Determining And Monitoring Strategic Net Worth Requirements

The financial crisis has highlighted the urgent need for credit unions to effectively determine and maintain appropriate net worth on an ongoing basis.

U.S. capital markets are under siege as never before. Almost the entire financial sector has been affected. Mortgage holders FNMA and FHLMC have essentially been nationalized and the federal government, in a move unthinkable in the past, is taking equity stakes in many of the nation's largest lenders. A number of the country's largest investment banks and insurance companies have fared worse.

This level of turmoil has made it increasingly clear that credit unions need to take a new look at the way they do business. One key focus of their attention has been net worth requirements.

In many ways, the stakes are higher for credit unions. That's because many of their financial sector cousins—such as banks, investment houses and insurance companies—have the authority to raise capital. Credit unions do not.

The big question now is what, if anything, can credit unions learn from the recent market turmoil that can help them remain strong and relevant in the long run?

Strategic Net Worth Requirements

What is the right amount?

The latest financial sector debacle has once again highlighted the importance of sound, pragmatic assessment and ongoing monitoring of strategic net worth requirements.

Credit unions that do not maintain adequate strategic net worth run the risk of:

- Becoming irrelevant to their membership and target market
- Having to bypass viable business opportunities
- Slipping into insolvency

That said, determining and maintaining a credit union's strategic net worth requirements is far from easy. The pitfalls are numerous. Correctly assessing and quantifying risk in an ever-evolving business environment is challenging. This was particularly the case during times when highly visible financial institutions were issuing optimistic economic forecasts and assuming that the good times would last forever…

These unrealistic assumptions and lack of timely action by executives have contributed greatly to the current worldwide economic crisis we are facing.

Components Of Strategic Net Worth Requirements

Determining the organization's strategic net worth requirements requires boards and managements to agree on both qualitative and quantitative components as well as broaden their thinking to include worst-case scenarios.

Once strategic net worth requirements are determined, it is important to have a disciplined process for taking timely action to manage within those requirements.

Components of strategic net worth include:

	Net worth needed to support strategy
+	Net worth needed to absorb: ▪ Interest rate risk ▪ Liquidity risk ▪ Credit risk ▪ Operational risk
+	Minimum net worth ratio[1]
=	Strategic net worth requirements

[1] *The minimum net worth ratio the board and management want to protect should risks materialize*

Worst-Case Scenarios

The term *worst-case* can be daunting. However, when establishing risk limits, we believe that the concept can help decision-makers shift their mindsets away from scenarios that are most likely to scenarios that are unexpected.

An Effective Comparison: Auto Insurance

One good way for credit unions to look at their strategic net worth requirements is to compare them to the rationale of deciding the appropriate amount of automobile insurance. Just about everyone has auto insurance, yet many prudent car insurance customers have coverage levels that are far above the legal minimums. Why is that? Most prudent drivers don't expect to make significant claims on their car insurance policies, yet they maintain the extra coverage just in case the unexpected occurs.

That raises an important question: why do many credit union boards and management teams establish risk limits for their organization based only on most-likely scenarios as opposed to factoring worst-case outcomes into their decision-making processes as well?

Any effective determination of a credit union's strategic net worth requirements should encompass both the most likely and the unexpected.

The Qualitative Component

There are many expensive and complicated models to help quantify different types of risk, such as interest rate and credit risks. Yet, while it is necessary to model risk, the harder part is determining strategic net worth requirements and using these guidelines as a filter for decision making.

The *qualitative* component of risk analysis is especially complex. It requires boards and management teams to reach consensus and to state in **clear terms** their appetite for risk and their determination to manage those risks—all while working toward achieving their stated strategic objectives.

We have outlined **some (but not all)** questions that should be considered.

Interest Rate Risk

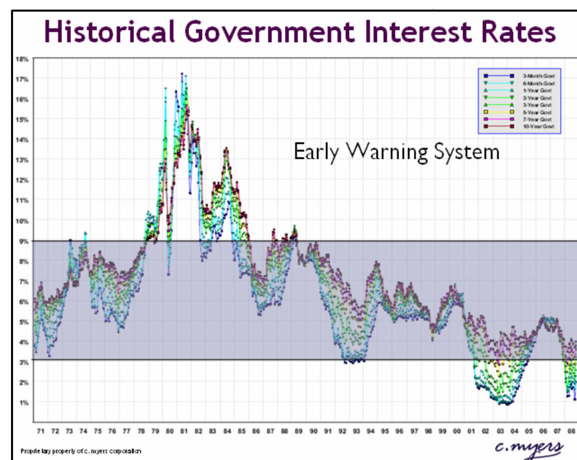
What is the worst-case interest rate environment for which *our credit union* should be prepared?

Many financial sector executives would answer 200 to 300 basis points. Decision makers may want to consider that if a 300 basis point rate increase were to occur as of the end of October, it would bring short-term rates to about 4%.

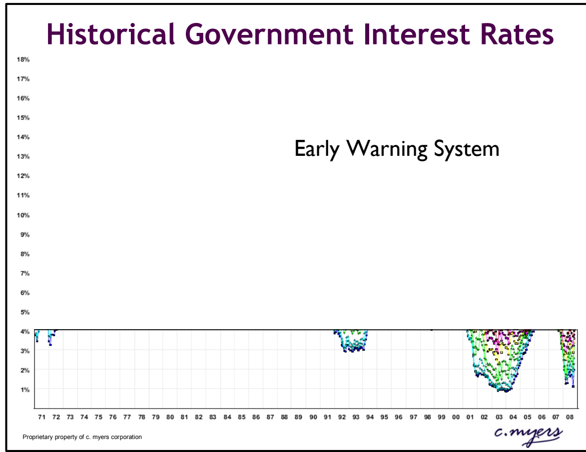
That is below the level that was in place during the summer of 2007 before the Fed started to lower rates.

In other words, in today's environment, it would be hard to justify a 300 basis point rate change as a worst-case interest rate scenario.

The traditional 300 basis point rate shock is an outdated methodology and just about invites decision makers to be blindsided. This is especially significant in low rate environments, which is a time when material risks can be embedded in financial structures and 300 basis point shocks are easier to pass.



Short-term interest rates have fluctuated between 3% and 9% about 80% of the time since the 1970s.



A 300 basis point change in short-term rates as of the end of October would assume that the worst-case interest rate environment for which a credit union needs to be prepared would be short-term rates increasing to about 4%.

Liquidity Risk

What is the worst-case liquidity environment for which *our credit union* should be prepared?

Liquidity risk can be incorporated into the interest rate risk component or can be viewed separately. Cost and access to liquidity should be considered. Many executives find it valuable to evaluate liquidity needs at three levels:

- Level 1—Sources and uses of liquidity from the financial structure
  This analysis should include one time uses of cash, such as cash outlays for branches, technology, bonus payouts, etc. in addition to sources and uses of liquidity from loans, investments, deposits, expenses and non-interest income.

  Level 1 does not rely on LOCs, which could be shut off from the credit union.

- Level 2—Sources and uses of liquidity including available LOCs
  Executives should understand if their LOCs are actually guaranteed, which likely comes at a higher cost. Most LOCs that credit unions have are not guaranteed.

- Level 3—Sources and uses of liquidity including available LOCs and unfunded commitments
  This analysis should help executives understand the percentage of unfunded commitments (e.g., credit cards, LOCs, and HELOCs) the credit union could cover.

Answering "What-if?"

Once the three levels of liquidity risk are understood, it makes sense to conduct "what-if" analyses.

Possible scenarios:
In recent weeks, bad news in the financial services industry has shaken consumer confidence. As a result, the credit union may one day experience fallout from the unfavorable publicity that consumers are hearing.

Consider conducting a "what-if" scenario that relates to loss of consumer confidence in the credit union. An option for starting the process is to assume that a portion of, or all, uninsured deposits are withdrawn and a majority of member CDs do not rollover at maturity.

Another "what-if" scenario is to assess the potential impact if LOCs are materially reduced or even shut off. Once understood, identify and test contingencies to determine if they would be sufficient to mitigate this type of liquidity issue.

Credit Risk

What is the worst-case loan loss for which *our credit union* should be prepared?

We have been asking our clients this question since 1991, the year we started working with credit unions. While worst-case scenarios are difficult to imagine, many of our clients have worked hard to be prepared.

Today's credit market conditions make perfectly clear the need to address this question, to understand the potential consequences and to be able to take corrective steps to mitigate a material portion of the risk.

Operational Risk

Are there any elements regarding *our credit union's* business operations that could bring us down?

Operational risks can include risks from improper transactions, lack of compliance with regulations and policies, fraud and potential loss of reputation.

These risks are often difficult to quantify. Therefore, many decision makers assess these risks from a qualitative perspective when establishing their strategic net worth requirements.

A Continuous Process

Make quantifying and understanding the credit union's strategic net worth requirements an ongoing part of business operations.

As external forces change and new business lines are introduced, these and other ongoing developments need to be thoroughly analyzed for potential risks. The information gathered should be factored into quantifying strategic net worth requirements.

After performing such an assessment, decision makers may determine that the organization has more than enough net worth to absorb worst-case losses; this could present business opportunities.

However, if it is determined that the net worth ratio is inadequate to absorb potential losses, there are at least three potential options:

(1) Develop and implement a plan to reduce the credit union's current risk levels.

(2) Develop and implement a plan to increase the credit union's net worth without adding material risks.

(3) Accept the risk, but develop and **test ahead-of-time** contingency plans that could be implemented if the risks were to materialize.

We recommend testing contingency plans in advance to determine if they generate sufficient financial results to offset the risks undertaken.

If you would like to discuss specific issues that relate to the determination and ongoing monitoring of your credit union's strategic net worth requirements, feel free to call any of our officers at: 800-238-7475.

- Sally Myers, CEO
- John Myers, President
- Rob Johnson, EVP/Principal
- Adam Johnson, SVP/Principal
- Pete Crusius, SVP/Principal
- Tim Busby, Vice President

About c. myers

Since the volatile 1980s, c. myers' principals have been providing sound decision information to executives in the financial services industry.

For the last 18 years, hundreds of credit unions, including 25% of those over $100 million in assets and 50% over $1 billion, have found value in our proven and practical approach to addressing emerging and complex business issues.