NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA

DATE: **November 2000** **LETTER NO.: 00-CU-08**

TO: **Board of Directors of all Federally Insured Credit Unions**

SUBJ: **Camel Rating System**

ENCL: **(1) Camel Rating System**
(2) Camel Ratios
(3) Camel Ratios

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. In 1998, Congress amended the Federal Credit Union Act to establish minimum capital standards for federally insured credit unions. The effective date of these amendments was August 7, 2000.

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. 161, dated December 1994 with corresponding modifications in Letter to Credit Unions No. 167, dated May 1995.

Prompt Corrective Action. On August 7, 1998, Congress enacted the Credit Union Membership Access Act ("CUMAA") that required the NCUA Board to adopt a system of "prompt corrective action" ("PCA") to restore the net worth of federally-insured credit unions which become inadequately capitalized. Part 702 of the NCUA Rules and Regulations (12 CFR 702) sets forth the statutory net worth categories, alternative system for "new" credit unions, and risk-based net worth requirements for federally-insured credit unions. The statute sets forth the five net worth categories based on a credit union's net worth ratio. The

categories are: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized."

Credit unions will report their net worth[1] ratio through the Call Report on the "PCA Worksheet." This will first apply to the year-end Call Report due to be filed by January 22, 2001. The risk-based net worth requirement for credit unions meeting the definition of "complex" will first apply on the basis of the data in the first quarter Call Report due to be filed by quarterly filers by April 23, 2001.

Significant Changes. Elimination of the "Capital to Assets" and "Net Capital to Assets" ratios is the most significant change to the CAMEL rating system. The ratio of "Net Worth to Total Assets" replaces the two aforementioned ratios. Simplification and uniformity of measurement were the motivations for using net worth as the primary measure of a credit union's financial strength. This change should eliminate inconsistencies and misunderstandings when referring to credit union's capital, whether it was "net" or "gross" capital.

Other supporting ratios using "capital" in the calculations were changed to use "net worth" instead.

Examination Guidelines. Part 702 permits a credit union to elect one of four measures of total assets for purposes of calculating its net worth ratio on a quarterly basis. Examiners are instructed to use the month-end balance of net worth to the month-end balance of total assets for examination purposes. If the examination date falls on a quarter-end, then the examiner should use the same total asset calculation as the credit union. If a material difference exists between the credit union's chosen method and the examination method, the examiner will discuss in the examination report the reasons for the difference and assign an appropriate capital component rating.

The CAMEL rating is not automatically determined by key ratios alone. Examiners are instructed to look behind the numbers to determine the significance of supporting ratios and trends. When evaluating the components of CAMEL, examiners look at both the quantitative measurements as well as the qualitative considerations outlined in Enclosure (1) before a final rating is determined. Examiners have the discretion to increase or decrease any rating as they determine necessary using their professional judgment.

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[1] Part 702 (12 C.F.R. §702) defines net worth as the retained earnings balance of the credit union at quarter end as determined under generally accepted accounting principles. Retained earnings consists of undivided earnings, regular reserves, and any other appropriations designated by management or regulatory authorities. This means that only undivided earnings and appropriations of undivided earnings are included in net worth. For low income-designated credit unions, net worth also includes secondary capital accounts that are uninsured and subordinate to all other claims, including claims of creditors, shareholders and the NCUSIF. For any credit union, net worth does not include the allowance for loan and lease losses account.

This Letter will be effective December 31, 2000, and it will supercede Letter 161 and Letter 167 on that date.

Sincerely,

_____/s/____________________________

Norman E. D'Amours
Chairman
National Credit Union Administration Board

Enclosures

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 and operational factors examiners assess in their evaluation of a credit union's performance. Credit unions are rated using a combination of financial ratios and examiner judgment.

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. The examiner must use 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.

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. Following are general definitions the examiner should use for assigning the credit union's CAMEL composite rating:

Rating 1 - Indicates strong performance and risk management practices that consistently provide for safe and sound operations. The historical trend and projections for key performance measures are consistently positive. Credit unions in this group are resistant to external economic and financial disturbances and capable of withstanding the unexpected actions of business conditions more ably than credit unions with a lower composite rating. 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. 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 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. Performance is marginal. Risk management practices may be less than satisfactory relative to the credit union's size, complexity, and risk profile. 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. 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. 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. 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.

Key financial ratios will continue to be provided for the capital, asset quality, and earnings, with supporting ratios for asset/liability management components to guide examiners in assigning the appropriate ratings. Examiners will rate credit unions based on their performance in absolute terms rather than against national peer averages or predetermined benchmarks. Peer averages or benchmarks do not necessarily reflect credit unions that are being operated in a safe and sound manner. The CAMEL ratings should accurately reflect the condition of the credit union regardless of peer performance.

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

CAPITAL

Capital cushions 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. It 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 be operating under an approved net worth restoration plan. Progress toward goals set forth in the plan will be considered by the examiner when evaluating capital adequacy.

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. The examiner should also consider **the interrelationships** with the other areas:

- Capital level and trend analysis;
- Compliance with earnings transfer requirements and 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;
- 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;
- Field of membership; and
- Economic environment.

RATINGS

Credit unions that maintain a level of capital fully commensurate with their 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 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.

*A*SSET QUALITY

Asset quality is rated in relation to:

- The quality of loan underwriting, policies, procedures and practices;
- 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 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 is able 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.**

The management rating is based on the following areas 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. It enables the credit union to make sound decisions and may help identify risks or weaknesses within an organization that may become magnified in an economic downturn.

As part of the strategic planning process, credit unions need to 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. An examiner should evaluate the business plan against the strategic plan to determine if it is consistent with its strategic plan. At smaller institutions, the written aspects of such a plan may be quite short, supplemented with direct communication, while at larger, very diversified institutions, the plan would be expected to be extensive and detailed.

The first step of a strong business plan is an assessment of the environment in which the credit union will operate over the medium term. The credit union should evaluate the external and internal factors influencing its business, including economic and regulatory issues, its member base, its competition, and its competitive opportunities. The credit union should also plan for different scenarios, e.g., high/low interest rate environment, full employment/layoffs, etc. Credit unions whose sponsor companies are downsizing need to prepare contingency plans for worse case scenarios. The analysis should produce a set of assumptions that will be incorporated into the business plan.

The second step is a clear, written statement of key objectives. These objectives should be consistent with its strategic plan and realistic in regard to the credit union's analysis of external and internal factors. The objectives should be measurable. The objectives can be expressed in terms of income and expense paths, projected balance sheets, and other
performance indicators, but should be accompanied by a clear statement of the acceptable level of risk that the credit union can assume in achieving the plan. The objectives may also include more general written statements (e.g., "fully implement the share draft program by year-end"). Finally, the plan should detail what mechanism the credit union will use to measure progress against the established objectives.

The third step of a strong business plan is it must be consistent with federal and state laws and NCUA regulations and that it provides sufficient capital to support any additional risk-taking.

The fourth step is to make sure the objectives are communicated to management and staff at every level to assure adherence to the business plan and strategic goals.

The final step is the plan's implementation. Examiners should assess how the plan is put into effect. The credit union's policies and procedures should be consistent with, and to some extent, directed at achieving the objectives in the business plan. The credit union's resources (employees, capital, equipment) should be consistent with the plan's objectives. A review of resource allocation would also include marketing and its member relationships. The management rating will be strongly influenced by the credit union's performance in achieving its plans.

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 will 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[2] offered. Examiners should consider the criticality of e-Commerce systems[3] 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

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[2] E-Commerce services includes 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.
[3] E-Commerce systems include: website systems (world wide web or internet/browser-based), home banking/PC-based, audio response/phone-based, wireless, and kiosk.

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.

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, as well as the credit union industry philosophy. A training program tailored to meet management needs should be in place and cross-training programs for office staff should be present.

7. Succession Planning. The ongoing success of credit unions 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.).

SERVICE TO MEMBERS

Management's efforts to educate the membership will play a key role in the credit union's ongoing success. Educational material discussing the history, philosophy, and uniqueness of the credit union industry will foster participation and loyalty by current and potential members.

Credit unions' goals are diverse: 1) to meet the financial service needs of members, with particular attention to the members themselves; 2) to provide access to low cost lending programs; and 3) to provide secure savings accounts that are used to redistribute credit union profits. Credit union members have a diverse array of financial service providers from which to choose. Credit unions must recognize demographic changes and the impact these changes have on how and what services should be provided in order to remain competitive.

In order to review service to members, the following areas need to be taken into consideration:

1. Loan to share ratio. Is the credit union marketing its loan program, providing the loan products the members want, and making loans easily assessable to qualified members? Credit unions with low loan to share ratios will be looked at closely to determine management's efforts to promote and generate loan demand. The review will focus primarily on the safety and soundness concerns associated with low loan to share ratios.

2. Market penetration. Have credit union services been extended to all potential members? What is the percent of members to potential members? Management's efforts to promote membership and services to all potential members is paramount to the future success of the credit union.

3. Rate structure. Are rates competitive?

4. Cost/benefit analysis. Is the credit union performing cost/benefit analyses on its major service products to ensure that the membership is not paying, either in reduction of dividends or higher loan rates, for services used by only a few? These analyses should include branch operations and CUSO activity. An essential part of the analyses performed will be the review of fees charged to the members. The equitable assessment of fees for various services should be part of every cost/benefit analysis performed.

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;
- Integration of risk management with planning and decision-making;
- Responsiveness to examination and audit suggestions, recommendations, or requirements;
- Adequacy of the allowance for loan and lease losses account and other valuation reserves; and,
- Appropriateness of the products and services offered in relation to the credit union’s size and management experience.

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

1. Compliance with all applicable state and federal laws and regulations. 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. Appropriateness of compensation policies and practices for senior management. Management contracts should not contain provisions that may 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 written evaluations are completed annually prior to any salary increases.

3. Avoidance of conflict of interest. Policies and procedures for avoidance of conflicts of interest should be in place. Nepotism should be avoided.

4. Professional ethics and behavior. Management should not use the credit union for private gain. Credit union property should not be used for anything other than authorized activities. Management needs to act impartially and not give preferential treatment to any private individual.

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. It enables a credit union 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. Future performance is of equal or greater value, including performance under various economic conditions. Examiners should 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.

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;
- Future earnings prospects under a variety of economic conditions;
- Net interest margin;
- Net nonoperating 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 is the identification, monitoring and control of (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 asset/liability management, including the management of interest-rate risk, cash flow, and liquidity, with a particular emphasis on assuring that the potential for loss in the credit union's activities is not excessive relative to its capital. In short, asset/liability management is the process of identifying, measuring, monitoring, reporting, and controlling interest rate and liquidity risks (balance sheet risks).

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 portfolio to changes in interest rates. In appraising asset/liability management, attention should be directed to the credit union's liability funding costs relative to its yield on assets and its market environment.

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 institution'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.

The cornerstone of a strong asset/liability 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 asset/liability management include:

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

In arriving at an overall rating for asset/liability management, consideration should be given to the overall adequacy of established policies and the effectiveness of risk optimization strategies. These policies should outline individual responsibilities, the credit union's risk tolerance, and ensure timely monitoring and reporting to the decision makers.

Examiners should determine that the asset/liability 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.

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

1. The asset/liability management policy and liquidity and contingency funding policy are either nonexistent or inadequate.
2. The board has established unacceptable limits on its risk exposure.
3. There is noncompliance with the board's policy.
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 management is 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.

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 reasonable anticipated liquidity needs. Policies, personnel, and planning reflect that risk management is conducted as part of the decision-making process.

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.

Ratings of 4 or 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 that 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.

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.

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

	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	< 1.5%	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[2]					
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%

[4] For those credit unions classified as "new" under Part 702 of the NCUA Rules and Regulations, which means both has 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[5]					
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[3]					
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%

[5] 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.

ENCLOSURE (2)

CAMEL RATIOS

CAPITAL

* Net Worth/Total Assets
Total Delinquent Loans/Net Worth
Solvency Evaluation
Classified Assets/Net Worth

ASSET QUALITY

*Delinquent Loans/Loans
*Net Charge Offs/Average Loans
Fair (Market) Value/Book Value {for investments held to maturity}
Accumulated Unrealized Gains or (Losses) on Available for Sale Securities/Cost of Investments Available for Sale
Delinquent Loans/Assets

EARNINGS

*Return on Average Assets {new name for Net Income/Average Assets before Reserve Transfers}
Net Operating Expenses/Average Assets
Fixed Asset + OREOs/Assets
Gross Income/Average Assets
Cost of Funds/Average Assets
Net Margin/Average Assets {Gross Income/Average Assets ratio minus Cost of Funds/Average Assets ratio}
Operating Expenses/Average Assets {excludes PLL, PIL, and cost of funds}
PLL Expense/Average Assets
Net Interest Margin/Average Assets {excludes other operating and fee income}
Operating Expenses/Gross Income {excludes PLL, PIL, and cost of funds}

ASSET/LIABILITY MANAGEMENT

Net Long Term Assets/Assets
Regular Shares/Total Shares and Borrowings
Total Loans/Total Shares
Total Loans/Total Assets
Cash + Short-term investments/Assets {short term investments are less than 1 year based on estimated remaining maturity}
Total Shares, Deposits, and Borrowings/Earning Assets
Borrowings/Total Shares and Net Worth
Estimated Loan Maturity in Months {Loan Turnover}

OTHER RATIOS

Market Growth {shares}
Net Worth Growth
Loan Growth
Asset Growth
Investment Growth

* Key Ratios

ENCLOSURE (3)

CAMEL RATIOS

1. CAPITAL

Key Ratio

NET WORTH / TOTAL ASSETS

(Regular Reserve + Appropriation for Non-Conforming Investments [*SCU Only*] + Other Reserves + Undivided Earnings + Uninsured Secondary Capital [*Low-Income Designated CU Only*] + Net Income or (Loss)) / Total Assets *

* Total assets means a credit union's total assets as measured by either the: (i) average quarterly balance of the four most recent calendar quarters; or (ii) average monthly balance over the three calendar months of the calendar quarter; or (iii) average daily balance over the calendar quarter; or (iv) quarter-end call report balance for the calendar quarter.

Examiners will use the month-end balance of net worth to the month-end balance of total assets as of the examination date for examination purposes if other than a quarter-end. If the examination date falls on a quarter-end, then the examiner should use the same total asset calculation as the credit union. If a material difference exists between the credit union's chosen method at the quarter end and the examination method, the examiner will discuss in the examination report the reasons for the difference and assign an appropriate capital component rating.

A credit union's net worth category classification is determined at the end of each calendar quarter with the effective date of the classification being the last day of the calendar month following the calendar quarter (see §702.101). Examiners should **recalculate** the credit union's net worth ratio (using the credit union's chosen "total assets") as of the prior quarter-end. If there is an error in the quarter-end calculation which places the credit union in a lower net worth category, the effective date of the net worth classification is the date the most recent final report of examination was given to the officials. **A credit union may not be reclassified as of an other than quarter-end examination date**, unless, as provided for in §702.101(b)(3), there is a reclassification by the **NCUA Board** based on safety and soundness concerns.

Supporting Ratios

TOTAL DELINQUENT LOANS / NET WORTH

Total Delinquent Loans / (Regular Reserve + Appropriation for Non-Conforming Investments [*SCU Only*] + Other Reserves + Undivided Earnings + Uninsured Secondary Capital [*Low-Income Designated CU Only*] + Net Income or (Loss))

SOLVENCY EVALUATION

(Total Assets – Total Borrowings – Uninsured Secondary Capital – Accounts Payable and Other Liabilities – Accrued Dividends & Interest Payable – Appropriation for Non-Conforming Investments) / Total Shares

CLASSIFIED ASSETS / NET WORTH

(Collection Problem Loans {includes both individually classified loans plus the amount calculated for the historical loss} + Other Potential Losses) / (Regular Reserve + Appropriation for Non-Conforming Investments + Other Reserves + Undivided Earnings + Uninsured Secondary Capital [*Low-Income Designated CU Only*] + Net Income or (Loss))

2. ASSET QUALITY

Key Ratios

DELINQUENT LOANS / LOANS

Total of Loans Delinquent More Than 2 Months / Total Loans

NET CHARGE OFFS / AVERAGE LOANS

(Total of Loans Charged Off {prior 12-month period} - Total Recoveries {prior 12-month period}) / Average Loans

Supporting Ratios

FAIR (MARKET) VALUE / BOOK VALUE (for investments held to maturity)

Market Value of Investments Held to Maturity / Book Value of Investments Held to Maturity

ACCUMULATED UNREALIZED GAINS OR (LOSSES) ON AVAILABLE FOR SALE SECURITIES {+ debits - credits} / COST OF INVESTMENTS AVAILABLE FOR SALE {the purpose of this ratio is to determine the decline or increase in the value of the investments available for sale}

Separate Equity Account for Accumulated Unrealized Gains or (Losses) on Available for Sale Securities / (Book Value of Investments Available for Sale + Accumulated Unrealized Gains or (Losses) on Available for Sale Securities)

DELINQUENT LOANS / ASSETS

Total of Loans Delinquent More Than 2 Months / Total Assets

3. EARNINGS

Key Ratio

RETURN ON AVERAGE ASSETS {annualized}
{New name for Net Income/Average Assets before Reserve Transfers}

(Net Income (Loss) After All Operating Expenses and All Cost of Funds) / ((Current Period Assets + Prior Year-end Assets) / 2)

Supporting Ratios

NET OPERATING EXPENSES / AVERAGE ASSETS {annualized}

(Total Operating Expenses - Provision for Loan Losses - Fee Income) / ((Current Period Assets + Prior Year-end Assets) / 2)

Note: Fee Income is defined as fees charged to members for services or membership (e.g., overdraft fees, ATM fees, credit card fees, etc.). Fee Income includes loan origination fees except when such fees were deferred consistent with Statement of Financial Accounting Standard (SFAS) 91. Reference Section 6010 of the Accounting Manual for Federal Credit Unions for an explanation of SFAS 91. Fee Income does not include Other Miscellaneous Income.

FIXED ASSETS + OREOs / ASSETS

(Land + Building + Other Fixed Assets + Other Real Estate Owned {OREOs}) / (Total Assets)

GROSS INCOME / AVERAGE ASSETS {annualized}

Gross Income / ((Current Period Assets + Prior Year-end Assets) / 2)

COST OF FUNDS / AVERAGE ASSETS {annualized}

Cost of Funds / ((Current Period Assets + Prior Year-end Assets) / 2)

NET MARGIN / AVERAGE ASSETS {annualized}

(Gross Income/Average Assets ratio - Cost of Funds /Average Assets ratio)

OPERATING EXPENSES / AVERAGE ASSETS {annualized}

(Total Operating Expenses - Provision for Loan Losses - Provision for Investment Losses) / ((Current Period Assets + Prior Year-end Assets) / 2)

PROVISION FOR LOAN LOSSES / AVERAGE ASSETS {annualized}

Provision for Loan Losses / ((Current Period Assets + Prior Year-end Assets) / 2)

NET INTEREST MARGIN/AVERAGE ASSETS {annualized}

(Interest on Loans + Income from Investments - Cost of Funds) / ((Current Period Assets + Prior Year-end Assets) / 2)

OPERATING EXPENSES / GROSS INCOME

(Total Operating Expenses - Provision for Loan Losses - Provision for Investment Losses) / Gross Income

4. ASSET/LIABILITY MANAGEMENT

Supporting Ratios

NET LONG-TERM ASSETS / ASSETS

(Long-term Investments {remaining average life or maturity and repricing greater than 3 years} + Fixed Rate Real Estate Loans {any real estate loans that will not reprice, refinance, or mature in the next 5 years} + Adjustable Rate Real Estate Loans {any real estate loans that will not reprice, refinance, or mature in the next 5 years} + Commercial Loans + Agricultural Loans + Fixed Assets + NCUSIF Deposit) / Total Assets

REGULAR SHARES / TOTAL SHARES AND BORROWINGS

Regular Shares / (Total Shares + Notes and Interest Payable)

TOTAL LOANS / TOTAL SHARES

Total Loans / Total Shares

TOTAL LOANS / TOTAL ASSETS

Total Loans / Total Assets

CASH + SHORT-TERM INVESTMENTS / ASSETS

(Cash + Investments less than 1 year based on estimated remaining maturity) / Total Assets

TOTAL SHARES, DEPOSITS, AND BORROWINGS / EARNING ASSETS

(Total Shares + Deposits + Notes and Interest Payable) / (Total Loans + Total Investments)

BORROWINGS / TOTAL SHARES AND NET WORTH

Notes and Interest Payable / (Total Shares + Regular Reserve + Appropriation for Non-Conforming Investments [*SCU Only*] + Other Reserves + Undivided Earnings + Uninsured Secondary Capital [*Low-Income Designated CU Only*] + Net Income or (Loss))

ESTIMATED LOAN MATURITY IN MONTHS (LOAN TURNOVER) {annualized}

Loans outstanding at the end of the prior year / (Loans outstanding at the end of the prior year + loans granted during the current period - Loans outstanding for the current period)

5. OTHER RATIOS

MARKET GROWTH (shares) {annualized}

(Current Period Shares - Prior Year-end Shares) / Prior Year-end Shares

NET WORTH GROWTH {annualized}

[(Regular Reserve + Appropriation for Non-Conforming Investments [*SCU Only*] + Other Reserves + Undivided Earnings + Uninsured Secondary Capital [*Low-Income Designated CU Only*] + Net Income or (Loss)) **{current period}** – (Regular Reserve + Appropriation for Non-Conforming Investments [*SCU Only*] + Other Reserves + Undivided Earnings + Uninsured Secondary Capital [*Low-Income Designated CU Only*] + Net Income or (Loss)) **{prior year-end}**] / (Regular Reserve + Appropriation for Non-Conforming Investments [*SCU Only*] + Other Reserves + Undivided Earnings + Uninsured Secondary Capital [*Low-Income Designated CU Only*] + Net Income or (Loss)) **{prior year-end}**

LOAN GROWTH {annualized}

(Current Period Loans - Prior Year-end Loans) / Prior Year-end Loans

ASSET GROWTH {annualized}

(Current Period Assets - Prior Year-end Assets) / Prior Year-end Assets

INVESTMENT GROWTH {annualized}

(Current Period Investments - Prior Year-end Investments) / Prior Year-end Investments