BOARD ACTION MEMORANDUM

TO: NCUA Board

DATE: May 7, 2013

FROM: Office of General Counsel
Office of Examination and Insurance

SUBJ: Part 703 Notice of Proposed Rulemaking—Derivatives

ACTION REQUESTED: Board approval to issue the attached notice of proposed rulemaking (NPRM) in the Federal Register with a 60-day public comment period.

DATE ACTION REQUESTED: May 16, 2013.

OTHER OFFICES CONSULTED: Regional Offices, ONES, and OCE.

VIEWS OF OTHER OFFICES CONSULTED: Concur.

BUDGET IMPACT, IF ANY: Derivatives authority will require an increase in NCUA resources due to the application approval process and enhanced supervision. From the outset, NCUA will expend resources to train staff, develop or acquire necessary analytical tools, and develop approval and supervisory processes. NCUA will need to recruit additional staff with derivatives expertise. The extent of these resource needs depends on a variety of factors:

- Number of credit union participants. The proposed rule limits eligible credit unions to those with assets of $250 million or more, of which there are currently 753 credit unions. The other eligibility criteria in the proposed rule, such as CAMEL ratings, the financial and managerial capacity needed to obtain derivatives authority, and the extent to which these credit unions have a need to mitigate interest rate risk, ultimately will determine how many credit unions are able to participate.
- Level of derivatives authority. The rule permits two levels of authority, with Level I authority permitting a more limited scope of activities than Level II. Level II applications will take more time to process, and those credit unions will require more oversight than Level I credit unions.
- Rate and timing of application inflow. Significant application inflow during the first two years of the authority becoming effective will require external support to augment NCUA resources.

Staff projects that 75 to 150 credit unions will apply for derivatives authority in the first two years. This projection is based on observed NCUA derivatives pilot program usage, and a review of the incidence of banks with derivatives positions based on bank Call Report data.

The two resource estimates below are based on the assumption that most credit unions will apply for derivatives authority within one year after the effective date of the rule, and the rate of incoming applications will slow over time. NCUA will require external resources to augment the agency's capacity and expertise during the application review process, as well as during the onsite examination and supervision of credit unions newly engaging in derivatives for the first two years.

The mix of credit unions seeking Level I versus Level II authority is estimated to be 75 percent / 25 percent.

The following tables summarize estimated costs for the scenarios discussed above.

Table 1 - Cost Estimates Based On 75 Credit Unions

		Mid-Year 2013	2014	2015
One Time	Pay & Benefits	-	$400,000	-
	Training	$300,000	-	-
	Subscriptions	$1,000,000	-	-
	Contracting	-	$3,800,000*	-
	Sub-Total	***$1,300,000***	***$4,200,000***	-
Recurring	Pay & Benefits	-	$1,800,000**	$1,800,000
	Subscriptions	-	$250,000	$250,000
	Sub-Total	-	***$2,050,000***	***$2,050,000***
	Total	***$1,300,000***	***$6,250,000***	***$2,050,000***

*Contracting budget may carry over into 2015 depending on credit union application flow. One-time start-up costs are expected to be absorbed by the end of 2015, so annual expenses in 2016 and beyond would be limited to the recurring costs.
**Scenario assumes six additional FTEs – five in the Regions and one in the Central Office.

Table 2 - Cost Estimates Based On 150 Credit Unions

		Mid-Year 2013	2014	2015
One Time	Pay & Benefits	-	$400,000	-
	Training	$300,000	-	-
	Subscriptions	$1,000,000	-	-
	Contracting	-	$6,500,000*	-
	Sub-Total	***$1,300,000****	***$6,900,000***	-
Recurring	Pay & Benefits	-	$3,600,000**	$3,600,000
	Subscriptions	-	$250,000	$250,000
	Sub-Total	-	***$3,850,000***	***$3,850,000***
	Total	***$1,300,000***	***$10,750,000***	***$3,850,000***

*Contracting budget may carry over into 2015 depending on credit union application flow.
**Scenario assumes twelve additional FTEs – ten in the Regions and two in the Central Office.

The following provides additional details on the specific cost elements included in the charts above:

- Training. The one-time training charge is for the development and execution of derivatives education for current NCUA staff.
- Subscriptions. The one-time and recurring line items for subscriptions provide for the acquisition, support, and maintenance of analytical tools for enhanced ALM supervision. An in-house balance sheet modeling capability will enable NCUA to conduct independent analysis of credit union balance sheet risk with and without derivatives positions, and provide field staff with information to appropriately challenge and assess credit union risk measurement processes and results.
- Pay and Benefits. The one-time pay and benefits line item represents the hours involved in derivatives-related training programs for current NCUA staff. The recurring pay and benefits line items are for the additional staff needed to supervise derivatives authority.
- Contracting. The one-time contracting line item is for external support to augment NCUA staff during the initial build-out of the derivatives supervision program, to assist with review of applications during peak volume periods, and to assist in conducting examinations and supervision during the first two years of the program.

The Board is considering application fees to defray the cost of processing applications for derivatives authority. Estimated application processing costs would range from $25,000 to $50,000 for Level I applications and would range from $75,000 to $125,000 for Level II applications. The Board would set the actual application fees in periodic guidance based on the evolving costs of processing applications.

The following tables contain estimated revenue using the application fee ranges, and demonstrate potential NCUA derivatives program cost offsets.

Table 3 –Application Fee Cost Offsets based on 75 Credit Unions

	Number of Credit Unions	**Application Fee**		**Potential Revenue**	
		Lower Range	**Upper Range**	**Lower Range**	**Upper Range**
Level I	55	$25,000	$50,000	$1,375,000	$2,750,000
Level II	20	$75,000	$125,000	$1,500,000	$2,500,000
Total	75			$2,875,000	$5,250,000
*Cost Recovery of One-time Costs ($5.50m)**				52%	95%
*Cost Recovery – all costs through 2014 ($7.55m)**				38%	70%

*** The cost recovery percentages assume 75 credit unions apply for derivatives authority. The percentages will be less relative to fixed startup costs if fewer than 75 credit unions apply.**

Table 4 –Application Fee Cost Offsets based on 150 Credit Unions

	Number of Credit Unions	Application Fee		Potential Revenue	
		Lower Range	Upper Range	Lower Range	Upper Range
Level I	110	$25,000	$50,000	$2,750,000	$5,500,000
Level II	40	$75,000	$125,000	$3,000,000	$5,000,000
Total	150			$5,750,000	$10,500,000
*Cost Recovery of One-time Costs ($8.20m)**				70%	128%
*Cost Recovery – all costs through 2014 ($12.05m)**				48%	87%

*** The cost recovery percentages assume 150 credit unions apply for derivatives authority. The percentages will be less relative to fixed startup costs if fewer than 150 credit unions apply.**

If the Board chooses to assess an application fee, the fee is envisioned to be nonrefundable and due at the time of application.

The Board may also consider discounting the application fee for credit unions upgrading from Level I authority to Level II authority after demonstrating a successful record for at least one exam cycle of sound derivatives management under Level I.

The Board is also considering an on-going supervision fee (not included in any estimates above) to recover the expense of enhanced ongoing supervision attributable to derivatives activity. The fee may be a standardized annual licensing fee paid by all participating credit unions, or may be based on actual or estimated resources used to supervise the activity.

The proposed rule seeks comment on the use of fees to offset costs associated with supervising credit unions with derivatives activity.

SUBMITTED TO INSPECTOR GENERAL FOR REVIEW: Yes.

RESPONSIBLE STAFF MEMBERS: Justin M. Anderson and Lisa Henderson, Staff Attorneys, Office of General Counsel; J. Owen Cole, Director of the Division of Capital and Credit Markets, Rick Mayfield, Senior Capital Markets Specialist, and Dale Klein, Senior Capital Markets Specialist, Office of Examination and Insurance; and Dr. John Worth, Chief Economist, Office of the Chief Economist.

SUMMARY: The NCUA Board is requesting public comment on an NPRM that would permit credit unions to engage in limited derivatives activities for the purpose of mitigating interest rate risk. The NPRM applies to federal credit unions and any federally insured, state-chartered credit unions that are permitted under applicable state law to engage in derivatives. The NPRM requires any credit union seeking derivatives authority to submit an application for one of two levels of authority. The two levels differ based on the permissible level of transactions and the regulatory requirements associated with operating a derivatives program. The NPRM follows two Advance Notices of Proposed Rulemaking requesting public comment on whether and how

NCUA should structure a regulation permitting credit unions to engage in derivatives transactions. If promulgated, the rule would be codified at new Subpart B to Part 703.

RECOMMENDED ACTION: The NCUA Board issue the attached NPRM.

ATTACHMENT: NPRM.