



June 26, 2007

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

**RE: Comments on Revision 3 – Discussion Draft WAC 208-800
Proposed Rules: Credit Union Alternative Share Insurance
Programs Posted June 15, 2007**

Director Jekel:

The Washington Credit Union League respectfully submits its observations to the DFI regarding its initiative to draft rules governing the application and renewal process to be followed by an alternative share insurer for Washington's state chartered credit unions. The League commends the DFI and its staff for the open academic environment created during this process, and its commitment to securing relevant input from the principal stakeholders.

As stated in earlier correspondence, the League is strongly in support of a private share insurance alternative for its member credit unions, and endorses the DFI's efforts to assure the development of a sound process for approving such an alternative provider. This support is grounded in policy determined by the League's board of directors. The League Board has articulated the industry position of opposing mandated federal deposit insurance without alternatives. The board also supports dual chartering through alternatives to federal deposit insurance. This position has been recently restated by Washington state chartered credit unions communicating directly with the Washington Department of Financial Institutions and the Division of Credit Unions, petitioning for reinstatement of deposit insurance options. The League believes the Division of Credit Unions must develop a workable rule.

The League appreciates the opportunity to comment on discussion draft revision #3 posted June 15, 2007. The League is commenting on behalf of our 125 member institutions and on behalf of 2.35 million Washington credit union members. The League brings together all categories of credit union charters to best represent the interests of this rapidly changing industry. Its membership—which includes both state domiciled as well as out-of-state credit unions doing business in Washington State, makes the League the largest credit union trade association in the Northwest region of the United States.

Summary of Comments

We have identified four key elements of the draft rules that we believe need further examination and consideration by the department. Specifically:

- The insurance licensure requirement under RCW 48;
- Regulatory procedures following default by a non-federal insurer;
- Stress tests for determining the adequacy of reserves; and,
- The definition of national geographic diversity.

Insurance Licensure

Historical review shows that the Washington Credit Union Share Guaranty Association (“WCUSGA”) operated from 1975 to 1995 responsibly protecting the savings of hundreds of thousands of Washington credit union members—all under the direct oversight and supervision of the DFI as required by RCW 31.12A. The OIC had no regulatory role in overseeing WCUSGA, nor was it needed. When RCW 31.12.408 was enacted in 1996 calling for the phase out of a then-successful WCUSGA, the legislature specifically included requirements in the new law designed to allow the DFI to continue its role as the sole supervisor of any future non-federal share insurance or guaranty fund.

If the legislature had wanted a future fund to be subjected to another state agency, it could have easily included specific language to that effect— but it did not. Further, it is the League’s understanding that it was never the intent of the legislature to require OIC licensure as required by the proposed rules. This understanding is based both on historical knowledge of League staff, and on a June 14, 2007 letter sent to OIC Commissioner Kreidler by Senator Margarita Prentice. Given the regulatory construct under which non-federal share insurance funds currently operate in other state, the original legislative intent of RCW 31.12.408, and, the basic requirements and exemptions for licensure under RCW 48, the League believes leaving this provision in the rules will effectively defeat the legislative intent of the law and render it inoperative. Accordingly, the League strongly encourages the DFI to reconsider the inclusion of the requirement that an applicant non-federal share insurer “must be an authorized insurer in compliance with Title 48 RCW...” [WAC 208-800-100]

Administrative Remedies

Under WAC 208-800-300, the Director is required to make an annual assessment of any operating and approved alternative share insurer. If the Director determines the approved provider does not meet the standards in RCW 31.12.408, the Director must immediately move to notify all non-federally insured Washington credit unions of this decision and proceed to hold a public hearing for the purpose of receiving comments on the finding. The Washington Credit Union League is concerned that the procedure set forth in this section of the draft rules lacks normal non-public due process for the approved alternative share insurer (i.e., exam findings communications, notices of deficiencies, supervisory hearings, a new business moratorium, departmental orders and letters of understanding).

The League has a reasonable worry that a future Director could make an arbitrary or hasty adverse finding based on matters outside of safety and

soundness or fact. Following the procedures under the proposed rule, before this decision is reviewed and determined to be unfounded, the damage to the effected credit unions and the state system as a whole will have already been done. The League considers the lack of a more protracted, non-public system of due process to be dangerous, as it exposes a converting credit union, all Washington credit unions and any approved provider to serious reputation risk.

Accordingly, the League recommends a more delineated and deliberate regulatory process be developed within the rules. This process should offer approved providers adequate time to remedy any cited deficiencies with RCW 31.12.408.

Adequacy of Reserves

The League believes the sections dealing with adequacy of reserves may be flawed and require additional development. The League's concerns derive from both a mathematical or mechanical perspective as well as a philosophical or operational one. With any review of an insurer's reserves, the League believes it is important for the DFI to bear in mind the nature of deposit insurance of all types of depository institutions across the array of charters within the national financial system.

First, it seems that the adequacy of a nonfederal fund's reserves could be best determined by independent professional actuaries who are in the business of opining as to reserves and capital. However, if the DFI decides to retain the required stress tests included in WAC 208-800-030(2) of Revision 3 of the draft proposed rules, the League would encourage it to heavily weigh the loss experience of the applicant organization in arriving at its assessment of the adequacy of an applicant's reserves.

Second, due to the complexity of this subject, and the need for all parties to have a better understanding of the sufficiency of the NCUSIF's reserves and those of a non-federal share insurer, the League has retained the services of one of the nation's most recognized experts in the field of deposit insurance, Mr. Bert Ely of Washington, D.C. His credentials and report to us on this and other matters are attached and should be considered the position of the League with respect to the subjects addressed therein.

National Geographic Diversity

One of the driving forces behind the push to phase out WCUSGA in 1995 was the fact that the fund lacked geographic diversity of membership. At that time, WCUSGA could only insure state chartered credit unions in the State of Washington. This concern over geographic diversity was pervasive even though no consumer ever lost money in a WCUSGA-insured credit union. The June 15, 2007 draft of the proposed rules includes language that may prove to be too stringent regarding geographic diversity. [WAC 208-800-100 (14)] By setting standards in the rules that measure diversity based on the entire country, the DFI fails to consider the fact that unlike federal insurance private share insurance is not permissible in every state. Also, the draft rules fail to recognize the importance of a fund's underlying risk diversification based on

underlying sponsorship/membership mix. Escalating unemployment within a credit union's membership base can be more concerning than regional economic risk.

Mr. Ely provided his observations on diversification and risk distribution in his attached report to the League. The League requests that the DFI consider his comments as an integral part of the League commentary in this regard.

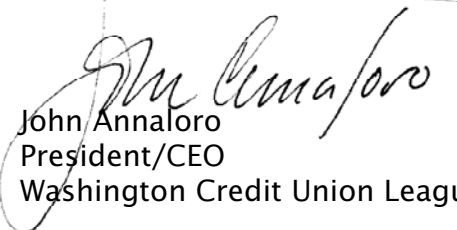
Summary

In closing, I thank you for the opportunity to offer specific input with respect to the proposed rules, and look forward to assisting the DFI in facilitating a reasonable, logical and practical final product that will allow our member credit unions to operate under the options afforded them by the legislature in 1996.

When RCW 31.12.408 was enacted, it was supported by credit unions and the Washington Credit Union League on the belief that in a future period an applicant nonfederal insurer, with greater diversity of membership than WCUSGA, a more stable and proven financial structure, and a track record of performance and regulatory acceptance would again return to our State.

The League requests that every effort be made to assure the enactment of workable rules that allow for credit union empowerment and self-determination.

Sincerely,



John Annaloro
President/CEO
Washington Credit Union League

JA:abm
Attachment

E L Y & C O M P A N Y, I N C.

901 King Street
Alexandria, Virginia 22314
703/836-4101
Fax: 703/836-1403

*Financial Institutions and
Monetary Policy Consulting*

Deposit Insurance and
Monetary Policy Studies
Public Policy Analyses
Strategic Planning

Mailing address:
Post Office Box 21010
Alexandria, Virginia 22320

Email: bert@ely-co.com
<http://www.ely-co.com>

Report by Bert Ely
to the
Washington State Department of Financial Institutions
with regard to
**proposed rules governing credit union
alternative share insurance programs**
June 25, 2007

Introduction

Bert Ely has been retained by the Washington Credit Union League to address three concerns raised by the Washington State Department of Financial Institutions (DFI) with regard to proposed rules governing the application and operation of an alternative share insurance program for credit unions (CU) chartered by the DFI. The concerns are (1) the adequacy of a share insurer's reserves in the face of a stress test, (2) risk dispersion – geographical and otherwise, and (3) the merits of an involuntary termination provision in a share-insurance contract. This report addresses each of these concerns, with the greatest attention devoted to the adequacy of reserves.

Appended to this report is a biography for Bert Ely, with a particular focus on his background on share and deposit-insurance issues. In the interest of full disclosure, Mr. Ely has provided consulting services at various times to American Share Insurance (ASI), a probable applicant under the proposed rules.

Adequacy of reserves in the face of a stress test

The adequacy of reserves is of vital importance for any insurer, for without adequate reserves an insurer will fail if it is hit with a high level of losses within a short period of time – the high level of losses will render it insolvent and it will fail as an insurer. For a share or deposit insurer, it makes no difference whether the losses result from the failure of a few large insured institutions (“tall trees”) or of many small insureds – what counts is the total amount of loss it incurs relative to its capacity to absorb losses.

The concept of reserves, or the capacity to absorb insured losses, consists of five components, with losses absorbed in this sequence: (1) current revenues, (2) loss reserves set aside on the insurer's balance sheet, (3) the insurer's retained earnings, (4) capital deposited with the insurer by its insureds, which capital can be used to absorb the insurer's losses, and (5) the insurer's ability to assess its

insureds to cover losses and/or to rebuild the insurer's capital capacity to assume insurance risks in the future.

The capacity to absorb losses must then be compared to the losses the insurer could face during an especially stressful time; i.e., when failures are (1) at record highs and (2) quite costly. Equally important, any such stress test must reflect what deposit and share insurers have experienced in the past, in terms of size and type of failure. That is, a stress test design must be rejected if it does not reflect the reality of past experience and realistic expectations for the future.

The definition of "adequate reserves" in the June 2007 draft rules proposed by the Washington DFI for authorizing share insurers fails in that regard – the first three components of the draft definition bear absolutely no relationship to the loss history, and the causes of, CU failures experienced by either ASI or the National Credit Union Administration's Share Insurance Fund (NCUSIF). The fourth component of the draft definition is more reasonable, but it should be applied to ASI in the context of ASI's demonstrated ability to hold its losses in failed CUs to a much lower level than the NCUSIF has exhibited.

The four components of the definition appear to be drawn from a 1997 study conducted by the U.S. Treasury Department¹ which constructed a four-part stress test for the NCUSIF and then tested the NCUSIF, based on year-end 1996 data on NCUSIF-insured CUs. The tests assumed (1) the failure of the largest credit union, (2) the failure of three of the largest ten credit unions (assuming each was the average size of the ten largest), (3) the failure of all credit unions with CAMEL ratings of 4 or 5, and (4) a repetition of the worst loss period in the NCUSIF's history, 1981-83.

History clearly shows that economic stress of the type envisioned by the Treasury study hits smaller depository institutions, and especially very small CUs, far harder than it does larger institutions – the largest depository institutions and CUs are the least likely to fail. Further, while it is conceivable that in a highly stressful economic situation most smaller 4 and 5-rated CUs might have to be resolved at some cost to a share insurer, larger 4 and 5-rated CUs, on average, should be cheaper to resolve, per asset or share dollar, than the smaller troubled CUs. Likewise, on the very slight chance that one of the largest CUs failed, its resolution cost, as a percentage of its assets or shares, almost certainly will be much lower than for a CU a tiny fraction of its size.

The NCUSIF's loss experience has been analyzed in great depth by the Filene Research Institute, an independent organization devoted exclusively to researching CU issues. This research is set forth in two recent papers, "Filene 2005" and "Filene 2007."² This research shows absolutely no basis for (1) assuming, as the proposed stress test does, the failure of very large credit unions, much less three of the ten largest, and (2) assuming, as the proposed stress test does, that all CAMEL 4 and 5-rated CUs will fail. Importantly, Filene 2007 (table on page 10) shows that not one single "large" NCUSIF-insured CU (i.e., a CU with assets exceeding \$250 million, measured in 2005 dollars) failed during the 25-year period, 1981 to 2005. At the end of 2005, the NCUSIF insured 537 CUs (6.2% of all NCUSIF insureds), each with over \$250 million of assets, who collectively owned 65.2% of all assets in NCUSIF-insured CUs. Based on the NCUSIF's loss experience, there is no reason to believe that any of these CUs are going to fail at a loss to the NCUSIF.

¹ "Credit Unions," United States Department of the Treasury, December 1997, pages 47-49.

² Wilcox, James, "Failures and Insurance Losses of Federally-Insured Credit Unions: 1971-2004," Filene Research Institute, 2005 ("Filene 2005") and Wilcox, James, "Determinants of Credit Union and Commercial Bank Failures: Similarities and Differences, 1981-2005," Filene Research Institute, 2007 ("Filene 2007").

The NCUSIF experience parallels ASI's experience over its 33-year history, for it has had no CU failures over \$250 million in assets. ASI's largest failure, measured in 2006 dollars, had \$99 million in assets while its second-largest failure had \$74 million in assets. The combined loss in these two failures, in 2006 dollars, totaled to just \$185,000, or .11% of their assets. Further, at the end of 2006, five-sixths (83.73%) of ASI's insured shares were in CUs larger than the largest ASI failure. In fact, those two failures are the only ones ASI has experienced in what Filene identified as "medium-sized CUs" – \$25 million to \$250 million in assets, measured in 2005 dollars. In the 1981-2005 period, NCUSIF experienced 59 failures in that size range, compared to ASI's two failures. This contrast – 59 versus 2 – is just one of many instances where ASI has demonstrated a better overall loss experience than NCUSIF.

Among "small" credit unions, defined by Filene as having less than \$25 million in assets, measured in 2005 dollars, the NCUSIF had 1,650 failures in the 1981-2005 period, compared to 113 small CU failures during that period that were insured by ASI. Both the ASI and NCUSIF failure experience clearly show that CU failures are not a phenomenon among large CUs – they largely occur among small and very small CUs. Due to ongoing CU consolidation, at the end of 2006, only 4% of ASI's insurance risk was in CUs with less than \$25 million in assets; that percentage most likely will continue to shrink as smaller CUs disappear through mergers and liquidations.

Three figures illustrate ASI's loss experience over its entire 33-year history and contrast that loss experience with ASI's present size-mix of insureds. **Figure 1** (at the end of this report) shows the distribution of ASI's 117 insurance losses over 33 years by asset size at time of failure (adjusted to 2006 dollars) and the amount of loss ASI experienced, as a percentage of the CU's total assets at the time it failed. Due to three outlier losses, the other 114 losses are concentrated in the lower left-hand corner of the chart. **Figure 2** presents a more comprehensible distribution of losses by excluding the three outliers. This chart demonstrates two key points underlying ASI's success as a share insurer: (1) its failures have been concentrated in very small CUs that today represent a very small (less than 1%) portion of its total insurance risk and (2) ASI's loss percentage has been quite low (generally under 10%) in all but the smallest failures. **Figure 3** shows the dramatic contrast between the size and loss percentage of ASI's failures and the size distribution of its present pool of insured CUs. Almost all of ASI's insurance risk today lies with CUs of a size that historically have experienced very few, if any, failures.

The Filene research does show that it is valid to consider in a stress test the ability of the insurer to absorb losses during a period of very high failures. The 1981-1994 period was a time of high failure rates for both the NCUSIF and ASI, particularly during the 1981-83 and the 1990-92 sub-periods. However, both insurers handled the high losses of those sub-periods with ease, with ASI experiencing much lower loss rates than did the NCUSIF, as the accompanying **Figure 4** shows; these loss rates are expressed as a percent of the year's average of the total amount of shares in CUs insured by that insurer. In only one year (1983) did ASI's loss rate exceed the NCUSIF loss rate. During the 1990-91 recession, and its aftermath, ASI's loss experience was dramatically lower than the NCUSIF's experience, reflecting ASI's superior ability to minimize CU failures and, when failure does occur, to minimize its losses in those failures.

ASI should not be subject to a stress test based on the NCUSIF's much worse loss experience in the 1981-83 period for this reason: An insurer can experience a substantial number of failures and still not be stressed financially if the average loss rate in the failures is low; loss rate is the amount of the insurer's loss divided by total assets or insured shares of the failed institution. The Treasury study

asserts that NCUA failures from January 1, 1994, to October 31, 1996 (at 34 months, far too short a period to evaluate loss experience), incurred a “weighted average charge rate to the [NCUSIF]” that was 19%, which Treasury rounded up to 20% for stress-test purposes. Unfortunately, the Treasury analysis provided absolutely no data on the individual failures, and loss rate in those failures, which went into its charge-rate calculation. Misspecifying a loss rate or the type of institutions most likely to fail can so greatly distort a stress test’s results as to make them meaningless.

The risk of loss in an insured CU is a function of several factors, including (1) the likelihood of an insolvency which causes a loss to the share insurer (i.e., the probability of failure, or PF) and (2) should a loss occur, the loss as a percentage of the amount of share insurance in place (loss given failure, or LGF). A factor reducing both the PF and the LGF is the intangible but very real “franchise” value of the failed CU. Franchise value represents the value which can be attributed to the CU having established a membership customer base and having attracted shares or deposits from those members. Consequently, instances arise when a CU that is slightly insolvent on a book-value basis (its shares and other liabilities exceed by a modest margin the market or liquidation value of its assets) can be merged into a financially strong CU, without any cost to the insurer, because the acquiring CU determines that the acquired CU’s franchise value exceeds the amount of the CU’s book-value insolvency. The larger a troubled CU is, the more easily it can be merged into another CU due to its franchise value, which has the effect of maximizing the realized franchise value, thereby minimizing any insolvency loss. This is a significant reason why loss ratios are lower in larger CU failures.

Key to a CU insurer’s ability to meet its share-insurance obligations, even in highly stressful situations, is to actively monitor its share insurance risks, particularly in (1) financially weaker CUs and (2) smaller CUs where fraud can much more readily cause an insolvency. Active monitoring and aggressive intervention when deteriorating conditions demand rapid action will (1) materially reduce a CU’s PF; i.e., the likelihood that it will become insolvent, and (2) reduce the LGF if the CU must be resolved at some cost to the insurer. Understanding what it takes to minimize losses, ASI actively monitors all of its insureds, with a special emphasis on its larger insureds, and acts quickly to address problem situations when they arise. For example, ASI requires an independent CPA audit of any primary insured with more than \$20 million in assets; the NCUA requires an independent audit only in those CUs with more than \$500 million in assets. Also, ASI performs direct share-account confirmation procedures in CUs with an insufficient segregation of duties. This direct confirmation procedure not only detects unrecorded deposits (a common form of fraud), but it also deters this type of fraud.

Both FDIC and ASI data show that over time, the PF and LGF decline as the asset size of the insured institution increases. That is, smaller institutions are more likely to become insolvent because they lack the economic viability of larger, more diverse institutions and they are more susceptible to fraud due to the inability to install and maintain strong internal controls. Therefore, any stress test of a deposit or share insurer must take into account (1) the size distribution of its insureds and (2) its loss experience among various size failures. Because the PF is so much higher for very small CUs than for large ones, it is much more realistic, when assessing a share insurer’s soundness, to view PF as a percent of the total assets of an insurer’s insured CUs than as a percent of the number of insured CUs.

Due to vast changes which have taken place among depository institutions, including widespread consolidation, stronger regulation, and improved risk-monitoring technology, the failure experience of all three deposit/share insurers – the FDIC, NCUSIF, and ASI – has improved dramatically since 1994. That is the year in which the remnants of the 1990-91 recession and the banking and S&L problems of the late 1980s and early 1990s were finally cleaned up. The 12 years

since then, which include the 2001 recession, have been quite benign, from a deposit/share insurance perspective.

For the 12-year period, 1995-2006, losses in failed NCUSIF CUs totaled to \$93.5 million in 226 CU failures with total assets of \$763 million, for a 12.3% loss rate. The average size of these failed CUs was just \$3.47 million. In sharp contrast, in the previous 14 year period (1981 to 1994), 2,050 NCUSIF CUs, with total assets of \$4.18 billion, failed, for a 20% loss rate; the average size of these failures was \$2.04 million. On an inflation-adjusted basis, the average size of the NCUSIF's failures increased from \$3.3 million in the 1981-1994 period compared to \$3.9 million in the 1995-2006 period.

ASI has experienced a similar improvement in its loss experience. For the most recent 12-year period, 1995 to 2006, ASI experienced a far sharper decline in the number of failures than the NCUSIF experienced, with just five failures over those twelve years; ASI's last failure was in 2003. The assets of these failures totaled to \$11.17 million (for an average size of \$2.23 million); the total insurance loss in these failures came to \$3.88 million. During the previous 14-year period, ASI dealt with 105 failures, which had total assets of \$232.4 million, for an average size of \$2.21 million. On an inflation-adjusted basis, though, the average size of a failed ASI-insured CU declined from the first period to the second period, dropping from \$3.8 million to \$2.5 million, while the NCUSIF saw the average size of its failures increase. However, for both insurers, these failed CUs were tiny compared to the much larger CUs which now account for almost all of each insurer's share-insurance risk.

ASI's total loss in the 1981-1994 period was just \$4.55 million, for a loss/asset ratio of 1.96%, less than one-tenth the NCUSIF's 1981-1994 loss ratio. Equally important, ASI's insurance losses during the 1981-1994 years consumed just 11.6% of ASI's investment income for those years – a very low loss experience for any insurer. Since ASI primary insureds place a deposit with ASI in lieu of paying explicit premiums, investment income is a suitable proxy for premium income; the NCUSIF generates income in the same manner. For the more recent 1995-2006 period, ASI's insurance losses consumed an even lower 7.1% of its investment income, despite a large loss described in the next paragraph.

ASI did experience one large loss in recent years, a \$3.79 million loss in the 2002 failure of Ironton SSP. Ironton was a tiny Ohio CU, with just \$231,000 in reported assets when it was closed. Its huge loss was due to insider fraud – incoming share deposits were not recorded, but instead diverted into criminal pockets.³ Yet as large as this loss was, it was exceeded by ASI's premium income that year – this loss caused absolutely no strain on ASI's finances. On the other hand, ASI's two largest failures had a loss rate of just .11%.

ASI's superior loss experience, compared to the NCUSIF, is due in part to ASI's ability to minimize losses in insolvent credit unions. According to Filene 2005 (Figure 14 on page 43), in the 1984-2004 period, the NCUSIF experienced 11 failures with a loss, in 2004 dollars, exceeding \$10 million; the NCUSIF's total loss in these failures was \$408 million, for an average loss of \$37.1 million, in 2004 dollars. Over that same 21-year period, the NCUSIF suffered another 127 failures with losses between \$1 million and \$10 million, for a total loss of \$347 million, an average loss of \$2.73 million. In its entire 33-year history, ASI has suffered just two losses over \$1 million – the

³ The NCUSIF has experienced similar substantial frauds in small, failed CUs. For example, Filene 2005 reports on page 44, in footnote 53, the 1988 failure of Franklin Community CU. In 2004 dollars, it had recorded assets of only \$4 million, yet Franklin was the NCUSIF's fourth-largest loss ever, with a loss of approximately \$50 million, again in 2004 dollars.

Ironton loss mentioned above and a \$2.05 million (2006 dollars) loss in a 1983 failure. ASI's third-largest loss was a \$773,000 failure in 1986.

Unlike the FDIC, the NCUA does not publish data on its individual failures, such as the total assets and shares at the time of failure and the cost of resolving that failure. This is a major policy failing by the NCUA because it is impossible to evaluate NCUSIF failures in terms of a distribution of those failures and loss percentages by asset size beyond utilizing the data in the Filene reports. Instead, ASI's ability to absorb losses in a highly stressful situation must be based on ASI's experience. The ASI experience teaches that ASI's largest losses, in percentage terms, occur among its smallest insureds. For example, over ASI's entire 33-year history, the largest failure with a loss percentage exceeding 10% was a CU with just \$3.8 million of assets; in 2006 dollars, that would equate to a credit union with \$7.7 million in assets. At the end of 2006, 108 of ASI's 172 primary-insured CUs exceeded that size; those 108 CUs accounted for more than 99% of ASI's insured shares.

While ASI can experience a large loss percentage in the failure of a very small CU, the dollar amount of such a loss would be quite modest relative to ASI's premium income. Never have losses in failed CUs come close to threatening ASI's capitalization. Today, ASI's insurance exposure largely lies in CUs larger than the largest ASI-insured CU that has ever failed. As of the end of 2006, 32 ASI-insured CUs, accounting for five-sixths of all ASI-insured shares, were larger than the largest ASI-insured CU that has ever failed, after adjusting the size of that 1988 failure for inflation; ASI's modest loss in that failure equaled just 1.3% of that CU's assets. At the other end of the scale, less than one-half of one percent of the shares of all ASI-insured CUs are in the 54 ASI-insured CUs under \$5 million in size; historically, over four-fifths of ASI's failures have occurred in the under-\$5 million size range.

Relative to its historic loss experience, ASI is extremely well reserved and capitalized, in several regards. First, ASI's loss reserve for its primary insurance program -- \$7.4 million at the end of 2006 -- equaled 1.7 times ASI's inflation-adjusted losses for the entire 1995-2006 period.

Second, ASI's retained earnings for its primary-insurance program (\$31.9 million at the end of 2006), at 4.3 times its reserve for primary-insurance guaranty losses on December 31, 2006, have the capacity to absorb losses well in excess of the total amount of loss (\$14.3 million, in 2006 dollars) ASI has experienced over its 33-year history without transmitting any losses to ASI-insureds.

Third, losses beyond that level can be covered by drawing down on participants' capital contributions to ASI and by assessing additional capital contributions on ASI-insureds. However, the likelihood of ASI-insolvency losses ever exceeding ASI's retained earnings is so remote as to defy calculation, except by utilizing assumptions which bear no relationship to either ASI's or the NCUSIF's loss experience over many decades.

Risk dispersion – geographical and otherwise

ASI has a good geographical dispersion of its insurance risk, with its insureds headquartered in eight states, spread from coast to coast, and with Texas coming on-board as the ninth state. Seven other states have statutory language that would permit private share insurance, should the state's CU regulator authorize it. Hence, ASI is operating in over half of the 16 states where potentially it can be a primary CU insurer. According to Census Bureau estimates, the nine states where ASI presently offers primary share insurance had 35% of the United State's population on July 1, 2006, so just those nine states give ASI a substantial population diversification as well as geographical dispersion. The other seven of the 16 states had another 15% of the nation's population, so ASI presently serves 70% of the population in those states which have authorized private share insurance or have the statutory authority to authorize it. Together, these 16 states account for half of the country's population.

In California, which represents 42% of ASI's primary insurance exposure, the smallest ASI-insured CU had \$17 million of assets at the end of 2006, a size well above the size CU where ASI and the NCUSIF have experienced most of their failures – on an inflation-adjusted basis, only two of ASI's 117 failures over its 33-year history exceeded \$17 million in assets; only six failures exceed \$10 million in inflation-adjusted assets. Further, it must be remembered that California is a very diverse state because of its large population (12.2% of the U.S. total) and its geographical reach (running over 700 miles, north to south, and accounting for 5.3% of the land area of United States, excluding Alaska). To put California further into prospective, its population exceeds the combined population of the country's 22 smallest states while its land area equals that of the twelve smallest states geographically.

Geography is not the only measure of risk dispersion – the nature of a CU's primary sponsor is another important risk-dispersion measure. ASI's insureds are heavily concentrated in the more stable segments of the economy. At the end of 2006, as best ASI can estimate, 63% of the insured shares in its primary insureds were in CUs with memberships centered in utilities (32%), governments (18%), education (10%), and healthcare (3%). Association and community-based CUs, which have diverse memberships, accounted for another 20% of ASI's insured shares at the end of 2006. Manufacturing, traditionally an area where CU failures follow on the heels of the closure of a CU sponsored by just one manufacturing employer, accounted for just 10% of ASI's total insured shares.

The merits of an involuntary termination provision in a share-insurance contract

An involuntary contract termination would terminate the CU's participation in the ASI share insurance program. Such a termination would have the effect of forcing the CU into a liquidating receivership or conservatorship overseen by the state agency which chartered the CU, unless the CU could obtain federal share insurance. If the CU could not obtain federal share insurance, it would be liquidated because all state-chartered CUs (except in Idaho) must be insured. As a practical matter, the State of Idaho will not permit the operation of an uninsured CU.

The involuntary termination of a CU's share-insurance contract with ASI would not terminate the insurance of shares in that CU – that insurance protection would continue until (1) the CU became a federally insured CU or (2), as would be more likely, the CU was merged into another CU or the CU's shares were paid in full to the CU's members during the course of the CU's liquidation. To the

extent that the CU's assets were insufficient to fund a liquidating payout, ASI would cover the shortfall from its reserves, its earnings, and, if necessary, from its capital. Likewise, if the merger of the terminated CU must be subsidized in some fashion, ASI would use its resources to provide that subsidy.

Neither ASI nor the NCUSIF have ever involuntarily terminated a CU's share insurance – all share-insurance terminations have been related to the liquidation or merger of a CU or as a consequence of a purchase-and-assumption transaction. That said, the power to terminate a CU's share insurance against its will (i.e., an involuntary contract termination) represents a powerful supervisory tool ASI can use, in consultation with the CU's state regulator, to force a CU to operate in a safe-and-sound manner without reducing or impairing in any manner the share-insurance protection of any insured shares in that CU. State CU supervisors value greatly ASI's ability to terminate share insurance upon 30 days' notice as the mere threat of such a termination forces the CU to deal with its problems much more quickly than would be the case were the CU federally insured and thus subject to termination only upon a one-year notice.

Conclusion

The Washington DFI is very properly giving careful consideration to the rules it is drafting governing the conditions under which a private share insurer may be authorized to provide primary share insurance to DFI-chartered CUs. The DFI has asked the right questions.

It is the opinion of Bert Ely that with regard to the three issues addressed in this report, ASI is qualified to be a private share insurer for DFI-chartered CUs. Based on (1) its loss history, (2) its present mix of insureds, (3) the steady disappearance of very small CUs which are most likely to fail, and (4) steadily improving risk-monitoring technology, ASI's current revenues, loss reserves, and retained earnings are more than adequate to qualify ASI as a primary insurer of DFI-chartered CUs. While the "tall tree" risk is a legitimate concern, neither the NCUSIF nor ASI has ever suffered a large CU failure nor is there any reason to think that they ever will.

Although ASI operates in nine states, it is quite diverse geographically, both in the regions of the country where it is active as an insurer and in the size of the states it serves. While ASI has its largest insurance risk in California, it is a highly diverse state. Further, ASI's California insureds are much larger than the average CU, which adds further strength to ASI's pool of insureds. Geography, though, is not the only measure of diversity, CU sponsorship is, too. In that regard, ASI has a very diversified set of sponsors for the CUs it insures, with substantial sponsorship among the more stable segments of the economy.

Although criticized by some, ASI's involuntary termination provision in its contract for primary share insurance is an extremely valuable, positive feature. While ASI has never used it, its very existence gives ASI, working with the CU's chartering agency, a powerful tool to motivate the management of a troubled CU to move sooner, rather than later, to take the necessary corrective action to improve itself, merge into a stronger CU, or commence a voluntary liquidation. Should an involuntary termination ever be initiated by ASI, the CU's insureds will not be left without share insurance for even a moment.

Respectively submitted,
Bert Ely

Resume and relevant experience of Bert Ely

Bert Ely has consulted on deposit insurance and banking structure issues since 1981. In 1986, he became an early predictor of the S&L crisis and a taxpayer bailout of the FSLIC. In 1991, he was the first person to correctly predict the non-crisis in commercial banking. In 1992, he correctly predicted the eventual taxpayer bailout of the Japanese banking system. In 1972, Ely made his first prediction of a banking failure, warning Virginia regulators of the pending failure of several uninsured industrial loan companies. Those failures cost depositors and debt holders millions of dollars. Ely also is quite familiar with the operations of the National Credit Union Share Insurance Fund, an experience which dates back to his preparation of the NCUSIF's 1985 annual report.

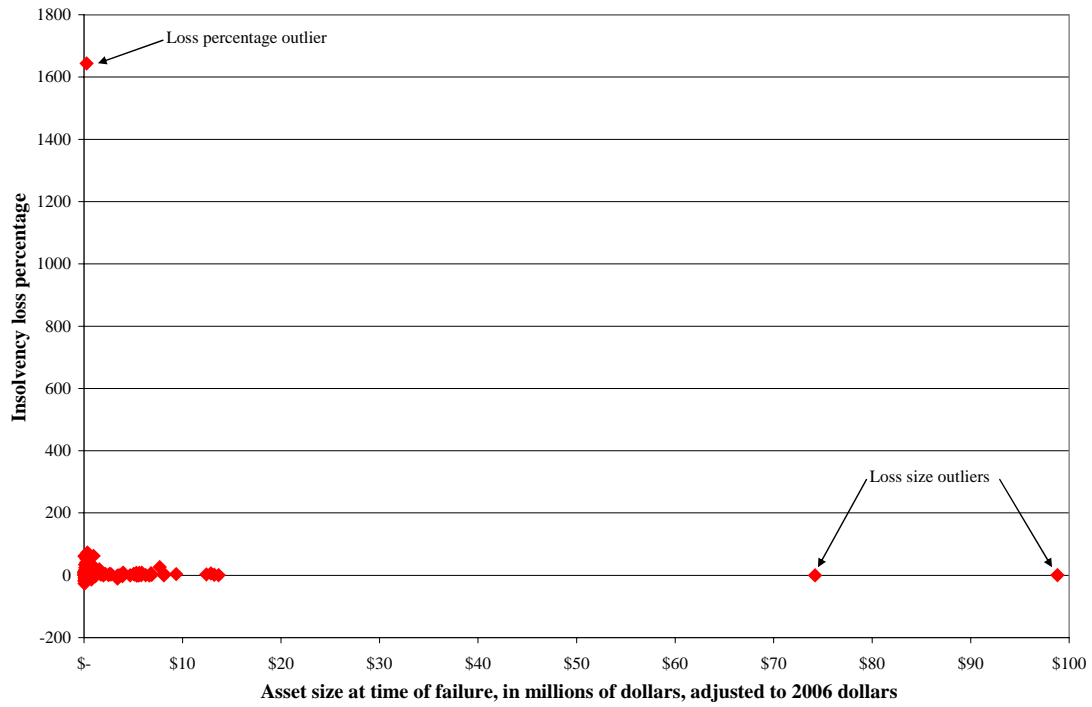
Ely continuously monitors conditions in the banking industry as well as monetary policy. In recent years, he has focused increased attention on the GSEs, notably Fannie Mae, Freddie Mac, and the Farm Credit System. Ely has helped to draft legislation to enact the cross-guarantee concept for privatizing banking regulation and its related deposit insurance and systemic risks. He has testified on numerous occasions before congressional committees on deposit insurance and banking issues and he often speaks on these matters to bankers and others.

Ely first established his consulting practice in 1972. Before that, he was the chief financial officer of a public company, a consultant with Touche, Ross & Company, and an auditor with Ernst & Ernst. He received his MBA from the Harvard Business School in 1968 and his Bachelor's degree in economics in 1964 from Case Western Reserve University.

American Share Insurance

Figure 1

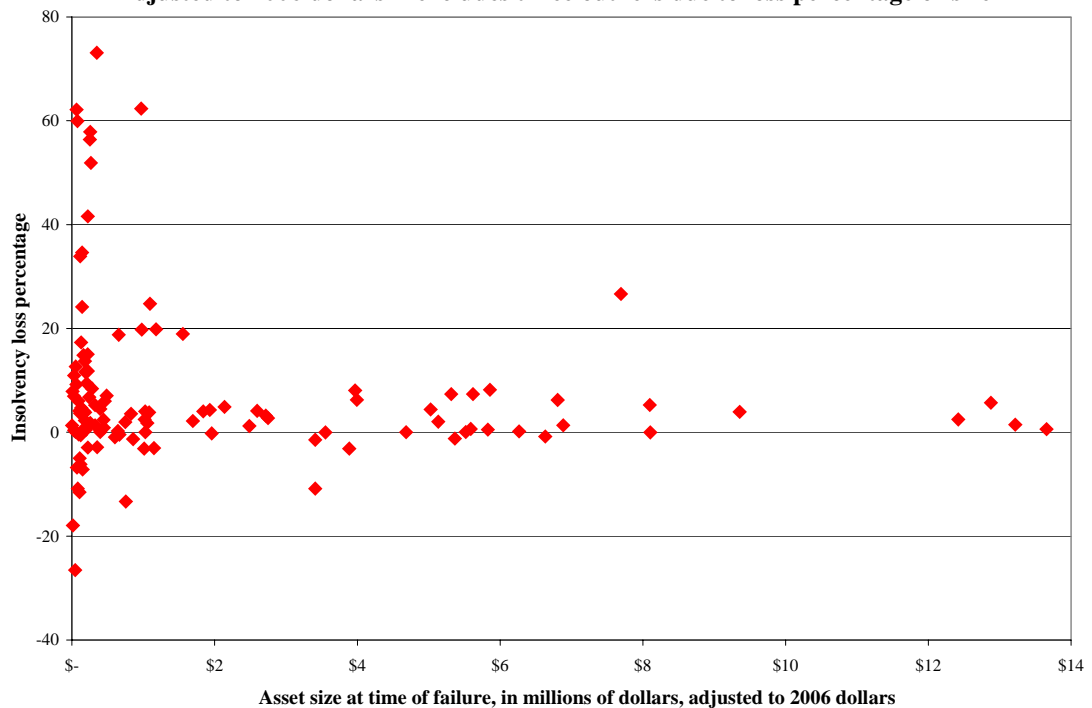
Distribution of insurance loss percentages by asset size at time of failure Adjusted to 2006 dollars



American Share Insurance

Figure 2

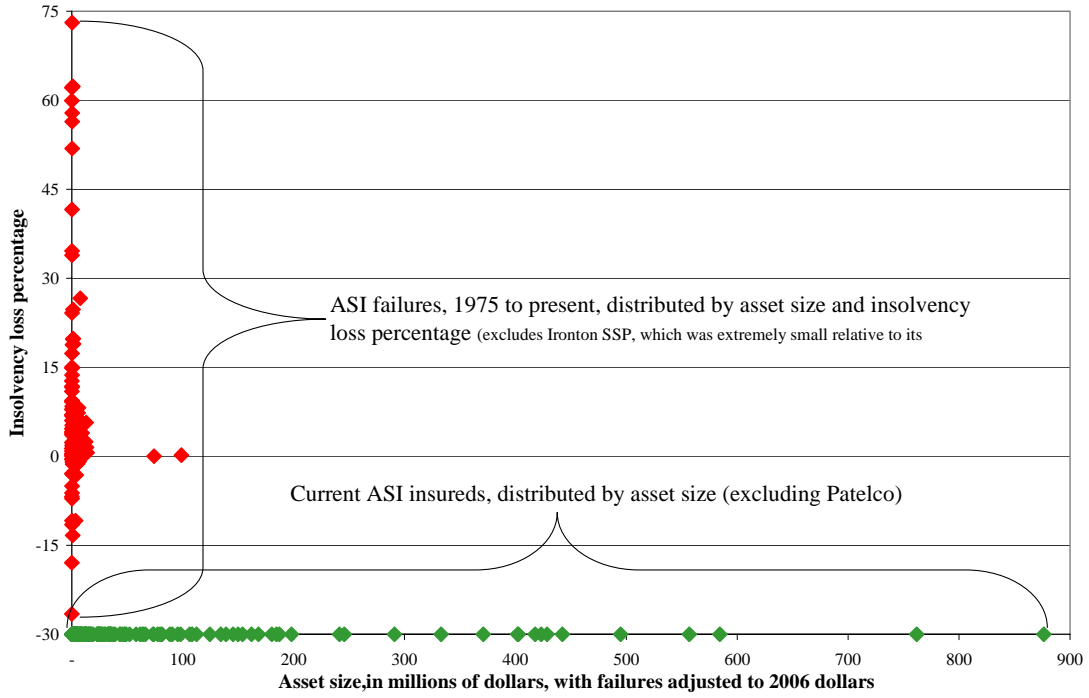
Distribution of insurance loss percentages by asset size at time of failure Adjusted to 2006 dollars -- excludes three outliers due to loss percentage or size



American Share Insurance

Figure 3

Insurance failures, with asset size adjusted to 2006 dollars, contrasted with the asset size of ASI insureds at December 31, 2006



American Share Insurance

Figure 4

Comparative loss experience -- ASI versus NCUSIF -- 1981 to 1994 -- Net insolvency loss in failures as a percent of average shares in insured Cus that year

