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OPINIONS

Diekmann: How the Butterflies Are Generating A Lot of Wind

BY **FRANK J. DIEKMANN**
JAN 30, 2014

Scientists spend gigantic dollars searching for proof of the smallest of theories. Physicists on the Large Hadron Collider to find the Higgs particle. Meteorologists on sophisticated computer models to measure the butterfly effect. Medical researchers on increasingly tiny prototypes to create controllable nanorobots.

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And yet all of them could save money and time proving how small changes can have large repercussions by looking no further than credit unions.

The ghost of 1998's Credit Union Membership Access Act continues to haunt, and it's doing so in ever more haunting ways. Case in point? That 7% minimum capital threshold for CUs that the banking industry was able to get inserted into the bill's final language.

As is so often the case, especially in Washington, attention is given to so many things that are loud and create a lot of buzz, but in the end amount to little more than unmarked tombstones in the Cemetery of Little Consequence. The banks ballyhoo a plan to get the CU tax exemption revoked, and before you know it there are emergency meetings being held, websites created, clever marketing campaigns brainstormed, PAC dollars spent, and a whole lotta noise made. And in the end? No serious threat to the tax exemption ever materialized.

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We Are Not Worthy

The scientific community should pause at their next symposium for a moment of deference to America's bankers. While the bankers talk large Hadron colliders, their most effective actions are with particles; specifically, the particles in the articles. A couple of sentences in CUMAA have now led to a decade-and-a-half of ramifications for America's financial co-ops, especially when it comes to strategies for growth. Talk about the butterfly effect (which holds that the tiny action from a butterfly's wings could put into motion events that would eventually lead to a tornado).

There was (and is) the 12.25% cap on member business lending that has been a "priority" for CU trade associations for so long it's difficult to remember when it was not. Then there's that 7% capital minimum; a figure everyone, including NCUA, agrees was a purely arbitrary figure. Its effect has been anything but arbitrary, as some CUs have had to put a governor on growth, lest they find themselves in dreaded PCA territory. Others have actually run off deposits, turned down loans, and taken a pass on long-term strategies for deploying capital (such as investing in CUSOs) in order to not threaten reserves.

Now NCUA has released a new risk-based capital proposal that will benefit some and hurt others. Analysts have described the agency's plan as something of a "carrot and stick" approach, but it's hard at this point to see CUMMA's fallout as anything other than stick and bigger stick, even for the most effective risk managers.

Former NCUA Chairman Dennis Dollar said that his early view of a capital reform plan includes a "concern that it seems to be 7% for everybody, but if you have a higher risk it has to be more than that. The danger is that if it isn't balanced carefully it becomes all stick and no carrot."

Speaking to a group of credit unions two weeks ago at an Orlando event organized by the San Diego-based CUSO CU Revest, Dollar sees something of what might be called a "butterflies and condors" effect.

"In any category, the larger credit unions are performing much better than the smaller credit unions. Loan growth. Member growth. Every category," he observed. "Where does the capital

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proposal fit into this? The things that are considered higher risk under the capital proposal are in the larger credit unions. But what's driving these larger CUs' performance? That willingness to invest their capital in more innovative products and services. There is only one category where smaller CUs have better numbers: capital ratios.

"I could make quite a case that these better-capitalized CUs are stronger. But look at the numbers and look where they are headed. Why? Because some are taking a conservative approach in hard times. The problem is the hard times are eating up the capital, and without investing in building more capital, you keep losing it. I could argue these larger CUs have taken that capital and invested it in capital building. Their capital is a little bit less, but where is that ratio going? Up."

Time To Decide

The NCUA's risk-based capital rule is now out for comment. I don't know if Dollar plans to submit a comment to his former employer, but if he does, it's likely to sound like this:

"If NCUA does not balance this regulation then these larger credit unions have got to decide 'I am either going to quit doing these things, which is going to affect my earnings, or I'm going to have to continue to do so but I now have less capital to invest in new branches, new technology, new services,'" he said. "If we're not careful and we don't balance it, you run the potential risk of killing the goose laying the golden egg. Your job isn't to avoid risk; your job is to manage risk. How unfortunate if the capital structure penalizes you for managing the capital NCUA is asking you to build."

What's that feeling in many CEOs' stomachs right now? Butterflies.

- Frank J. Diekmann can be reached at frank.diekmann@sourcemedia.com.

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Comments (1)

Setting up risk based capital rules without addressing access to capital is like trying to lose weight by exercise alone... in the end there is an unhappy outcome.

Posted by TreeMan | Friday, January 31 2014 at 11:01AM ET