Too Much Net Worth: The Elephant in the Living Room

John Dolan-Heitlinger, President & CEO, Keys Federal Credit Union
2/21/2005

Monday, February 21, 2005
URL: http://www.creditunions.com/home/articles/template.asp?article_id=1555

Now we all know that the net worth ratio is an important measure of the ability of a credit union to withstand financial losses. Capital is accumulated to mitigate unforeseeable credit risk, interest rate risk, asset liability mismatching, natural and economic disasters, uninsured losses, criminal activity, staff ineptitude, *etc*. (1)

However, from the *member's* standpoint too much capital can be just as harmful as too little. This is the elephant in the living room that our credit union movement has ignored year after year. This excess capital, and regulatory pressures to build it, encourages the conversion of credit unions to banks. Our average net worth ratio of above 10% is an embarrassment, like being overweight. From a member's standpoint it is an unnecessary burden that lowers their returns from the credit union and reduces the credit union's competitiveness.

Let's go through the basics:

The appropriate level of net worth needed is determined by analyzing the credit union's balance sheet and operations in two ways:

1. Applying generally accepted measures of risk inherent in the balance sheet of the credit union. One example is the risk-adjusted net worth requirements specified in NCUA Rules & Regulations §702.106. If the credit union's net worth meet the levels specified in these calculations then the level of net worth is deemed to be sufficient. NCUA Rules & Regulations §702.106 includes conservative definitions of "Adequately Capitalized" (6% net worth) and "Well Capitalized" (7% net worth) that are accepted "default" levels not requiring analysis.
2. Applying a series of worst-case scenarios to the credit union's financial statements and seeing if the amount of capital is sufficient to withstand these scenarios. Computer models are typically used for this analysis. If the net worth is sufficient to withstand a worst-case scenario without total depletion, then the level of net worth would be seen as sufficient.

Now, some argue that having more and more capital is always good because it provides an interest free source of funds. Let me quote from a paper by Harold Sollenberger (2) that exposes the critical flaws in this argument:

The argument that more equity provides costless funds, lowering the credit union's average cost of funds is mechanically correct but economically flawed. The basic points are that excess equity:

- Has an opportunity cost. Members could be using these funds for other purposes – buy cars, pay tuition for children, make deposits to earn cash dividends, and do many other things that bring benefits. Even though the credit union tells the member that its equity is the member's ownership interest, the member never sees the money and has no vested interest in it, creating a false promise of benefit.
- Represents lost competitive advantage. Having earned the net income in the past means that the credit union has charged too much for loans and paid too little for deposits - both meaning that it could have been more competitive for member business.
- Causes the credit union to have a lower return on equity (ROE) than the economic system expects. As equity percentages grow, the ability to maintain a satisfactory return on equity employed is endangered. In a competitive economy, capital flows to businesses that can earn satisfactory returns on equity and away from businesses that cannot maintain an adequate return. In the credit union situation, excess capital is captured by management and the board, not allowing it to be returned to the ownermembers. ROE for credit unions in recent years has been under 10 percent, while banks in the same size categories have averaged 13 percent and above. It is common for banks and other organizations to set 15 percent as strategic targets for ROE.

These are three critical issues that every decision maker must face – alternatives, competition, and returns. Too much equity costs the credit union in all three concerns.

Rather than helping reduce the excess capital in our movement the NCUA has removed all constraints on its examiners to require more capital beyond regulatory requirements. This allows NCUA examiners to threaten and coerce credit unions into accumulating net worth levels far in excess of the levels required by regulations or analytical methods, e.g. 8%, 9%, 10%, and higher. Examiners are not required to provide any *quantification* of risk to justify requiring such inflated levels of capital. When challenged by references to regulations or analysis the examiner's response is, "Regardless of what the regs say or analysis shows, it's my professional opinion that more capital would be good for the credit union."

However, the Credit Union Act and NCUA Rules and Regulations direct the regulator to a higher calling. Although these require safety and soundness, the legislative and administrative intents are clearly to encourage credit unions to serve their members in a way that *efficiently* manages risk to benefit the member. To ignore our movement's over-capitalization and the harm that it does to credit union members is not in the best interests of the movement or our credit union members.

The bottom line:

Should an examiner be allowed to require or pressure a credit union to have a greater net worth than the level required by regulations if there is no quantitative analysis that shows that, under any plausible scenario, the credit union will need that level of capital to remain solvent?

If our movement is truly dedicated to serving our members as efficiently and effectively as possible, the answer is clearly no.

Footnotes:
(1) Predictable loan and investment losses are fully provided for in separate allowance accounts based on GAAP.
(2) Strategic Equity Planning: Finding the Ideal Capital Position© published March 2004 by Dr. Harold M. Sollenberger, Professor of Accounting and Information Systems, Broad Graduate School of Management, Michigan State University, East Lansing, Michigan

Are you a CEO interested in having your opinion featured in our weekly CEO Corner? Contact Melissa Murphy for more information.