

April 19, 2007

Ms. Linda Jekel
Director of Credit Unions
Department of Financial Institutions
P.O. Box 41200
Olympia, WA 98504-1200

Re: Alternative Share Insurance Draft Regulations – Commentary on April Draft

Dear Ms. Jekel:

Thank you for providing us the opportunity to comment on the Division of Credit Union's (the "DCU") proposed second draft of the Alternative Share Insurance Regulations (the "[April Draft](#)") dated April 12, 2007, OTS-9542.3. As you are aware, we represent the Washington Bankers Association and the Washington Independent Community Bankers Association and provide these comments on their behalf.

This letter supplements our letter to you of March 15, 2007 (the "[March Letter](#)") regarding the discussion draft of February 12 (the "[Original Draft](#)") and unless expressly stated to the contrary herein, all of our concerns as articulated in the March Letter are incorporated by this reference. We appreciate the DCU's decision to extend the informal [comment period](#) regarding the promulgation of these rules. However, we remain concerned that the rules as drafted (i) precipitously fall short in their protection of credit union member depositor expectations, (ii) materially dilute the legislative mandate for the administrative approval of an alternative share insurance program "equivalent" to federal insurance, (iii) inexcusably compromise the mission of the DCU and (iv) unnecessarily put at risk the fine reputation of this administration should the system ultimately fail and a succeeding administration and legislature be left to deal with its aftermath.

As we reminded the DCU in March, the legislative mission of the DCU is articulated in [RCW 31.12.015](#) and includes as its primary mission "to protect members' financial interests". All other articulated missions of the DCU must be subordinate to this mandate. History shows that deposit insurance systems fail and that all due deliberation is required before Washington's system of protection is altered. *The judgment the DCU uses to set the standards for rules for alternative share insurance should improve member interests and not put those interests at unnecessary risk.* We will be constantly referring back to this standard through the remainder of this commentary. We express ten nonexclusive concerns regarding the April Draft.

1. The reasons for the rules require more detailed justification.

As drafted, Proposed WAC 208-800-010 reviews the current state of the law and articulates the legal elements for the approval of an alternative system. These are not reasons and the paragraph needs a substantial rewriting. The DCU currently partners with the NCUA in the supervision and examination of state-chartered credit unions. Much of the supervisory tools are mandated in federal law and are informally adopted into state practice. Also, the DCU shares examination

resources by combining with NCUA examiners to make up joint examination teams or by adopting each other's reports of examination. In a private insurance system, much of the legal framework and the administrative efficiencies of this system are lost.

We recommend that at the next public hearing on the April Rules that (i) the DCU provide a study of the supervisory rules applicable to NCUA insured state-chartered credit unions that will not otherwise apply to privately insured state-chartered credit unions, (ii) the DCU should provide a plan for how it intends to fill the supervisory void left by the inapplicability of such rules, (iii) the DCU should be prepared to present and analyze its personnel needs and the fiscal impact the loss of NCUA supervision and examination staff will have on the supervision and examination staff of the DCU, (iv) the DCU should provide a current statement of revenue collections and direct and indirect expenses and a projection of these cash flows based upon reasonable assumptions about increased workload and associated expenses, and finally (v), WAC 208-800-010 should be substantially expanded to include this analysis into the proposed rules.

2. Provisions in the April Draft materially alter the Original Draft without reference or an explanation for the changes.

At the top of the April Draft, this statement appears, **“PLEASE NOTE: NEW TEXT HIGHLIGHTED IN YELLOW”**. There are roughly ten areas in the April Draft where yellow highlights appear, leading a reasonable reader to conclude that no other text has been revised in the draft. To the contrary, substantial portions of the April Draft have been revised without an indication of a highlight. Many of these revisions materially dilute the standards articulated in the Original Draft, which will be discussed in greater detail below. There are at least fifteen (15) occasions in the April Draft where material revisions are made to the Original Draft that are not otherwise indicated. The definitions in -030 relating to “Access to additional sources of funds”, “Adequate resources”, “equity ratio”, “Equivalent share insurance program”, “Geographic regions”, “Insurance contract”, “National geographic diversity”, “Other sources of funds”, “Proportionately equal reserves” and “Replenishment” are revised without reference. Other areas include, Proposed WAC 208-800-100 (9), (13) and Proposed WAC 208-800-200(1).

We recommend that the April Draft be reconstituted in legislative redline form, comparing it with the Original Draft. In addition, DCU should explain all changes made so the public can understand the intent of the DCU in making the changes. We stress, that given the magnitude of the changes both in terms of quantity and substance from the Original Draft, this process must be undertaken for the April Draft and NOT merely commenced with the May Draft. There are simply too many significant changes from the Original Draft to be ignored from the record.

3. The rules circuitously grant the rulemaking authority broad discretion to interpret its own rules.

The apparent purpose of the rules is to establish processes and standards for the approval of an alternative share insurance provider. However, rather than detailing the basis for such processes and standards, the rules in seven material areas, simply articulate that the applicant must provide information “acceptable to the director” without sufficient detail regarding what is expected.

Apparently, the director will inform the applicant when to stop, once it is determined that sufficient detail is provided. This phrase appears in Proposed WAC 208-800-030(1), (2), (14), and -100(2), (9), (10) and -300(1). This is too arbitrary of a standard.

We recommend that DCU review these provisions and where appropriate amend the rules to provide greater detail concerning the acceptable regulatory standard.

4. The definition “Access to additional sources of funds” is materially diluted from the Original Draft without justification.

Please review below a redline of the April version of the definition “Access to additional sources of funds.”

“Access to additional sources of funds” means availability of funds ~~with, other than premium or assessment revenue, to be relied upon for payment of insured claims, and documented by contract, statute or title. Funds in this category must have~~ reasonable liquidity as acceptable to the director.

This definition has been materially diluted without reason or justification. Absent a compelling reason to the contrary, it would appear to us that the original version better protects member interests. As stated in the introduction to this letter, deposit insurance systems fail and fail catastrophically. This is due primarily because of its inherent instability. A deposit insurance system relies upon the financial well-being of the system it is attempting to insure. So long as the system suffers foreseeable losses, the system remains solvent solely because it can replenish its own loss reserves. During catastrophic financial events like those experienced during the federal S&L crisis of the late eighties and early nineties, the savings and loan system failed because the industry it was attempting to insure could no longer cover the insurance assessments necessary for the replenishment of the fund. A sound insurance system will have risk sharing features that extend beyond its own financial resources. For the federal savings and loan system, that access to additional sources of funds ultimately turned out to be the United States taxpayer. As costly as that was to the taxpayer, no individual insured depositor lost money as a result of the failure of the fund. Contrast that unfortunate experience to the collapse of the Rhode Island Share and Deposit Indemnity Corporation (“RISDIC”) which was the subject matter of Washington legislative hearings in December of 1995, prior to the legislation that terminated WCUSGA. RISDIC lacked a credible additional source of funds when the system could no longer reserve for its own losses, leaving the consequences of the insolvency to the Governor’s office and the Rhode Island legislature to deal with the aftermath of depositor losses.

We recommend that (i) the original definition be restored and (ii) a prerequisite for a favorable determination of “equivalency” require a risk sharing feature that provides access to funds “other than premium of insured claims” that is “equivalent” to the risk sharing features of federal insurance. Further, we are curious as to why the DCU made this change, especially absent anything in the written record from commentators that we could find, requesting such a change.

5. The definition of “Adequate reserves” is materially diluted from the Original Draft without justification.

Please review below a redline of the April version of the definition “Adequate reserves”.

“Adequate reserves” means the balance of the provision for insured losses account, in an amount acceptable to the director and reserves sufficient to cover known and unknown losses, and adjusted to provide for macroeconomic trends, including systemic risk factors, such as increasing consumer debt levels, bankruptcies, loan defaults and mortgage delinquencies ~~meet regulatory safety and soundness standards, with the highest available level of safety for share accounts.~~

This definition appears to articulate the accounting standards that appear in FAS 5, *Accounting of Contingencies* and FAS 114, *Accounting by Creditors for the Impairment of a Loan*. We would defer to the accountants for the appropriate GAAP accounting standards. However, we are concerned that the standard in the last phrase has been deleted to the detriment of member depositor interests.

We recommend that (i) the DCU consult with the accountants to arrive at a definition that is consistent with GAAP and (ii) that the standard “highest available level of safety for share accounts” be reinserted into the draft.

6. The definition of “Equivalent share insurance program” should meet a standard consistent with DCU’s statutory mandate to protect member financial interests and not merely meet a mechanical minimum statutory standard based upon a rigid definition of equivalency.

On its face, the definition that appears in the proposed rules in -030(10) seems sufficient. But the provision, if read mechanically, could be satisfied if the director determines that (i) reserves are proportional, (ii) there is sufficient national geographic diversity, (iii) there is sufficient adequate reserves and (iv) one of three additional elements exist, (x) replenishment, (y) reinsurance or (z) “other sources of funds”. Such a mechanical reading may satisfy the letter of the statute but wholly violate its spirit.

We recommend that the rules should make clear that the statutory standards in RCW 31.12.408(1) are indicia of minimum “equivalency” and that the director’s ultimate determination will be made after consideration of the totality of the circumstances including but not limited to whether the alternative system is consistent with the DCU’s ultimate statutory mandate to protect member interests. RCW 31.12.015.

7. The requirement in Original Draft -100(5) should be restored.

Please review below a redline version of the original provision of -100(5) now present in April Draft -100(6).

Documentation of the corporate and financial relationship between the applicant and ~~any of its subsidiaries. If the applicant's subsidiaries are in the business of providing insurance or risk management, applicant shall provide written proof of indemnification, whereby applicant's primary share insurance company assets will not be held liable for the subsidiary's acts, omissions or contractual obligations~~ its corporate affiliates(.)

This revision has been materially diluted. The Original Draft required an important structural safeguard; that the fund be used exclusively to insure Primary Deposits. The revision is not consistent with member depositor interests. It appears obvious to us why the DCU amended this provision - because, [ASI's commentary](#), page 3, demanded it. In its commentary, ASI wrote "The inclusion of this provision in the application requirements will prohibit ASI from applying for permission to do business in Washington State." (Emphasis original.) It is no justification to compromise a material credit union member interest to accommodate a potential applicant.

We recommend that the original requirement be restored.

8. The requirement in Original Draft -100(8) should be restored.

Please review below a redline version of the original provision of -100(8) now present in April Draft -100(9).

A written statement agreeing to timely provide a copy of ~~the~~ any executed contract for ~~finite~~ reinsurance, ~~in if any is obtained. Any contract for reinsurance shall be for~~ an amount of coverage acceptable to the director, ~~upon commencement of business in Washington state and annually thereafter. The statement shall include an agreement to provide a minimum and shall provide that the reinsurer is liable to the alternative share insurer for the payment of policy benefits and that the reinsurer will provide a minimum~~ of thirty days written notice of cancellation of reinsurance.

This revision dilutes a requirement for reinsurance and makes it optional. We would think that the legislature would find such a casual disregard of the spirit of the equivalency standard alarming. Again, it is obvious to us why the DCU amended this provision - because, ASI's commentary, page 4, demanded it. In its commentary, ASI wrote, "Currently, ASI does not have any reinsurance on its primary insured risks... This provision needs to be stricken." (Emphasis original.) This is no reason for DCU to ignore legislative intent.

We recommend that the original requirement be restored.

9. The requirement that the alternative share insurance fund have share insurance contracts reflecting a “national geographic diversity” should be broader and articulate specific identifiable and measurable standards.

Proposed WAC 208-800-100(2)(c) requires the applicant to provide proof of primary share insurance contracts that reflect a national geographic diversity, as that term is defined in - 030(13). We are pleased that DCU has expanded the geographic test in the Original Draft from the use of three time zones and now proposes eight geographic regions as defined by the BEA of the U.S. Department of Commerce. We believe that this continues to be a minimalist approach, however, and object to its use as not being sufficiently broad. Also, there is nothing in the rule that mandates a standard under which the analysis will be analyzed. The standard is merely, again, one that is “satisfactory to the director”.

We have two recommendations. First, we reiterate our suggestion regarding the use of the [12 Federal Reserve Districts](#) rather than [8 economic regions](#) as defined by the BEA. Second, we recommend that the DCU adopt in the rules a quantifiable standard based upon a methodology used by the Federal Reserve and the U.S. Department of Justice to analyze concentrations of market power called the [Herfindahl-Hirschman Index \(“HHI”\)](#). The HHI is a commonly accepted measure of market concentration and can easily be adapted to analyze portfolio concentrations. As a measure of market power, it is calculated by squaring the market share of each firm competing in a market, and then summing the resulting numbers. For these purposes and using the 8 economic regions (solely for illustrative purposes), a fully diversified portfolio would have 12.5% of its share insurance contracts in each economic region. The HHI for a fully diversified portfolio would therefore be 1250 (12.5 squared times 8). A fully concentrated portfolio would have 100% of its share insurance contracts in one economic region, reflecting an HHI of 10,000 (100 squared times 1). Any result that is three times a fully diversified portfolio, or a score of 3750 should raise a presumption against the fund being geographically diversified.

10. Proposed WAC 208-800-100(7) requires the imposition of a new fee without justification.

The proposed rules impose an application fee. However, the rules do not cite any statutory provisions authorizing such a fee.

We recommend the DCU cite in the rule the statutory authority for the imposition of the fee.

We thank you for this opportunity to provide you with our view of the April Draft.

Very truly yours

John L. Bley
On behalf of the WBA and the WICBA