

**STATE OF MICHIGAN
DEPARTMENT OF INSURANCE AND FINANCIAL SERVICES**

Before the Director of the Department of Insurance and Financial Services

In the Matter of:

Order No. 14-033-CU

Request by DFCU Financial to Use
Interest Rate Derivatives

Issued and Entered
this 23rd day of June 2014
By Annette E. Flood
Director

**ORDER AUTHORIZING STATE-CHARTERED CREDIT UNIONS
TO PURCHASE INTEREST RATE DERIVATIVES FOR THE PURPOSE OF
MITIGATING INTEREST RATE PORTFOLIO RISK**

I. BACKGROUND

DFCU Financial (DFCU) is a state-chartered credit union. DFCU applied to the Department of Insurance and Financial Services (DIFS) for authority to exercise powers not specifically authorized by the Michigan Credit Union Act (MCUA), MCL 490.101 *et seq.* Specifically, DFCU requested that DIFS authorize domestic credit unions to purchase interest rate derivatives in order to mitigate interest rate portfolio risk.

According to DFCU, the use of derivatives is commonplace in the financial industry as part of sound risk management practices. DFCU also states that permitting state-chartered credit unions to access the interest rate derivatives market would allow credit unions to keep their interest rate risk exposure relatively stable. Credit unions purchasing derivatives for this purpose would do so by purchasing a derivative with a notional amount equivalent to the amount of a particular loan and/or deposit portfolio with interest rate risk. By entering into interest rate derivatives contracts in this manner, credit unions would diversify their interest rate portfolio.

DFCU also claims that permitting credit unions to use derivatives in this manner would ensure continued competitiveness with other financial services providers, many of whom already use interest rate derivatives as a method of hedging against interest rate risk.

Under Section 208 of the MCUA, the Director may, upon application by one or more domestic credit unions, issue an order authorizing domestic credit unions to exercise powers not specifically authorized by the MCUA if the Director finds that those powers are appropriate and necessary to compete with other providers of financial services in this state. MCL 490.208(1).

II. ISSUE

This order addresses whether it is appropriate and necessary to authorize domestic credit unions to purchase interest rate derivatives for the purpose of mitigating interest rate risk.

III. ANALYSIS

Under Section 208 of the MCUA, the Director may, upon application by one or more domestic credit unions, issue an order authorizing domestic credit unions to exercise powers not specifically authorized by the MCUA, if the Director finds that those powers are appropriate and necessary to compete with other providers of financial services in this state. MCL 490.208(1). In issuing an order authorizing additional powers, the Director “shall consider the ability of the domestic credit unions to exercise the additional power in a safe and sound manner, the authority of the domestic credit unions under state or federal law or regulation, the powers of other competing entities providing financial services, and any specific limitations on domestic credit union powers contained in this act or in any rules or other law of this state.” MCL 490.208(2). Taking each of the criteria in Section 208(2) in turn, the Director makes the following findings.

Ability to Exercise the Additional Power in a Safe and Sound Manner

Interest rate derivatives are widely utilized in the financial services industry. The market for these derivatives is liquid and well-functioning. Interest rate derivatives are a common method of hedging risk. Existing investment limitations and regulatory requirements in the MCUA including, but not limited to, Sections 401 and 431, would continue to apply to these transactions, and would ensure that the activity would be subject to regulatory oversight.

Accordingly, domestic credit unions may purchase interest rate derivatives in a safe and sound manner.

Authority Under State and Federal Law and Regulations

Domestic credit unions do not presently have specific authority to purchase interest rate derivatives under state or federal law or regulations. However, Sections 401 and 431 of the MCUA provide authority to enter into analogous transactions and thus provide support for authorizing domestic credit unions to exercise this additional power.

Section 401 enumerates the powers that a domestic credit union may exercise, including, among other things, the power to enter into contracts. MCL 490.401(2)(a). Interest rate derivatives are contracts in which the counterparty agrees to provide for the right to pay or receive a notional amount of money at a given interest rate. Accordingly, to the extent derivatives purchases are contracts, domestic credit unions are authorized to enter into them under Section 401 of the MCUA.

In addition, under Section 431, a domestic credit union may invest funds not used in loans to its members in an obligation that meets all of the following criteria:

- (i) In the domestic credit union's prudent judgment, which may be based in part upon estimates which it believes are reliable, there is adequate evidence that the obligor of the obligation will be able to

perform all it undertakes to perform in connection with the obligation, including all debt service requirements, and that the obligation may be sold with reasonable promptness at a price that corresponds to its fair value.

(ii) The investment characteristics of the obligation are not considered distinctly or predominantly speculative.

(iii) The obligation is not in default in the payment of principal or interest.

(iv) The obligation is a marketable obligation in the form of a bond, note, or debenture, commonly regarded as an investment security, and salable under ordinary circumstances with reasonable promptness at a fair value. MCL 490.431(1)(d).

The purchase of interest rate derivatives for the purpose of mitigating interest rate portfolio risk meets each of the criteria set forth in Section 431(1)(d) of the MCL, specifically:

1. Interest rate derivatives are widely utilized in the financial services industry and the market for these derivatives is liquid and well-functioning. As a result, it is likely that domestic credit unions would be able to sell interest rate derivatives with reasonable promptness at a price that corresponds to their fair value.
2. Interest rate derivatives are a common method of hedging risk and are not considered to be distinctly or predominantly speculative.
3. Each derivatives contract would be a new contract, and thus would not violate the requirement that the obligation not be in default in the payment of principal or interest.
4. Interest rate derivatives are marketable obligations analogous to Treasury notes, which also feature discrete duration and interest rate sensitivity that depend on the maturity of the bond or contract. Interest rate derivatives are increasingly regarded as an investment security and are clearly salable under ordinary circumstances with reasonable promptness at a fair value.

Accordingly, the Director finds that there is statutory support under Section 431(d) of the MCUA for permitting domestic credit unions to purchase interest rate derivatives. The Director will apply the criteria set forth in Section 431(d) to evaluate a particular interest rate derivative purchase program.

Powers of Other Competing Entities Providing Financial Services

Competing federal credit unions, operating under recently promulgated National Credit Union Administration regulations, have the authority to purchase interest rate derivatives. See 12 C.F.R. § 703.100-703.114. Domestic credit unions compete directly with federal credit unions, and are placed at a competitive disadvantage when federal credit unions have an additional tool at their disposal to mitigate their interest rate portfolio risk.

Similarly, the Director's predecessor authorized state-chartered banks, which also compete with domestic credit unions, to pledge assets as collateral security in interest rate swap transactions. This activity is analogous to the activities discussed here.

Specific Limitations on Domestic Credit Union Powers

State laws and regulations impose no specific limitations on the power to purchase interest rate derivatives.

Conclusion

Based on the foregoing, the Director finds that:

- domestic credit unions may purchase interest rate derivatives for the purpose of mitigating interest rate portfolio risk in a safe and sound manner;
- domestic credit unions do not currently have specific authority to purchase interest rate derivatives under state or federal law or regulations;
- Sections 401 and 431 of the MCUA support authorizing such activity;
- competing federal credit unions operating under recently promulgated NCUA regulations already have the authority to engage in such purchases, thereby placing

domestic credit unions at a competitive disadvantage if they are not permitted to use these derivatives;

- there are no specific limitations on domestic credit union powers under the MCUA or other law that would prohibit authorizing these additional powers; and
- granting this additional authority is appropriate and necessary to enable domestic credit unions to compete with other providers of financial services.

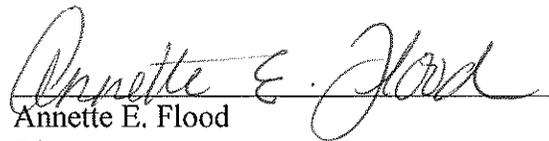
IV. ORDER

Therefore, it is **ORDERED** that DFCU's request for additional powers is granted and that DFCU is expressly authorized to purchase interest rate derivatives for the purpose of mitigating interest rate portfolio risk.

It is further **ORDERED** that all domestic credit unions are expressly authorized to purchase interest rate derivatives for the purpose of mitigating interest rate portfolio risk.

It is further **ORDERED** that any domestic credit union planning to purchase interest rate derivatives for the purpose of mitigating interest rate risk shall, no later than 60 days prior to the commencement of the purchase, notify the Director of its plan to engage in such activity.

This determination does not exempt domestic credit unions from any other requirement or obligation in the MCUA or other state law that may otherwise apply to the exercise of this additional power.


Annette E. Flood
Director