



National Credit Union Administration

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SUBJECT: NCUA Comment on Washington State proposal for Alternative Share Insurance Original w/attachments FED ex'd

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## National Credit Union Administration

April 12, 2007

### Office of the Board

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

Re: NCUA Comments on Washington State Alternative Share Insurance Rulemaking.

Dear Ms. Jekel:

We are pleased to respond to your request for the comments of the National Credit Union Administration (NCUA) on a proposed rule published by the Washington Department of Financial Institutions (DFI) regarding alternative share insurance for Washington-chartered credit unions.<sup>1</sup>

Washington law requires state-chartered credit unions to maintain account insurance on member share accounts. The statute allows credit unions to use a nongovernmental share insurance program provided it is "equivalent" to federal insurance in that 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.<sup>2</sup>

Washington law also requires that: (1) the DFI must find the alternative share insurance program is equivalent to NCUA's share insurance program before any credit union may insure its share deposits with such an alternative share insurer; (2) the DFI must review any approved share insurer on an annual basis to determine if it maintains its equivalency; and (3) if the insurer fails to maintain equivalency, the DFI must order those credit unions insured by the alternative

<sup>1</sup> Proposed regulation WAC 208-800-030 and Division of Credit Unions Bulletin No. B-07-02 (February 12, 2007).

<sup>2</sup> Wash. Rev. Code §31.12.408(1).

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insurer to apply immediately to the NCUA to convert back to federal share insurance.<sup>3</sup>

The proposed regulation implements the statute and explains the qualification and application standards for an alternative insurer applying for approval to do business in Washington. Generally, we believe the proposal is thorough and well-designed. We do have a few suggestions we believe might improve the proposal. Our suggestions relate to the calculation of the equity ratio and special assessments, the adequacy of reserves, and involuntary termination of share insurance coverage. We also address some of the advantages of federal share insurance coverage.

### **1. Equity ratio and special assessments.**

The proposal requires the share insurance contract between the alternative insurer and the credit union meet certain substantive requirements. One requirement reads:

If the alternative share insurer's equity ratio is less than the required minimum percent, the insurer shall assess a premium charge in an amount calculated to restore the equity ratio and maintain it at or above the required minimum percentage.<sup>4</sup>

The proposal does not define how the "required minimum percent" is calculated, and we recommend the rule define it.<sup>5</sup> Additionally, one potential alternative share insurer currently advertises that, under its share insurance contract, none of its insured credit unions can be assessed premiums in an amount greater than three percent of their assets.<sup>6</sup> The proposed rule should clarify that neither state law in the insurer's state of incorporation nor the share insurance contract can limit the insurer's obligation or ability to make assessments necessary to restore the equity ratio to the required minimum percentage.

<sup>3</sup> Wash. Rev. Code §31.12.408(2) and (3).

<sup>4</sup> Proposed WAC 208-800-100(11)(a).

<sup>5</sup> The proposed definition of "equity ratio" at WAC 208-800-030(4) is somewhat confusing. The definition contains a formula but then mentions NCUA's normal operating level. The alternative insurer's actual equity ratio may, at any given time, be more, less, or the same as NCUA's normal operating level.

<sup>6</sup> "Question: How do the limits of liability for federally and privately insured credit unions differ? Answer: Both federally and privately insured credit unions are required to maintain a minimum level of equity within their insurance funds. Should these funds fall below the minimum required level, federally insured credit unions are required by law to be reassessed premiums until the equity level is restored. There is no limit as to the liability federally insured credit unions have. ASI-insured credit unions must also restore their fund, **but are limited, by contract, to contributing a maximum of three percent of their assets.**" [http://www.americanshare.com/public/pages/primary/creditunion\\_1.cfm](http://www.americanshare.com/public/pages/primary/creditunion_1.cfm), March 5, 2007 (emphasis added).

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## **2. Adequacy of reserves.**

The proposed rule provides generally for a comparison of the alternative insurer's equity ratio, reserves, and reinsurance with those of the National Credit Union Share Insurance Fund (NCUSIF). We believe the proposed rule can be improved by requiring a more specific analysis of the adequacy of the alternative insurer's reserves in connection with exposure to large credit unions and problem credit unions.

As noted by Vartan Gregorian, the President of Brown University, in his 1991 study on the collapse of the Rhode Island Share and Deposit Indemnity Corporation (RISDIC):

Private and federal cooperative funds were generally required by statute to have at least one percent of deposits in reserve. RISDIC's ratio of funds to deposits, as its supporters often pointed out, was generally better than the NCUSIF's. But this ratio hides a fundamental weakness in RISDIC: the inability of the fund to absorb the loss of its largest members. In this way, the difference between RISDIC and NCUSIF was critically significant.<sup>7</sup>

In 1997, the United States Department of the Treasury recommended NCUA examine the adequacy of its reserves through stress tests that simulated various possible catastrophic loss scenarios, including (1) the failure of NCUA's largest insured credit union, (2) the failure of three of NCUA's top ten largest insured credit unions, and (3) the failure of all NCUA-insured CAMEL 4 and CAMEL 5 credit unions.<sup>8</sup> The tests assumed the historical loss rate to the NCUSIF of 20% of insured shares and calculated the effect on the NCUSIF's equity ratio and the amount of the assessment the NCUSIF would need to charge each credit union to restore the equity ratio to an acceptable level.

We agreed with the Department of the Treasury that the adequacy of share insurance reserves should be measured against scenarios that test those reserves. The tests proposed by the Treasury provide for a quantifiable and objective approach to measuring the adequacy of reserves related to exposure to large credit unions and problem credit unions. Accordingly, NCUA runs these stress tests on a periodic basis, and here are the results of the most recent tests on the NCUSIF:

<sup>7</sup> V. Gregorian, Carved in Sand, A Report on the Collapse of the Rhode Island Share and Deposit Indemnity Corporation (Carved in Sand), March 14, 1991, at 11.

<sup>8</sup> U.S. Department of the Treasury, Credit Unions (December 1997), at 47-49.

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<b>Stress Test for the NCUSIF (as of 12/31/2006)</b>			
Type of failed credit union	Amount of insured shares (billions)	Adjusted equity ratio assuming loss to NCUSIF equals 20% of insured shares.	Assessment required of each insured credit union, as a percentage of its assets, to restore equity ratio to 1.2% <sup>9</sup>
Largest insured credit union	\$17.8	0.67%	0.40%
Three of top 10 largest insured credit unions <sup>10</sup>	\$19.0	0.62%	0.44%
All CAMEL 4 and 5 credit unions	\$5.5	1.13%	0.05%

Note that in none of these potentially catastrophic circumstances do NCUA's subsequent assessments to restore the NCUSIF's equity ratio to 1.2 percent have a significant impact on the assets of insured credit unions. This is not necessarily so for private insurers. While we do not have precise financial data on the American Share Insurance Corporation (ASI), the only private primary share insurance company currently operating in the United States, we estimate the failure of Patelco Credit Union, its largest insured credit union, might produce something like the following result:

<b>Estimated Stress Test for ASI (as of 12/31/2005)</b>			
Type of failed credit union	Amount of insured shares (billions)	Adjusted equity ratio assuming loss to ASI equals 20% of insured shares.	Assessment required of each insured credit union, as a percentage of its assets, to restore equity ratio to 1.2%
Largest insured credit union	\$3.07	(2.49%)	3.58%

Of course, loss rates to an insurance fund may be significantly higher than 20% in any given failure. Fraud, for example, is one factor that may contribute to a higher loss rate. Another factor, unique to privately-insured institutions and that could contribute to higher loss rates, is the incentive for the credit union-owned insurer to attempt to assist troubled credit unions in cases when immediate regulatory action is appropriate, thus exacerbating the ultimate insurable loss.<sup>11</sup> Also, the failure of a large, privately-insured institution may cause a loss of confidence in the private insurer and a run on its insured institutions that would make it very difficult for the private insurer to recover from that failure. A run on privately-insured credit unions could even lead to withdrawals from, and damage

<sup>9</sup> The Federal Credit Union Act requires the NCUSIF maintain an equity ratio of at least 1.2%. 12 U.S.C. §1782a(c)(2).

<sup>10</sup> Assuming each credit union has insured shares equal to the average of the ten largest credit unions.

<sup>11</sup> See *Carved in Sand*, *supra* note 7, at Executive Summary. We do not believe ASI has any outside directors.

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to, federally-insured credit unions if members are confused about the differences between private and federal share insurance.

Accordingly, we recommend you require any alternative share insurance applicant to demonstrate, through similar stress testing, the adequacy of its reserves. One way to address this issue in your rule might be to redefine "adequate reserves" in WAC 208-800-30 as follows:

(6) "Adequate reserves" means reserves sufficient to meet regulatory safety and soundness standards. The term includes the insurer's demonstrated ability to recover from stress tests that assume: (a) the failure of the insured's largest credit union; (b) the failure of three of its ten largest insured credit unions; and (3) the failure of all of its CAMEL 4 and 5 insured credit unions.

### ***3. Involuntary termination of share insurance coverage.***

In Washington, any alternative insurance program must be "equivalent" to federal insurance, and the proposed regulation defines "equivalent" to mean "equal in value, measure, force, effect, or significance."<sup>12</sup> While the proposal specifically addresses the alternative insurer's equity ratio, reserves, reinsurance, risk diversification, and minimum account coverage, all these may be meaningless if the insurer can terminate insurance coverage before the credit union or its conservator have submitted a claim.

Section 206 of the Federal Credit Union Act (FCUA) sets forth the terms and conditions under which NCUA can terminate a credit union's federal share insurance.<sup>13</sup> The FCUA enumerates the reasons for termination and provides the credit union with extensive and lengthy due process before termination takes effect.<sup>14</sup> If NCUA decides to terminate share insurance, the credit union's members must be notified immediately and the insurance coverage on their accounts continues for another full year, giving the members an opportunity to move their money before it becomes uninsured.<sup>15</sup>

In Colorado, like Washington, alternative share insurance is permissible if the Colorado DFI first determines the proposed alternative insurance program is "comparable" to federal share insurance.<sup>16</sup> In 2002, an alternative share insurer applied to David Paul, the Commissioner of the Colorado DFI, for permission to

<sup>12</sup> Proposed WAC 208-800-030(1).

<sup>13</sup> 12 U.S.C. §1786.

<sup>14</sup> 12 U.S.C. §1786(b), (c).

<sup>15</sup> 12 U.S.C. §1786(d).

<sup>16</sup> Colo. Rev. Stat. §11-30-117.5 (2006).

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insure Colorado credit unions. As part of his decision, which we have attached, Commissioner Paul analyzed the terms and conditions for involuntary termination under the alternative insurance program. He found that, unlike NCUA, the alternative insurer could terminate its insurance: (1) for a variety of reasons; (2) upon short notice to the credit union; (3) without a prior hearing; and (4) with no required notice to members whose accounts would be affected and who might desire to move their money.<sup>17</sup> For these and other reasons, Commissioner Paul determined the alternative insurance program was not comparable to federal share insurance.

We believe your proposed regulation, to ensure equivalency of the alternative insurance program in terms of value, effect, and significance, should also address the potential for involuntary termination. One way to address this issue is to amend the proposed provisions related to the share insurance contract, perhaps by adding a new paragraph WAC 208-800-100(e) to read as follows:

**(e) Involuntary Termination.** The contract must contain provisions that describe the conditions upon which the insurer can terminate insurance, the due process afforded the credit union, and the notice given to account owners before the effective date of termination. The conditions and process for involuntary termination must be equivalent to those afforded by law and regulation to federally-insured credit unions and their members.

Commissioner Paul was particularly concerned about notice to members. You might consider adding an additional, substantive requirement that the insurer guarantee some minimum notice to members before they lose insurance coverage on their accounts.

#### ***4. Compliance with federal audit and disclosure laws.***

Section 1831t of title 12 of the United States Code contains important consumer protection requirements for depositors at depository institutions lacking federal deposit insurance. 12 U.S.C. §1831t. Section 1831t requires these depositories obtain written acknowledgments from their depositors that the depositors know (1) the institution is not federal insured and (2) if the institution fails the federal government does not guarantee the depositor will get his or her money back. Section 1831t also requires disclosure of these facts in advertisements and other media. Section 1831t further requires every private deposit insurer obtain an annual independent audit that includes a determination of whether the deposit insurer follows generally accepted accounting principles and has set aside sufficient reserves for losses.

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<sup>17</sup> Letter to Credit Union Managers from Commissioner David Paul, dated March 5, 2003 (Paul Letter).

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We believe that it is in the interests of Washington state and its credit union members to ensure any alternative insurance program operating in Washington complies with §1831t. Accordingly, we recommend that you amend the application requirements in proposed WAC 208-800-100 to require two things of each applicant insurer: first, that it certify its intent to comply with §1831t, and, second, that it describe the measures it will undertake to ensure its insured credit unions also comply with §1831t.

**5. Advantages of federal share insurance.**

The Washington statute implicitly recognizes the importance of federal share insurance as it requires you to order credit unions with alternative insurance to make immediate application to the NCUA to go back to federal insurance if you revoke the alternative insurer's approval to operate in Washington. If you approve an alternative insurer and then revoke that approval, NCUA would have to evaluate each application for federal insurance on a case-by-case basis, and we can make no guarantee that any particular application would meet our insurability requirements. In addition, NCUA would like to be on record as stating our concern that an alternative share insurance program can place an undue burden on the NCUSIF if the alternative insurer accepts only well-capitalized and well-managed credit unions and leaves weaker credit unions to be insured by the NCUSIF. Of course, the NCUSIF remains strong and provides its insured credit unions, their members, and their state regulators with many advantages. As we told Commissioner Paul in the attached letter we wrote in December, 2002, these advantages include:

- The NCUSIF provides high levels of insurance coverage at a reasonable cost.
- The NCUSIF is backed by the full faith and credit of the U.S. Government. The importance of this guarantee, when added to the lines of credit available to the NCUSIF through the U.S. Treasury and the Federal Financing Bank, cannot be overstated.
- The NCUSIF is well diversified in every sense of the word, as it insures over 8,000 credit unions, with different fields of membership, charters, and business strategies, located in every state, the District of Columbia, Puerto Rico and the U.S. territories and possessions.
- NCUA's organization, independence, and resources are important safety and soundness safeguards. NCUA is independent from the credit unions it insures; it is accountable to the President and Congress; it is subject to audit by the Government Accountability Office; it works closely with state

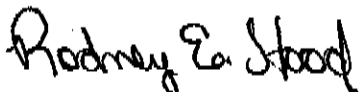
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regulators; and it provides training and support to regulators and credit unions alike.

Again, we appreciate the opportunity to comment on your proposal. We have attached for your information the various documents mentioned above and, also, a copy of the NCUA's Report to the Congress: Study of Further Possible Changes to the Deposit Insurance System (February 2007) and the Federal Deposit Insurance Corporation's An Evaluation of Further Possible Changes to the Deposit Insurance System (February 12, 2007). If there is anything else we can do for you, do not hesitate to contact us.

Sincerely,



Rodney E. Hood  
Vice Chairman



JoAnn Johnson  
Chairman



Gigi Hyland  
Board Member

Attachments