

May 25, 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 May Draft

Dear Ms. Jekel:

Thank you for providing us the opportunity to comment on the Division of Credit Union's (the "DCU") proposed third draft of the Alternative Share Insurance Regulations (the "[May Draft](#)") dated May 11, 2007^[1], 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 letters to you of March 15, 2007 (the "[March Letter](#)") and April 19, 2007 (the "[April Letter](#)") and unless expressly stated to the contrary herein, all of our concerns as articulated in the March and April Letters are incorporated by this reference. Although we think that the proposed rules as drafted to date continue to fall precipitously short of legislative intent in many respects, we will focus our comments in only three material areas:

- Adequate reserves
- National geographic diversity
- Confidentiality

1. The stress tests used to test the adequacy of reserves as presented in revised proposed WAC -030(2) fall short of the generally accepted manner in which stress tests are performed.

We note in American Share Insurance's comment letter of April 30, 2007 ("[ASI's Letter](#)") that ASI describes itself as "the only private share insurer for credit unions in the country authorized to provide alternative (private) primary share insurance." Further, on page 17 of a report to Congress by the NCUA, "Study of Further Possible Changes to the Deposit Insurance System" dated February, 2007, (the "[NCUA Report](#)"), the NCUA expresses concern about the concentration of risk inherent in the ASI primary fund, primarily as a result of the conversion of Patelco Credit Union in 2002, "Patelco currently has approximately \$3.3 billion in insured shares, representing approximately 25 percent of the total shares insured by ASI." The Colorado Commissioner of the Division of Financial Services in a letter dated March 5, 2003 (the "[Colorado Letter](#)") reviewed ASI's program in late 2002 in response to state-chartered credit unions' interest in switching from federal to private deposit insurance and concluded that ASI's coverage was "not comparable" to NCUSIF coverage due to, among other things, a lack of geographic and single institution diversification of risk in the fund. It is reasonable for us to assume that the facts as presented above are known to the DCU since they have already been referenced in documents on DCU's website.

The revision to the definition of "Adequate reserves" is welcome as far it goes. It appears legitimate since it is taken, in part, from a methodology used by a U.S. Treasury Study to determine the viability of the NCUSIF. However, we believe there are material omissions from the Treasury methodology in the test as drafted by the DCU that would have a significant bearing on a fund that is concentrated due to a single "tall tree". The test appears to come from a U.S. Department of the Treasury study (the "[Treasury Study](#)") on Credit Unions dated December, 1997 page 47-49, referenced in the [NCUA Letter](#) to DCU dated April 12, 2007. Below, in redline form, is the stress test as articulated by the Treasury Study as compared to the proposed revision.

For our stress tests, we estimated the potential effect on the Share Insurance Fund of:

- The failure of the largest credit union;
- The failure of three of the ten largest credit unions (assuming each was the average size of the ten largest);
- The failure of all credit unions with CAMEL ratings of 4 or 5^{[2][+]}; and
- A repetition of the worst loss period in the Share Insurance Fund's history (1981-1983).

The omissions are quite serious considering the facts actually known to the DCU about ASI. Absent the parenthetical in the second test above, an applicant can ignore the “tall trees” in the top ten and as a matter of fact could always select credit unions in positions 8, 9, and 10. Adding the parenthetical eliminates this type of game playing. Also, the elimination of the fourth test is serious in that the applicant should test for the worst period of loss in an applicant's history.

The stress test cannot be relied upon as a final analysis either. When dealing with the failure of deposit insurance systems the state is dealing with low probability but extremely high cost events. Unfortunately, recent history proves that these low probability events occur with devastating results. Funds fail for reasons that a stress test would not predict. It is entirely reasonable that a fund would fail for a combination of factors. As described in President Gregorian's report to Rhode Island Governor Sundlun entitled “Carved in Sand” dated March 14, 1991, the Rhode Island fund failed due to an initial series of losses followed by a “contagion of fear,” a bank run^{[3][+]}. It is likely that a fund with a tall tree could deplete its reserves with the failure of the tall tree and would be unable to recapitalize in time to avoid the contagion. A contagion could also arise among competing state regulators. In a multiple state setting, the probability of failure is arguably higher since any one of the state regulators could impose an enforcement action on the insuring authority in order to protect its citizens to the potential detriment of other states' citizens.

It doesn't always take the failure of the top ten, either. The last time the state of Washington had private deposit insurance available to its credit union members the failure of a single small credit union had a very material impact on the fund. Although not a failure of the fund, Emerald City Credit Union's failure in the fall of 1995 caused a loss to the WCUSGA contingency reserve of approximately 20% notwithstanding the fact that ECCU constituted a mere 0.25% of the total assets in the WCUSGA system.

All of this points out the sobering reality of the inherent limits of financial institutions regulation. No regulator, state or federal, can ever foresee all possible contingencies in a failure without the benefit of hindsight. This underscores the seriousness of this matter and the need for any deposit insurance mechanism to have at its disposal additional sources of funds beyond assessments to make the system viable. Federal insurance has the taxpayer, private insurance needs a viable reinsurance mechanism, but unfortunately none exist because no insurance company will undertake the risk to underwrite it^{[4][§]}. The proposed rules ignore this glaring weakness by making reinsurance an option rather than a requirement. No private deposit insurance should be allowed to serve the citizens of the state of Washington until the private sector can come up with an economically viable source of alternative funds “equivalent” (even if not “identical”) to a taxpayer backup. The fact that the private sector has determined that reinsurance is not economically viable ought to speak volumes. We refer you to point 8 of our [April Letter](#).

We recommend that the entire text of the stress test as described in the Treasury Study be included in the proposed rules. In addition, any applicant should be required to prove that it has resources beyond assessments, like reinsurance, that it can draw from in order to replenish its fund promptly in order to preempt any possibility of a contagion of fear.

2. The test for “National geographic diversity” weights all credit unions equally and profoundly usurps the legislative intent that the risk of the fund be spread throughout the nation.

Statutory provisions should be implemented in a manner that supports a common sense interpretation of legislative intent. The statute in RCW 31.12.408(1)(c) requires the applicant to show that it has “share insurance contracts” that reflect a national geographic diversity. Nowhere in the statute is the term “share insurance contract” defined. That is left to the DCU. The DCU has chosen to define the term “insurance contract” in -030(12) as a contract between the insurance provider and a state-chartered credit union and makes it abundantly clear that a contract “with a credit union counts as one contract, regardless of the number of branches or members the credit union may have”. To us, it is self-evident that the purpose of the geographic diversity requirement is to assure that applicants whose fund risk is not sufficiently spread out among geographic regions *not* be allowed to serve credit union members in our state. To accept the methodology proposed by the DCU is to assume that a failure of a \$4.2 *billion* (with a “b”) credit union would cause the same amount of loss as a \$4.2 *million* (with an “m”) credit union. Such an assumption defies logic and renders the geographic test meaningless. Certainly, the legislature did not intend for \$4.2 billion to equal \$4.2 million. One is 1000 times the size of the other. Not all deposit insurance contracts are created equally. The coverage of each contract will depend on the size of each credit union. The *volume* of primary insured deposits covered by the contract is far more important in measuring risk to the fund than the mere existence of that one contract. DCU’s approach defies common sense and is another example of a minimalist approach usurping legislative intent.

We recommend that the term “share insurance contract” be redefined in the rules to take into consideration the risk each one of those contracts have to the fund by taking into account the volume of the primary insured deposits covered by each share insurance contract. In addition, we reiterate our suggestion that a standard be imposed to measure geographical diversity based on the HHI methodology using primary deposit concentrations. We refer the reader to comment 9 of our [April Letter](#) which describes in more detail the methodology that should be adopted.

3. New proposed revisions protecting application information is overly broad and as a practical matter eliminates all transparency from the application process.

The proposed addition in -100(19) governs the confidentiality of application information. Although the paragraph initially articulates the position that the DCU should “appropriately protect *certain* information within the application” the rule goes on to apparently keep from public inspection *all* information in the application. The paragraph goes on to incorporate by reference certain provisions of the insurance code concerning examinations and ignores its own statutory provisions and rules in RCW 31.12.565(1)(d) and WAC 208-12. We have no objection to maintaining the confidentiality of personal financial, business plans and other proprietary business information. We also note that the rules directly applicable to credit unions already exempt that information from public inspection. However, to declare all aspects of an application protected as examination information is overly broad and would have the effect of prohibiting public oversight of the application process. Furthermore, it would make the public hearing requirement in the statute meaningless as nothing could be discussed at the public hearing without violating the proposed rule. This is not what the legislature or the governor’s office expects of open government.

We recommend that the provisions in RCW 31.12.565(1)(d) and WAC 208-12 apply to the application process.

For the reasons stated herein, the rules as drafted materially dilute a common sense interpretation of the legislative intent of the provisions that govern the approval of a private deposit insurance system for credit union members. In addition, based upon the new proposed rules governing confidentiality, the DCU is attempting to perform its deliberations while materially impeding public oversight and participation. This is very disturbing. We were encouraged with the DCU when it opted to extend the informal comment period concerning these proposed rules. Yet, to date, the DCU is silent concerning the original draft and the reasons for the proposed changes it has made. There has been no written dialogue. Unfortunately, we must conclude that an extension of the process does not necessarily make the process any more deliberative. It’s been like speaking to a mime.

Since we have heard no detailed articulated justifications or reasons for the rules methodology, we are only left to speculate and interpret intentions from what we can divine from objective facts. Left on its own, it appears that the DCU would promulgate rules that (i) define geographic diversity in three geographic regions, one of which would be half of the continental United States, (ii) ignore size as a criteria of risk, (iii) minimalize the use of other sources of replenishment beyond additional assessments, and (iv) prefer to perform all of its deliberations under the veil of confidentiality.

It appears to us that the rules from the outset have been designed to legitimize an application for private deposit insurance rather than to evaluate it.

We thank you for this opportunity to provide you with our view of the May 11 Draft.

Very truly yours

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

[1][*] These comments do not reflect any changes made by the DCU as of the May 23 draft and are based upon the draft as of May 11.

[2][†] Since an applicant will not be privy to CAMELS ratings, we assume for the sake of this discussion that this is a test that the DCU would perform.

[3][†] For other studies on how private deposit insurance systems fail see “Similarities and Dissimilarities in the Collapse of Three State-Chartered Private Deposit Insurance Funds,” Walker F. Todd, Federal Reserve Bank of Cleveland Working Paper 9411, dated October 1994 ([link](#)) and “Lessons from the Collapse of Three State-Chartered Private Deposit Insurance Funds,” Walker F. Todd, Federal Reserve Bank of Cleveland, dated May 1, 1994 ([link](#)).

[4][§] According to “Carved in Sand,” Aetna was the last insurance company to reinsure deposits when it got out of the business in 1981. See page 76 of the [Report](#). This appears to continue to be the case based upon commentary previously submitted by ASI in their first (undated) commentary on page 4 ([link](#)).