http://www.fsis.usda.gov/regulations_&_policies/Federal_Register_Notices/index.asp.

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Done at Washington, DC on May 23, 2013.

Alfred V. Almanza,

Administrator.

[FR Doc. 2013–12763 Filed 5–24–13; 8:45 am]

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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: Proposed Rule.

SUMMARY: This proposed rule permits credit unions to engage in limited derivatives activities for the purpose of mitigating interest rate risk. This proposed rule applies to federal credit unions and any federally insured, state-chartered credit unions that are permitted under applicable state law to engage in derivatives transactions. It requires any credit union seeking derivatives authority to submit an application for one of two levels of authority. Level I and Level II authority differ on the permissible levels of transactions as well as the application, expertise, and systems requirements associated with operating a derivatives program.

DATES: Comments must be received on or before July 29, 2013.

ADDRESSES: You may submit comments by any of the following methods (Please send comments by one method only):

• *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments.

• *NCUA Web Site: http://www.ncua.gov/RegulationsOpinionsLaws/proposed_regs/proposed_regs.html.* Follow the instructions for submitting comments.

• *E-Mail:* Address to *regcomments@ncua.gov.* Include "[Your name]—Comments on Proposed Rule—Derivatives" in the email subject line.

• *Fax:* (703) 518–6319. Use the subject line described above for email.

• *Mail:* Address to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314–3428.

• *Hand Delivery/Courier:* Same as mail address.

FOR FURTHER INFORMATION CONTACT: Justin M. Anderson or Lisa Henderson, Staff Attorneys, Office of General Counsel, at the above address or telephone (703) 518–6540; J. Owen Cole, Director, Division of Capital and Credit Markets, or Rick Mayfield, Senior Capital Markets Specialist, Office of Examination and Insurance, at the above address or telephone (703) 518–6360; or Dr. John Worth, Chief Economist, Office of the Chief Economist, at the above address or telephone (703) 518–6660.

SUPPLEMENTARY INFORMATION:

I. Background

A. Introduction

The NCUA Board (Board) is proposing to allow credit unions to engage in limited derivatives transactions [1] for the purpose of mitigating interest rate risk (IRR). This proposed authority does not, however, allow credit unions to offer derivatives. This proposed rule applies to all federal credit unions (FCUs) and all federally insured state- chartered credit unions (FISCUs) that are expressly permitted by applicable state law to engage in derivatives transactions. The Board believes this proposed rule allows eligible credit unions to utilize an additional tool to mitigate IRR, while also reducing risk to the National Credit Union Share Insurance Fund (NCUSIF).

The rule requires eligible credit unions to apply to NCUA or, in the case of a FISCU, NCUA and the applicable state supervisory authority (SSA), for either Level I or Level II derivatives authority. As discussed in greater detail below, Level I and Level II authority differ on the permissible levels of transactions as well as the application, expertise, and systems requirements.

B. The Act and NCUA's Regulations

The Federal Credit Union Act (Act) provides FCUs with the authority to invest in certain securities, obligations, and accounts.[2] For safety and soundness reasons, however, NCUA has adopted regulatory restrictions on certain investments and activities permitted by the Act.[3] Currently, derivatives are among the investments specifically prohibited by NCUA.[4]

[1] A derivative is an instrument whose price is dependent on or derived from one or more underlying assets. A derivatives transaction involves a contract between two parties, called counterparties, that exchange value based on the fluctuation of the underlying asset or index. A counterparty is the other party to the derivatives transaction and can include swap dealers and major swap participants, which are terms to identify entities that operate primarily in the derivatives market. These transactions may involve collateral and a collateral custodian, which is an entity that holds the collateral for the two contracting parties.

[2] 12 U.S.C. 1757(7) and (15).

[3] 12 CFR 703.16.

[4] *Id.* at 703.16(a). Section 703.16(a), however, provides three exceptions to the general prohibition on derivatives. First, an FCU may purchase or sell any derivatives permitted under § 703.14(g) or under § 701.21(i) of NCUA's lending regulations. Second, an FCU may purchase or sell an embedded option not required under generally accepted accounting principles (GAAP) to be accounted for separately from the host contract. Third, an FCU may enter into interest rate lock commitments or

Continued

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

Traditionally, derivatives instruments have been customizable over-the-counter instruments. They span a wide variety of types and structures, many of which are unsuitable for credit unions. As the financial derivatives markets have evolved, however, greater standardization of contracts, collateral requirements, market participation and price transparency have made certain derivatives more suitable for meeting the risk mitigation needs of some credit unions. In addition, given the historically low interest rate environment of the last few years, IRR now poses a material risk to many credit unions.

Recognizing that derivatives can be beneficial in helping credit unions to mitigate IRR, the Board believes it is appropriate to allow credit unions to use derivatives for the limited purpose of IRR mitigation. The Board notes, however, that derivatives are not the only way for credit unions to control IRR. Rather, the Board emphasizes that derivatives are just one tool that credit unions may employ as part of a comprehensive ALM strategy.

This rule builds on the IRR rule that the Board issued in 2012, which required certain federally insured credit unions to develop and adopt a written policy on IRR management and a program to effectively implement that policy.[5] The IRR rule provides guidance in developing an effective IRR management program to identify, measure, monitor, and control IRR. This proposed rule does not change any of the requirements in the IRR rule, but rather is another measure the Board is taking to enhance risk management alternatives.

C. 1998 IRPS

This proposed rule is consistent with a 1998 Interpretive Ruling and Policy Statement (IRPS) 98–2, Investment Securities and End-User Derivatives issued by NCUA.[6] IRPS 98–2 provides guidance to credit unions on sound practices for managing the risks of investment securities and end-user derivatives activities, including transactions in swaps and caps. While derivatives are generally prohibited by regulation for FCUs, the IRPS provides guidance on other investments as well and applies to FISCUs with derivatives authority under applicable state law. The Board, therefore, joined the other Federal Financial Institutions Examination Council members in promulgating the guidance.

The IRPS notes that effective management of the risks associated with securities and derivatives instruments represents an essential component of safe and sound practice. It identifies certain elements as fundamental to all sound risk management programs. These elements include oversight by a credit union's board of directors and senior management and a comprehensive risk management process that effectively identifies, measures, monitors, and controls risk. This proposed rule incorporates many of the guiding principles of IRPS 98–2, as well as lessons learned from the derivatives pilot programs and comments received on two advanced notices of proposed rulemaking (ANPRs).

D. Pilot Programs

Since 1999, the Board has been evaluating pilot programs for limited derivatives authority. These pilot programs have provided NCUA with insight to move from a limited experimental authority to a more general regulatory authority. They have shown the Board that most credit unions need to develop sufficient experience, management, and infrastructure before beginning a derivatives program. Once these are developed, however, credit unions can operate a limited derivatives program in a safe and sound manner.

In addition, several key lessons emerged from NCUA's experience with the derivative pilot programs. Some programs were managed directly by credit unions, while others were administered by external service providers. NCUA observed that the understanding and management of derivatives transactions, while generally sound and effective, were rudimentary in some instances. Various weaknesses were encountered over time. Some areas of concern included: lack of, or inadequate, assessments of the capacity to absorb losses and establish processes to proactively limit loss exposure; lack of due diligence on counterparties and credit risk mitigation; lack of vigilant collateral management; heavy reliance on external parties to value derivatives for base and stress scenarios; and lack of analysis and disclosure for transaction costs (spreads over market). These noted areas, which were addressed through the supervision process, have influenced the Board's current perspective on the need for the requirements and limits contained in this rule. These lessons also raise the need for NCUA's supervision skills and resources to be enhanced commensurate with a broader derivatives authority that expands beyond limited pilot usage. This rule is crafted to address these lessons and the comments received on the two ANPRs.

E. ANPRs

1. ANPR I

In June 2011, the Board issued an ANPR (ANPR I) requesting public comment on whether and how to modify its rule on investment and deposit activities to permit FCUs to enter into derivatives transactions for the purpose of offsetting IRR.[7] The Board requested comment on five broad topics, three of which related to NCUA's pilot programs and third-party programs. The other two topics directly addressed independent derivatives authority. The following summary focuses on the topics directly related to the promulgation of this proposed rule.

First, the Board asked if it should consider allowing credit unions to engage in independent derivatives activities. Ten out of 29 commenters believed the Board should allow credit unions to engage in derivatives activity independently, subject to ability, expertise, adequate understanding and controls, so long as the activity is shown to reduce IRR. Three commenters supported allowing credit unions to engage in derivatives activity independently without further comment. Three commenters supported allowing credit unions that have already demonstrated ability in a third party program to have independent derivatives authority. Two supported independent approval only if limited and qualified by high standards.

Next, the Board asked what criteria it should consider in allowing a credit union to independently engage in derivatives activities. The Board suggested criteria such as asset size, capital adequacy, balance sheet composition, or risk exposure with and without derivatives. Nine commenters believed there should not be numerical criteria, such as size. Five commenters thought there should be other criteria

forward sales commitments made in connection with a loan originated by the FCU. The Board believed that the benefits of the three exceptions outweighed the potential risk and recognized these items were tools FCUs needed.

[5] 71 FR 5155 (February 2, 2012).

[6] IRSP 98–2 (October 1, 1998).

[7] 76 FR 37030 (June 24, 2011).

such as experience, correlation testing and modeling expertise. Two commenters said the criteria should be the capital or earnings of the credit union.

In addition, ten commenters stated that credit unions applying to engage independently should follow the present third party pilot program standards. Two credit unions said that NCUA should require credit unions to prepare succession plans, exit plans, and to engage independent CPAs. Five commenters said that approval to engage independently should be given on a similar basis as part 704 Expanded Authorities.[8]

Finally, the Board asked if it should require credit unions to demonstrate enhanced functionality in terms of the experience of personnel, credit analysis and reporting infrastructure to evaluate the creditworthiness of derivative counterparties. Ten commenters said that there is no need for enhanced credit functionality because requirements for bilateral collateral, credit ratings and mandatory clearing make this unnecessary. Three commenters believed credit unions should show enhanced credit functionality and that the standard should be clear and objective. Twelve commenters argued credit unions should demonstrate enhanced hedging expertise including modeling, live pricing, hedge impact, trade execution, system capabilities and reporting balance sheet strategies.

2. ANPR II

The Board issued a second ANPR in January 2012 (ANPR II)[9] to obtain further industry input to help ensure that any rule granting independent derivatives authority is manageable for both participating FCUs and NCUA, while simultaneously protecting the credit union industry from undue risk. In ANPR II, the Board asked six questions regarding the conditions under which NCUA might grant authority for an FCU to engage in derivatives transactions independently.

Question One. The Board asked if NCUA should require an FCU to demonstrate a material IRR exposure or another risk management need, before it receives independent derivatives authority. Seven commenters supported such a requirement, and 19 opposed it. Eleven of those 19 commenters expressed concern that such a requirement would prevent FCUs from proactively managing IRR through the use of derivatives before IRR poses a danger to the FCU.

Question Two. The Board asked if it was appropriate to require minimum performance levels, as measured, for example, by CAMEL ratings and net worth classifications, when considering whether to grant an FCU's application to independently engage in derivatives transactions. The Board further asked, if the answer is yes, what performance measures and levels would be appropriate and should the Board permit waivers from these requirements.

Seventeen commenters stated that NCUA should require minimum performance levels before approving an FCU's application for independent derivatives authority. The majority of the suggested metrics were CAMEL ratings and net worth classifications. Four commenters suggested a CAMEL 2 rating as a minimum and one suggested a CAMEL 3 rating. Some commenters opposed using CAMEL ratings because the ratings contain elements that are not relevant to an FCU's need or capability to support an independent derivatives program.

Eight commenters argued that NCUA should not require minimum performance levels. One commenter stated that poorly capitalized FCUs would actually benefit from derivatives. Another stated that standards are not necessary because the market would not support an FCU in poor financial health as a counterparty. Two commenters supported allowing waivers from performance standards if an FCU could demonstrate that it met certain criteria, such as need, or could show that it had the ability to transact derivatives.

Question Three. The Board asked what derivatives experience and expertise an FCU's staff should demonstrate before receiving independent derivatives authority. The Board questioned whether NCUA should require additional experience and expertise when there is more complexity in the FCU's statement of financial condition and to what extent an FCU should be allowed to rely on an outside party to fulfill any such requirements.

Nineteen commenters stated that experience or demonstrated skill was necessary to conduct derivatives transactions, but they did not want NCUA to condition approval of independent derivatives authority on specific experience requirements. Several commenters suggested that FCU boards of directors should define experience based on each FCU's derivatives program. One commenter stated that FCUs should demonstrate an advanced level of skill in conducting derivatives transactions, and one commenter suggested a broader level of experience such as professional accreditations to satisfy an experience requirement. Other commenters argued that, because ''plain vanilla'' derivatives instruments present little or no risk, the Board should not require specific experience. Seven commenters supported NCUA allowing third parties to meet an experience requirement, and seven were opposed.

Question Four. The Board asked whether NCUA should limit FCUs to using interest rate swaps and interest rate caps and whether interest rate swaps should be pay-fixed/receive-floating instruments. The Board also asked what other limits it should establish to ensure that an FCU does not transact interest rate derivatives in an amount greater than the level of its IRR exposure.

Twenty-five commenters agreed that NCUA should allow FCUs to use interest rate caps[10] and pay-fixed/receive-floating interest rate swaps[11] to offset and manage IRR. Twenty of these commenters, however, suggested that NCUA also allow credit unions to use other types of derivatives, including floors, collars, pay-floating/receive-fixed swaps, pay-variable/receive-fixed swaps, basis swaps, forwards, futures, and swaptions.

Question Five. The Board asked whether NCUA or an FCU's board of directors should establish exposure limits for FCUs and whether there should be limits on the aggregate amount of each type of derivatives instrument in the portfolio or on the aggregate amount of derivatives transacted with any counterparty. The Board also asked whether limits should be based on the notional amount of a derivatives instrument, its mark-to-market valuation, or both. Twenty-three commenters suggested that an FCU's board of directors should set the exposure limits, and five supported regulatory limits.

Question Six. The Board requested comment on whether there are ways to mitigate counterparty risk besides posting collateral and sought suggestions for appropriate collateralization conditions. Fourteen commenters supported collateral requirements, and four were opposed. Six credit unions stated that FCUs

[8] 12 CFR part 704, Appendix B.

[9] 77 FR 5416 (Feb. 3, 2012).

[10] In an interest rate cap, one party agrees to compensate another party for the amount by which an underlying short-term rate exceeds a specified rate on a series of dates during the life of the contract.

[11] A pay-fixed/receive-floating interest rate swap is an agreement where a credit union pays the counterparty a fixed rate of return in exchange for returns based upon future rates of a floating rate index for a predetermined period of time.

should be allowed to use letters of credit from a Federal Home Loan Bank or similar institution to meet collateral requirements. Three credit unions suggested that NCUA should allow the use of a non-zero threshold for collateral [12] posting by the counterparty, subject to the capital strength of the credit union.

II. Proposed Amendments

Taking into account the lessons learned from the pilot programs, the comments from the ANPRs, and the guiding principles in the IRPS, the Board is proposing the following amendments. The Board believes these amendments achieve a balance between IRR mitigation, a safe and sound derivatives program, and flexibility for credit unions.

A. Changes to Part 703

This proposed rule divides part 703 into two subparts. Subpart A consists of the current part 703, with some minor modifications. These modifications, discussed below, include added definitions the Board believes will add to the clarity to the rule. Subpart B consists of rules and requirements relating to IRR derivatives authority.

As discussed above, current § 703.16(a) lists derivatives as a prohibited investment for FCUs, but provides three exceptions.[13] This proposed rule deletes the general prohibition against derivatives in § 703.16(a) and moves the exceptions described there to a new permissible investments paragraph in § 703.14. Proposed paragraph (k) of § 703.14 authorizes FCUs to enter into all of the derivatives transactions permitted in current § 703.16(a) plus the derivatives transactions permitted in proposed subpart B of part 703.

This proposed rule also adds a definition of ''derivatives,'' ''forward sales commitment,'' and ''interest rate lock commitment'' and updates the definition of ''fair value.'' The new definitions clarify terms that are currently used in part 703. The updated definition of ''fair value'' cross references the definition used in GAAP.

B. Derivatives Authority

This proposed rule allows credit unions to enter into interest rate swaps and to purchase interest rate caps, and it requires pre-approval for all derivatives users. There will be two levels of pre-approval, Level I and Level II, permitting different degrees of derivatives authority with differing degrees of regulatory requirements.

C. Application of the Proposed Rule

The Act permits the Board to prescribe rules and regulations for all federally insured credit unions it deems are necessary to protect the NCUSIF and the credit union industry.[14] Before implementing a rule that applies to all federally insured credit unions, the Board carefully considers all available alternatives and the degree of risk posed to the NCUSIF by an activity the Board seeks to regulate. In the area of derivatives, the Board recognizes the risks inherent in these instruments and that the unregulated use of derivatives poses significant risk to the NCUSIF. For those reasons, this proposed rule applies to both FCUs and certain FISCUs described below.

This proposed rule applies to any FISCU that is permitted by its state law to engage in derivatives. This proposed rule does not grant any FISCU authority to engage in derivatives if applicable state law does not expressly allow it. It does, however, require those FISCUs with derivatives authority under state law to follow the requirements of this proposed rule. In addition, if aspects of a state's derivatives rule are more restrictive than this rule, FISCUs in that state must follow the more restrictive provisions of the state rule. In all other cases, a FISCU with derivatives authority must follow this proposed rule.

As discussed in more detail below, this proposed rule requires a FISCU to submit an application to its SSA. The SSA will review the application and forward its decision to NCUA for concurrence. The Board believes this approach will create a uniform system of approval and examination of credit unions permitted to engage in derivatives transactions, leading to greater protection of the NCUSIF.

D. Levels of Authority

As noted above, this proposed rule requires pre-approval from NCUA or, in the case of a FISCU, from the applicable SSA with NCUA's concurrence. Credit unions meeting specific eligibility criteria under this rule are permitted to apply for Level I or Level II derivatives authority.

Level I derivatives authority contains lower permissible transaction limits, but also entails a more streamlined application process and less restrictive requirements with respect to experience, personnel, and systems. Conversely, Level II allows for higher transaction limits set by NCUA up to a specific ceiling, but entails an onsite evaluation, higher regulatory requirements, a higher application fee, and the necessary personnel and systems to be in place before a credit union may apply. The following chart highlights the differences between Level I authority and Level II authority. These differences are discussed in more detail in other sections of this preamble.

LEVEL I AND LEVEL II COMPARISON

Level I	Level II
Eligibility: To apply for Level I authority a credit union must: • Show, in its application, how derivatives are part of the credit union's IRR mitigation strategy. IRR mitigation may be of current or prospective IRR. • Have a composite CAMEL code rating assigned by NCUA of 1, 2, or 3 with a management component of 1 or 2. • Have assets of at least $250 million, as of its most recent call report.	Eligibility: • In addition to all of the eligibility criteria under Level I in this chart, a credit union seeking Level II authority must also be able to demonstrate in its application why the limits for Level I authority are not sufficient to meet the credit union's IRR mitigation needs.
Authorities and Limits:	Authorities and Limits:

[12] A threshold amount is the amount of unsecured credit each party is prepared to accept before requiring collateral. A non-zero threshold arrangement means that the parties would be willing to accept some level of unsecured credit.

[13] 12 CFR § 703.16(a).

[14] 12 U.S.C. § 1789(11).

LEVEL I AND LEVEL II COMPARISON—Continued

Level I	Level II
• Interest rate swaps are limited to a notional value of 100% of net worth. • Interest rate caps are limited to an aggregate book value of 10% of net worth. • The combined limit of interest rate swaps and interest rate caps is limited to 100% of the aggregate limits based on usage. • Aggregate fair value loss on all interest rate swap positions cannot exceed 10% of net worth.[15] • Maximum weighted average life of all derivatives transactions may not exceed 5 years. • A single derivatives position maturity may not exceed 7 years.	• Interest rate swaps are limited to a notional value of 250% of net worth. • Interest rate caps are limited to an aggregate book value of 25% of net worth. • NCUA will set the combined limit of interest rate swaps and interest rate caps during the approval process. • Aggregate fair value loss on all interest rate swap positions cannot exceed 25% of net worth.[16] • Maximum weighted average life of all derivatives transactions may not exceed 7 years. • A single derivatives position maturity may not exceed 10 years. • Single counterparty notional exposure cannot exceed 100% of net worth for interest rate swaps and single counterparty book value may not exceed 10% of net worth for interest rate caps.
Application Review by Regulators: • 90 days from the date the appropriate Field Director determines a credit union's application is complete or receives a decision from an SSA, in the case of a FISCU.	Application Review by Regulators: • 120 days from the date the appropriate Field Director determines a credit union's application is complete or receives a decision from an SSA, in the case of a FISCU.
Application content. A credit union must demonstrate: • How derivatives are one part of the credit union's IRR mitigation strategy. Mitigation may be of current or prospective IRR. • How it plans to acquire, employ, and/or create the required resources, policies, processes, systems, internal controls, modeling, and competencies. • That its senior executive officers and board of directors understand the role derivatives play in the credit union's balance sheet management and the risk inherent in derivatives activities. • How it intends to use external service providers.	Application content. In addition to the content required in an application for Level I, a credit union applying for Level II authority must also: • Demonstrate why the limits for Level I authority are not sufficient for it to use derivatives as part of its IRR mitigation strategy. • Have the systems and personnel required by this rule in place *before* submitting its application.
External service providers: A credit union may contract with external service providers to: • Support: ○ Evaluating credit risk management. ○ Evaluating liquidity risk. ○ Asset/liability risk management. • Conduct: ○ Accounting reporting. ○ Counterparty exposure management. ○ Collateral management. ○ Trade execution. ○ Transaction management. ○ Financial statement auditing. ○ Legal services.	External service providers: A credit union may contract with external service providers to: • Support: ○ Asset/liability risk management. ○ Evaluating credit risk. ○ Counterparty exposure management. ○ Evaluating liquidity risk. ○ Collateral management. ○ Transaction management. • Conduct: ○ Accounting reporting. ○ Trade execution. ○ Financial statement auditing. ○ Legal services.
Application fee: As set by NCUA. The Board is considering amounts starting at $25,000.	Application fee: • As set by NCUA. The Board is considering amounts between $75,000 and $125,000.

E. Permissible Transactions

As stated above, this proposed rule limits permissible derivatives transactions for both Level I and Level II to interest rate caps and interest rate swaps. The Board considered all of the comments requesting additional levels of derivatives authority. At the present time, however, the Board believes that credit unions' capabilities and experience dictate a targeted approach to permissible derivatives. In addition, the Board believes this limited permissibility achieves the purpose of this rule, which is to provide credit unions with a meaningful tool to mitigate IRR. The Board recognizes and intends that these proposed limits may not provide mitigation for 100% of every credit union's IRR. Rather, the Board intends derivatives to be one part of a broader IRR mitigation and ALM strategy.

With regard to interest rate swaps, the Board is proposing to authorize only standard ''pay-fixed/receive-floating'' and ''pay-floating/receive-fixed'' [17] interest rate swaps. It is currently anticipated that most interest rate swaps users would enter into ''pay-fixed/receive-floating'' transactions to hedge against rising interest rates. This ''plain vanilla'' interest rate swap affords some protection against the most common interest rate exposure experienced by credit unions with material IRR sensitivity, namely, a statement of financial condition with an asset portfolio that does not reset to external rate changes as quickly as its liabilities.

[15] A credit union with Level I authority that exceeds this limit may not enter into any new derivatives transactions and must submit a corrective action plan to NCUA (or NCUA and the applicable SSA, in the case of a FISCU).

[16] A credit union with Level II authority that exceeds this limit may not enter into any new derivatives transactions and must submit a corrective action plan to NCUA (or NCUA and the applicable SSA, in the case of a FISCU).

[17] A pay-floating/receive-fixed interest rate swap is an agreement where a credit union pays the counterparty returns based on a floating rate index in exchange for returns based on a fixed rate of interest on a predetermined notional amount for a predetermined period of time.

Most credit unions use non-maturity and other short-term shares to fund longer duration assets creating an inherent re-pricing mismatch for which pay-fixed/receive-floating interest rate swaps can provide some effective mitigation.

Many variations of swap structures exist. NCUA is not authorizing any of the complex variations of the pay-fixed/receive-floating interest rate swaps structure because doing so introduces measures of complexity and risk that are more difficult to model, measure, monitor, and control. The Board does not believe the marginal risk management utility from more complex structures is sufficient to warrant the additional inherent risks. The Board seeks comment on whether credit unions believe that complex swap structures are necessary and, if so, which structures and why.

The Board is also restricting derivatives transactions to derivatives that are not leveraged. In some cases financial instruments have multipliers assigned to interest rate payments. These multipliers create a form of leverage that can either increase or decrease exposure to the rate or index to which the financial instrument is exposed. For example, a financial instrument could be structured to pay a floating rate of 3-month Treasury Bills times 1.2. This multiplier creates leverage and is impermissible under this proposed rule. This proposed rule allows credit unions to engage in a limited amount of ''plain vanilla'' derivatives transactions. Incorporating leverage could result in derivatives exposure beyond the limitations in this rule.

The Board is also excluding from the definition of interest rate swaps those where the notional amount varies because it does not believe the benefits of these instruments offset their added complexity. The maturity of instruments where the notional amounts vary can change in ways that may be unrelated to a credit union's own IRR. The Board does not intend for derivatives usage to add layers of complexity to a credit union's IRR management. Instead, the Board intends for credit unions to use derivatives as one tool in a comprehensive IRR management approach.

Consistent with the limitations for variable rate investments set in § 703.14(a),[18] NCUA is limiting permissible indices for interest rate swaps to domestic interest rates. In addition, any derivatives transaction must be denominated in U.S. dollars. These restrictions are consistent with the use of derivatives to manage IRR, as a credit union's IRR is correlated to changes in domestic interest rates.

The Board is also proposing to set a three-day settlement requirement for derivatives transactions. The counterparties to a derivatives transaction negotiate many elements of the transaction, including the settlement terms. The Board is proposing a three-day limitation based on market convention and believes it allows sufficient time to settle, while preventing forward-settling transactions, which can be used for speculation rather than mitigation. The Board invites comments on the appropriateness of this limit in the context of not wanting to allow forward-settling derivatives transactions.

Finally, this proposed rule prohibits credit unions from using derivatives to create structured liability offerings[19] for members or nonmembers, except as permitted under § 703.14(g) of NCUA's regulations.[20] That provision allows FCUs to purchase equity options for the purpose of offering their members dividends based on the performance of an equity index. Except for such dividends, FCUs may not use derivatives to offer structured liability products.

F. Eligibility

1. IRR Mitigation

As noted above, some commenters to the ANPRs expressed concerns with the general concept of requiring credit unions to demonstrate a material IRR exposure or another risk management need as a condition of derivatives authority. Other commenters supported requiring a credit union to demonstrate material IRR exposure before being granted independent derivatives authority. Among commenters expressing concerns with the concept of demonstrated need, one common concern was that requiring demonstrated need will reduce FCUs' incentives to responsibly manage IRR. The concern suggests that CUs will either proactively increase IRR in order to demonstrate need or will be less vigilant in managing IRR.

The purpose of this rule is to provide credit unions that meet certain standards with interest rate derivatives as an additional tool to reduce IRR exposure. As suggested by commenters, the Board recognizes that requiring the demonstration of material need for IRR reduction may create perverse incentives and lead to unintended consequences.

As discussed below, rather than demonstrate material interest rate risk exposure, a credit union must present a comprehensive risk management strategy, and articulate how the inclusion of interest rate derivatives will complement existing risk mitigation tools. In addition, a credit union applying for Level II authority must show why the limits in Level I authority are not sufficient to meet its IRR mitigation needs. The Board believes these requirements eliminate the unintended consequences cited by commenters, while ensuring a credit union fully considers how derivatives fit within its overall IRR mitigation strategy.

2. CAMEL Requirements

This proposed rule also requires a credit union's most recent composite CAMEL code rating, assigned by NCUA, to be a 1, 2, or 3, with a management component rating of 1 or 2. The Board believes that a high management component rating accounts for credit unions that may have a weak financial position because of IRR, but have the management in place to effectively identify, measure, monitor, and control significant risks. The Board intends this eligibility requirement to ensure that well-managed credit unions that need derivatives to mitigate IRR are able to obtain this authority.

3. Asset Threshold

As an eligibility requirement, the Board is also proposing an asset threshold of $250 million. An asset threshold of $250 million includes most credit unions with IRR exposure and the capacity to use derivatives. The Board arrived at this threshold by analyzing interest rate exposure at credit unions of varying asset size, the share of these credit unions' assets as a share of the credit union system, and the use of interest rate derivatives by similarly-sized community banks.

a. IRR Exposure

The Board notes that IRR is more prevalent among credit unions with assets over $250 million. Table 1 provides the average share of fixed rate assets, average share of money market deposits, and average share of non-core deposits (*e.g.,* deposits other than regular share and share draft accounts). These assets and liabilities represent the primary drivers of IRR exposure in a credit union's portfolio. Credit unions with more than $250 million in total

[18] 12 CFR § 703.14(a).

[19] A structured liability is an offering with contractual option features, such as periodic caps and calls, similar to those found in structured securities or structured notes.

[20] 12 CFR § 703.14(g).

assets have nearly twice the exposure to fixed rate assets and hold a much greater share of non-core deposits than credit unions with $250 million or less in assets.

Credit unions with more than $250 million in total assets represent 78% of the system-wide assets. With much of the IRR in these larger credit unions, the rule covers the vast majority of the IRR in the credit union system.

TABLE 1—IRR EXPOSURE AT CREDIT UNIONS BY ASSET CATEGORY (2012Q4) [21]

	Asset category			
	< $250M	$250M–$1B	$1B–$5B	$5B+
Share of Loans in Fixed Rate Mortgages	18%	35%	38%	36%
Share of Deposits in Money Market Accts	8%	22%	27%	26%
Share of Non-Core Deposits	32%	54%	60%	61%
Number of Credit Unions	6,066	556	180	17
Share of Systemwide Assets	22%	27%	33%	18%

b. Capacity

The cost to build staff and execute trades, and the counterparty requirements for many derivatives contracts, restricts most of these transactions to large commercial banks and community banks with more than $250 million in total assets. The Board believes this also holds true with credit unions. Table 2 below demonstrates the increasing likelihood of derivatives participation among larger financial institutions.

TABLE 2—CAPACITY FOR DERIVATIVES BASED ON BANK USE RATES [22]

	Asset category			
	< $250M	$250M–$1B	$1B–$5B	$5B+
Number of Banks and Thrifts	4,506	1,918	490	178
Number of Banks and Thrifts Holding Any Interest Rate Derivatives	347	535	280	148
Derivatives Use Rate	8%	28%	57%	83%
Average Notional Amount Held	$0.7M	$12M	$94M	$1.0T

Based on these considerations, the Board believes an asset threshold of $250 million is appropriate. It will allow those credit unions with the need and capacity to take advantage of this additional IRR mitigation tool.

In addition, a threshold of $250 million is a benchmark NCUA uses in other supervision areas, such as for annual examinations for FISCUs. The Board believes this figure represents a relative distinction between credit unions with more complex asset-liability structures and risks.

G. Proposed Requirements

The following discussion outlines the proposed requirements for credit unions with Level I and Level II authority. The Board points out the distinctions between the two levels and explains the reason for the differences. As discussed above, the difference between the two levels is in the permissible levels of transactions, as well as the application, expertise, and systems requirements.

1. Policies and Procedures

This proposed rule requires a credit union applying for Level I or Level II authority to operate according to written policies and procedures. These policies and procedures must, at a minimum, address managerial oversight, scope of activities, approved counterparties, risk management, legal issues, accounting standards, limits, counterparty exposure, margin requirements, and reporting requirements. The proposed rule requires that a credit union's board of directors review these policies and procedures annually and update them when necessary.

The Board believes it is important for everyone involved in a credit union's derivatives program, including external service providers, to be aware of the derivatives program's requirements, restrictions, and parameters. In addition, the Board believes written policies help ensure a credit union's board of directors contemplates every aspect of a derivatives program and the effect each will have on the credit union. An annual review will ensure the policies are updated to reflect the changing environment and the credit union's needs and goals.

2. Collateral Requirements

The Board is proposing requirements for collateral to ensure credit unions are fully protected in the event of market disruptions or counterparty defaults. These proposed collateral requirements include limiting collateral to highly liquid instruments permitted under the Act.

The proposed rule restricts the forms of collateral that are permitted for a credit union to the most liquid and easily valued instruments so that they can be easily negotiated even in times of market illiquidity. In addition, collateral arrangements must be bilateral and collateral may not be held by counterparties except at a legally separate affiliate. These requirements ensure that a credit union's exposure is de minimis by specifying that derivatives positions are priced daily, that the threshold amounts at which collateral is required are zero, and that mandatory triggers for transfer amounts are low. The Board has also included a proposed requirement that accounts for cases where a credit union lacking financial strength may be required to

[21] Data from the 2012Q4 NCUA Call Report.

[22] Data calculated from the 2012Q4 FDIC Call Report and is calculated for all banks and thrifts that report non-zero notional amounts outstanding for interest rate derivatives contracts.

post additional collateral for a counterparty to be willing to transact.

The Board notes that all of these proposed collateral provisions are based on common practices in the derivatives market. In addition, the Board believes these provisions will help protect the safety and soundness of a credit union with derivatives authority and will not pose an unreasonable burden.

This proposed rule limits eligible collateral to cash, Treasury securities, fixed-rate non-callable agency debentures, and zero-coupon non-callable agency debentures. Eligible collateral must also be permissible under the Act, part 703 of NCUA's regulations, and the credit union's own investment policy. NCUA is aware that these collateral restrictions are more limited than the permissible investments in the Act and NCUA's regulations, but the Board believes implementing narrower limitations is necessary to ensure collateral will be both highly liquid and easy to value. The Board notes that both Treasury and agency securities are generally considered the most liquid debenture sectors within the fixed-income arena. Furthermore, limiting agencies to fixed-rate and zero-coupon, non-callable structures further increases liquidity and ease of valuations. The importance of collateral in a derivatives transaction is to protect a credit union in the event the derivatives counterparty fails. Requiring highly liquid and easy to value securities, or cash, will help ensure credit unions are protected in the event of a counterparty default. The Board believes these restrictions will provide ample collateral options to derivatives counterparties.

In addition, the proposed rule requires that derivatives exposures be fully collateralized. This requirement is also an integral part of derivatives clearing requirements for banking organizations participating in the derivatives markets, including margins on collateral. Collateral management integrally reinforces good counterparty management.

Credit unions also need to consider the possible effects of derivatives transactions on liquidity. This includes the use of liquid assets as collateral for transactions which may reduce assets available for other liquidity needs. Margin requirements can fluctuate and require increasing amounts of collateral. Credit unions with Level II derivatives authority in particular should be aware of additional liquidity pressure from increased margin requirements for counterparty exposure under potential stress conditions where the credit union's loss on a derivatives position increases significantly. The replacement cost for a terminated or defaulted derivative transaction can also impinge on liquidity.

The proposed rule also limits a collateral custodian to an entity that is not the counterparty to the transaction (except for affiliates that are separate legal entities organized under U.S. law), is authorized to be a custodian, is subject to federal or state examination, and has equity of at least $50 million. Like the restrictions on counterparties discussed below, the Board is proposing this limitation to ensure that any entity holding collateral in a derivatives transaction is qualified and well capitalized so as not to add undue risk to a derivatives transaction.

3. Counterparty Requirements

In addition to the proposed collateral requirements to reduce risk to credit unions, the Board is proposing counterparty requirements with the same intent. First, the proposed rule limits credit risk by limiting permissible counterparties to swap dealers and major swap participants as defined by the Commodity Futures Trading Commission (CFTC).[23] At the time of this proposed rule, more than 70 domestic swap dealers have provisionally registered with the CFTC under its clearing requirements. By restricting counterparties to swap dealers and major swap participants, the Board is limiting counterparties to established institutions that meet the standards of and are subject to oversight by the CFTC. This pool of counterparties is sufficiently broad for credit unions to access the derivatives markets. The proposed rule also limits counterparties to those doing business under the laws of the United States to protect credit unions in case of counterparty dispute.

Second, the Board is proposing to require credit unions to develop the internal capacity to conduct a credit risk analysis of any potential counterparty. This means that a credit union must be able to carefully assess the likelihood of default and timely repayment of derivatives obligations. In addition, a credit union must be aware of the financial strength of its counterparties, as well as the counterparty's capital buffers to absorb losses and access liquidity.

4. Reporting

The proposed rule requires the senior executive officers to deliver a monthly report to the credit union's board of directors on certain aspects of the derivatives program. The proposed rule defines a credit union's senior executive officers as a credit union's chief executive officer (typically this individual holds the title of president or treasurer/manager), any assistant chief executive officer (*e.g.,* any assistant president, any vice president or any assistant treasurer/manager), and the chief financial officer (controller) that are directly within the chain of command for the oversight of a credit union's derivatives program, as identified in a credit union's process and responsibility framework.

This report must include an identification of noncompliance with the credit union's policies or any applicable law or regulation, including this rule, utilization limits, an itemization of the credit union's individual positions, a comprehensive view of the credit union's balance sheet, and the cost of executing new derivatives transactions. The Board believes it is important for a credit union's board of directors to be timely and accurately informed about the condition of the derivatives program so that it can make adjustments in the derivatives strategy to ensure the short and long-term goals of the credit union are met.

The Board also expects that senior executive officers would receive daily and weekly reports from individuals responsible for managing transactions and tracking risk compliance. While not included in the rule, the Board believes this is a prudent strategy to ensure adequate supervision of the derivatives program.

5. Systems, Processes, Personnel

The Board believes that appropriate systems, processes, and personnel are vital to a safe and successful derivatives program. The Board, therefore, has proposed several related requirements. The Board notes certain differences between systems, processes, and personnel requirements for Level I and those for Level II. The Board believes that the Level II requirements should be greater because of the higher transaction limits. The specific requirements are discussed below.

a. Personnel

Having the proper personnel in place at a credit union is fundamental to ensuring the safety and soundness of a derivatives program. To ensure a derivatives program is well managed and achieves the goals of the credit union, the board of directors, senior executive officials, and qualified derivatives personnel need to have varying degrees of knowledge and

[23] 17 CFR §§ 1.3(ggg) and (hhh).

expertise to carry out their respective functions.

i. A Credit Union's Board of Directors

A credit union's board of directors is responsible for establishing the business plan for the credit union and ensuring that the policies and programs achieve the goals of that plan. A credit union's board of directors must receive training before the credit union enters into any derivatives transactions, and annually thereafter. This training should educate the board members on the benefits and risks associated with derivatives, as well as how derivatives fit within a credit union's balance sheet and can be used as an effective IRR mitigation tool. The Board expects this training will provide a credit union's board of directors with the knowledge necessary to fulfill its fiduciary responsibility and provide strategic oversight of a derivatives program. A credit union must make evidence of this training available during its next NCUA or SSA examination.

ii. Senior Executive Officers

A credit union's senior executive officers are tasked with carrying out the credit union board's plan for using derivatives. This includes understanding the benefits and risks associated with derivatives as well as knowing how derivatives fit within the credit union's business model and balance sheet. As these officers are directly overseeing the day-to-day operation of a credit union's derivatives program, the Board expects them to have a comprehensive understanding of derivatives. During a credit union's application process, NCUA will evaluate each senior executive officer responsible for overseeing the credit union's derivatives program to ensure that each person has the education, skills, and experience necessary to oversee a derivatives program that is managed safely and effectively.

A credit union must immediately notify NCUA (and, if applicable, the appropriate SSA) when a senior executive officer position as defined in this rule becomes vacant.[24] A credit union must also immediately provide NCUA (and, if applicable, the appropriate SSA) with documentation evidencing knowledge and experience for any person who becomes a senior executive officer as defined in this rule while the credit union has derivatives authority. This supporting documentation must demonstrate that the new senior executive officer has the skill and experience required by the rule. Failure to provide this documentation or to show that the new senior executive officer is qualified under the rule will mean the credit union is no longer in compliance with the rule, and would be subject to the regulatory violation provisions, discussed below.

iii. Qualified Derivatives Personnel

In order to engage in any new activity, it is incumbent on the credit union to ensure that personnel with appropriate training and experience are responsible for the day-to-day activity. The risk of a derivatives program is not limited by the complexity of permissible products. While the Board is proposing ''plain vanilla'' interest rate swaps and interest rate caps as a way to mitigate a credit union's IRR, these tools still present complex issues with the transaction, risk management, and the operational aspects of a derivatives program.

The proposed rule requires three years of experience for qualified derivatives personnel at a credit union seeking Level I authority and five years of experience for Level II. The Board believes that increased limits correlate with increased risk, which necessitates additional experience by a credit union's qualified derivatives personnel. To satisfy the experience requirement of the proposed rule, qualified derivatives personnel must have at least the requisite number of years of direct transactional experience in the trading, structuring, analyzing, monitoring, or auditing of financial derivatives transactions at a financial institution, a risk management advisory practice, or a financial regulatory organization. Staff must also have the demonstrated expertise in statement of financial condition analysis. The Board believes that direct experience with derivatives allows a credit union to effectively manage risk and properly execute all derivatives transactions.

The Board recognizes the comments on ANPR II stating that NCUA should not condition approval on experience requirements. The Board believes that without qualified staff, however, a credit union will not be able to safely and effectively manage a derivatives program.

6. Internal Controls Structure

In addition to having the proper personnel in place, it is imperative that a credit union be organized in a way that ensures the proper level of oversight, separation of duties, and reviews and audits. As discussed below, this proposed rule has six requirements the Board believes will ensure a credit union's derivatives program is operated safely and soundly.

a. Separation of Duties

An important internal controls principle is dividing duties so that no one person has sole control over any transaction and its recording and accounting. Separation of duties helps reduce an employee's opportunity to commit and conceal fraud or errors. Errors in derivatives operations can result in significant losses because of the effect of leverage. Accordingly, the proposed rule requires that as part of its derivatives management and internal controls structure, a credit union maintain separation of duties for the functions of: (1) Derivatives execution and oversight; (2) accounting for and confirmation of derivatives transactions; (3) ALM; and (4) credit, collateral, and liquidity management. The Board believes these core functions must be accomplished by different people to ensure an effective system of checks and balances.

b. Framework

This proposed rule also requires a credit union with derivatives authority to maintain, in its written derivatives policy, a written and schematic description of the derivatives decision process. This framework description must show how decisions on derivatives are made, starting with the board's decision to use derivatives to mitigate IRR, to the senior executives formulating a derivatives plan and choosing the counterparties and derivatives, to the execution of the derivatives transaction and the monitoring and accounting through the life of the transaction. The Board is requiring that this framework be both written and in a schematic or flow chart form. A visual depiction of a credit union's decision process provides the credit union's employees and examiners with a useful summary of who is making and executing all of the decisions and functions associated with the credit union's derivatives program.

c. Internal Controls Audit

A credit union with Level I or Level II derivatives authority must, at least annually, have an internal controls audit conducted by an external service

[24] *Senior executive officer* is, for the purposes of this proposed rule, a credit union's chief executive officer (typically this individual holds the title of president or treasurer/manager), any assistant chief executive officer (*e.g.,* any assistant president, any vice president or any assistant treasurer/manager), and the chief financial officer (controller) that are directly within the chain of command for the oversight of a credit union's derivatives program, as identified in a credit union's process and responsibility framework, discussed in § 703.108(b)(2) of the proposed rule.

provider. The credit union must ensure the external service provider is experienced in auditing derivatives transactions, including, but not limited to, valuation methods and risk management modeling techniques, and is familiar with the credit union's IRR model and the related assumptions and inputs to test for reasonableness.

The scope of the audit must include coverage of the accounting, legal, operating and risk controls. The legal audit section should ensure executed contracts are in place with all counterparties and external service providers used in the derivatives program. The auditors will need to ensure all material contracts have been reviewed by counsel.

Scoping for operating and risk controls should include at a minimum a review of and testing for segregation of duties to ensure no one party or department is responsible for executing, documenting (accounting), and risk reporting of derivatives transactions along with compliance with policies and procedures. In addition, the audit must address collateral management to ensure the credit union is adequately monitoring and valuing its positions with counterparties. This includes independent valuations and review of counterparty pricing reports.

d. Financial Statement Audit

Currently, NCUA only requires financial statement audits for credit unions with assets of $500 million or more.[25] The Board, however, is proposing to require financial statement audits for any credit union with derivatives authority. Financial statement audits express an opinion as to whether the financial statements fairly present the credit union's financial position and the results of the operations and its cash flows in conformity with GAAP. The licensed certified public accountants responsible for the financial statement audit must have experience evaluating derivatives transactions.

Using derivatives exposes credit unions to a variety of risks, including market, counterparty, credit, and liquidity risks. Consequently, the review of written policies, internal controls, financial reporting, and regulatory requirements is imperative. Because accurate financial reporting is paramount to effectively manage risk and make sound business decisions, the Board believes it is prudent to require financial statement audits for all credit unions with approved derivatives authority. This is a new requirement only for those credit unions with assets between $250 million and $500 million. The Board is also proposing a conforming change to part 715 to clarify that credit unions with assets over $500 million and any credit union engaged in derivatives must obtain a financial statement audit.

e. Legal Review

The proposed rule requires a credit union to obtain a legal opinion from qualified counsel before executing any derivatives transaction. Qualified counsel means an attorney with at least five years of experience reviewing derivatives transactions. This attorney may be the credit union's in-house counsel or the credit union may need to retain outside counsel. The Board is proposing this requirement to ensure that any attorney providing a legal opinion on a credit union's derivatives program has the requisite skills and experience to properly evaluate International Swap Dealers Association (ISDA) agreements and compliance.

The legal opinion must conclude that the credit union's ISDA agreements are enforceable and the credit union is in compliance with all applicable laws and regulations relating to its derivatives program. Like the 1998 IRPS, this proposed rule also requires that a credit union ensure any counterparty is authorized to enter into the transaction.

f. Hedge Review[26]

The proposed rule requires a credit union to conduct a hedge review before executing a derivatives transaction. This review entails identifying and documenting the circumstances leading to the decision to hedge, specifying the derivatives strategy, and demonstrating that the derivatives transaction is protecting against the loss it was intended to mitigate. The Board included this requirement to ensure that two conditions are met: (1) A credit union with derivatives authority is using derivatives for their intended purpose, the mitigation of IRR; and (2) the credit union has a well thought out and documented plan of how and why it will hedge particular IRR on its balance sheet. The Board believes this requirement achieves both of these goals.

7. Transaction Management

The proposed rule requires credit unions to have support systems in place to provide accurate and timely transaction processing. The Board believes this requirement will help credit unions ensure that derivatives transactions are executed in a timely manner and in accordance with the policy of the credit union's board of directors. Under this requirement, credit unions should be able to document a derivatives transaction, including the price paid, collateral requirements, identification of the counterparty, life of the transaction, and reason for the hedge. Under the reporting section of the proposed rule, these items must be included in the monthly report to the credit union's board of directors. Further, the Board believes a credit union must be able to accurately account and record a derivatives transaction, just as it would any other transaction.

8. Asset Liability Management (ALM)

The proposed rule describes the management of derivatives as part a credit union's overall ALM. It is critical for the credit union to have staff with sufficient expertise to perform this function. It is equally important for the credit union to have an ALM function in place that is sufficiently well-developed to measure, monitor, and control all aspects of the credit union's statement of financial condition, including the credit union's derivatives activities. A credit union will need to manage the risk of derivatives transactions itself, within a clearly stated ALM strategy, while testing and demonstrating the effectiveness of these transactions in reducing IRR exposure. Therefore, as well as testing past effectiveness, a credit union must assess the likely effectiveness of its derivatives transactions in reducing IRR exposure going forward under a range of stressed rate and statement of financial condition scenarios. The credit union will also need to consider a variety of alternative strategies to reduce IRR in order to perform this function successfully.

The proposed rule identifies a number of ALM process elements that are necessary to successfully manage derivatives activity. Clear, comprehensive reporting by senior management to the credit union's board of directors is essential to identify any policy exceptions and to ensure that management of derivatives is clear and transparent at the highest level. The credit union should state individual and aggregate derivatives exposure within the context of the overall balance sheet of the credit union. The credit union should clearly capture, monitor, and report the cost of these transactions. Appropriate separation of duties is necessary to maintain accurate review and disclosure. The credit union will

[25] 12 CFR § 715.5.

[26] Hedge review means an analysis of the specific derivatives transaction a credit union is considering, to ensure that the transaction will mitigate IRR on the credit union's balance sheet.

need ALM systems that are able to identify the value of any of its derivatives transactions, and must have the capacity to state this value as part of a net economic value calculation of the credit union's balance sheet.

9. External Service Providers

The Board believes external service providers (ESPs)[27] can play a vital role in the overall success of a derivatives program. The Board, however, is concerned that overreliance on ESPs in the complex area of derivatives may lead to additional risk to the credit union. Potential conflicts exist because external parties do not share the same fiduciary responsibility as the credit union and they have financial objectives and incentives that are different as well. The Board, therefore, is proposing to allow credit unions to utilize ESPs in limited ways, provided that credit unions meet certain conditions and restrictions. In addition, the Board is proposing differing levels of ESP involvement for credit unions with Level I and Level II authority. As noted above, credit unions with Level II authority must have a higher degree of infrastructure and experience to obtain a higher level of authority. Behind this requirement is the idea that these credit unions should have more internal capacity, and, therefore, less reliance on ESPs, than credit unions with Level I authority.

First, the proposed rule prohibits credit unions from using ESPs that are principals or agents to derivatives transactions involving the credit union. NCUA is aware that some credit unions have ESP relationships with firms that provide services and act as agents or principals for securities trades. Unlike securities, derivatives transactions are unique agreements between two parties and pricing transparency is typically considerably more limited. This limited transparency makes it harder for a credit union to determine what fees are being charged to execute the transaction. Additionally, principals or agents may have an incentive to enter into derivatives trades to generate income for themselves. The potential conflicts of interest and the limited transparency are the primary reasons for the prohibition on ESPs being principals or agents in derivative transactions. The Board further believes that credit unions have sufficient alternatives for ESPs beyond principals or agents in derivative transactions.

Second, the Board believes that credit unions can make responsible use of contractual services provided by independent ESPs, as part of an effective derivatives and balance sheet management process. Responsible use of ESPs requires a credit union to have the internal capacity, experience and skills to oversee and manage any ESP activities. More generally, a credit union must retain responsibility and control over the derivatives and balance sheet management process and decision making. The credit union is responsible for managing ESP work products and must have a full understanding of ESPs' activities.

While the Board supports the use of ESPs, there are some activities that the Board believes are so central to demonstrating effective managerial control that the credit union must conduct them.[28] The Board is proposing to allow Level II credit unions more restricted use of ESPs because it believes that institutions able to take greater risks must have greater in-house risk-management capabilities.

The proposed rule classifies a number of activities into two categories of permissible use of contractual services and support. The functions in each classification vary between Level I and Level II authority. The two classifications are:

Support: A credit union is required to conduct the functions in this category. ESPs can provide assistance and input, but a credit union is prohibited from allowing an ESP to conduct the function or activity in lieu of the credit union.

Conduct: A credit union may contract with an ESP to conduct a function or activity in this category as part of the management and internal controls structure. While a credit union is responsible for managing an ESP's work quality and must have full understanding of all ESP activities and work products, it is not required to maintain in-house capacity for the function or activity. The table below summarizes the permissible uses of ESPs outlined in the proposed rule.

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

10. Limits

a. Interest Rate Swaps and Interest Rate Caps

The proposed rule includes limits for Level I and Level II authorities on the amount of derivatives exposure a credit union may take. These limits are intended to provide credit unions with sufficient tools to manage IRR based on the credit union's ability to independently manage its derivatives program. The Board, in establishing the limits, is also trying to limit the amount of potential loss exposure derivatives transactions may cause the credit union and NCUSIF. Derivatives exposure limits are measured differently for interest rate caps and interest rate swaps. The Board chose relatively simple measurement tools and acknowledges they may not fully capture all risks associated with derivative exposure. However, the

[27] An external service provider is any entity that provides services to assist a credit union in carrying out its derivatives program and the requirements of this rule. An external service provider does not include a credit union service organization that is wholly owned by the credit union receiving the services.

[28] For purposes of this rule, a wholly owned credit union service organization may perform these functions for the credit union that wholly owns it. If the CUSO provides services to other credit unions, it will be an ESP and subject to the restrictions in the proposed rule.

Board is comfortable that the methodology limits loss exposure, is easy to understand, and will allow credit unions to manage their IRR exposure. In addition, the Board chose these proposed limits with the intent that derivatives would not provide every credit union with complete IRR mitigation. Rather, the Board intends derivatives to be one part of an overall IRR mitigation strategy.

The proposed limit on interest rate caps is measured by the exposure of book value to net worth. The Board chose book value as the limit's measurement basis since it measures the amount of net worth at risk if the cap becomes worthless through the event of a default by the counterparty. Interest rate caps are typically purchased with strike rates [29] above current rates and pay the purchaser when interest rates increase above the strike rate. The premium that a purchaser pays at inception of the interest rate cap represents the maximum amount of potential loss to net worth on day one of the transaction. This premium will fluctuate over time, and value changes are reflected through changes in the income statement. GAAP hedge accounting treatment dictates whether the premium can be amortized or is subject to changes in fair value. The Board considered using notional value as a limitation, but decided book value was a more appropriate measurement because it accurately captures the risk associated with interest rate caps without unreasonably limiting a credit union's ability to mitigate IRR. The Board specifically requests that interested stakeholders provide suggestions of alternative methodologies to measure and limit cap exposure for credit unions and explain why the alternative is better than book value. The Board requests that any alternative measurement for credit unions to measure and report be straightforward.

The proposed limit on interest rate swaps is measured using notional exposure and fair value loss. Both measurements use the credit union's net worth as the basis. The Board chose two separate types of limitations for interest rate swaps based on lessons learned from the corporate credit union crisis. Unlike interest rate caps, an interest rate swap can result in the credit union owing the counterparty if rates move the opposite way from which the credit union is hedging. This loss can be magnified if the value of the hedged assets declines. Therefore, the Board is proposing to limit the notional amount of swap exposure a credit union may have regardless of whether the credit union is in a fair value gain or loss position. Further, the Board is proposing fair value loss limits that trigger a suspension of derivatives transactions and the submission of a corrective action plan if the credit union reaches certain levels of losses. As noted above, the proposed rule contains different loss limits for Level I and Level II.

The proposed rule allows credit unions with Level I authority to have book value of up to 10% of net worth in caps and up to a notional value of 100% of net worth in swaps exposure with a total fair value loss limit on swaps of 10% of net worth. A credit union with Level I authority using both interest rate swaps and interest rate caps will be subject to a combined limit. The combined limit requires that the sum of the percentage utilization of the interest rate swaps limit and interest rate caps limit is less than or equal to 100%. For example, consider a credit union that holds interest rate swaps with a notional balance equal to 75% of net worth (or 75% of the interest rate swaps limit) and interest rate caps with an aggregate book value equivalent 2.5% of net worth (or 25% of the interest rate caps limit). Combining the interest rate caps and interest rate swaps limits utilization percentages (75% + 25%) equals 100%. Therefore this credit union is at the limit and unable to add additional derivative positions.

Both the interest rate swaps limit and the interest rate caps limit are designed to make identifying and tracking exposure easy for credit unions. The Board believes these limits are appropriate given the risks, personnel, and systems required under the proposed rule for Level I authority, which are discussed above. The Board also believes these limits are sufficient for credit unions with lower levels of IRR and infrastructure to adequately use derivatives as an additional IRR mitigation tool.

The proposed rule allows credit unions with Level II authority to have book value of up to 25% of net worth in interest rate caps and up to a notional value of 250% of net worth in interest rate swaps exposure with a total fair value loss limit on interest rate swaps of 25% of net worth. NCUA will establish a combined limit for credit unions with Level II authority up to the maximum limit for caps and swaps. NCUA will establish this limit during the approval process based on the resources and need of the applying credit union. The Board believes these higher limits, in contrast to those for Level I, are appropriate given the added requirements for Level II credit unions. These higher limits will allow a credit union with considerably more infrastructure and experience to utilize additional derivatives to mitigate higher levels of IRR.

As identified in the discussion of the Level I and Level II limits on swaps, the proposed rule includes limits on a credit union's loss on swaps. The Board believes it is appropriate to include this additional limit on swaps given their riskier nature and the potential for losses. The Board's goal is to ensure the financial health of a credit union is not jeopardized by the declining value of swaps positions. The difference in the individual limits in this area reflects a higher level of experience and derivatives management capability at Level II credit unions, as well as a higher level of regulatory due diligence at the time NCUA reviews a credit union applying for Level II authority.

b. Maturity

In addition to the limits discussed above, the proposed rule includes limits on the individual maturities of derivatives transactions and the combined weighted average life of derivatives transactions for both Level I and Level II. Unlike exposure limits, these limits are applied equally to interest rate caps and interest rate swaps and are based on the notional amount. The Board notes that, like bonds, the risk of derivatives transactions increases as the maturity length increases. The Board believes that limiting the term of individual transactions and the weighted average life of the portfolio is an additional way to limit losses for a credit union and the NCUSIF, while not hindering a credit union's ability to mitigate IRR.

The proposed rule prohibits a credit union with Level I derivatives authority from having individual derivatives transactions that exceed a maturity of seven years. Further, the weighted average life of all derivatives in the credit union's portfolio cannot exceed five years. The Board believes these limits are appropriate given the risks, personnel, and systems required for Level I authority.

Conversely, the proposed rule prohibits credit unions with Level II derivatives authority from having derivatives transactions that have a maturity longer than ten years or a weighted average life of all derivatives in its portfolio greater than seven years. These longer maturities reflect the increased requirements for and supervision of a credit union with Level II authority.

[29] Strike rate means the interest rate that triggers payments to the credit union under the contract.

The following table illustrates the differing limits between Level I and Level II:

Authority	Level I	Level II
Interest Rate Caps	Book value of up to 10% of net worth	Book value of up to 25% of net worth.
Interest Rate Swaps	• Notional value of up to 100% of net worth • Must suspend derivative activity if total fair value of swap loss position exceeds 10% of net worth.	• Notional value of up to 250% of net worth. • Must suspend derivative activity if total fair value of swap loss position exceeds 25% of net worth.
Combined Limits	A weighting between both limits to equal 100%. For example, 50% of cap limit would allow for 50% of swap limit.	Determined during approval process.
Tenor Limits	• Derivative portfolio weighted average life limit of 5-years. • Single transaction maturity limit of 7-years	• Derivative portfolio weighted average life limit of 7-years. • Single transaction maturity limit of 10-years.

G. Application Procedures and Content and Review

The Board is proposing an application process that requires an applying credit union to demonstrate the requisite systems and expertise to support derivatives. In accordance with the increased levels for a credit union applying for Level II authority, the application process for this authority will be more thorough and will include an NCUA on-site review of the derivatives program infrastructure.

1. Application Content

The application process begins with the credit union submitting comprehensive documentation demonstrating that it meets the requirements for the level of authority it is applying for. The Board considers derivatives authority as an advanced ALM tool and expects a credit union's infrastructure to sufficiently support the activity. Application requirements represent items the Board regards as necessary components of enhanced ALM and critical derivatives program functions.

A credit union applying for either level must provide an IRR mitigation plan, which demonstrates how derivatives fit within that plan. The Board notes that while the need to mitigate IRR may be a prospective need, a credit union may not use derivatives to speculate. A credit union's plan should show that derivatives are an effective part of a credit union's IRR mitigation plan and that the credit union has other tools it is using to mitigate IRR. In addition to this requirement, a credit union applying for Level II authority must demonstrate why the limits in Level I are insufficient for its IRR mitigation needs. A credit union should be able to show in its application that even after employing other mitigation strategies it still has a need for derivatives limits that are higher than under Level I.

A credit union's senior executive officers and board of directors must understand how derivatives fit within the credit union's business model and balance sheet and be able to articulate how they intend to use ESPs. A credit union applying for Level I must demonstrate how it plans to acquire and employ the necessary systems, personnel and infrastructure, and do so before transacting in derivatives. A credit union, however, applying for Level II authority must have these in place before it applies. This requirement for Level II ensures that NCUA can adequately evaluate all of the components of the proposed derivatives program during its onsite review.

2. Application Review

After a credit union has compiled all of the information for its application, it must submit it to NCUA, or its SSA in the case of a FISCU. An SSA will evaluate an application and send its decision to NCUA for concurrence. Once the Field Director receives a complete application or a decision from an SSA, as applicable, NCUA will begin its review process. The Board notes that NCUA will not begin its review of an application until the appropriate Field Director determines that the application is complete and in compliance with the regulation and any applicable supervisory guidance. The proposed rule requires that a Field Director make this determination within 30 days of the date it receives an application from a credit union. NCUA will use its best efforts to review every application as quickly as possible.

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

Given the complex nature of derivatives and the level of due diligence the agency must perform to ensure derivatives programs are safe and sound, the Board believes these time frames are reasonable. The Board recognizes that a review of a derivatives program will vary between credit unions and the Board wants to ensure field staff has adequate time to conduct a thorough review. In addition, while not required under the proposed rule, it may be necessary for NCUA to conduct an onsite review of a credit union applying for Level I authority.

3. Appeals

The proposed rule also permits a credit union that has had its application denied by a Field Director to appeal to NCUA's Supervisory Review Committee within 60 days from the date of denial. For any final rule that becomes effective, the Board would make a corresponding change to IRPS 11–1, which lists the issues that credit unions may appeal to NCUA's Supervisory Review Committee.

H. Pilot Program Participants and FISCUs With Derivatives

The Board recognizes that current participants in the various derivatives pilot programs and FISCUs with active positions may not meet the requirements of a final rule promulgated by the Board. The Board wants to provide these credit unions with sufficient time to bring their programs into compliance with a final rule. This proposed rule, therefore, includes a section addressing this goal.

Specifically, the proposed rule provides that any credit union that, as of January 1, 2013, is holding derivatives under an NCUA derivatives pilot program or state law has 12-months from the effective date of a final rule to come into compliance with the rule's requirements. The Board set a date of January 1, 2013, to ensure that only credit unions with active positions before publication of this proposed rule could take advantage of the 12-month grace period. Compliance would include submitting an application for review under the provisions of the rule. During this 12-month period, a pilot participant is permitted to continue operating its derivatives program in accordance with its pilot program terms and conditions. A FISCU may also continue to operate its derivatives program under the applicable state law during this time period.

If a credit union fails to meet the requirements of the rule after 12 months, the rule requires that the credit union immediately cease entering into new derivatives transactions and within 30 days present a corrective action plan to NCUA (and SSA, in the case of a FISCU) outlining how and when it will cure any deficiencies or how it will unwind its derivatives program. A credit union under a corrective action plan is not permitted to enter into any new derivatives transactions until notified by NCUA.

A credit union that is otherwise in compliance with the rule, but is holding active positions it purchased prior to January 1, 2013, will not be subject to the corrective action plan requirements discussed above. Rather, the credit union will be required to inform NCUA and the SSA, in the case of a FISCU, how it will handle these active positions.

I. Regulatory Violation

The proposed rule provides a system of corrective action if a credit union with derivatives authority fails to comply with the rule, has safety or soundness concerns identified by NCUA, or fails to employ the resources, policies, processes, and competencies that it identified in its application for approval. If NCUA determines a credit union has failed any of these aspects, the credit union must immediately cease entering into any new derivatives transactions and must also present a corrective action plan to NCUA and the SSA, in the case of a FISCU, within 30 days.

A credit union's corrective action plan must address the deficiencies identified by NCUA and how the credit union will promptly fix these deficiencies. NCUA will evaluate all corrective action plans to determine if they are realistic and sufficient to remedy the deficiencies. In the case of a FISCU, this plan must also be approved by the applicable SSA. If NCUA, and the SSA, if applicable, approve a credit union's corrective action plan, NCUA will also notify the credit union when it is permitted to begin entering into new derivatives transactions.

In addition to or in lieu of a corrective action plan, NCUA may terminate a credit union's derivatives authority based on a violation of NCUA's regulations or safety and soundness concerns. NCUA will only require divestiture if it determines that doing so would not pose additional risks to the credit union.

J. Application Fees

The Board is considering instituting a fee structure for those credit unions that apply for derivatives authority. As discussed above, NCUA's application review process and ongoing enhanced supervision is labor and resource intensive. Rather than pass this cost on to the credit union industry as a whole, the Board believes it may be prudent to pass this cost directly to the credit unions seeking approval. Application fees may also serve as a deterrent to credit unions that are unsure whether or not they can meet all of the qualifications required to implement a safe and sound derivatives program.

The Board is considering a Level I application fee with amounts starting at $25,000 and a Level II application fee with amounts ranging from $75,000 to $125,000 based on the complexity of the application. The Board would set this fee in periodic guidance based on the evolving costs of processing an application.

In addition, the Board will maintain authority to modify the Level II application fee if the credit union operates under Level I authority for a period of time. The Board notes that NCUA will expend fewer resources to review the Level II application of a Level I credit union due to familiarity with the credit union's current practices. This situation may warrant a reduced Level II application fee. This reduction in application fee would largely depend on the length of time a credit union operates under Level I authority before applying for Level II authority. The Board also notes that this application fee would be in addition to any fees charged by an SSA for an application by a FISCU. The Board is interested in comments on this approach.

K. Supervision and/or Examination Fees

In addition to application fees, the Board is seeking comments on the pros and cons of recovering the costs of ongoing supervision of credit unions engaged in derivatives. The Board is particularly interested in comments as to whether annual NCUA costs for staff, contractors, and/or examination hours should be borne entirely by the credit unions engaged in derivatives.

For example:

- Should NCUA charge an annual licensing fee to the credit unions approved to engage in derivatives?
- Should NCUA charge credit unions that have purchased derivatives for examination time spent evaluating their derivatives activity?
- How would NCUA isolate and determine the staff hours involved in supervision of derivatives activity?
- Would an annual licensing fee or additional yearly charge act as a deterrent to qualified credit unions from using derivatives to mitigate IRR?

In responding to the above questions, it should be noted that the Board would not intend for any annual charges to act as a deterrent to qualified credit unions but rather as a more equitable way of assessing the cost of the derivatives program. The Board intends to encourage qualified credit unions to purchase risk-mitigating derivatives.

Commenters might want to consider who would benefit if more credit unions engage in risk-mitigating derivatives and if NCUA enhances derivatives supervision:

- Would credit unions that purchase derivatives and successfully mitigate IRR benefit directly from a reduction in potential losses?
- Would that reduction in potential losses at credit unions with more than $250 million in assets benefit the NCUSIF?
- Would all federally insured credit unions benefit indirectly from NCUA's enhanced supervision of derivatives?

L. Changes to Part 715

As noted above, the Board is also proposing a change to § 715.2 to clarify the financial statement audit requirement. Currently, this section only requires a credit union over $500 million in assets to obtain a financial statement audit. The proposed change clarifies that this requirement is in addition to the requirement in this rule that any credit union with derivatives authority, regardless of size, must obtain a financial statement audit.

M. Changes to Part 741

Subpart B of part 741 contains a list of regulations that, by their terms, apply only to FCUs but that NCUA has determined, for safety and soundness reasons, apply to FISCUs. Section 219 of part 741 addresses investments, providing that FISCUs must follow the requirements in part 703 regarding purchasing shares or deposits in corporate credit unions.[30] The proposed rule designates that provision as

[30] 12 CFR 741.219.

paragraph (a) of section 219 and adds a new paragraph (b) which requires FISCUs, which are permitted by state law to engage in derivatives transactions, to follow the requirements in subpart B of part 703.

III. 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).[31] The proposed rule allows credit unions to enter into certain derivatives transactions to reduce IRR. Since the proposed 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.[32] 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 proposal to OMB for its review and approval. Persons interested in submitting comments with respect to the information collection aspects of the proposed rule should submit them to OMB at the address noted below.

1. Estimated PRA Burden

For the purposes of calculating the PRA burden, NCUA estimates that 150 credit unions will apply for and be granted derivatives authority. NCUA further estimates that approximately 75 percent of this number, or 113, will be Level I credit unions and 25 percent, or 37, will be Level II credit unions.

Section 703.104 of the proposed 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 it will take a credit union seeking Level I derivatives authority an average of 40 hours to develop appropriate policies and procedures and a credit union seeking Level II authority 80 hours to do so. This is a one-time recordkeeping burden.

Section 703.104(b) of the proposed 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 Level I or Level II respondent.

Section 703.107 of the proposed rule requires a credit union's senior executive officers to provide a monthly, comprehensive derivatives report to the credit union's board of directors. NCUA estimates this ongoing recordkeeping burden will take an average of 2 hours per month (24 hours per year) per Level I or Level II respondent.

Section 703.108(a)(1) of the proposed 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 Level I or Level II respondent.

Section 703.108(b)(2) of the proposed 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 10 hours per Level I respondent and 20 hours per Level II respondent. The ongoing burden of maintaining the description will take 2 hours per year per Level I or II respondent.

Section 703.108(b)(4) of the proposed 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 20 percent, or 12, 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 703.108(b)(6) of the proposed rule requires a credit union, before executing a 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 703.111 and 703.112 of the proposed rule require a credit union seeking Level I or Level II 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 703.117 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 6 credit unions may have to submit an action plan each year and that a plan will take an average of 10 hours to prepare.

Summary of Collection Burden

Written policies and procedures:
113 Level I credit unions × 40 hours = 4520 hours (one-time burden).
37 Level II credit unions × 80 hours = 2960 hours (one-time burden).
Board review of policies and procedures:
150 credit unions × 10 hours = 1500 hours.
Monthly derivatives report:
150 credit unions × 24 hours = 3600 hours.
Evidence of Board training:
150 credit unions × 4 hours = 600 hours.
Derivatives process description:
113 Level I credit unions × 10 hours = 1130 hours (one-time burden).
37 Level II credit unions × 20 hours = 740 hours (one-time burden).
150 credit unions × 2 hours = 300 hours.
Financial statement audit:
12 credit unions × $50,000 = $600,000.
Pre-execution analysis:
150 credit unions × 4 hours = 600 hours.
Application:
150 credit unions × 50 hours = 7500 hours (one-time burden).

[31] 5 U.S.C. 603(a).

[32] 44 U.S.C. 3507(d); 5 CFR part 1320.

Corrective action plan:
6 credit unions × 10 hours = 60 hours.
Total Annual Hours Burden:
23,510 (16,850 one-time only).
Total Annual Cost Burden:
$600,000.

2. Submission of Comments

NCUA considers comments by the public on this proposed collection of information in:

• Evaluating whether the proposed collection of information is necessary for the proper performance of the functions of NCUA, including whether the information will have a practical use;

• Evaluating the accuracy of NCUA's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used;

• Enhancing the quality, usefulness, and clarity of the information to be collected; and

• Minimizing the burden of collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology; *e.g.,* permitting electronic submission of responses.

The Paperwork Reduction Act requires OMB to make a decision concerning the collection of information contained in the proposed regulation between 30 and 60 days after publication of this document in the **Federal Register**. Therefore, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. This does not affect the deadline for the public to comment to NCUA on the substantive aspects of the proposed regulation.

Comments on the proposed information collection requirements should be sent to: Office of Information and Regulatory Affairs, OMB, New Executive Office Building, Washington, DC 20503; Attention: NCUA Desk Officer, with a copy to Mary Rupp, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314–3428.

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. The proposed rule does 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. While the Board notes that this proposed rule applies to certain FISCUs, the Board does not believe that this rule rises to the level of a regulation ''that has 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. This rule does not grant any authority to FISCUs that has not been granted by applicable state law. In addition, any FISCU applying must apply to its state first and NCUA must concur with the state's determination. 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 proposed 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).

e. Agency Regulatory Goals

NCUA's goal is to promulgate clear and understandable regulations that impose minimal regulatory burden. The Board requests comments on whether this rule is understandable and minimally intrusive.

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 May 16, 2013.

Mary F. Rupp,

Secretary of the Board.

For the reasons discussed above, the National Credit Union Administration proposes to amend 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. Existing sections §§ 703.1 through 703.20 are redesignated under the following subpart A heading:

Subpart A—General Investment and Deposit Activities

* * * * *

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

§ 703.2 Definitions.

* * * * *

Derivatives means an instrument that has its price based on or derived from one or more underlying assets.

* * * * *

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 a property 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 borrower's application is processed.

* * * * *

■ 4. Add paragraph (k) to § 703.14 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. Remove paragraph (a) of § 703.16 and redesignate paragraphs (b), (c), (d), as (a), (b), (c), respectively.

■ 6. Add subpart B to read as follows:

Subpart B—Derivatives Authority

Sec.

703.100 Purpose and Scope.
703.101 Definitions.
703.102 Permissible derivatives transactions.
703.103 Eligibility.
703.104 Policies and procedures for operating a Level I or Level II program.
703.105 Collateral requirements for operating a Level I or Level II program.
703.106 Counterparty requirements for operating a Level I or Level II program.
703.107 Reporting requirements for operating a Level I or Level II program.
703.108 Systems, processes, and personnel requirements for operating a Level I or Level II derivatives program.
703.109 Specific Level I limits and requirements.
703.110 Specific Level II limits and requirements.
703.111 Applying for Level I or Level II authority.
703.112 Application content.
703.113 Application review by regulators.
703.114 Pilot program participants and FISCUs with active derivatives positions.
703.115 Regulatory violation.

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

Subpart B—Derivatives Authority

§ 703.100 Purpose and Scope.

(a) *Application of this subpart.* Unless explicitly specified otherwise, the requirements of this subpart apply to:

(1) Federal credit unions; and

(2) Federally insured, state-chartered credit unions that are permitted to engage in derivatives transactions under applicable state law.

(b) Sections 703.101–703.109 and 703.111–703.116 apply to a Level I derivatives program. Sections 703.101–703.108 and 703.110–703.116 apply to a Level II derivatives program.

(c) *Purpose.* This subpart allows credit unions to purchase interest rate caps and enter into interest rate swap transactions exclusively for the purpose of reducing their interest rate risk exposure.

§ 703.101 Definitions.

For purposes of this subpart:

(a) *Book value means* the value at which the derivative is carried on a statement of financial condition prepared in accordance with GAAP;

(b) *Counterparty* means the other party that participates in a derivatives transaction;

(c) *Derivative* means an instrument that has its price based on or derived from one or more underlying assets;

(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;

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

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

(g) *Field Director* means an NCUA Regional Director, the Director of the Office of National Examinations and Supervision, or any other NCUA Director designated to directly supervise credit unions eligible to apply for this authority;

(h) *Hedge* means to enter into a derivatives transaction to protect against loss created by changes in interest rates;

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

(j) *Interest rate risk* means the estimated change in earnings or value of an asset, liability, portfolio, or statement of financial condition as measured in terms of price, net interest income, or net economic valuation change from current levels;

(k) *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, paid in U.S. dollars. The exchange may be fixed to floating or floating to fixed;

(l) *ISDA agreement* means an agreement specified by the International Swaps and Derivatives Association that consists of a master agreement, a schedule, confirmations, definition booklets, and a credit support annex;

(m) *Leveraged derivative* means a derivative with interest rates that change proportionally with the contractual rate or index;

(n) *Major swap participant* has the meaning defined by the Commodity Futures Trading Commission in 17 CFR § 1.3(hhh);

(o) *Minimum transfer amount* means the amount of collateral that can be required per transfer to cover exposure in excess of the collateral threshold;

(p) *Net economic value* means the economic value of assets minus the economic value of liabilities;

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

(r) *Notional amount* means the predetermined dollar amount on which exchanged interest payments are based;

(s) *Novate* 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;

(t) *Structured liability offering* means an offering with contractual option features, such as periodic caps and calls, similar to those found in structured securities or structured notes;

(u) *Senior executive officer* is, for the purposes of this rule, a credit union's chief executive officer (typically this individual holds the title of president or treasurer/manager), any assistant chief executive officer (*e.g.,* any assistant president, any vice president or any assistant treasurer/manager), and the chief financial officer (controller) that are directly within the chain of command for the oversight of a credit union's derivatives program, as identified in a credit union's process and responsibility framework, discussed in § 703.108(b)(2) of this subpart;

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

(w) *Threshold amount* means an unsecured credit exposure that the parties are prepared to accept before asking for collateral; and

(x) *Weighted average life* means the weighted average length of time to the final maturity of derivatives contracts, calculated by multiplying the notional amount of each contract by the time to maturity and then adding each of those numbers together and dividing by the total notional amount of the contracts.

§ 703.102 Permissible derivatives transactions.

As part of its regulator approved strategy, a credit union may only purchase interest rate caps or enter into interest rate swap transactions that are:

(a) For the purpose of managing interest rate risk;

(b) Not leveraged;

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

(d) Denominated in U.S. dollars;

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

(f) Settled within three business days of entering into the transaction; and

(g) Interest rate swaps that do not have fluctuating notional amounts.

§ 703.103 Eligibility.

(a) A credit union may apply for Level I or Level II derivatives authority if it meets the following criteria:

(1) It provides an interest rate risk mitigation plan, which includes derivatives and shows how derivatives are one aspect of its overall interest rate risk mitigation strategy;

(2) Its most recent composite CAMEL code rating assigned by NCUA is 1, 2, or 3 with a management component of 1 or 2; and

(3) It has assets of at least $250 million, as of its most recent call report.

(b) A credit union seeking Level II authority must also show why the limits under Level I authority are insufficient for it to effectively mitigate interest rate risk.

§ 703.104 Policies and procedures for operating a Level I or Level II program.

A credit union must operate according to written, comprehensive policies and procedures for control, measurement, and management of derivatives transactions.

(a) At a minimum, the policies and procedures must cover:

(1) Managerial oversight and responsibilities;

(2) Scope of activities;

(3) Approved counterparties;

(4) Risk management (market, credit, liquidity, settlement, and operations);

(5) Legal issues;

(6) Accounting and financial reporting in accordance with GAAP;

(7) Derivatives limits;

(8) Aggregate counterparty exposure;

(9) A limit on the amount of exposure the credit union will have to any single counterparty, expressed as a percentage of net worth;

(10) Margin requirements; and

(11) Reporting requirements.

(b) A credit union's board of directors must review the derivatives policies and procedures annually and update them when necessary.

§ 703.105 Collateral requirements for operating a Level I or Level II program.

(a) A credit union's collateral arrangements must be supported by a bilateral ISDA credit support annex and comply with all applicable requirements of the Commodity Futures Trading Commission.

(b) A credit union may only accept collateral to secure a derivatives transaction that is permissible for a credit union to hold as enumerated in the Federal Credit Union Act, subpart A of this part, and its investment policies. Acceptable collateral is limited to cash, Treasury securities, fixed-rate non-callable agency debentures, and zero-coupon non-callable agency debentures.

(c) Daily, a credit union must price derivatives positions and calculate its fair value exposure.

(d) Daily, a credit union must be collateralized for all transactions to at least 100 percent of the transactions, based on the risk of the collateral.

(e) A credit union must set threshold amounts to zero.

(f) A counterparty to a derivatives transaction cannot hold or be the custodian of the collateral, except for affiliates of the counterparty that are separate legal entities. In any custodial arrangement, the custodian must: be organized and doing business under the laws of the United States or any state thereof; authorized under such laws to exercise corporate trust or custodial powers; have equity of at least $50,000,000; and be subject to supervision or examination by a federal or state authority.

(g) The minimum transfer amount must be less than or equal to $250,000.

(h) A credit union using collateral netting arrangements must have the ability to disaggregate and report individual exposures within and across all counterparties.

(i) A credit union may agree to provide additional collateral to a counterparty in a credit support annex so long as the credit union complies with all other collateral provisions in this subpart.

(j) A credit union must have systems in place to effectively manage collateral.

(1) A credit union's collateral management process must monitor its collateral daily and ensure that its derivatives positions are collateralized at all times in accordance with the collateral requirements of this subpart and the credit union's ISDA agreement with its counterparty. This includes the posting, tracking, valuing, and reporting of collateral to state positive and negative exposure using a daily fair value.

(2) A credit union must have the ability to analyze and measure potential liquidity needs related to its derivatives program and stemming from additional collateral requirements due to changes in interest rates. It must also be able to calculate and track contingent liquidity needs in the event a derivatives transaction needs to be novated or terminated. A credit union's senior executive officers must establish effective controls for liquidity exposures arising from both market or product liquidity and instrument cash flows.

§ 703.106 Counterparty requirements for operating a Level I or Level II program.

(a) A credit union must have an ISDA agreement in place to establish a credit relationship with any counterparty.

(b) Any derivatives counterparty must be either a ''swap dealer'' or ''major swap participant,'' and:

(1) Organized and doing business under the laws of the United States or any state thereof; or

(2) A United States branch of a foreign depository institution, licensed to do business under the laws of the United States or any state thereof.

(c) A credit union must calculate and manage individual counterparty exposure by book value and fair value. A credit union must conduct stress tests of counterparty exposures.

(d) A credit union must analyze counterparty credit risks, including, but not limited to: counterparty exposures, concentrations, credit exceptions, and nonperforming contracts. The credit union's board of directors must receive monthly, detailed reports addressing aggregate counterparty credit exposures.

§ 703.107 Reporting requirements for operating a Level I or Level II program.

At least monthly, a credit union's senior executive officers must deliver to the credit union's board of directors, separately or as part of the standard funds management or asset/liability report, a comprehensive derivatives report. At a minimum, this report must include:

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

(b) Utilization of the limits in § 703.109 or § 703.110, as applicable, and the limits in the credit union's policies;

(c) An itemization of the credit union's individual positions and aggregate fair and book values;

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

(e) The cost of executing new derivatives transactions. A credit union can express this cost through a comparison with observed market quotes and/or offering levels from other counterparties. Observed market quotes can include swap rates or external service provider modeled cap prices.

§ 703.108 Systems, processes, and personnel requirements for operating a Level I or Level II derivatives program.

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

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

document retention policy, until its next NCUA or state supervisory authority examination.

(2) *Senior executive officers.* A credit union's senior executive officers must have sufficient knowledge and experience to understand, approve, and provide oversight for the derivatives activities commensurate with the complexity of the derivatives program. These individuals must have a comprehensive understanding of how derivatives fit into the credit union's business model and risk management process. A credit union must immediately notify NCUA (and, if applicable, the appropriate SSA) when a senior executive officer position as defined in this rule becomes vacant. A credit union must also immediately provide NCUA (and, if applicable, the appropriate SSA) with documentation evidencing knowledge and experience for any person who becomes a senior executive officer as defined in this rule while the credit union has derivatives authority.

(3) *Qualified derivatives personnel.* To engage in derivatives transactions with Level I authority, a credit union must have knowledgeable and experienced employees that, except as provided in § 703.110(f) of this subpart for Level II authority, have at least three years of direct transactional experience in the trading, structuring, analyzing, monitoring, or auditing of financial derivatives transactions at a financial institution, a risk management advisory practice, or a financial regulatory organization. Staff must also have the demonstrated expertise in the statement of financial condition analysis described in § 703.107(d) of this subpart. These employees must, at a minimum, accomplish the following:

(i) *Asset/liability risk management.* Staff must be qualified to understand and oversee asset/liability risk management including the appropriate role of derivatives. This 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 rate and statement of financial condition scenarios, and evaluating the relative effectiveness of alternative strategies;

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

(iv) *Credit, collateral, and liquidity management.* Staff must be qualified to evaluate credit risk, manage collateral, and evaluate liquidity risk, as described in §§ 703.105 and 703.106 of subpart B of this part.

(b) *Required management and internal controls structure.* To effectively manage its derivatives activities, a credit union must allocate resources sufficient to support the scope and complexity of its derivatives activities. An effective management and internal controls structure includes, at a minimum, the following:

(1) *Separation of duties.* A credit union's process, whether conducted internally or by an external service provider, must have appropriate separation of duties for the following functions:

(i) Derivatives execution and oversight;

(ii) Accounting for and confirmation of the derivatives transactions;

(iii) Asset/liability risk management; and

(iv) Credit, collateral, and liquidity management.

(2) *Process and responsibility framework.* A credit union must maintain, in its derivatives policies and procedures, a written and schematic (*e.g.* flow chart or organizational chart) description of the derivatives decision process. The process must include the roles of staff, external advisors, senior executive officers, the board of directors, and any others involved in the derivatives program and demonstrate separation of duties, independent risk management, and effective oversight.

(3) *Internal controls review.* A credit union must have an internal controls audit at least annually that ensures the timely identification of weaknesses in internal controls, modeling methodologies, and the risk oversight process. This internal controls review must be performed by external individuals qualified to evaluate the attributes of a derivatives program. An internal controls audit must incorporate an evaluation of the effectiveness of internal controls relevant to measuring, monitoring, reporting, and limiting risks. The scope of the internal controls review must also include coverage of the accounting, legal, operating, and risk controls.

(4) *Financial statement audit.* A credit union must obtain an annual financial statement audit, as defined in § 715.2(d) of this chapter, by an independent state-licensed certified public accountant with at least two years of experience evaluating derivatives transactions.

(5) *Legal review.* Before executing any transactions under this subpart, a credit union must receive a legal opinion from qualified counsel stating that the credit union's ISDA agreements are enforceable and that the credit union is complying with applicable laws and regulations relating to operating a derivatives program. Qualified counsel means an attorney with at least five years of experience reviewing derivatives transactions. A credit union must also ensure any counterparty is authorized to enter into such transactions.

(6) *Hedge review.* Before executing any derivatives transaction, a credit union must 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.

(c) *Transactions management.* A credit union must have support systems in place to provide accurate and timely transaction processing.

(d) *Asset/liability risk management.* A credit union must have the systems and operational capacity to derive net economic value and understand interest rate risk.

(e) *Use of external service providers.* As specified in § 703.109 and § 703.110, as applicable, a credit union may use external service providers to support or conduct certain aspects of its derivatives program, provided:

(1) The external service provider, including affiliates, cannot:

(i) Be a counterparty to any derivatives transactions involving the credit union;

(ii) Be a principal or agent in any derivatives transaction involving the credit union; or

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

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

(3) The credit union documents the specific uses of external service providers in its process and responsibility framework, as described in § 703.108(b)(2) of this subpart.

§ 703.109 Specific Level I limits and requirements.

A credit union with Level I derivatives authority must comply with the following specific limits and requirements:

(a) A credit union approved only to enter into interest rate swaps must restrict the aggregate notional amount of its interest rate swap transactions to 100 percent of net worth.

(b) A credit union approved only to purchase interest rate caps must restrict the aggregate book value of its interest rate cap transactions to 10 percent of net worth.

(c) A credit union approved to transact interest rate swaps and purchase interest rate caps may not exceed a combined limit of 100 percent of the aggregate amount of each limit the credit union used under paragraphs (a) and (b) of this section. For example, a credit union may hold 80 percent of the limit for interest rate caps and 20 percent of the limit for interest rate swaps, but cannot hold 100 percent of the limit for each. This combined limit can be represented as:

$$100*\left[\frac{Notional\_amount\_of\_swaps}{Net\_Worth}\right]\Big/100 + 100*\left[\frac{Book\_value}{Net\_Worth}\right]\Big/10 \leq 100$$

(d) The aggregate fair value loss of all swap positions into which the credit union has entered cannot exceed 10 percent of net worth.

(e) The maximum permissible weighted average life on all derivatives positions may not exceed five years and the maximum permissible maturity for any single derivatives position may not exceed seven years.

(f) *Use of external service providers.* A credit union may use external service providers to support or conduct certain processes, subject to the following restrictions:

(1) *Support.* A credit union must internally and independently carry out and conduct the following functions, but may obtain assistance and input from an external service provider, provided the external service provider does not conduct the functions in lieu of the credit union:

(i) Evaluating credit risk management;

(ii) Evaluating liquidity risk; and

(iii) Asset/liability management.

(2) *Conduct.* Provided a credit union maintains responsibility for the following activities and an understanding of all of an external service provider's activities and work product, a credit union may contract with an external service provider to conduct these functions in lieu of the credit union:

(i) Accounting and financial reporting;

(ii) Counterparty exposure management;

(iii) Trade execution;

(iv) Transaction management;

(v) Legal services;

(vi) Collateral management; and

(vii) Financial statement audit.

§ 703.110 Specific Level II limits and requirements.

A credit union with Level II derivatives authority must comply with the following specific limits and requirements:

(a) For a credit union approved only to enter into interest rate swaps, NCUA will establish the aggregate notional amount of its interest rate swap transactions at an amount not to exceed 250 percent of net worth.

(b) For a credit union approved only to purchase interest rate caps, NCUA will establish the aggregate book value of its interest rate cap transactions at an amount not to exceed 25 percent of net worth.

(c) For a credit union approved to transact interest rate swaps and interest rate caps, NCUA will establish the appropriate cumulative limit not to exceed individual limits in paragraphs (a) and (b) of this section.

(d) The aggregate fair value loss of all swap positions into which the credit union has entered cannot exceed 25 percent of net worth.

(e) The maximum permissible weighted average life on all derivatives positions may not exceed seven years and the maximum permissible maturity for any single derivatives position may not exceed ten years.

(f) The qualified derivatives personnel described in § 703.108(a)(3) must have at least five years of direct transactional experience in the trading, structuring, analyzing, monitoring, or auditing of financial derivatives transactions at a financial institution, a risk management advisory practice, or a financial regulatory organization. In addition to the activities the qualified derivatives personnel are required to conduct in § 703.108(a)(3), they must also price options and undertake statement of financial condition simulations under multiple interest rate scenarios.

(g) The exposure by notional amount to any single derivatives counterparty cannot exceed 100 percent of net worth for interest rate swaps and the book value may not exceed ten percent of net worth for interest rate caps.

(h) *Use of external service providers.* A credit union may use external service providers to support or conduct certain processes, subject to the following restrictions:

(1) *Support.* A credit union must internally and independently carry out and conduct the following functions, but may obtain assistance and input from an external service provider, provided the external service provider does not conduct the functions in lieu of the credit union:

(i) Asset/liability risk management;

(ii) Evaluating credit risk;

(iii) Counterparty exposure management;

(iv) Evaluating liquidity risk;

(v) Collateral management; and

(vi) Transaction management.

(2) *Conduct.* Provided a credit union maintains responsibility for the following activities and an understanding of all of an external service provider's activities and work product, the credit union may contract with an external service provider to conduct these functions in lieu of the credit union:

(i) Accounting and financial reporting;

(ii) Trade execution;

(iii) Financial statement audit; and

(iv) Legal services.

§ 703.111 Applying for Level I or Level II authority.

An eligible credit union must submit a request for Level I or Level II authority and a detailed application, consistent with this subpart, before engaging in any derivatives transactions. The application must include draft policies and procedures, the process and responsibility framework, and the proposed systems and personnel needed to efficiently and effectively manage the credit union's derivatives activities. A credit union must submit its application to:

(a) The applicable Field Director, in the case of an FCU; or

(b) The applicable state supervisory authority, in the case of a FISCU.

§ 703.112 Application content.

A credit union applying for derivatives authority must demonstrate all of the following in its application:

(a) An interest rate risk mitigation plan, which includes derivatives and shows how derivatives are one aspect of its overall interest rate risk mitigation strategy. A credit union applying for Level II authority must also show why the limits under Level I authority are not sufficient for it to mitigate interest rate risk.

(b) How it plans to acquire, employ, and/or create the resources, policies, processes, systems, internal controls, modeling, and competencies to meet the requirements of this subpart. A credit union applying for Level II authority must have the systems and personnel required under this subpart in place before submitting its application.

(c) That it has senior executive officers and a board of directors that understand the role derivatives play in the credit union's interest rate risk management and the risk inherent in derivatives activities.

(d) How it intends to use external service providers as part of its derivatives program.

§ 703.113 Application review by regulators.

(a) *State supervisory authority review.* A state supervisory authority will review an application submitted under this subpart and forward its decision to the applicable Field Director for concurrence.

(b) *NCUA review.* After receiving an FCU's application or a state supervisory authority's decision, within 30 days from the date of its receipt, the Field Director will determine if the application is complete and meets the requirements of this subpart. The Field Director will notify the credit union within the following time frames if NCUA has approved or denied its application and the reason(s) for any denial:

(1) *Level I.* 90 days from the date the appropriate Field Director determines a credit union's application is complete or, in the case of a FISCU, receives a decision from the applicable SSA; or

(2) *Level II.* 120 days from the date the appropriate Field Director determines a credit union's application is complete or, in the case of a FISCU, receives a decision from the applicable SSA.

(c) *Right to appeal.* Within 60 days from the date of denial by the Field Director, a credit union may submit a written appeal to NCUA's Supervisory Review Committee.

§ 703.114 Pilot program participants and FISCUs with active derivatives positions.

(a) A credit union that, as of January 1, 2013, is holding derivatives under NCUA's derivatives pilot program or applicable state law must comply with the requirements of this subpart, including the application procedures, within 12 months from the effective date of this subpart. During the 12-month interim period, the credit union may continue to operate its derivatives program in accordance with its pilot program terms and conditions or applicable state law.

(b) A credit union holding derivatives under NCUA's derivatives pilot program or state law that does not comply with the requirements of this subpart within 12 months 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 the appropriate Field Director (and SSA in the case of a FISCU) describing how it will cure any deficiencies or unwind its derivatives program.

(c) A credit union that is otherwise compliant with this subpart except that it is holding impermissible active derivatives positions it entered into before January 1, 2013, may enter into new derivatives transactions in accordance with this subpart, provided it provides NCUA (or NCUA and the SSA, in the case of a FISCU) with a plan accounting for the active positions in violation of this subpart.

§ 703.115 Regulatory violation.

(a) A credit union engaging in derivatives transactions that no longer meets the requirements of subpart B of this part; fails to fully comply with its approved strategy, including employing the resources, policies, processes, and competencies that formed the basis for the approval; or has safety and soundness concerns identified by NCUA:

(1) Must present a corrective action plan to the appropriate Field Director (and state supervisory authority in the case of a FISCU) within 30 days of the determination of the violation; and

(2) May not enter into any new derivatives transactions until the Field Director (and state supervisory authority in the case of a FISCU) approves the corrective action plan.

(b) NCUA may revoke a credit union's derivatives authority at any time for failure to comply with the requirements of this section or for any other safety and soundness reasons. Revocation will prohibit a credit union from entering into any new derivatives transactions. Revocation will not require the credit union to terminate existing derivatives transactions if, at the discretion of the Field Director (and state supervisory authority in the case of a FISCU), doing so would not be practicable or deemed unsafe or unsound. The Field Director (and state supervisory authority in the case of a FISCU) may require a credit union to terminate existing derivatives transactions if doing so would not pose a safety and soundness concern.

(c) Within 60 days of NCUA's written notice of revocation of a credit union's derivatives authority, a credit union may appeal this decision to the NCUA Board. During the appeals process, the credit union does not have to terminate existing derivatives transactions, but it may not enter into any new derivatives transactions.

PART 715—SUPERVISORY COMMITTEE AUDITS AND VERIFICATIONS

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

Authority: 12 U.S.C. 1761(b), 1761(d), 1782(a)(6).

■ 8. Revise paragraph (a) of § 715.5 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 § 703.108(b)(4) 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, .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) *Derivatives.* Any credit union which is insured pursuant to Title II of the Act and permitted by its state law to engage in derivatives must follow the requirements of subpart B of part 703 of this chapter.

[FR Doc. 2013–12638 Filed 5–28–13; 8:45 am]

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DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 71

[Docket No. FAA–2013–0345; Airspace Docket No. 13–AEA–6]

Proposed Amendment of Class E Airspace; Factoryville, PA

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Notice of proposed rulemaking (NPRM).

SUMMARY: This action proposes to amend Class E Airspace at Factoryville, PA, as the Lake Henry VORTAC has been decommissioned, requiring airspace redesign at Seamans Field Airport. This action would enhance the safety and airspace management of Instrument Flight Rules (IFR) operations at the airport.

DATES: Comments must be received on or before July 15, 2013.

ADDRESSES: Send comments on this rule to: U.S. Department of Transportation, Docket Operations, West Building Ground Floor, Room W12–140, 1200 New Jersey SE., Washington, DC 20590–0001; Telephone: 1–800–647–5527; Fax: 202–493–2251. You must identify the Docket Number FAA–2013–0345; Airspace Docket No. 13–AEA–6, at the beginning of your comments. You may also submit and review received comments through the Internet at *http://www.regulations.gov.*

FOR FURTHER INFORMATION CONTACT: John Fornito, Operations Support Group, Eastern Service Center, Federal Aviation Administration, P.O. Box 20636, Atlanta, Georgia 30320; telephone (404) 305–6364.

SUPPLEMENTARY INFORMATION:

Comments Invited

Interested persons are invited to comment on this rule by submitting such written data, views, or arguments, as they may desire. Comments that provide the factual basis supporting the views and suggestions presented are particularly helpful in developing reasoned regulatory decisions on the proposal. Comments are specifically invited on the overall regulatory, aeronautical, economic, environmental, and energy-related aspects of the proposal.

Communications should identify both docket numbers (FAA Docket No. FAA–2013–0345; Airspace Docket No. 13–AEA–6) and be submitted in triplicate to the Docket Management System (see **ADDRESSES** section for address and phone number). You may also submit comments through the Internet at *http://www.regulations.gov.*

Persons wishing the FAA to acknowledge receipt of their comments on this action must submit with those comments a self-addressed stamped postcard on which the following statement is made: ''Comments to Docket No. FAA–2013–0345; Airspace Docket No. 13–AEA–6.'' The postcard will be date/time stamped and returned to the commenter.

All communications received before the specified closing date for comments will be considered before taking action on the proposed rule. The proposal contained in this notice may be changed in light of the comments received. A report summarizing each substantive public contact with FAA personnel concerned with this rulemaking will be filed in the docket.

Availability of NPRMs

An electronic copy of this document may be downloaded from and comments submitted through *http://www.regulations.gov.* Recently published rulemaking documents can also be accessed through the FAA's Web page at *http://www.faa.gov/airports_airtraffic/air_traffic/publications/airspace_amendments/.*

You may review the public docket containing the proposal, any comments received, and any final disposition in person in the Dockets Office (see the **ADDRESSES** section for address and phone number) between 9:00 a.m. and 5:00 p.m., Monday through Friday, except Federal Holidays. An informal docket may also be examined between 8:00 a.m. and 4:30 p.m., Monday through Friday, except Federal Holidays at the office of the Eastern Service Center, Federal Aviation Administration, Room 350, 1701 Columbia Avenue, College Park, Georgia 30337.

Persons interested in being placed on a mailing list for future NPRM's should contact the FAA's Office of Rulemaking, (202) 267–9677, to request a copy of Advisory circular No. 11–2A, Notice of Proposed Rulemaking distribution System, which describes the application procedure.

The Proposal

The FAA is considering an amendment to Title 14, Code of Federal Regulations (14 CFR) part 71 to amend Class E airspace extending upward from 700 feet above the surface at Seamans Field Airport, Factoryville, PA. Airspace reconfiguration within an 8.2-mile radius of the airport is necessary due to the decommissioning of the Lake Henry VORTAC, and for continued safety and management of IFR operations at the airport.

Class E airspace designations are published in Paragraph 6005 of FAA Order 7400.9W, dated August 8, 2012, and effective September 15, 2012, which is incorporated by reference in 14 CFR 71.1. The Class E airspace designation listed in this document will be published subsequently in the Order.

The FAA has determined that this proposed regulation only involves an established body of technical regulations for which frequent and routine amendments are necessary to keep them operationally current. It, therefore, (1) is not a ''significant regulatory action'' under Executive Order 12866; (2) is not a ''significant rule'' under DOT Regulatory Policies and Procedures (44 FR 11034; February 26, 1979); and (3) does not warrant preparation of a Regulatory Evaluation as the anticipated impact is so minimal. Since this is a routine matter that will only affect air traffic procedures and air navigation, it is certified that this proposed rule, when promulgated, would not have a significant economic impact on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

The FAA's authority to issue rules regarding aviation safety is found in Title 49 of the United States Code. Subtitle I, Section 106 describes the authority of the FAA Administrator. Subtitle VII, Aviation Programs, describes in more detail the scope of the agency's authority. This proposed rulemaking is promulgated under the authority described in Subtitle VII, Part, A, Subpart I, Section 40103. Under that section, the FAA is charged with prescribing regulations to assign the use of airspace necessary to ensure the safety of aircraft and the efficient use of airspace. This proposed regulation is within the scope of that authority as it would amend Class E airspace at Seamans Field Airport, Factoryville, PA.

This proposal would be subject to an environmental analysis in accordance with FAA Order 1050.1E, ''Environmental Impacts: Policies and Procedures'' prior to any FAA final regulatory action.

Lists of Subjects in 14 CFR Part 71

Airspace, Incorporation by reference, Navigation (air).