA, NCUA is submitting a copy of this final rule to OMB for its review and approval. NCUA also submitted a copy of the proposed rule to OMB for review.

1. Estimated PRA Burden

For the purposes of calculating the PRA burden, NCUA estimates that 43 credit unions will apply for and be granted derivatives authority. NCUA estimates for the final rule were modified from the proposed rule's estimates based on rule changes and feedback received during the comment period.

NCUA will grant entry limit authority to qualifying credit unions that NCUA recognizes meet the requirements of this rule. After a one year period of continuous risk mitigation with interest rate derivatives and no safety and soundness issues related to the activity, the credit union will be considered to have standard limit authority. Certain credit unions with experience mitigating risk with interest rate derivatives may be granted standard limit authority at the time of application. NCUA estimates that:

- 10 credit unions will qualify for and be granted standard limit authority;
- 33 credit unions will apply for and be granted entry limit authority;

Section 703.106(d) of the rule requires a credit union to operate according to written, comprehensive policies and procedures for control, measurement, and management of derivatives transactions. To do so, a credit union must first develop such policies and procedures. NCUA estimates that on average it will take a credit union seeking derivatives authority an average of 50 hours to develop appropriate policies and procedures. This is a one-time recordkeeping burden.

[1] 5 U.S.C. 603(a).

[2] 44 U.S.C. 3507(d); 5 CFR part 1320.

Section 703.106(d) of the rule requires a credit union's board of directors to review the derivatives policies and procedures annually and update them when necessary. NCUA estimates this ongoing recordkeeping burden will take an average of 10 hours per year per respondent.

Section 703.105(a) of the rule requires a credit union's senior executive officers to provide a quarterly, comprehensive derivatives report to the credit union's board of directors. Section 703.105(b) requires that at least monthly, credit union staff must deliver a comprehensive derivatives report to the credit union's senior executive officers. NCUA estimates this ongoing recordkeeping burden will take an average of 2 hours per respective reporting cycle (total of 8 hours per year for board reporting and 24 hours per year for senior management reporting).

Section 703.106(a)(1) of the rule requires that a credit union retain evidence of annual derivatives training for its board of directors. NCUA estimates this ongoing recordkeeping requirement will take an average of 4 hours per year per respondent.

Section 703.106(b)(1) of the rule requires that a credit union maintain a written and schematic description of the derivatives decision process. NCUA estimates that the one-time recordkeeping burden of creating the description will take 12.5 hours on average. The ongoing burden of maintaining the description will take 2 hours per year per respondent.

Section 703.106(b)(2) requires that for the first two years after commencement of its derivatives program, a credit union must have an internal controls review focused on the integration and introduction of derivatives functions. This review must be performed by an independent external unit or, if applicable, the credit union's internal auditor. NCUA estimates that an internal controls review for a credit union's derivatives program will cost approximately $50,000 each year for the first two years.

Section 703.106(b)(3) of the rule requires a credit union engaging in derivatives transactions to obtain an annual financial statement audit by a certified public accountant. Section 715.5(a) of NCUA's Regulations already requires FCUs with assets of $500 million or greater to obtain an annual financial statement audit. Currently, approximately 60 credit unions with assets between $250 million and $500 million that meet the proposed CAMEL ratings requirements do not obtain annual financial statement audits. Due to the overhead costs associated with derivatives activity, NCUA estimates that ten percent, or six, of these credit unions will apply for and be granted derivatives authority. NCUA further estimates that a financial statement audit for a credit union of this size would cost approximately $50,000.

Section 703.106(b)(4) of the rule requires a credit union, before executing any derivatives transaction, to identify and document the circumstances leading to the decision to hedge, specify the derivatives strategy the credit union will employ, and demonstrate the economic effectiveness of the hedge. NCUA estimates a credit union will execute an average of 2 transactions per year and that it will take an average of 2 hours per transaction to complete the pre-execution analysis. This results in an ongoing recordkeeping burden of 4 hours per year per respondent.

Sections 703.109, 703.110 and of the rule require a credit union seeking derivatives authority to submit a detailed application to NCUA. NCUA estimates that this one-time recordkeeping burden will take an average of 50 hours per respondent to prepare. This estimate does not include developing policies and procedures for operating a derivatives program and creating and maintaining a written and schematic description of the derivatives decision process, as those recordkeeping requirements are already accounted for above.

Section 703.114 of the proposed rule requires a credit union that no longer meets the requirements of subpart B of part 703 to submit a corrective action plan to NCUA. NCUA estimates that 3 credit unions may have to submit an action plan each year and that a plan will take an average of 10 hours to prepare.

Section 741.219 requires a FISCU to notify NCUA in writing at least 30 days before it begins engaging in derivatives. This notice will be a one-time burden. NCUA estimates that 30 FISCUs will have to prepare this notice, and that the notice will take an average of 0.5 hours to prepare.

**Summary of Collection Burden**

*Written policies and procedures:* 43 credit unions × 50 hours = 2,150 hours (one-time burden).

*Board review of policies and procedures:* 43 credit unions × 10 hours = 430 hours.

*Derivatives reporting:* 43 credit unions × 32 hours = 1,376 hours.

*Evidence of board training:* 43 credit unions × 4 hours = 172 hours.

*Derivatives process description:* 43 credit unions × 12.5 hours = 537.5 hours (one-time burden).

43 credit unions × 2 hours = 86 hours.

Independent internal controls review: 43 credit unions × $50,000/year for 2 years $4,300,000 (one-time burden).

*Financial statement audit:* 6 credit unions × $50,000 = $300,000.

*Pre-execution analysis:* 43 credit unions × 4 hours = 172 hours.

*Application:* 43 credit unions × 50 hours = 2,150 hours (one-time burden).

*Corrective action plan:* 3 credit unions × 10 hours = 30 hours.

*FISCU notice:* 30 credit unions × 0.5 hours = 15 hours (one-time burden).

*Total Annual Hours Burden:* 7,118.5 (4,852.5 one-time only).

*Total Annual Cost Burden:* $4,600,000 ($4,300,000 one-time only).

*(c) Executive Order 13132*

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order to adhere to fundamental federalism principles. This final rule applies only to FCUs, and only requires a FISCU to notify NCUA in writing at least 30 days before it begins engaging in derivatives transactions. Accordingly, the rule will not have substantial direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. NCUA has, therefore, determined that this proposal does not constitute a policy that has federalism implications for purposes of the executive order.

*(d) Assessment of Federal Regulations and Policies on Families*

NCUA has determined that this final rule will not affect family well-being within the meaning of § 654 of the Treasury and General Government Appropriations Act, 1999, Pub. L. 105–277, 112 Stat. 2681 (1998).

**List of Subjects**

*12 CFR Part 703*

Credit unions, Investments.

*12 CFR Part 715*

Audits, Credit unions, Supervisory committees.

*12 CFR Part 741*

Credit, Credit Unions, Reporting and recordkeeping requirements, Share insurance.

By the National Credit Union Administration Board, on January 23, 2014.

**Gerard Poliquin,**

*Secretary of the Board.*

For the reasons discussed above, the National Credit Union Administration is amending parts 703, 715, and 741 as follows:

## PART 703—INVESTMENT AND DEPOSIT ACTIVITIES

■ 1. The authority citation for part 703 continues to read as follows:

**Authority:** 12 U.S.C. 1757(7), 1757(8), 1757 (15).

■ 2. In part 703, designate §§ 703.1 through 703.20 as subpart A under the following heading:

## Subpart A—General Investment and Deposit Activities

* * * * *

■ 3. Amend § 703.2 by revising the definitions of ''derivative'' and ''fair value'' and adding definitions of ''forward sales commitment'' and ''interest rate lock commitment'' to read as follows:

### § 703.2 Definitions.

* * * * *

*Derivative* means a financial contract which derives its value from the value and performance of some other underlying financial instrument or variable, such as an index or interest rate.

* * * * *

*Fair value* means the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date, as defined by GAAP.

* * * * *

*Forward sales commitment* means an agreement to sell an asset at a price and future date specified in the agreement.

* * * * *

*Interest rate lock commitment* means an agreement by a credit union to hold a certain interest rate and points for a specified amount of time while a prospective borrower's application is processed.

* * * * *

■ 4. In § 703.14, add paragraph (k) to read as follows:

### § 703.14 Permissible investments.

* * * * *

(k) *Derivatives.* A Federal credit union may only enter into in the following derivatives transactions:

(1) Any derivatives permitted under § 701.21(i) of this chapter, § 703.14(g), or subpart B of this part;

(2) Embedded options not required under generally accepted accounting principles (GAAP) adopted in the United States to be accounted for separately from the host contract; and

(3) Interest rate lock commitments or forward sales commitments made in connection with a loan originated by a Federal credit union.

### § 703.16 [Amended]

■ 5. In § 703.16, remove paragraph (a) of and redesignate paragraphs (b) through (d) as (a) through (c), respectively.

■ 6. Add subpart B to read as follows:

## Subpart B—Derivatives Authority

Sec.



### § 703.100 Purpose and scope.

(a) *Purpose.* This subpart allows Federal credit unions to enter into certain derivatives transactions exclusively for the purpose of reducing interest rate risk exposure.

(b) *Scope.* (1) This subpart applies to all Federal credit unions. Except as provided in § 741.219, this rule does not apply to federally insured, state-chartered credit unions.

(2) *Mutual funds.* This subpart does not permit a Federal credit union to invest in registered investment companies or collective investment funds under § 703.14(c) of this part, where the prospectus of the company or fund permit the investment portfolio to contain derivatives.

### § 703.101 Definitions.

For purposes of this subpart:

*Amortizing notional amount* means a characteristic of a derivative, in which the notional amount declines on a predetermined fixed basis over the term of the contract, according to an amortization schedule to which the parties agree when executing the contract;

*Basis swap* means an agreement between two parties in which the parties make periodic payments to each other based on floating rate indices multiplied by a notional amount;

*Cleared swap* has the meaning as defined by the Commodity Futures Trading Commission in 17 CFR 22.1;

*Counterparty* means a swap dealer, derivatives clearing organization, or exchange that participates as the other party in a derivatives transaction with a Federal credit union;

*Credit support annex* means the terms or rules under which collateral is posted or transferred between a Federal credit union and a counterparty to mitigate credit risk that may result from changes in the fair value of derivatives positions;

*Derivative* means a financial contract which derives its value from the value and performance of some other underlying financial instrument or variable, such as an index or interest rate;

*Derivatives clearing organization* has the meaning as defined by the Commodity Futures Trading Commission in 17 CFR 1.3(d);

*Economic effectiveness* means the extent to which a derivatives transaction results in offsetting changes in the interest rate risk that the transaction was, and is, intended to provide;

*Exchange* means a central financial clearing market where end users can trade futures, as defined in this section of this subpart;

*External service provider* means any entity that provides services to assist a Federal credit union in carrying out its derivatives program and the requirements of this subpart;

*Fair value* has the meaning specified in § 703.2 of subpart A of this part;

*Field director* means an NCUA Regional Director or the Director of the Office of National Examinations and Supervision;

*Forward start date* means an agreement that delays the settlement date of a derivatives transaction for a specified period of time;

*Futures commission merchant (FCM)* has the meaning as defined by the Commodity Futures Trading Commission in 17 CFR 1.3(p);

*Futures* means a U.S. Treasury note financial contract that obligates the buyer to take delivery of Treasury notes (or the seller to deliver Treasury notes) at a predetermined future date and price. Futures contracts are standardized to facilitate trading on an exchange;

*Hedge* means to enter into a derivatives transaction to mitigate interest rate risk;

*Interest rate cap* means a contract, based on a reference interest rate, for payment to the purchaser when the reference interest rate rises above the level specified in the contract;

*Interest rate floor* means a contract, based on a reference interest rate, for payment to the purchaser when the reference interest rate falls below the level specified in the contract;

*Interest rate risk* means the vulnerability of a Federal credit union's earnings or economic value to movements in market interest rates;

*Interest rate swap* means an agreement to exchange future payments of interest on a notional amount at specific times and for a specified time period;

*Introducing broker* means a futures brokerage firm that deals directly with the client, while the trade execution is done by a futures commission merchant;

*ISDA protocol* means a multilateral contractual amendment mechanism that has been used to address changes to International Swap and Derivatives Association (ISDA) standard contracts since 1998;

*Leveraged derivative* means a derivative where the value of the transaction does not change in a one to one proportion with the contractual rate or index;

(x) *Margin* means the minimum amount of funds that must be deposited between parties to a derivatives transaction, as detailed in a credit support annex or clearing arrangement;

*Master service agreement* means a document agreed upon between two parties that sets out standard terms that apply to all derivatives transactions entered into between those parties. Each time the same two parties enter into a transaction, the terms of the master service agreement apply automatically and do not need to be re-negotiated. The most common form of a master service agreement is a master ISDA agreement;

*Minimum transfer amount* means the minimum amount of collateral that a party to a derivatives transaction will require, per transfer, to cover exposure in excess of the collateral threshold;

*Net economic value* means the economic value of assets minus the economic value of liabilities;

*Net worth* has the meaning specified in § 702.2 of this chapter;

*Non-cleared* means transactions that do not go through a derivatives clearing organization;

*Notional amount* means the contracted amount of a derivatives contract for swaps and options on which interest payments or other payments are based. For futures contracts, the notional amount is represented by the contract size;

*Novation* means the substitution of an old obligation with a new one that either replaces an existing obligation with a new obligation or replaces an original party with a new party;

*Reference interest rate* means the index or rate to be used as the variable rate for resetting derivatives transactions;

*Reporting date* means the end of the business day on the date used to report positions and fair values for limit compliance (e.g., daily, month-end, quarter-end and fiscal year-end);

*Senior executive officer* has the meaning specified in § 701.14 of this chapter and any other similar employee that is directly within the chain of command for the oversight of a Federal credit union's derivatives program, as identified in a Federal credit union's process and responsibility framework, as discussed in § 703.106(b)(1) of this subpart;

*Structured liability offering* means 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;

*Swap dealer* has the meaning as defined by the Commodity Futures Trading Commission in 17 CFR 1.3(ggg);

*Swap execution facility* means a Commodities and Futures Trading Commission-registered facility that provides a system or platform for participants to execute cleared derivatives transactions;

*Threshold amount* means an unsecured credit exposure that a party to a derivatives transaction is prepared to accept before requesting additional collateral from the other party;

*Trade date* means the date that a derivatives order (new transactions, terminations, or assignments) is executed in the market; and

*Unamortized premium* means the balance of the upfront premium payment that has not been amortized.

### § 703.102 Permissible derivatives.

(a) *Products and characteristics.* A Federal credit union with derivatives authority may apply to use each of the following products and characteristics, subject to the limits in § 703.103 of this subpart:

(1) Interest rate swaps with the following characteristics:

(i) Settle within three business days, unless the Federal credit union is approved for a forward start date of no more than 90 days from the trade date; and

(ii) Do not have fluctuating notional amounts, unless the Federal credit union is approved to use derivatives with amortizing notional amounts.

(2) Basis swaps with the following characteristics:

(i) Settle within three business days, unless the Federal credit union is approved for a forward start date of no more than 90 days from the trade date; and

(ii) Do not have fluctuating notional amounts, unless the Federal credit union is approved to use derivatives with amortizing notional amounts.

(3) Purchased interest rate caps with no fluctuating notional amounts, unless the Federal credit union is approved to use derivatives with amortizing notional amounts.

(4) Purchased interest rate floors with no fluctuating notional amounts, unless the Federal credit union is approved to use derivatives with amortizing notional amounts.

(5) U.S. Treasury note futures (2-, 3-, 5-, and 10-year contracts).

(b) *Overall program characteristics.* A Federal credit union may only enter into derivatives, as identified and described in paragraph (a) of this section, that have the following characteristics:

(1) Not leveraged;

(2) Based on domestic rates, as defined in § 703.14(a) of subpart A of this part;

(3) Denominated in U.S. dollars;

(4) Except as provided in § 703.14(g) of subpart A of this part, not used to create structured liability offerings for members or nonmembers;

(5) Have contract maturity terms of equal to or less than 15 years, at the trade date; and

(6) Meet the definition of a derivative under GAAP.

### § 703.103 Derivative authority.

(a) *General authority.* A Federal credit union that is approved for derivatives authority under § 703.111 of this subpart may use any of the products and characteristics, described in § 703.102(a), subject to the following limits, which are described in more detail in Appendix A to this subpart:

(1) *Entry limits authority.* Unless a Federal credit union is permitted to use standard limits authority under this subpart, the aggregate fair value loss (as defined in Appendix A) on all of a Federal credit union's derivatives positions may not exceed 15 percent of net worth, and a Federal credit union's weighted average remaining maturity notional (as defined in Appendix A), may not exceed 65 percent of net worth.

(2) *Standard limits authority.* A Federal credit union that is permitted to use standard limits authority may not exceed an aggregate fair value loss on all

of the Federal credit union's derivatives positions of 25 percent of net worth, and a weighted average remaining maturity notional of 100 percent of net worth, provided:

(i) The Federal credit union has engaged in derivatives at the entry limits authority for a continuous period of one year (beginning on the trade date of its first derivatives transaction); and

(ii) The Federal credit union has not been notified in writing by NCUA of any relevant safety and soundness concerns while engaged in derivatives at the entry limits authority.

(b) *Limit description*—(1) *Fair value limit.* The fair value limit is calculated by aggregating the fair values for all derivatives positions at the reporting date. If an aggregate loss exists, it must be less than the limit set forth in this subpart. A further description of this limit and example calculations are detailed in Appendix A to this subpart.

(2) *Weighted average remaining maturity notional limit.* The weighted average remaining maturity notional limit is calculated by aggregating the notional amount for all derivatives positions based on each derivative's pricing sensitivity and maturity. A further description of this limit and example calculations are detailed in Appendix A to this subpart.

**§ 703.104 Requirements for derivative counterparty agreements, collateral and margining.**

(a) A Federal credit union may have exchange-traded, centrally cleared, or non-cleared derivatives, in accordance with the following:

(1) *Exchange-traded and cleared derivatives.* A Federal credit union with derivatives that are exchange-traded or centrally cleared must:

(i) Comply with the Commodity Futures Trading Commission's rules;

(ii) Use only swap dealers, introducing brokers, and/or futures commission merchants that are current registrants of the Commodity Futures Trading Commission; and

(iii) Comply with the margining requirements required by the futures commission merchant.

(2) *Non-cleared derivative transactions.* A Federal credit union with derivatives that are non-cleared must:

(i) Have a master service agreement and credit support annex with a registered swap dealer that are in accordance with ISDA protocol for standard bilateral agreements;

(ii) Utilize margining requirements contracted through a credit support annex and have a minimum transfer amount of $250,000 for daily margining requirements; and

(iii) Accept as collateral, for margin requirements, only cash (U.S. dollars), U.S. Treasuries, government-sponsored enterprise debt, and government-sponsored enterprise residential mortgage-backed security pass-through securities.

(b) *Counterparty, collateral, and margining management.* A Federal credit union must:

(1) Have systems in place to effectively manage collateral and margining requirements;

(2) Have a collateral management process that monitors the Federal credit union's collateral and margining requirements daily and ensures that its derivatives positions are collateralized at all times and in accordance with the collateral requirements of this subpart and the Federal credit union's agreement with its counterparty. This includes the posting, tracking, valuation, and reporting of collateral using fair value; and

(3) Analyze and measure potential liquidity needs related to its derivatives program and stemming from additional collateral requirements due to changes in interest rates. The Federal credit union must calculate and track contingent liquidity needs in the event a derivatives transaction needs to be novated or terminated, and must establish effective controls for liquidity exposures arising from both market or product liquidity and instrument cash flows.

**§ 703.105 Reporting requirements.**

(a) *Board reporting.* At least quarterly, a Federal credit union's senior executive officers must deliver a comprehensive derivatives report to the Federal credit union's board of directors. The report may be delivered separately or as part of the standard funds management or asset/liability report.

(b) *Senior executive officer and asset liability committee.* At least monthly, Federal credit union staff must deliver a comprehensive derivatives report to the Federal credit union's senior executive officers and, if applicable, the Federal credit union's asset liability committee.

(c) *Comprehensive derivatives report.* At a minimum, the reports required in paragraphs (a) and (b) of this section must include:

(1) Identification of any areas of noncompliance with any provision of this subpart or the Federal credit union's policies;

(2) Utilization of the limits in § 703.103 and any additional limits in the Federal credit union's policies;

(3) An itemization of the Federal credit union's individual positions and aggregate current fair values, and a comparison with the Federal credit union's fair value loss and notional limit authority, as described in Appendix A to this subpart;

(4) A comprehensive view of the Federal credit union's statement of financial condition, including, but not limited to, net economic value calculations for the Federal credit union's statement of financial condition done with derivatives included and excluded;

(5) An evaluation of the effectiveness of the derivatives transactions in mitigating interest rate risk; and

(6) An evaluation of effectiveness of the hedge relationship and reporting for derivatives in compliance with GAAP.

**§ 703.106 Operational support requirements.**

(a) *Required experience and competencies.* A Federal credit union operating with derivatives authority must internally possess the following experience and competencies:

(1) *Board.* Before entering into any derivatives transactions, and annually thereafter, a Federal credit union's board members must receive training that provides a general understanding of derivatives and the knowledge required to provide strategic oversight of the Federal credit union's derivatives program. This requirement includes understanding how derivatives fit into the Federal credit union's business model and risk management process. The Federal credit union must maintain evidence of this training, in accordance with its document retention policy, until its next NCUA examination.

(2) *Senior executive officers.* A Federal credit union's senior executive officers must be able to understand, approve, and provide oversight for the derivatives activities. These individuals must have a comprehensive understanding of how derivatives fit into the Federal credit union's business model and risk management process.

(3) *Qualified derivatives personnel.* To engage in derivatives transactions, a Federal credit union must employ staff with experience in the following areas:

(i) *Asset/liability risk management.* Staff must be qualified to understand and oversee asset/liability risk management, including the appropriate role of derivatives. This 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;

(ii) *Accounting and financial reporting.* Staff must be qualified to understand and oversee appropriate accounting and financial reporting for derivatives transactions in accordance with GAAP;

(iii) *Derivatives execution and oversight.* Staff must be qualified to undertake or oversee trade executions; and

(iv) *Counterparty, collateral, and margining management.* Staff must be qualified to evaluate counterparty, collateral, and margining risk as described in § 703.104 of this subpart.

(b) *Required management and internal controls structure.* To effectively manage its derivatives activities, a Federal credit union must assess the effectiveness of its management and internal controls structure. At a minimum, the internal controls structure must include:

(1) *Transaction support.* Before executing any derivatives transaction, a Federal credit union must identify and document the circumstances that lead to the decision to hedge, specify the derivatives strategy the Federal credit union will employ, and demonstrate the economic effectiveness of the hedge;

(2) *Internal controls review.* For the first two years after commencing its derivatives program, a Federal credit union must have an internal controls review that is focused on the integration and introduction of derivatives functions. This review must be performed by an independent external unit or, if applicable, the Federal credit union's internal auditor. The review must ensure the timely identification of weaknesses in internal controls, modeling methodologies, risk, and all operational and oversight processes;

(3) *Financial statement audit.* Any Federal credit union engaging in derivatives transactions pursuant to this subpart must obtain an annual financial statement audit, as defined in § 715.2(d) of this chapter, and be compliant with GAAP for all derivatives-related accounting and reporting;

(4) *Process and responsibility framework.* A Federal credit union must maintain a written and schematic description (e.g., flow chart or organizational chart) of the derivatives management process in its derivatives policies and procedures. The description must include the roles of staff, qualified personnel, external service providers, senior executive officers, the board of directors, and any others involved in the derivatives program;

(5) *Separation of duties.* A Federal credit union's process, whether conducted internally or by an external service provider, must have appropriate separation of duties for the following functions defined in paragraph (a)(3) of this section:

(i) Asset/liability risk management;

(ii) Accounting and financial reporting;

(iii) Derivatives execution and oversight; and

(iv) Collateral, counterparty, and margining management.

(c) *Legal review.* A Federal credit union with derivatives authority must hire or engage legal counsel to reasonably ensure that all derivatives contracts adequately protect the legal and business interests of the Federal credit union. The Federal credit union's counsel must have legal expertise with derivatives contracts and related matters.

(d) *Policies and procedures.* A Federal credit union with derivatives authority must operate according to comprehensive written policies and procedures for control, measurement, and management of derivatives transactions. At a minimum, the policies and procedures must address the requirements of this subpart, except for those in §§ 703.108 through 703.114, and any additional limitations imposed by the Federal credit union's board of directors. A Federal credit union's board of directors must review the policies and procedures described in this section annually and update them when necessary.

**§ 703.107 External service providers.**

(a) *General.* A Federal credit union with derivatives authority may use external service providers to support or conduct aspects of its derivatives program, provided:

(1) The external service provider, including affiliates, does not:

(i) Act as a counterparty to any derivatives transactions that involve the Federal credit union;

(ii) Act as a principal or agent in any derivatives transactions that involve the Federal credit union; or

(iii) Have discretionary authority to execute any of the Federal credit union's derivatives transactions.

(2) The Federal credit union has the internal capacity, experience, and skills to oversee and manage any external service providers it uses; and

(3) The Federal credit union documents the specific uses of external service providers in its process and responsibility framework, as described in § 703.106(b)(1) of this subpart and the application.

(b) *Support functions.* A Federal credit union must perform the following functions internally and independently. A Federal credit union may have assistance and input from an external service provider, provided the external service provider does not conduct the following functions in lieu of the Federal credit union:

(1) Asset/liability risk management; and

(2) Liquidity risk management.

**§ 703.108 Eligibility.**

(a) A Federal credit union may apply for derivatives authority under this subpart if it meets the following criteria:

(1) The Federal credit union's most recent NCUA-assigned composite CAMEL code rating is 1, 2, or 3, with a management component of 1 or 2; and

(2) The Federal credit union has assets of at least $250 million as of its most recent call report.

(b) Notwithstanding paragraph (a)(2) of this section, a Federal credit union may request permission from the appropriate field director to apply for derivatives authority, subject to requirements imposed by the field director. If the field director grants such permission, the application will be subject to §§ 703.109 through 703.111.

**§ 703.109 Applying for derivatives authority.**

An eligible Federal credit union must receive written approval to use derivatives by submitting a detailed application, consistent with this subpart and any guidance issued by NCUA. A Federal credit union must submit its application to the applicable field director.

**§ 703.110 Application content.**

A Federal credit union applying for derivatives authority must document how it will comply with the requirements of this subpart and any guidance issued by NCUA, and must include all of the following in its application:

(a) 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;

(b) 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;

(c) Draft policies and procedures that the Federal credit union has prepared in accordance with § 703.106(d) of this subpart;

(d) 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;

(e) 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;

(f) A description of how the Federal credit union will support the operations of margining and collateral; and

(g) A description of how the Federal credit union will comply with GAAP.

**§ 703.111 NCUA approval.**

(a) *Interim approval.* The field director will notify the Federal credit union in writing if the field director has approved or denied its application and, if applicable, the reason(s) for any denial. A Federal credit union approved for derivatives authority may not enter into any derivatives transactions until it receives final approval from NCUA under paragraph (c) of this section.

(b) *Notice of readiness.* A Federal credit union approved under paragraph (a) of this section must provide written notification to NCUA when it is ready to begin using derivatives.

(c) *Final approval.* NCUA will review every approved Federal credit union's derivatives program to ensure compliance with this subpart and evaluate the Federal credit union's implementation of the items in its application. This supervisory review may be conducted on site. After NCUA has completed its review, the field director will notify the Federal credit union in writing if the field director has granted final approval and the Federal credit union may begin entering into derivatives transactions. If applicable, the notification will include the reason(s) for any denial. A Federal credit union may not enter into any derivatives transactions under this subpart until it receives this determination from the applicable field director. At a field director's discretion, a Federal credit union may reapply under this subsection if the field director has determined that the Federal credit union has demonstrated compliance with this subpart and its application.

(d) *Right to appeal.* A Federal credit union may submit a written appeal to the NCUA Board within 60 days from the date of denial by NCUA under paragraph (b) or (c) of this section.

**§ 703.112 Applying for additional products or characteristics.**

(a) A Federal credit union with derivatives authority may subsequently apply for approval to use additional products and characteristics, described in § 703.102 of this subpart, that it did not request in its initial application, subject to the following:

(1) A Federal credit union must submit an application to NCUA;

(2) A Federal credit union's application must include a list of the products and/or characteristics for which it is applying; and

(3) A Federal credit union must include a justification for each product and/or characteristic requested in the application and an explanation of how the Federal credit union will use each product and/or characteristic requested.

(b) The field director will notify the Federal credit union in writing if the field director has approved or denied its application for additional products or characteristics. If applicable, the notification will include the reason(s) for denial.

(c) A Federal credit union may appeal any denial of an application for additional products and/or characteristics in accordance with § 703.111(d).

**§ 703.113 Pilot program participants with active derivatives positions.**

(a) A Federal credit union with outstanding derivatives positions under NCUA's derivatives pilot program as of January 1, 2013, must comply with the requirements of this subpart within 12 months of the effective date of this subpart, including the requirement to submit an application for derivatives authority. During the 12-month interim period, the Federal credit union may continue to operate its derivatives program in accordance with its pilot program terms and conditions.

(b) A Federal credit union with outstanding derivatives positions under NCUA's derivatives pilot program as of January 1, 2013, that does not comply with the requirements of this subpart within 12 months of the effective date of this subpart, or does not want to continue engaging in derivatives transactions, must:

(1) Stop entering into new derivatives transactions; and

(2) Within 30 days, present a corrective action plan to NCUA describing how the Federal credit union will cure any deficiencies or wind down its derivatives program.

**§ 703.114 Regulatory violation.**

(a) A Federal credit union with derivatives authority that no longer meets the requirements of this subpart or fails to comply with its approved strategy (including employing the resources, policies, procedures, accounting, and competencies that formed the basis for the approval) must:

(1) Immediately stop entering into any new derivatives transactions until the Federal credit union is in compliance with this subpart. During this period, however, the Federal credit union may terminate existing derivatives transactions. NCUA may permit a Federal credit union to enter into offsetting transactions if NCUA determines these transactions are part of a corrective action strategy.

(2) Within three business days from the regulatory violation, provide the appropriate field director notification of the regulatory violation, which must include a description of the violation and the immediate corrective action the Federal credit union is taking; and

(3) Within 15 business days after notifying the appropriate field director, submit a written corrective action plan to the appropriate field director.

(b) NCUA may revoke a Federal credit union's derivatives authority at any time if a Federal credit union fails to comply with the requirements of this subpart. Revocation will prohibit a Federal credit union from executing any new derivatives transactions under this subpart, and may require the Federal credit union to terminate existing derivatives transactions if, in the discretion of the applicable field director, doing so would not pose a safety and soundness concern.

(c) Within 60 days from the date of the related field director's action, a Federal credit union may appeal the following to the NCUA Board:

(1) NCUA's revocation of a Federal credit union's derivatives authority; and

(2) NCUA's order that a Federal credit union terminate existing derivatives positions.

(d) With respect to an appeal regarding revocation of a Federal credit union's derivatives authority, the Federal credit union may not enter into any new derivatives transactions until the NCUA Board renders a final decision on the appeal. The Federal credit union may, however, elect to terminate existing derivatives positions. With respect to an appeal regarding an order to terminate a Federal credit union's existing derivatives positions, the Federal credit union is not required to terminate any existing positions until the NCUA Board renders a final decision on the appeal.

**Appendix to Subpart B—Examples of Derivative Limit Authority Calculations**

*Limit authority.* A Federal credit union that is approved for derivatives authority under § 703.111 may use any of the products and characteristics described in § 703.102(a), subject to the following position and risk limits:

TABLE 1—AUTHORITY LIMITS

| Limit authority | Entry limits (first 12 months of transactions) | Standard limits |
|---|---|---|
| Fair Value Loss (See (a) below) | 15% of net worth | 25% of net worth. |
| Weighted Average Remaining Maturity Notional (WARMN) (See (b) below) | 65% of net worth | 100% of net worth. |

(a) *Calculating the fair value loss limit for compliance with this subpart.* To demonstrate compliance with the fair value loss limit authority of this subpart, a Federal credit union must combine the total fair value (as defined by product group below) of all derivatives transactions. The fair value loss limit is exclusive to the derivatives positions (not net of offsetting gains and losses in the hedged item).

(1) The resulting figure, if a loss, must not exceed the Federal credit union's authorized fair value loss limit:

(i) *Options*—the gain or loss is the difference between the fair value and the unamortized premium at the reporting date;

(ii) *Swaps*—the gain or loss is the fair value at the reporting date; and

(iii) *Futures*—the gain or loss is the difference between the exchange closing price at the reporting date and the purchase or sales price.

(2) *Example calculations for compliance with this subpart: fair value loss limit.* The table below provides an example of the fair value loss limit calculations for a sample Federal credit union that has entry level authority. The sample Federal credit union has a net worth of $100 million and total assets of $1 billion; its fair value loss limit is −$15 million (15 percent of net worth).

TABLE 2—EXAMPLE FAIR VALUE LOSS CALCULATIONS

| | Fair value gains (losses) | | | | % of Net worth (percent) | Limit violation |
|---|---|---|---|---|---|---|
| | Options | Swaps | Futures | Total | | |
| Scenario A | $1,000,000 | $2,000,000 | $200,000 | $3,200,000 | 3 | No. |
| Scenario B | 5,000,000 | 10,000,000 | 2,000,000 | 17,000,000 | 17 | No. |
| Scenario C | 1,000,000 | (3,000,000) | 250,000 | (1,750,000) | (2) | No. |
| Scenario D | 1,000,000 | (20,000,000) | (2,000,000) | (21,000,000) | (21) | Yes. |
| Scenario E | (2,000,000) | (10,000,000) | 1,000,000 | (11,000,000) | (11) | No. |

(b) *Calculating the WARMN exposure for compliance with this subpart.* The WARMN calculation adjusts the gross notional of a derivative to take into account its price sensitivity and remaining maturity. The WARMN limit is correlated to the fair value loss limit, as described in paragraph (a) of this appendix, for a 300 basis point parallel shift in interest rates. To demonstrate compliance with the WARMN limit authority of this subpart, a Federal credit union must calculate the WARMN using the following reference table, definitions, and calculation steps:

TABLE 3—SUMMARY OF WARMN CALCULATION

| Product | Step #1 gross notional | Adjustment factor (percent) | Step #2 adjusted notional | Step #3 WARM |
|---|---|---|---|---|
| Options (Caps) | Current notional | 33 | 33% of current notional | Time remaining to maturity. |
| Options (Floors) | Current notional | 33 | 33% of current notional | Time remaining to maturity. |
| Swaps | Current notional | 100 | 100% of current notional | Time remaining to maturity. |
| Futures | Contract size | 100 | 100% of contract size | Underlying contract. |
| | | | Sum = Total Adjusted Notional | Sum = Overall WARM |
| Step #4 WARMN = Adjusted Notional x (WARM/10) | | | | |

(1) *Step #1—Calculate the gross notional of all outstanding derivative transactions.* (i) For options and swaps, all gross notional amounts must be absolute, with no netting (i.e., offsetting a pay-fixed transaction with a receive-fixed transaction). The gross notional for derivatives transactions with amortizing notional amounts is the current contracted notional amount, in accordance with the amortization schedule.

(ii) For futures, the gross notional is the underlying contract size as designated by the Chicago Mercantile Exchange (CME) product specifications (e.g., a five-year Treasury note futures contract will use $100,000 for each contract purchased or sold and reported here on a gross basis for limit purposes.)

(2) *Step #2—Convert each gross notional by its derivative adjustment factor to produce an adjusted gross notional.* The derivative adjustment factor approximates the price sensitivity for each of the product groups in order to weight the notional amount by sensitivity before weighting for maturity.

(i) For cap and floor options, the derivative adjustment factor is 33 percent. For example, an interest rate cap with a $1 million notional amount has an adjusted gross notional of $330,000 ($1,000,000 × 0.33 + $330,000).

(ii) For interest rate swaps and Treasury futures, the derivative adjustment factor is 100 percent. For example, an interest rate swap with a $1 million notional amount has an adjusted gross notional of $1,000,000 ($1,000,000 × 1.00 = $1,000,000).

(iii) The total adjusted notional for all derivatives positions is the sum of (i) and (ii) above.

(3) *Step #3—Produce the weighted average remaining time to maturity (WARM) for all derivatives positions.* (i) For interest rate caps, interest rate floors, and interest rate swaps, the remaining maturity is the time left between the reporting date and the contracted maturity date, expressed in years (round up to two decimals);

(ii) For Treasury futures, the remaining maturity is the underlying deliverable Treasury note's maximum maturity (e.g., a five-year Treasury note future has a five-year remaining maturity); and

(iii) Determine the WARM using the adjusted gross notional, as set forth in subsection (2) of this section, and the remaining time to maturity as defined for each product group above in paragraphs (b)(3)(i) and (ii) of this appendix.

(4) *Step #4—Produce the WARMN by converting the WARM to a percentage and then multiplying the percentage by the total adjusted gross notional.* (i) Divide the WARM, as calculated in paragraph (b)(3) of this appendix, by ten to convert it to a percentage (e.g., 7.75 WARMN is translated to 77.5 percent); and

(ii) Multiply the WARM converted to a percentage, as described in paragraph (c)(4)(i) of this appendix, by total adjusted gross notional, described in paragraph (c)(2) of this appendix.

(5) *Compare WARMN calculation to the WARNM limit for compliance.* The total in step four (4) must be less than the limit in paragraph (a)(1)(ii) or (a)(2)(ii) of this appendix, as applicable.

(6) *Example calculations for compliance with this subpart: WARMN.* The table below provides an illustrative example of the WARMN limit calculations for a sample Federal credit union that has entry level authority. The sample Federal credit union has a net worth of $100 million and total assets of $1 billion; its notional limit authority is $65 million (65 percent of net worth).

TABLE 4—EXAMPLE WARMN LIMIT CALCULATION

| | Options | Swaps | Futures | Total |
|---|---|---|---|---|
| Gross Notional (Step #1) | $100,000,000 | $50,000,000 | $5,000,000 | $155,000,000 |
| Adjustment Factor | 33% | 100% | 100% | |
| Adjusted Notional (Step #2) | $33,000,000 | $50,000,000 | $5,000,000 | $88,000,000 |
| Weighted Average Remaining Maturity (WARM) (Step #3) | 7.00 | 8.50 | 5.00 | 7.74 |
| | | Weighted Average Remaining Maturity Notional (WARMN) (Step #4): | | [1] $68,100,000 |
| | | Notional Limit Authority (65% of net worth) | | $65,000,000 |
| | | Under/(Over) Notional Limit Authority | | ($3,100,000) |

[1] (77.4% of Step #3.)

## PART 715—SUPERVISORY COMMITTEE AUDITS AND VERIFICATIONS

■ 7. The authority citation for part 715 continues to read as follows:

**Authority:** 12 U.S.C. 1757, 1766(a), and 1781–1790; 31 U.S.C. 3717.

■ 8. In § 715.5, revise paragraph (a) to read as follows:

### § 715.5 Audit of Federal Credit Unions.

(a) Total assets of $500 million or greater. To fulfill its Supervisory Committee audit responsibility, a Federal credit union having total assets of $500 million or greater, except as provided in § 703.106(b)(3) of this chapter, must obtain an annual audit of its financial statements performed in accordance with Generally Accepted Auditing Standards by an independent person who is licensed to do so by the State or jurisdiction in which the credit union is principally located.

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## PART 741—REQUIREMENTS FOR INSURANCE

■ 9. The authority citation for part 741 is revised to read as follows:

**Authority:** 12 U.S.C. 1757, 1766(a), 1781–1790, and 1790d; 31 U.S.C. 3717.

■ 10. Revise § 741.219 to read as follows:

### § 741.219 Investment requirements.

(a) Any credit union which is insured pursuant to Title II of the Act must adhere to the requirements stated in part 703 of this chapter concerning transacting business with corporate credit unions.

(b) Any credit union which is insured pursuant to Title II of the Act must notify the applicable NCUA Regional Director or the Director of the Office of National Examinations and Supervision in writing at least 30 days before it begins engaging in derivatives.

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## DEPARTMENT OF TRANSPORTATION

## Federal Aviation Administration

## 14 CFR Part 39

**[Docket No. FAA–2013–0501; Directorate Identifier 2011–SW–036–AD; Amendment 39–17732; AD 2014–02–04]**

**RIN 2120–AA64**

## Airworthiness Directives; Eurocopter France Helicopters

**AGENCY:** Federal Aviation Administration (FAA), DOT.

**ACTION:** Final rule.

**SUMMARY:** We are adopting a new airworthiness directive (AD) for Eurocopter France (Eurocopter) Model EC 155B and EC155B1 helicopters. This AD requires repetitively inspecting the lower and upper front and rear fittings (fittings) that attach the upper fin to the fenestron for a crack and, if there is a crack, removing all four fittings from service. This AD also requires, within a specified time, removing all fittings from service, and the fittings would not be eligible to be installed on any