



August 7, 2007

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

RE: NAFCU's Comments on Washington State Alternative Share Insurance Rulemaking

Dear Ms. Jekel:

On behalf of the National Association of Federal Credit Unions (NAFCU), I am responding to your request for comment on the Washington State Department of Financial Institutions' (WDFI) proposed rule regarding alternative share insurance for credit unions chartered by the State of Washington. Two of NAFCU's principle tenets are: 1) ensuring the overall safety and soundness of the whole U.S. credit union system; and 2) for credit union members to have deposit insurance fully equal, in every respect, to the FDIC deposit insurance provided for the customers of all U.S. banks.

NAFCU appreciates the opportunity to comment on this important issue. While we recognize that secondary share insurance (i.e., insuring shares above the ceiling provided under by federal insurance) provided by private entities is important, NAFCU believes that primary share insurance should only be provided by the Federal government. For the reasons set forth below, we urge the WDFI to refrain from using its statutory authority to promulgate rules under which a private entity may obtain approval to provide primary share insurance.

State and Federal regulators alike are bestowed with the responsibility of ensuring that Americans' deposits are as safe as possible. The importance of deposit insurance as a tool in meeting this responsibility was emphasized by the former Chairman of Federal Reserve Board Alan Greenspan, who testified before the Senate Committee on Banking, Housing and Urban Affairs in April 2002 that "deposit insurance was designed ... to protect the unsophisticated depositor with limited financial assets from the loss of their modest savings.... and, "it is clear that deposit insurance has played a key—**at times even critical**—role in achieving the stability in ... financial markets." (Emphasis added).

NAFCU believes that primary share insurance coverage provided by private entities is fundamentally flawed and cannot adequately protect American depositors.

Ultimate Backing

One essential aspect of primary share insurance must be that it is as strong of a backing as possible. Because the ultimate backing is that of the U.S. government, only coverage provided by insurance funds that are backed by the U.S. government can meet this fundamental criterion. As the WDFI is aware, the National Credit Union Share Insurance Fund (NCUSIF), which is administered by the three-member Board of the National Credit Union Administration (NCUA), is one such insurance fund. The vast majority of credit unions that are chartered by the state in which they are organized and operate, maintain primary share insurance with the NCUSIF.

Congress has explicitly stated that shares insured by the NCUSIF are **backed by the full faith and credit of the United States government**. See FCU Act § 205(a), as amended by The Federal Deposit Insurance Reform Conforming Amendments Act of 2005, Pub. Law 109-173 (requiring that each federally insured credit union display signs that states that insured share accounts are “backed by the full faith and credit of the United States Government”); see also, The Competitive Equality Banking Act of 1987 § 901(b), Pub. Law 100-86 (reaffirming that deposits in federally insured depository institutions are backed by the full faith and credit of the United States).

In contrast, the only private share insurance program currently in operation does not have federal backing and has **no reinsurance**. For this very reason, the General Accountability Office in 2003 doubted the ability of a private insurer’s ability to “absorb catastrophic losses.” See *Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management*, GAO-04-91, U.S. General Accounting Office (Oct. 2003). Similarly, in recognition of the fact that private insurance is not equivalent to federal insurance, section 151 of the Federal Deposit Insurance Corporation Improvement Act of 1991 requires any depository institution lacking federal insurance to make conspicuous disclosures that “the institution is not federally insured[,] and ... that if the institution fails, the Federal Government does not guarantee [the return of the deposit].” Pub. Law 102-242.

The significant discrepancy between privately insured and federally insured shares cannot be overstated. As such, NAFCU strongly urges the WDFI to consider these factors in light of the purpose of primary depository insurance: to protect our nation’s consumers against devastating loss to their savings.

NCUSIF and Dual Chartering

The dual chartering system, which NAFCU fully supports, is a major strength of the financial services industry and essential to assuring the maximum security of Americans’ shares and deposits. Currently, state-chartered credit unions whose shares are insured by the NCUSIF are subject to rigorous safety and soundness regulations promulgated and administered by the NCUA, but still enjoy charter options available to them under state regimes. This flexibility is evidenced by the 5,159 federal and 3,146 state chartered credit unions that are presently federally insured. NAFCU opposes

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significant alterations to the current dual chartering and supervisory system. An option to maintain primary share insurance with a private insurer is a significant alteration and one that threatens this system.

Conclusion

Just four years ago, the state of Colorado considered whether to permit its state-chartered credit unions to be privately insured under Colorado's statutory standard that private insurance must be "comparable" to that provided by the National Credit Union Administration (NCUA). The Colorado regulator found that "primary private share/deposit insurance ... is not 'comparable' to that provided by the NCUSIF."

As is readily apparent, **the statutory standard in Washington is even more stringent than that of Colorado**, requiring that the private insurance program be "equivalent" to federal insurance. Some of the most compelling factors leading to Colorado's determination included the fact that the NCUSIF: 1) is backed by the full faith and credit of the U.S. government; 2) has the authority to borrow up to \$100 million from the U.S. Treasury and up to \$5 billion from the NCUA's Central Liquidity Facility; 3) would be able to absorb losses in the amount of \$5.6 billion, compared to the \$157.7 million of the private insurer; and 4) has less single institution concentration and has a more broadly diversified geographic risk (i.e., at the end of 2002, while about 25 percent of the private insurers total insured shares was made up of shares of one credit union, the largest credit union in the NCUSIF accounted for only about 3 percent of the total insured shares in the fund).

NAFCU urges the state of Washington to use similar restraints as Colorado. The factors that led to the Colorado regulator's conclusion are substantially the same today. As then, private share insurance cannot adequately insure members' shares and increases the risk to the credit union industry as a whole. Accordingly, we urge the WDFI to refrain from promulgating the proposed rule, and consequently, protect credit union members from the risk exposure associated with privately insuring shares. For further information and discussion, we have attached an appendix to this letter.

NAFCU would like to thank you for the opportunity to share its views on the proposed rule. Should you have any questions or require additional information please do not hesitate to contact me or Dan Berger, Senior Vice President for Government Affairs, at (703) 522-4770, ext. 203 or dberger@nafcu.org.

Sincerely,



Fred R. Becker, Jr.
President/CEO
FRB/tt

APPENDIX

Equivalence to Federal Insurance

Washington, like all states and the Federal government, requires that credit unions that it charters maintain insurance on members' share accounts. Under Washington law, credit union members' shares may be federally insured or insured by a private insurance program that is "equivalent" to a federal insurance program. A private insurance program would be equivalent if it: (a) holds reserves proportionately equal to the federal share insurance program; (b) maintains adequate reserves and access to additional sources of funds through replenishment features, reinsurance, or other sources of funds; and (c) has share insurance contracts that reflect a national geographic diversity. Wash. Rev. Code. § 31.12.408(1).

Proportionately Equal Reserves

Washington state law mandates that the private insurance hold reserves "proportionately equal" to the federal insurance program. The June 15, 2007, draft of the proposed rule defines "proportionately equal reserves" to mean "capital accounts based upon equity ratio that is calculated in the same manner as, and equals or exceeds, the NCUSIF's current equity ratio." Proposed WAC 208-800-030 (18).

NAFCU does not believe that a comparison of the NCUSIF's and a private insurance fund's equity ratio provides an accurate test for determining proportional equality in reserves. Additional factors, such as reinsurance, NCUSIF's ability to borrow \$100 million from the U.S. Treasury and up to \$5 billion from the NCUA's Central Liquidity Facility, must be considered to fairly and responsibly compare a private fund to NCUSIF and make the statutorily required determination that the private fund holds "proportionately equal reserves." Further, in making the comparison, the WDFI should consider that NCUSIF insures many credit unions that are not well capitalized, yet capitalization is an integral part of qualifying for private insurance. Lastly, comparison of the funds' reserves without taking into consideration risk (i.e., concentration, reinsurance and capitalization, reputation risk, among other things) does not accurately reflect whether the funds are "equivalent."

The current status of the NCUSIF further reveals its superior standing to any private insurance program. For example, as of May 2007, the total dollar amount in NCUSIF retained earnings is \$1.7 billion, more than the total dollar amount of historic losses at NCUSIF (\$1.05 billion). Thus, the NCUSIF can currently withstand loss at least equal to the amount of loss it has experienced in its three and a half decades of existence.

Adequate Reserves and Access to Additional Sources of Funds

Under Washington law, the second requirement for "equivalency" is that the private insurance program maintains adequate reserves and access to additional sources of funds through replenishment features. The proposed rule would require a private

insurance provider to demonstrate that “adequate reserves” are maintained by conducting “stress tests” similar to what NCUA conducts. NAFCU notes that should this rule be implemented, the state of Washington should require that the necessary data required to conduct all three tests be made publicly available.

The first proposed stress test requires the insurer to demonstrate the ability to recover from the collapse of the insurer’s largest credit union. NAFCU believes that concentration risk, which this test would evaluate, is among the most important factors in determining the strength of a deposit insurance fund. In this regard, NAFCU points out that the largest credit union that maintains share insurance with NCUSIF comprises about 3% of the total shares insured. On the other hand, nearly one-quarter of the total shares insured by the only private entity that provides this private insurance are from **a single credit union**. As the NCUA pointed out in its April 12, 2007, letter to the WDFI, while the failure of the largest credit union would require the NCUA to assess .40% of each insured credit union’s total assets to restore the equity ratio to 1.2%, if the largest privately insured credit union fails, an assessment of 3.58% of the total assets of each credit union that currently has primary share insurance is required to recapitalize the private fund to 1.2%. A 3% or more recapitalization assessment could significantly damage many of the privately insured credit unions’ net worth ratios. At the very least, the WDFI should require a private insurer to show that to recapitalize its fund would not require assessment greater than the corresponding assessment for the NCUSIF.

Additionally, the statute’s requirement that the private insurer has access to additional sources of funds through replenishment features, such as reinsurance or other sources should be taken literally. That is, while NAFCU does not believe that there is a substitute for federal insurance in providing primary share insurance, we believe that demonstration that the insurer has access to additional funds, *including* reinsurance and available credit should be a minimum requirement. In this respect, we reiterate that there are no private share insurance providers that have reinsurance and as the Colorado regulatory correctly pointed out, the only private entity currently providing share insurance has limited availability to credit.

Geographic Diversity

The third, and final test, in determining “equivalency” is that the private insurer has share insurance contracts that reflect a national geographic diversity.

The only private entity currently providing share insurance to credit unions provides the product in 8 states. National geographic concentration, rather than geographic diversity, characterizes its allocation of contracts. This is illustrated by the fact that about 42% of its primary insured shares are in California, and another 44% are in just three states, Illinois, Nevada and Ohio (86% in four states). This high level of concentration in a few states not only proves that the final prong of the equivalency test is not met, but also that the fate of the shares held by credit union members in one state can easily be in the hands of other state regulators and economies.

Prompt Corrective Action

An important NCUA policy concerning the NCUSIF is known as “prompt corrective action.” See 12 U.S.C. § 1790d and 12 C.F.R. Part 702. A major purpose of the policy is to resolve problems with federally insured credit unions with minimal loss to NCUSIF. Under the NCUA regulations, if a federally-insured credit union does not meet certain capital standards, NCUA will take supervisory actions to improve the financial condition of the credit union. This policy, along with others that are directed at the safety and soundness of credit unions, provides protection for the health of the NCUSIF through regulatory oversight of credit unions, and consequently, plays an important role in protecting the share account holders of other insured credit unions.

NAFCU strongly believes that a private insurance program must provide for a PCA-type regime. To NAFCU’s knowledge, no private entity that currently provides share insurance has a comparable policy. Among other things, such policy would counter a major trap created by concentrating risk on one or a few large credit unions - forbearance (i.e., “too big to fail”) in the case that one of the institutions collapses.

Involuntary Termination

Lastly, NAFCU believes that the current version of the proposed rule does not adequately test whether a private insurance program is equivalent to NCUSIF because it does not address involuntary termination. Under the FCU Act, the NCUA must provide due process before terminating insurance coverage, and after the determination to terminate, must notify the credit union’s members immediately and continue coverage for a full year thereafter. The WDFI should not overlook the importance of due process, notice and additional coverage in arrangements involving involuntary termination.

Lessons From the Past

At least eight privately operated insurance funds for financial institutions have failed or cease to operate since 1976, including in Mississippi (1976), Nebraska and California (1983), Ohio and Maryland (1985), Utah and Colorado (1987) and Rhode Island (1991). See Walker F. Todd, *Lessons from the Collapse of Three State-Chartered Private Insurance Funds*, Economic Commentary, Federal Reserve Bank of Cleveland (1994). As the former Chairman of the Board of Governors of the Federal Reserve System Alan Greenspan testified, “... **there is no private insurer substitute for deposit insurance from the government.**” *Federal Deposit Insurance Reform: Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate*, April 23, 2002 (Statement of A. Greenspan). Subsequently, Chairman Greenspan stated that, “... **the experience over the years with private insurance has not been impressive ... in the past, various types of ... insurers found that out to their dismay, and bankruptcy.**” *Deposit Insurance: Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate*, February 26, 2003 (Statement of A. Greenspan).

The Rhode Island Debacle

The collapse of an insurer of share accounts can be devastating to the share account holders. It also unjustifiably increases risks to the financial services industry more broadly, decreases consumer confidence in financial institutions and has the potential to have a substantial adverse impact on, if not devastate, a state's economy. Such was the case in the early 1990's in Rhode Island when the Rhode Island Share and Deposit Indemnity Corporation (RISDIC) failed. The Rhode Island tragedy, which is well-known and about which the WDFI is likely familiar, began as a result of state examiners uncovering \$14 million in fraud in just one institution. After the collapse of the private insurer, however, many who were either close to the situation or familiar with issues related to share insurance have concluded the insurer's collapse was due to the lack of adequate backing.

The similarities between the facts surrounding the Rhode Island situation and the current environment should not be overlooked. Most importantly, similar to private insurance offered today, shares insured by the RISDIC did not have the backing of the Federal government. Also, the RISDIC did not maintain reinsurance with a third party. The lack of adequate financial backing (no Federal government backing and no private reinsurance, among other things) resulted in the insurer's inability to withstand the collapse of a number of financial institutions in Rhode Island. And, the amount of funds available to cover the losses was less than the amount of insured deposits of one institution and far less than the amount of estimated loss.

The state subsequently had to step in and use taxpayer funds to pay out the insurer's debts to share account holders. Even with assistance from the Federal government, the state had to issue over \$41 million in bonds for the bailouts. In addition, *all* privately insured deposits were frozen for an extended period, and two-thirds of all depositors' claims were frozen for much of 1991. Rhode Island citizens were not able to access their money until the situation was resolved. To rectify the problems, the Governor was left with no choice but to require the institutions to obtain federal insurance before reopening, which took months in some cases and which never occurred for some of the larger institutions because of their inability to qualify. Thereafter, Rhode Island revised its laws to require that all credit unions maintain insurance with the NCUSIF. Rhode Island taxpayers, however, paid for the bailout for over a decade because the private insurer could not keep its promise of insuring credit union members' shares.

Other States' Losses

Rhode Island is not the only state that had to deal with a failed experiment with privately operated share insurance program, and needed to dig into the state's coffers and taxpayers pockets. In the mid-1980's, Ohio issued \$151 million in bonds to fund the re-openings of institutions which the insurer was unable to cover. In Maryland, the largest privately insured institution lost an estimated \$200 million, which exceeded the \$175 million available in the privately operated insurance fund. During the crisis, over \$1.15

Appendix to August 7, 2007, NAFCU Letter to WDFI

billion of deposits were frozen, unavailable for withdrawals. As was the case in Rhode Island and Ohio, Maryland taxpayers shouldered the bailout in the years following.