

# How The Crisis Has Changed Views On CU Capital

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NEW ORLEANS-Before the recession began in 2007, CUNA Chief Economist Bill Hampel was asked by a reporter for his views on a credit union that had a net worth ratio of 16%. It's over-capitalized he replied.

Three years later with the corporate system struggling, the recession, and the effects of the subprime fiasco still depressing markets, that same credit union's net worth ratio now hovers around 13%. There is, of course, little discussion these days about credit unions being over-capitalized.

## Evolving View

At CUNA's May CFO conference in New Orleans, Hampel was asked by that same reporter if his views on capital had changed with regard to that same credit union, which today is a member of the adequately capitalized corporate in Wisconsin, while it is also a member of an Illinois-based corporate, which recently reported a net worth ratio of 2%.

Hampel answered that his views on capital have changed a bit and that an adequate capital range today would be from 8% to 10%, depending on individual circumstances. That's up from his previous view that the 7% to 9% range was ideal.

Each credit union has to find its appropriate capital range, said Hampel. "There is a cost of capital; it is not free. The cost of capital is a foregone member benefit."

The role of capital in credit unions has evolved during the past century. Purists through the years held that capital should be limited to a minimum and returned to the members in the form of lower prices and improved services. If there was capital left over at the end of the year it should be returned to the members via patronage refunds, many suggested. Building capital reserves was not considered a priority.

Economic realities along with the recession of the 1980s brought home the necessity of building up net worth. Credit unionists began to shift their perception to build more capital.

This view was strengthened by NCUA's CAMEL system of regulation with the first letter-and most important letter-in the acronym being Capital.

## Once Bitten, Twice Shy

The failure of the savings and loan industry also served to make credit union regulators overly cautious or zealous, depending upon one's view of the regulators. This also brought the view for some that credit unions were managing their organizations not for their members, but for the regulators. Building capital became a priority.

Harold Sollenberger, emeritus professor of accounting and management systems at Michigan State University, addressed the issue of ideal capital at that same CUNA CFO conference. He noted that credit union capital was 6.24% in 1986 when deposits were regulated, as shown in the chart at top right, and managing a credit union was during a happier and less complicated time.

Some in the industry had previously made the argument that from 2000 to 2008 credit unions were over-capitalized to the disadvantage of members. Capital is not "cheap or free money" observed Sollenberger, agreeing with Bill Hampel. "If capital is not used efficiently, members lose opportunities."

In a profit-making entity, if an enterprise has excessive capital, it won't turn enough profit to provide a return on equity and the stockholders will sell the stock, noted Sollenberger. Buyers simply refuse to pay a high price for low returns and the stock price is bid down and the competition yields a market assessment of sufficient capital.

### **The Credit Union Dilemma**

The credit union dilemma is that no similar equilibrium process exists, according to Sollenberger. The only stockholder surrogate is the complaining member who wants better dividends and loan rates. Board members are the members' representatives, but they tend to be less demanding as shareholders.

The key protector of capital is the NCUA, said Sollenberger, but the agency is perceived by many as acting more on behalf of the National Credit Union Share Insurance Fund than of the members, he suggested.

The reality is that the management teams and the board of directors of a credit union have little incentive to keep capital at the "equilibrium" or competitive levels. Unlike a for-profit enterprise, there is little reward for a CEO or management to take risk in most credit unions.

"Excess capital has a big opportunity cost for its members; they could be using these funds for other purposes-to buy cars, pay tuition for children, make deposits," said Sollenberger. "Excess capital represents a lost competitive advantage. If the credit union earned the extra net income in the past, it means that the credit union has charged too much for loans and paid too little for deposits."

Sollenberger has developed a process for developing ideal capital that he details in a white paper, "Strategic Planning for Ideal Capital in the New Economy," which is available on the CUNA CFO Council's website. It involves managers and board members planning and discussing the various risks to the credit union and their significance.

That process uses risk-based capital as a tool for determining capital adequacy, which is essentially what for-profit entities use.

Basel II, for example, is the international standard for financial institution capital. Basel II is a risk-weighted system issued by the Bank for International Settlements. This system, Sollenberger noted, sticks to the big three risks: credit risk, operational risk, and market risk.

### **Appropriate Capital Critical**

Given the changed economic environment of possible regulatory changes, the corporate restructuring and tightening or loosening of operating regulation, the appropriate capital level is becoming more critical.

Additional changes in the environment affecting capital levels include changes in acceptable credit standards and in economic conditions that influence credit quality perceptions and realities, according to Sollenberger.

Add to this volatile mix the effects of possible dramatic interest rate yield curve changes over short time periods-which may be coming in the near future.

Sollenberger's method is to develop a strategic view of capital by considering the following areas:

- Risks. Assess all risks facing the credit union-financial, competitive, membership, economic and operating

- Plans. Evaluate growth, outreach and change
- Leadership. Consider leadership competence and experience
- Markets. Consider financial marketplaces, competitors and partners
- Trade-offs. Recognize conflicts between safety, soundness and competitiveness

### **Assessing the Risks**

Most credit unions face the following risks; some may overlap. Risks can be combined and new ones can be added to the list. Sollenberger said the risks that should be assessed for capital planning are: Credit risk, interest rate risk, liquidity risk, earning power risk, growth risk, technology risk, business risk, and leadership risk.

Sollenberger suggests that credit unions begin the capital planning exercise with a base of 6% capital.

His white paper has a worksheet for each of the risk factors and decisions include a group discussion between management and the board deciding between a 0.2% or 0.3% addition to the capital-not a 1% or 2% addition.

Creating an ideal capital target relies on assessment, planning, and finally on execution, said Sollenberger.

The goal for an ideal capital number is as important as any other financial target. Among Sollenberger's key conclusions:

- A credit union's equity position must be strategically planned.
- An ideal equity position is the result of considering all risks facing a credit union-reflecting true risk-based capital adequacy.
- The ideal equity goal is a range-preferably 1% or less.
- To achieve a consensus, the risk assessment must involve key managers and board members,
- Financial risks are evaluated using historical, present, and forecast information about the credit and information and knowledge about a set of high performing peer credit unions.
- This strategic equity position will have more utility than any examiner recommended equity action.