NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314

DATE: **March 2003** **LETTER NO.:** **03-CU-04**

TO: **Federally Insured Credit Unions**

SUBJ: **CAMEL Rating System**

ENCL: **CAMEL Rating System**

Periodically, the National Credit Union Administration ("NCUA") reviews the CAMEL Rating System to respond to continuing economic and regulatory changes in the credit union industry. This revision is particularly timely and prompted, in large part, by our implementation of the risk-focused examination process.

CAMEL Background. The CAMEL Rating System was adopted by NCUA in October 1987. Its purpose is to provide an accurate and consistent assessment of a credit union's financial condition and operations in the areas of Capital Adequacy, Asset Quality, Management, Earnings, and Asset/Liability Management. It is not intended to be used as a "report card," but as an internal tool to measure risk and allocate resources for supervision purposes. The last version of the CAMEL Rating System was published in Letter to Credit Unions No. 00-CU-08, dated November 2000.

Significant Changes. This revision to the CAMEL Rating System incorporates the principles of the risk-focused examination program recently implemented. A risk-focused examination is intended to focus an examiners' time on activities and areas posing the highest risk. It is a forward-looking approach that evaluates a credit union's current and potential risk. Financial indicators, while useful, often represent lagging indicators of changing risk. The key to effective risk management is effectiveness in a credit union's overall management. Management impacts all seven risks found in credit union operations – credit, interest rate, liquidity, transaction, compliance, strategic, and reputation. An examiner's overall assessment of the credit union is based on numerous factors as discussed in greater detail in the enclosure rather than just on the credit union's current financial condition. Both the composite and management ratings are determined by several selective factors and are not based solely on a numerical average of the other component ratings.

This revision also eliminates the separate list of key and supplemental ratios along with their related formulas. Credit unions and examiners are directed to the “Financial Performance Report” and “User’s Guide for NCUA’S Financial Performance Report” (NCUA 8008) to find calculated ratios and corresponding formulas. This change ensures consistency in the calculation of ratios by providing a single reference.

Examination Guidelines. The CAMEL rating is not automatically determined by matrix ratios alone. The matrix ratios for the capital, asset quality, and earnings components provide minimal guidance for the examiner’s final assessment of the individual component rating. For the risk-focused examination to be effective the examiner must look behind the numbers to determine the significance of supporting ratios, trends, projections, and the interrelationships with the seven risk categories. Likewise, when evaluating the CAMEL components, examiners will consider both the quantitative measurements as well as the qualitative considerations outlined in the Enclosure before a final rating is determined. To ensure objectivity and the uniqueness of individual credit unions during the examination process, examiners do have the discretion to increase or decrease any rating if in their professional judgment a change in rating is justified.

This Letter is effective immediately and it will supercede Letter to Credit Unions No. 00-CU-08.

Sincerely,

/S/

Dennis Dollar
Chairman

Enclosure

ENCLOSURE

CAMEL RATING SYSTEM

The CAMEL rating system is based upon an evaluation of five critical elements of a credit union's operations: Capital Adequacy, Asset Quality, Management, Earnings, and Asset/Liability Management. This rating system is designed to take into account and reflect all significant financial, operational, and management factors examiners assess in their evaluation of a credit union's performance and risk profile. Examiners rate credit unions using a combination of financial ratios (quantitative factors) and examiner judgment (qualitative factors).

Since the composite CAMEL rating is an indicator of the viability of a credit union, it is important that examiners rate credit unions based on their performance in absolute terms rather than against peer averages or predetermined benchmarks. Peer averages or benchmarks do not necessarily reflect that credit unions are operated in a safe and sound manner. The CAMEL ratings should accurately reflect the condition of the credit union regardless of peer performance. Examiners use the financial ratios and trends displayed on the Financial Performance Report and other calculated ratios to guide them in assigning appropriate ratings. Examiners are also expected to use their professional judgment and consider both qualitative and quantitative factors when analyzing a credit union's performance. Since numbers are often lagging indicators of a credit union's condition, the examiner must also conduct a qualitative analysis of current and projected operations when assigning CAMEL ratings.

Part of the examiner's qualitative analysis includes an assessment of the credit union's risk management program. Examiners assess the amount and direction of risk exposure in seven categories: *Credit, Interest Rate, Liquidity, Transaction, Compliance, Reputation, and Strategic* and determine how the nature and extent of these risks affect one or more CAMEL components.

Although the CAMEL composite rating should normally bear a close relationship to the component ratings, the examiner should not derive the composite rating solely by computing an arithmetic average of the component ratings. General definitions the examiner utilizes for assigning the credit union's CAMEL composite rating follow:

Rating 1 - Indicates strong performance and risk management practices that consistently provide for safe and sound operations. Management clearly identifies all risks and employs compensating factors mitigating concerns. The historical trend and projections for key performance measures are consistently positive. Credit unions in this group resist external economic and financial disturbances and withstand the unexpected actions of business conditions more ably than credit unions with a lower composite rating. Any weaknesses are

minor and can be handled in a routine manner by the board of directors and management. These credit unions are in substantial compliance with laws and regulations. Such institutions give no cause for supervisory concern.

Rating 2 - Reflects satisfactory performance and risk management practices that consistently provide for safe and sound operations. Management identifies most risks and compensates accordingly. Both historical and projected key performance measures should generally be positive with any exceptions being those that do not directly affect safe and sound operations. Credit unions in this group are stable and able to withstand business fluctuations quite well; however, minor areas of weakness may be present which could develop into conditions of greater concern. These weaknesses are well within the board of directors' and management's capabilities and willingness to correct. These credit unions are in substantial compliance with laws and regulations. The supervisory response is limited to the extent that minor adjustments are resolved in the normal course of business and that operations continue to be satisfactory.

Rating 3 - Represents performance that is flawed to some degree and is of supervisory concern. Risk management practices may be less than satisfactory relative to the credit union's size, complexity, and risk profile. Management may not identify and provide mitigation of significant risks. Both historical and projected key performance measures may generally be flat or negative to the extent that safe and sound operations may be adversely affected. Credit unions in this group are only nominally resistant to the onset of adverse business conditions and could easily deteriorate if concerted action is not effective in correcting certain identifiable areas of weakness. Overall strength and financial capacity is present so as to make failure only a remote probability. These credit unions may be in significant noncompliance with laws and regulations. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Such credit unions require more than normal supervisory attention to address deficiencies.

Rating 4 - Refers to poor performance that is of serious supervisory concern. Risk management practices are generally unacceptable relative to the credit union's size, complexity and risk profile. Key performance measures are likely to be negative. Such performance, if left unchecked, would be expected to lead to conditions that could threaten the viability of the credit union. There may be significant noncompliance with laws and regulations. The board of directors and management are not satisfactorily resolving the weaknesses and problems. A high potential for failure is present but is not yet imminent or pronounced. Credit unions in this group require close supervisory attention.

Rating 5 - Considered unsatisfactory performance that is critically deficient and in need of immediate remedial attention. Such performance, by itself or in combination with other weaknesses, directly threatens the viability of the credit union. The volume and severity of problems are beyond management's ability or

willingness to control or correct. Credit unions in this group have a high probability of failure and will likely require liquidation and the payoff of shareholders, or some other form of emergency assistance, merger, or acquisition.

NCUA's longstanding policy to disclose CAMEL composite and component ratings only to the officials of the credit union being rated will remain unchanged.

*C*APITAL

Capital provides a cushion to fluctuations in earnings so that credit unions can continue to operate in periods of loss or negligible earnings. It also provides a measure of reassurance to the members that the organization will continue to provide financial services. Likewise, capital serves to support growth as a free source of funds and provides protection against insolvency. While meeting statutory capital requirements is a key factor in determining capital adequacy, the credit union's operations and risk position may warrant additional capital beyond the statutory requirements. Maintaining an adequate level of capital is a critical element.

Part 702 of the NCUA Rules and Regulations sets forth the statutory net worth categories, and risk-based net worth requirements for federally insured credit unions. References are made in this Letter to the five net worth categories which are: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized."

Credit unions that are less than "adequately capitalized" must operate under an approved net worth restoration plan. Examiners evaluate capital adequacy by assessing progress toward goals set forth in the plan.

Determining the adequacy of a credit union's capital begins with a qualitative evaluation of critical variables that directly bear on the institution's overall financial condition. Included in the assessment of capital is the examiner's opinion of the strength of the credit union's capital position over the next year or several years based on the credit union's plan and underlying assumptions. Capital is a critical element in the credit union's risk management program. The examiner assesses the degree to which credit, interest rate, liquidity, transaction, compliance, strategic, and reputation risks may impact on the credit union's current and future capital position. The examiner also considers **the interrelationships** with the other areas:

- Capital level and trend analysis;
- Compliance with risk-based net worth requirements;
- Composition of capital;
- Interest and dividend policies and practices;
- Adequacy of the Allowance for Loan and Lease Losses account;
- Quality, type, liquidity and diversification of assets, with particular reference to classified assets;
- Loan and investment concentrations;
- Growth plans;
- Volume and risk characteristics of new business initiatives;
- Ability of management to control and monitor risk, including credit and interest rate risk;

- Earnings. Good historical and current earnings performance enables a credit union to fund its growth, remain competitive, and maintain a strong capital position;
- Liquidity and funds management;
- Extent of contingent liabilities and existence of pending litigation;
- Field of membership; and
- Economic environment.

RATINGS

Credit unions that maintain a level of capital fully commensurate with their current and expected risk profiles and can absorb any present or anticipated losses are accorded a rating of 1 for capital. Such credit unions generally maintain capital levels at least at the statutory net worth requirements to be classified as "well capitalized" and meet their risk-based net worth requirement. Further, there should be no significant asset quality problems, earnings deficiencies, or exposure to credit or interest-rate risk that could negatively affect capital.

A capital adequacy rating of 2 is accorded to a credit union that also maintains a level of capital fully commensurate with its risk profile both now and in the future and can absorb any present or anticipated losses. However, its capital position will not be as strong overall as those of 1 rated credit unions. Also, there should be no significant asset quality problems, earnings deficiencies, or exposure to interest-rate risk that could affect the credit union's ability to maintain capital levels at least at the "adequately capitalized" net worth category. Credit unions in this category should meet their risk-based net worth requirements.

A capital adequacy rating of 3 reflects a level of capital that is at least at the "undercapitalized" net worth category. Such credit unions normally exhibit more than ordinary levels of risk in some significant segments of their operation. There may be asset quality problems, earnings deficiencies, or exposure to credit or interest-rate risk that could affect the credit union's ability to maintain the minimum capital levels. Credit unions in this category may fail to meet their risk-based net worth requirements.

A capital adequacy rating of 4 is appropriate if the credit union is "significantly undercapitalized" but asset quality, earnings, credit or interest-rate problems will not cause the credit union to become critically undercapitalized in the next 12 months. A 4 rating may be appropriate for a credit union that does not have sufficient capital based on its capital level compared with the risks present in its operations.

A 5 rating is given to a credit union if it is critically undercapitalized, or has significant asset quality problems, negative earnings trends, or high credit or interest-rate risk exposure is expected to cause the credit union to become

"critically undercapitalized" in the next 12 months. Such credit unions are exposed to levels of risk sufficient to jeopardize their solvency.

ASSET QUALITY

Asset quality is rated in relation to:

- The quality of loan underwriting, policies, procedures and practices;
- The internal controls and due diligence procedures in place to review new loan programs, high concentrations, and changes in underwriting procedures and practices of existing programs;
- The level, distribution and severity of classified assets;
- The level and composition of nonaccrual and restructured assets;
- The ability of management to properly administer its assets, including the timely identification and collection of problem assets;
- The existence of significant growth trends indicating erosion or improvement in asset quality;
- The existence of high loan concentrations that present undue risk to the credit union;
- The appropriateness of investment policies and practices;
- The investment risk factors when compared to capital and earnings structure; and
- The effect of fair (market) value of investments vs. book value of investments.

The asset quality rating is a function of present conditions and the likelihood of future deterioration or improvement based on economic conditions, current practices and trends. The examiner assesses credit union's management of credit risk to determine an appropriate component rating for Asset Quality. Interrelated to the assessment of credit risk, the examiner evaluates the impact of other risks such as interest rate, liquidity, strategic, and compliance.

The quality and trends of all major assets must be considered in the rating. This includes loans, investments, other real estate owned (OREOs), and any other assets that could adversely impact a credit union's financial condition.

RATINGS

A rating of 1 reflects high asset quality and minimal portfolio risks. In addition, lending and investment policies and procedures are in writing, conducive to safe and sound operations and are followed. A 2 rating denotes high-quality assets although the level and severity of classified assets are greater in a 2 rated institution. Credit unions that are 1 and 2 rated will generally exhibit trends that are stable or positive.

A rating of 3 indicates a significant degree of concern, based on either current or anticipated asset quality problems. Credit unions in this category may have only a moderate level of problem assets. However, these credit unions may be experiencing negative trends, inadequate loan underwriting, poor documentation, higher risk investments, inadequate lending and investment controls and monitoring that indicate a reasonable probability of increasingly higher levels of problem assets and high-risk concentration.

Asset quality ratings of 4 and 5 represent increasingly severe asset quality problems. A rating of 4 indicates a high level of problem assets that will threaten the institution's viability if left uncorrected. A 4 rating should also be assigned to credit unions with moderately severe levels of classified assets combined with other significant problems such as inadequate valuation allowances, high-risk concentration, or poor underwriting, documentation, collection practices, and high-risk investments. Rating 5 indicates that the credit union's viability has deteriorated due to the corrosive affect of its asset problems on its earnings and level of capital.

***M*ANAGEMENT**

Management is the most forward-looking indicator of condition and a key determinant of whether a credit union possesses the ability to correctly diagnose and respond to financial stress. The management component provides examiners with objective, and not purely subjective, indicators. An assessment of management is not solely dependent on the current financial condition of the credit union and will not be an average of the other component ratings.

Reflected in this component rating is both the board of directors’ and management’s ability to identify, measure, monitor, and control the risks of the credit union’s activities, ensure its safe and sound operations, and ensure compliance with applicable laws and regulations. Management practices should address some or all of the following risks: credit, interest rate, liquidity, transaction, compliance, reputation, strategic, and other risks.

The management rating is based on the following areas, as well as other factors as discussed below.

BUSINESS STRATEGY/FINANCIAL PERFORMANCE

The credit union's **strategic plan** is a systematic process that defines management's course in assuring that the organization prospers in the next two to three years. The strategic plan incorporates all areas of a credit union's

operations and often sets broad goals, e.g., capital accumulation, growth expectations, enabling credit union management to make sound decisions. The strategic plan should identify risks within the organization and outline methods to mitigate concerns.

As part of the strategic planning process, credit unions should develop **business plans** for the next one or two years. The board of directors should review and approve the business plan, including a budget, in the context of its consistency with the credit union's strategic plan. The business plan is evaluated against the strategic plan to determine if it is consistent with its strategic plan. Examiners also assess how the plan is put into effect. The plans should be unique to and reflective of the individual credit union. The credit union's performance in achieving its plan strongly influences the management rating.

Information systems and technology should be included as an integral part of the credit union's strategic plan. Strategic goals, policies, and procedures addressing the credit union's information systems and technology ("IS&T") should be in place. Examiners assess the credit union's risk analysis, policies, and oversight of this area based on the size and complexity of the credit union and the type and volume of e-Commerce services[1] offered. Examiners consider the criticality of e-Commerce systems[2] and services in their assessment of the overall IS&T plan.

Prompt corrective action may require the development of a **net worth restoration plan** ("NWRP") in the event the credit union becomes less than adequately capitalized. A NWRP addresses the same basic issues associated with a business plan. The plan should be based on the credit union's asset size, complexity of operations, and field of membership. It should specify the steps the credit union will take to become adequately capitalized. If a NWRP is required, the examiner will review the credit union's progress toward achieving the goals set forth in the plan.

INTERNAL CONTROLS

An area that plays a crucial role in the control of a credit union's risks is its system of internal controls. Effective internal controls enhance the safeguards against system malfunctions, errors in judgment and fraud. Without proper controls in place, management will not be able to identify and track its exposure to risk. Controls are also essential to enable management to ensure that operating units are acting within the parameters established by the board of directors and senior management.

[1] E-Commerce services include those services a credit union provides, and a member accesses, via electronic means including, but not limited to: Internet/World Wide Web services, wireless services, home banking (direct dial in) services, online bill paying services, and account transaction processing services.

[2] E-Commerce systems include: Web site systems (World Wide Web or Internet/browser-based), home banking/PC-based, audio response/phone-based, wireless, and kiosk.

Seven aspects of internal controls deserve special attention:

1. Information Systems. It is crucial that effective controls are in place to ensure the integrity, security, and privacy of information contained on the credit union's computer systems. In addition, the credit union should have a tested contingency plan in place for the possible failure of its computer systems.

2. Segregation of Duties. The credit union should have adequate segregation of duties and professional resources in every area of operation. Segregation of duties may be limited by the number of employees in smaller credit unions.

3. Audit Program. The effectiveness of the credit union's audit program in determining compliance with policy should be reviewed. An effective audit function and process should be independent, reporting to the Supervisory Committee without conflict or interference with management. An annual audit plan is necessary to ensure that all risk areas are examined, and that those areas of greatest risk receive priority. Reports should be issued to management for comment and action and forwarded to the board of directors with management's response. Follow-up of any unresolved issues is essential, e.g., examination exceptions, and should be covered in subsequent reports. In addition, a verification of members' accounts needs to be performed at least once every two years.

4. Record Keeping. The books of every credit union should be kept in accordance with well-established accounting principles. In each instance, a credit union's records and accounts should reflect its actual financial condition and accurate results of operations. Records should be current and provide an audit trail. The audit trail should include sufficient documentation to follow a transaction from its inception through to its completion. Subsidiary records should be kept in balance with general ledger control figures.

5. Protection of Physical Assets. A principal method of safeguarding assets is to limit access by authorized personnel. Protection of assets can be accomplished by developing operating policies and procedures for cash control, joint custody (dual control), teller operations, and physical security of the computer.

6. Education of Staff. Credit union staff should be thoroughly trained in specific daily operations. A training program tailored to meet management needs should be in place and cross-training programs for office staff should be present. Risk is controlled when the credit union is able to maintain continuity of operations and service to members.

7. Succession Planning. The ongoing success of any credit union will be greatly impacted by the ability to fill key management positions in the event of resignation or retirement. The existence of a detailed succession plan that

provides trained management personnel to step in at a moment's notice is essential to the long-term stability of a credit union. A succession plan should address the Chief Executive Officer (or equivalent) and other senior management positions (manager, assistant manager, etc.).

OTHER MANAGEMENT ISSUES

Other key factors to consider when assessing the management of a credit union include, but are not limited to:

- Adequacy of the policies and procedures covering each area of the credit union's operations (written, board approved, followed);
- Budget performance compared against actual performance;
- Effectiveness of systems that measure and monitor risk;
- Risk-taking practices and methods of control to mitigate concerns;
- Integration of risk management with planning and decision-making;
- Responsiveness to examination and audit suggestions, recommendations, or requirements;
- Compliance with laws and regulations;
- Adequacy of the allowance for loan and lease losses account and other valuation reserves;
- Appropriateness of the products and services offered in relation to the credit union's size and management experience;
- Loan to share ratio trends and history;
- Market penetration;
- Rate structure; and
- Cost/benefit analysis of major service products.

The board of directors and management have a fiduciary responsibility to the members to maintain very high standards of professional conduct:

1. <u>Compliance with all applicable state and federal laws and regulations.</u> Management should also adhere to all laws and regulations that provide equal opportunity for all members regardless of race, color, religion, sex, national origin, age, or handicap.

2. <u>Appropriateness of compensation policies and practices for senior management.</u> Management contracts should not contain provisions that are likely to cause undue hardship on the credit union. The board needs to ensure performance standards are in place for the CEO/Manager and senior management and an effective formal evaluation process is in place and being documented.

3. <u>Avoidance of conflict of interest.</u> Appropriate policies and procedures for avoidance of conflicts of interest and management of potential conflicts of interest should be in place.

4. Professional ethics and behavior. Management should not use the credit union for unauthorized or inappropriate personal gain. Credit union property should not be used for anything other than authorized activities. Management should act ethically and impartially in carrying out appropriate credit union policies and procedures.

RATINGS

A management rating of 1 indicates that management and directors are fully effective. They are responsive to changing economic conditions and other concerns and are able to cope successfully with existing and foreseeable problems that may arise in the conduct of the credit union's operation.

For a management rating of 2, minor deficiencies are noted, but management produces a satisfactory record of performance in light of the institution's particular circumstances.

A 3 rating in management indicates that either operating performance is lacking in some measures, or some other conditions exist such as inadequate strategic planning or inadequate response to NCUA supervision. Management is either characterized by modest talent when above average abilities are needed or is distinctly below average for the type and size of the credit union. Thus, management's responsiveness or ability to correct less than satisfactory conditions is lacking to some degree.

A management rating of 4 indicates that serious deficiencies are noted in management's ability or willingness to meet its responsibilities. Either management is considered generally unable to manage the credit union in a safe and sound manner or conflict-of-interest situations exist that suggest that management is not properly performing its fiduciary responsibilities. In these cases, problems resulting from management weakness are of such severity that management may need to be strengthened or replaced before sound conditions can be achieved.

A management rating of 5 is applicable to those instances where incompetence or self-dealing has been clearly demonstrated. In these cases, problems resulting from management weakness are of such severity that some type of administrative action may need to be initiated, including the replacement of management, in order to restore safe and sound operations.

***E*ARNINGS**

The continued viability of a credit union depends on its ability to earn an appropriate return on its assets which enables the institution to fund expansion, remain competitive, and replenish and/or increase capital.

In evaluating and rating earnings, it is not enough to review past and present performance alone. Future performance is of equal or greater value, including performance under various economic conditions. Examiners evaluate "core" earnings: that is the long-run earnings ability of a credit union discounting temporary fluctuations in income and one-time items. A review for the reasonableness of the credit union's budget and underlying assumptions is appropriate for this purpose. Examiners also consider the interrelationships with other risk areas such as credit and interest rate.

Key factors to consider when assessing the credit union's earnings are:

- Level, growth trends, and stability of earnings, particularly return on average assets;
- Quality and composition of earnings;
- Adequacy of valuation allowances and their affect on earnings;
- Adequacy of budgeting systems, forecasting processes, and management information systems, in general;
- Future earnings prospects under a variety of economic conditions;
- Net interest margin;
- Net non-operating income and losses and their affect on earnings;
- Quality and composition of assets;
- Net worth level;
- Sufficiency of earnings for necessary capital formation; and
- Material factors affecting the credit union's income producing ability such as fixed assets and other real estate owned (“OREOs”).

RATINGS

Earnings rated 1 are currently, and are projected to be, sufficient to fully provide for loss absorption and capital formation with due consideration to asset quality, growth, and trends in earnings.

An institution with earnings that are positive and relatively stable may receive a 2 rating, provided its level of earnings is adequate in view of asset quality and operating risks. The examiner must consider other factors, such as earnings trends and earnings quality to determine if earnings should be assigned a 2 rating.

A 3 rating should be accorded if current and projected earnings are not fully sufficient to provide for the absorption of losses and the formation of capital to meet and maintain compliance with regulatory requirements. The earnings of such institutions may be further hindered by inconsistent earnings trends, chronically insufficient earnings or less than satisfactory performance on assets.

Earnings rated 4 may be characterized by erratic fluctuations in net income, the development of a severe downward trend in income, or a substantial drop in earnings from the previous period, and a drop in projected earnings is anticipated. The examiner should consider all other relevant quantitative and qualitative measures to determine if a 4 is the appropriate rating.

Credit unions experiencing consistent losses should be rated 5 in Earnings. Such losses may represent a distinct threat to the credit union's solvency through the erosion of capital. A 5 rating would normally be assigned to credit unions that are unprofitable to the point that capital will be depleted within twelve months.

ASSET/*L*IABILITY MANAGEMENT

Asset/liability management (ALM) is the process of evaluating, monitoring, and controlling balance sheet risk (interest rate risk and liquidity risk). A sound ALM process integrates strategic, profitability, and net worth planning with risk management. Examiners review (a) interest rate risk sensitivity and exposure; (b) reliance on short-term, volatile sources of funds, including any undue reliance on borrowings; (c) availability of assets readily convertible into cash; and (d) technical competence relative to ALM, including the management of interest rate risk, cash flow, and liquidity, with a particular emphasis on assuring that the potential for loss in the activities is not excessive relative to its capital. ALM covers both interest rate and liquidity risks and also encompasses strategic and reputation risks.

Interest Rate Risk

Interest-Rate Risk - the risk of adverse changes to earnings and capital due to changing levels of interest rates. Interest-rate risk is evaluated principally in terms of the sensitivity and exposure of the value of the credit union's investment and loan portfolios to changes in interest rates. In appraising ALM, attention should be directed to the credit union's liability funding costs relative to its yield on assets and its market environment.

When evaluating this component, the examiner considers: management's ability to identify, measure, monitor, and control interest rate risk; the credit union's size; the nature and complexity of its activities; and the adequacy of its capital and earnings in relation to its level of interest rate risk exposure. The examiner also considers the overall adequacy of established policies, the effectiveness of risk

optimization strategies, and the interest rate risk methodologies. These policies should outline individual responsibilities, the credit union's risk tolerance, and ensure timely monitoring and reporting to the decision-makers. Examiners determine that the ALM system is commensurate with the complexity of the balance sheet and level of capital.

Key factors to consider in evaluating sensitivity to interest rate risk include:

- Interest-rate risk exposure at the instrument, portfolio, and balance sheet levels;
- Balance sheet structure;
- Liquidity management;
- Qualifications of risk management personnel;
- Quality of oversight by the board and senior management;
- Earnings and capital trend analysis over changing economic climates;
- Prudence of policies and risk limits;
- Business plan, budgets, and projections; and,
- Integration of risk management with planning and decision-making.

Liquidity Risk

Liquidity Risk - the risk of not being able to efficiently meet present and future cash flow needs without adversely affecting daily operations. Liquidity is evaluated on the basis of the credit union's ability to meet its present and anticipated cash flow needs, such as, funding loan demand, share withdrawals, and the payment of liabilities and expenses. Liquidity risk also encompasses poor management of excess funds.

The examiner considers the current level of liquidity and prospective sources of liquidity compared to current and projected funding needs. Funding needs include loan demand, share withdrawals, and the payment of liabilities and expenses. Examiners review reliance on short-term, volatile sources of funds, including any undue reliance on borrowings; availability of assets readily convertible into cash; and technical competence relative to liquidity and cash flow management. Examiners also review the impact of excess liquidity on the credit union's net interest margin, which is an indicator of interest rate risk.

The cornerstone of a strong liquidity management system is the identification of the credit union's key risks and a measurement system to assess those risks.

Key factors to consider in evaluating liquidity management include:

- Balance sheet structure;
- Contingency planning to meet unanticipated events (sources of funds – adequacy of provisions for borrowing, e.g., lines of credit, corporate credit union membership, FHLB agreements);

- Contingency planning to handle periods of excess liquidity;
- Cash flow budgets and projections; and
- Integration of liquidity management with planning and decision-making.

Examiners will consider the overall adequacy of established policies, limits, and the effectiveness of risk optimization strategies when assigning a rating. These policies should outline individual responsibilities, the credit union's risk tolerance, and ensure timely monitoring and reporting to the decision makers.

Examiners determine that the liquidity management system is commensurate with the complexity of the balance sheet and amount of capital. This includes evaluating the mechanisms to monitor and control risk, management's response when risk exposure approaches or exceeds the credit union's risk limits, and corrective action taken, when necessary.

Asset/Liability Management

Examiners will have regulatory concern if one or more of the following circumstances exist:

1. An overall asset/liability management policy addressing interest rate risk, liquidity, and contingency funding is either nonexistent or inadequate.
2. The board has established unacceptable limits on its risk exposure.
3. There is noncompliance with the board's policies or limits.
4. There are weaknesses in the management measurement, monitoring, and reporting systems.

RATINGS

A rating of 1 indicates that the credit union exhibits only modest exposure to balance sheet risk. Management has demonstrated it has the necessary controls, procedures, and resources to effectively manage risks. Interest rate risk and liquidity risk management are integrated into the credit union's organization and planning to promote sound decisions. Liquidity needs are met through planned funding and controlled uses of funds. Liquidity contingency plans have been established and are expected to be effective in meeting unanticipated funding needs. The level of earnings and capital provide substantial support for the degree of balance risk taken by the credit union.

A rating of 2 indicates that the credit union's risk exposure is reasonable, management's ability to identify, measure, monitor, control, and report risk is sufficient, and it appears to be able to meet its reasonably anticipated needs. There is only moderate potential that earnings performance or capital position will be adversely affected. Policies, personnel, and planning reflect that risk management is conducted as part of the decision-making process. The level of

earnings and capital provide adequate support for the degree of balance sheet risk taken by the credit union.

A rating of 3 indicates that the risk exposure of the credit union is substantial, and management's ability to manage and control risk requires improvement. Liquidity may be insufficient to meet anticipated operational needs, necessitating unplanned borrowing. Improvements are needed to strengthen policies, procedures, or the organization’s understanding of balance sheet risks. A rating of 3 may also indicate the credit union is not meeting its self-imposed risk limits or is not taking timely action to bring performance back into compliance. The level of earnings and capital may not adequately support the degree of balance sheet risk taken by the credit union.

Ratings of 4 and 5 indicate that the credit union exhibits an unacceptably high exposure to risk. Management does not demonstrate an acceptable capacity to measure and manage interest-rate risk, or the credit union has an unacceptable liquidity position. Analyses under modeling scenarios indicate that a significant deterioration in performance is very likely for credit unions rated 4 and inevitable for credit unions rated 5. Ratings of 4 or 5 may also indicate levels of liquidity such that the credit union cannot adequately meet demands for funds. Such a credit union should take immediate action to lower its interest-rate exposure, improve its liquidity, or otherwise improve its condition. The level of earnings and capital provide inadequate support for the degree of balance sheet risk taken by the credit union.

A rating of 5 would be appropriate for a credit union with an extreme risk exposure or liquidity position so critical as to constitute an imminent threat to the credit union's continued viability. Risk management practices are wholly inadequate for the size, sophistication, and level of balance sheet risk taken by the credit union.

KEY RATIOS FOR CREDIT UNIONS WITH ASSETS OF $2 MILLION OR LESS

	CODE 1	**CODE 2**	**CODE 3**	**CODE 4**	**CODE 5**
1. CAPITAL[3]					
Net Worth/Total Assets	> 7%	6% - 6.99%	4% - 5.99%	2% - 3.99%	< 2%
2. ASSET QUALITY					
Delinquent Loans/Loans	< 1.5%	1.5 – 3.5%	> 3.5 – 7%	> 7 – 9.5%	> 9.5%
Net Charge Offs/Avg. Loans	< .25%	.25 - .75%	> .75 – 1.75%	> 1.75 – 2.5%	> 2.5%
3. EARNINGS					
Return on Avg. Assets	> 1.25%	.9 – 1.25%	.4 - < .9%	.2 - < .4%	< .2%

KEY RATIOS FOR CREDIT UNIONS WITH ASSETS OF $2 - $10 MILLION

	CODE 1	CODE 2	CODE 3	CODE 4	CODE 5
1. CAPITAL[3]					
Net Worth/Total Assets	> 7%	6% - 6.99%	4% - 5.99%	2% - 3.99%	< 2%
2. ASSET QUALITY					
Delinquent Loans/Loans	< 1.5%	1.5 – 3.5%	> 3.5 – 5%	> 5 – 8.25%	>8.25%
Net Charge Offs/Avg. Loans	< .25%	.25 - .75%	> .75 – 1.5%	> 1.5 - 2.5%	> 2.5%
3. EARNINGS					
Return on Avg. Assets	> 1%	.8 – 1%	.35 - <.8%	.15 - < .35%	< .15%

[3] For those credit unions classified as "new" under Part 702 of the NCUA Rules and Regulations, which means both have been in operation for less than ten (10) years and has $10,000,000 or less in total assets, examiners must use their judgment when assigning a Capital component rating. Consideration should be given to whether the credit union is meeting its goals under its business plan or revised business plan or complying with mandatory or discretionary supervisory actions.

KEY RATIOS FOR CREDIT UNIONS WITH ASSETS OF
$10 – $50 MILLION

	CODE 1	CODE 2	CODE 3	CODE 4	CODE 5
1. CAPITAL[4]					
Net Worth/Total Assets	> 7%	6% - 6.99%	4% - 5.99%	2% - 3.99%	< 2%
2. ASSET QUALITY					
Delinquent Loans/Loans	< 1.25%	1.25 –2.5%	>2.5 – 3.5%	>3.5 – 5.5%	> 5.5%
Net Charge Offs/Avg. Loans	< .25%	.25 - .75%	> .75 – 1.5%	> 1.5 – 2%	> 2%
3. EARNINGS					
Return on Avg. Assets	> 1%	.8 – 1%	.35 - < .8%	.2 - < .35%	< .2%

KEY RATIOS FOR CREDIT UNIONS WITH ASSETS OF
$50 MILLION OR MORE

	CODE 1	CODE 2	CODE 3	CODE 4	CODE 5
1. CAPITAL[4]					
Net Worth/Total Assets	> 7%	6% - 6.99%	4% - 5.99%	2% - 3.99%	< 2%
2. ASSET QUALITY					
Delinquent Loans/Loans	< 1.25%	1.25 – 2.25%	> 2.25 – 3.25%	>3.25 –4.75%	>4.75%
Net Charge Offs/Avg. Loans	< 25%	.25 - .6%	> .6 – 1.2%	> 1.2 – 1.8%	> 1.8%
3. EARNINGS					
Return on Avg. Assets	> 1%	.8 – 1%	.35 - < .8%	.2 - < .35%	< .2%

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[4] For those credit unions meeting the criteria for an applicable net worth requirement, per §702.103 of the Rules and Regulations (quarter-end total assets exceed $10 million and its risk-based net worth requirement exceeds 6 percent), examiners must use their judgment when assigning a Capital component rating. Consideration should be given to the credit union's current net worth compared to its risk-based net worth requirement, if applicable.