Bank Strategy Insights

FINANCIAL SERVICES GROUP | BALANCE SHEET STRATEGIES

October 23, 2020

Update on Credit Union Hedging

Please see this week's **Rate Sheet** and **Yield Curve Opportunities**.

We've covered a wide variety of topics recently, many of them related to creative ways banks can use derivatives to hedge their balance sheets. Next week we will shift focus, presenting our quarterly analysis of balance sheet trends, as seen through quarterly earnings reports. Our recent increased coverage of derivatives, however, is a conscious effort to reflect a corresponding increase in the ways in which banks are adding them to their hedging toolkit. Between a more transparent regulatory roadmap created by Dodd-Frank regulations, simplified derivatives accounting rules issued in August 2017 that allow more hedging strategies to qualify and reduce the burden of effectiveness testing, and increased examiner acceptance, community bank use of derivatives has grown exponentially since the financial crisis. Simply put, for many financial institutions, derivatives offer an efficient way to hedge interest rate risk, both on the asset and liability side of the balance sheet. But as banks' expertise grew, many credit unions, until recently, were left behind.

On October 15, 2020, the NCUA Board unanimously approved a proposal (click here for full proposal) to modernize regulations governing the use of interest rate derivatives used by Federal Credit Unions (FCUs). The Board is attempting to provide FCUs with more flexibility to manage interest rate risk, particularly in these unprecedented times as they seek to help members during the economic downturn. The proposal moves to a principles-based approach in order to make it easier and more efficient for FCUs to manage interest rate risk, reduces some of the burden of pre-approval, and removes hard regulatory limits on the amount of derivatives use. The proposal will be open for comment for 60 days.

Why now?

Since the NCUA published the final derivatives Rule 12 CFR Part 703 in 2014, the NCUA has been able to observe industry usage and build staff experience in order to more effectively supervise activity. Given the safe and effective use of derivatives observed, the Board feels that there are several areas where regulatory relief may be granted while still preserving safety and soundness.

Who does this impact?

The proposal applies only to federal credit unions and removes the need for regulatory pre-approval for FCUs with at least $500mm in total assets and a CAMEL rating of 1 or 2. FCUs less than $500mm in total assets or with a CAMEL rating greater than 2 would still be required to apply for derivatives authority in a similar manner prescribed by the current rule.

Federally-insured state chartered credit unions (FISCUs) must continue to have approval from the applicable state regulator with a notification to the NCUA.

Summary of Key Changes:

Topic	Proposal	Rationale
Pre-approval Process for Derivatives Authority	Eliminated for FCUs with > $500mm in total assets and CAMELS 1 or 2	Larger, complex FCUs with strong ratings are deemed to have sufficient internal controls
Forwarding Starting Swaps (FSS)	Removes the limitation on FSS	Allowed subject to the 15yr maximum tenor limit (forward start + swap tenor)
Regulatory Notional Limits	Proposed to eliminate notional limits	Consistent with a principles based-approach
Fluctuating Notional Limits	Fluctuating/amortizing notional limits now allowed	Consistent with elimination of notional limits
Restriction on Leveraged Derivatives	Leveraged Derivatives now allowed	Consistent with elimination of notional limits
Fair Value Loss and WARMN limits	Removes both entry and standard limits	Consistent with elimination of notional limits and a principles-based approach

Counterparty Requirements:

The proposal requires each FCU to have an executed ISDA/CSA agreement in place with its swap counterparty and mandates that the agreement be reviewed by counsel with derivatives expertise prior to execution[1]. The CSA is required to have a maximum threshold limit amount of $250,000. Accepted collateral is limited to cash, U.S. treasuries, U.S. government agency debt and MBS pass-throughs, and GSE backed debt and MBS pass-throughs. We believe this to be consistent with standard industry margining requirements.

Prohibited Activities:

The proposal continues to prohibit written options where compensation is received. Derivatives usage is limited to USD-denominated swaps calculated of off domestic interest rates or LIBOR-based derivatives, with appropriate oversight on LIBOR transition risks, with domestic counterparties. External Service Providers (ESPs) may not act as the swap counterparty, while also acting as advisors, to avoid creating a conflict of interest.

Reporting Requirements:

The proposal retains the requirement that a quarterly derivatives report be delivered to the Board with a monthly report prepared for the senior executive officer with direct oversight of derivatives usage and the ALCO committee. Transaction reviews must identify the rationale for the strategy and economic effectiveness.

[1] Note that we offer financial advice on ISDA/CSA negotiations as part of our full service offering.

Training Requirements:

The proposal retains training requirements such that the Board has a general understanding of the product in order to provide strategic oversight, but the proposal no longer mandates annual training. If there is a change in personnel such that the Board and/or senior executive officer no longer possess sufficient knowledge, additional training will be required prior to additional swaps being executed.

Piper Sandler views this proposal as a prudent industry development allowing FCUs to hedge interest rate risk, while leveling the playing field with banks. We stand ready to help our credit union clients with all aspects of derivatives education and trade execution, including structuring, reporting, and ongoing monitoring requirements.

If any of these observations pique your interest, please contact your Piper Sandler representative or email us at PSbankstrategyinsights@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

Other Thoughts from Around the Firm

Technology is at the forefront of senior bank executives' minds as winning new customers, increasing efficiency and managing risk, through the implementation of new technology, is core to their strategic plans. This was highlighted in the results of Piper Sandler's 1st Fintech Survey. Senior bank executives are steadfast in their commitment to grow and evolve their business through technology, although concerns around cost, return on investment, business interruption and interoperability with current systems can slow adoption.

As we endeavor to better understand our depository clients' views on Fintech, we have prepared our 2nd Fintech Survey - please see the link below. By clicking on the link, you will be taken to Survey #2 which builds on Survey #1 by gathering additional information on tech strategy, vendor selection and core banking systems.

This 5 minute survey can be filled out by any and all members of your senior leadership team and, when completed, will meaningfully contribute to our continuing efforts to provide unparalleled thought leadership and best-in-class advice.

Thank you in advance for taking the time to respond to this survey and we look forward to sharing our insights with you.

LINK TO SURVEY:

Piper Sandler FSG Fintech Survey #2

If learning more about our recent work is of interest to you, please don't hesitate to contact FSG-Solutions at FSG-Solutions@psc.com for more information.

CONTACTS

Scott Hildenbrand
Managing Director
Head of Balance Sheet Analysis and Strategy
Head of Piper Sandler Hedging Services
212 466-7865

Jim Armstrong
Managing Director
212 466-7978

Jean Bonatucci
Managing Director
212 466-7793

Matt C. Brunner
Managing Director
913 345-3371

Mary Marshall
Managing Director
212 466-7890

Jorge Puente
Managing Director
212 466-7835

Ryan Smith
Managing Director
212 466-7966

Leah J. Viault, CFA
Director
212 466-7769

Kris E. Johnson, CFA
Vice President
612 303-0608

Kelly Hughes
Assistant Vice President
212 466-7856

Kevin Wanke
Assistant Vice President
212 466-7988

Sarah De Vries
Analyst
612 303-0616

Matt Earley
Analyst
212 466-7816

Hill Fleet
Analyst
212 466-7825

Meet our Team