NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION

NATIONAL CREDIT UNION SHARE INSURANCE FUND

LETTER NO. 161

DATE: DECEMBER 1994

DEAR BOARD OF DIRECTORS:

The National Credit Union Administration (NCUA) adopted the CAMEL Rating System in October 1987, 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 Liquidity. The system is NCUA's internal tool to measure risk and allocate resources for supervision purposes and is not intended to be used as a grading system. Over the past several months, NCUA has reviewed and updated the CAMEL Rating System to respond to continuing economic changes in the credit union industry.

A detailed discussion for each of the component areas is presented in Enclosure (1). The number of key ratios has been reduced from eleven in 1987, to seven in 1991, to five with this release. Two key ratios (Fixed Assets + OREOS/Assets and Net Operating Expenses/Average Assets) have become supporting ratios primarily because they were not found to be material to the analysis of the respective Component areas. Other changes include:

* Twelve new "supporting ratios" that will assist examiners in analyzing the various CAMEL Component areas (See bolded ratios in Enclosure (2));

* Reduced Capital Adequacy "benchmark" ratios that reflect the stability in credit unions;

* Increased Asset Quality "benchmark" ratios that will not penalize credit unions for managing the reasonable risks associated with various lending and investment decisions;

* A revised Management Review section that is expanded to include objective indicators of management's ability. The four areas include: Business Strategy/Financial Performance, Internal Controls, Management Conduct, Service to Members;

* A reduced Earnings analysis to one key ratio - Return on Average Assets - which represents the bottom-line;

* A revised Liquidity section addressing interest rate sensitivity; and

* Expanded latitude for examiners to adjust the Component and Composite ratings.

Enclosures (2) and (3) identify the CAMEL key ratios, supporting ratios, and the formulas used in the calculation of these ratios. Revisions have been made to the benchmark values used to evaluate the CAMEL key ratios. These benchmarks assist examiners by providing them with an initial quantitative assessment of the financial health of the credit unions they are examining. The key ratio ranges are reflected in Enclosure (4).

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 will have the discretion to increase or decrease any rating as they determine necessary. The rules that if any component is rated 4 or 5, the composite rating cannot be higher than a 3, or if 3 of the 5 components are rated 3 or lower, the composite rating cannot be higher than a 3, have been eliminated.

This Letter will be effective with implementation of the new AIRES examination program scheduled for release early in 1995. It will supersede Letter No. 144 when implemented.

For the National Credit Union Administration Board,

Norman E. D'Amours Chairman

Enclosures FICUs

ENCLOSURE (1)

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 the examiner 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 merely 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 that consistently provides 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. Such institutions give no cause for supervisory concern.

Rating 2 - Reflects satisfactory performance that consistently provides 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, areas of weakness can be seen which could develop into conditions of greater concern. 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. 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. Such credit unions require more than normal supervisory attention to address deficiencies.

Rating 4 - Refers to poor performance that is of serious supervisory concern. 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. 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 impairs 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.

Examiners will have the optional use of assigning plus (+) or minus (-) CAMEL ratings to signify improving or declining trends.

Financial ratios will continue to be provided for the capital, asset quality, earnings, and asset/liability management components to guide examiners in assigning the appropriate ratings. It is important that examiners 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 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.

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 CAMEL areas:

* Capital level and trend analysis;
* Compliance with reserve requirements;
* Composition of capital;
* Interest and dividend policies and practices;
* Adequacy of the Allowance for Loan Losses account;
* Asset Quality, the 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 which 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 well in excess of NCUA regulatory requirements. 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 profiles and can absorb any present or anticipated losses. However, its capital position will not be overall as strong 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 in excess of the minimum NCUA regulatory requirements.

A capital adequacy rating of 3 reflects a level of capital that complies with NCUA's regulatory capital requirements, and indicates that regulators expect the institution to remain in compliance for at least 12 months. 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.

A capital adequacy rating of 4 is appropriate if the credit union is undercapitalized but asset quality, earnings, credit or interest-rate problems will not cause the credit union to become critically under-capitalized 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, even though the credit union may meet NCUA's minimum regulatory requirements.

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 and essentially have no access to capital sources on a ongoing basis.

ASSET 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 adequacy of the allowance for loan losses account and other valuation reserves;
* The level and composition of non accrual 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 investments, other real estate owned (OREOs), and any other assets that could adversely impact a credit union's financial condition.

In rare instances, fair (market) values may not be readily available for higher risk investments such as CMOs and other derivatives. In those cases, the fair (market) value to be used in the various ratio calculations will be determined based on the present value of the future cash flows of the investments.

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, but 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.

MANAGEMENT

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 has been updated to provide examiners with objective, and not purely subjective, indicators. An assessment of management should not solely be dependent on the current financial condition of the credit union, nor should the management rating be an average of the other component ratings.

The management rating is to be based on the following four 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. 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 down turn.

As part of the strategic planning process, credit unions need to develop a business plan for the next one or two years. The board of directors should review and approve the business plan 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/lay-offs, 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 regards 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 can 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. Since financial performance is the primary indicator of the viability of a credit union, the management rating will be strongly influenced by the credit union's performance in achieving its plans.

INTERNAL CONTROLS

An area that plays a crucial role in the control of a credit union's risks is its internal controls. Effective internal controls enhance the safeguards against system malfunctions, errors in judgment and fraud. Although a credit union's controls are currently subject to careful on-site review and evaluation, internal controls remain an area of major concern. 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 information can be assembled quickly and efficiently by the credit union's computer system. In addition, the credit union should have a tested contingency plan in place for the possible failure of its computer system.

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 moments 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.).

MANAGEMENT CONDUCT

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 which 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.

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.

While the goal of banks is to maximize profits, while credit unions' goals are more 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 saving accounts that are used to redistribute credit union profits. A credit union does not necessarily have to offer a lot of service products to its members, e.g., ATMs, share drafts, certificates, etc., to be rated highly in this area, nor should examiners penalize credit unions for not offering these services.

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, 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.

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.

EARNINGS

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. 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;
* Net interest margin;
* Net nonoperating income and losses and their affect on earnings;
* Quality and composition of assets;
* Capital level, both gross and net;
* If earnings are sufficient for necessary capital formation; and
* Material factors affecting the credit union's income producing ability (fixed assets and 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.

Earnings rated 5 should be experiencing consistent losses. 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/LIABILITY 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 to its capital.

The level of detail included in an asset/liability management program is a function of the complexity of a credit union's Balance Sheet and operations. Therefore, smaller credit unions with basic operations and service will require less detail and analysis. However, even small credit unions must be sensitive to interest rate changes and the affect on earnings and liquidity.

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 sensitivity, exposure, and management;
* Interest-rate risk management;
* Asset/liability structure;
* Cost of funds;
* Secondary market;
* Trend analysis;
* Liquidity management;
* Sources of funds;
* Net interest margin ratio (which helps highlight credit unions with excessive cost of funds and ALM problems); and
* Business plan, budgets, projections.

Interest-Rate Risk - the risk of sensitivity and exposure of the credit union's assets, liabilities, and earnings to changes in 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 anticipated 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.

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 asset/liability management strategies. These policies should also assure that an adequate reporting mechanism and sufficient audit capability are in place to ensure compliance with the policies.

Examiners should review a credit union's maturity and repricing of its assets in conjunction with the type of deposit base used to finance those assets. Mechanisms to monitor and control the risk taken in the credit union should be included. This involves comparing the actual level of risk to the desired level and instituting corrective action when necessary.

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

1. The asset/liability management policy is 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 reporting system.

Ratings

A rating of 1 indicates that the credit union exhibits only modest exposure to risk. Management is considered proficient at both the measurement and management of risk. Such credit unions also have ready and easy access to external sources of funds and do not depend on borrowed funds and are easily able to meet their liquidity needs.

A rating of 2 indicates that the credit union's risk exposure is reasonable, management's ability to measure and manage risk is sufficient, and it appears to be able to meet its reasonably anticipated liquidity needs.

A rating of 3 indicates that the risk exposure of the credit union is substantial, that management's ability to measure and manage risk requires improvement, or that the credit union may have an inadequate level of liquid assets to meet projected needs.

The self-assigned interest-rate sensitivity limits may seem unreasonable, or the credit union's financial position may exceed its self-imposed limits under modeling scenarios. A rating of 3 may also indicate that the credit union has insufficient liquidity.

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.

ENCLOSURE (2)

CAMEL RATIOS

CAPITAL

*Capital/Assets

*Net Capital/Assets

Total Delinquent Loans/Capital

Solvency Evaluation

Classified Assets/Capital

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 Capital

#Estimated Loan Maturity in Months {Loan Turnover}

OTHER RATIOS

Market Growth {shares}

Capital Growth

#Net Capital Growth/Asset Growth

Loan Growth

Asset Growth

Investment Growth

New ratios

* Key Ratios

ENCLOSURE (3)

CAMEL RATIOS

1. CAPITAL

Key Ratios

CAPITAL/ASSETS

(Allowance for Loan Losses + Allowance for Investment Losses + Regular Reserve + Investment Valuation Reserve + Other Reserves + Accumulated Unrealized Gains or (Losses) on "Available for Sale" Investments + Undivided Earnings + Net Income or (Loss)) / Total Assets

NET CAPITAL / ASSETS

([Allowance for Loan Losses + Allowance for Investment Losses + Regular Reserve + Investment Valuation Reserve + Other Reserves + Accumulated Unrealized Gains or (Losses) on "Available for Sale" Investments + Undivided Earnings + Net Income or (Loss)] - [Collection Problem Loans {includes both individually classified loans plus the amount calculated for the historic loss} + (Book Value of Investments - Fair (Market) Value of Investments) + Other Identified Losses]) / Total Assets

Supporting Ratios

TOTAL DELINQUENT LOANS / CAPITAL

Total Delinquent Loans / (Allowance for Loan Losses + Allowance for Investment Losses + Regular Reserve + Investment Valuation Reserve + Other Reserves + Accumulated Unrealized Gains or (Losses) on "Available for Sale" Investments + Undivided Earnings + Net Income or (Loss))

SOLVENCY EVALUATION

((Total Assets + Allowance for Loan Losses + Allowance for Investment Losses) - (Liabilities + Collection Problem Loans {includes both individually classified loans plus the amount calculated for the historical loss} + [Book Value of Investments - Fair (Market) Value of Investments] + Other Identified Losses)) / Total Shares

CLASSIFIED ASSETS / CAPITAL

(Collection Problem Loans {includes both individually classified loans plus the amount calculated for the

historical loss} + [Book Value of Investments - Fair (Market) Value of Investments] + Other Potential Losses) / (Allowance for Loan Losses + Allowance for Investment Losses + Regular Reserve + Investment Valuation Reserve + Other Reserves + Accumulated Unrealized Gains or (Losses) on "Available for Sale" Investments + Undivided Earnings + 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 3 years} + Adjustable Rate Real Estate Loans {any real estate loans that will not reprice, refinance, or mature in the

next 3 years} + Commercial Loans + Agricultural Loans + Fixed Assets) / 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 capital

Notes and Interest Payable / (Total Shares + Allowance for Loan Losses + Allowance for Investment Losses + Regular Reserve + Investment Valuation Reserve + Other Reserves + Accumulated Unrealized Gains or (Losses) on "Available for Sale" Investments + Undivided Earnings + 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

CAPITAL GROWTH {annualized}

[(Allowance for Loan Losses + Allowance for Investment Losses + Regular Reserve + Investment Valuation Reserve + Other Reserves + Accumulated Unrealized Gains or (Losses) on "Available for Sale" Investments + Undivided Earnings + Net Income or (Loss)) {current period} - (Allowance for Loan Losses + Allowance for Investment Losses + Regular Reserve + Investment Valuation Reserve + Other Reserves + Accumulated Unrealized Gains or (Losses) on "Available for Sale" Investments + Undivided Earnings + Net Income or (Loss)) {prior year-end}] / (Allowance for Loan Losses + Allowance for Investment Losses + Regular Reserve + Investment Valuation Reserve + Other Reserves + Accumulated Unrealized Gains or (Losses) on "Available for Sale" Investments + Undivided Earnings + Net Income or (Loss)) {prior year-end}

NET CAPITAL GROWTH / ASSET GROWTH {annualized}

([Allowance for Loan Losses + Allowance for Investment Losses + Regular Reserve + Investment Valuation Reserve + Other Reserves + Accumulated Unrealized Gains or (Losses) on "Available for Sale" Investments + Undivided Earnings + Net Income or (Loss)] - [Collection Problem Loans {includes both individually classified loans plus the amount calculated for the historic loss} + (Book Value of Investments - Fair {Market}Value of Investments) + Other Identified Losses]) {current period} - ([Allowance for Loan Losses + Allowance for Investment Losses + Regular Reserve + Investment Valuation Reserve + Other Reserves + Accumulated Unrealized Gains or (Losses) on "Available for Sale" Investments + Undivided Earnings + Net Income or (Loss)] - [Collection Problem Loans {includes both individually classified loans plus the amount calculated for the historic loss} + (Book Value of Investments - Fair {Market} Value of Investments) + Other Identified Losses]) {prior year-end} / ((Total Assets (current period) - Totals Assets {prior year-end}) /Total Assets {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

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ENCLOSURE (4)

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

1. CAPITAL CODE 1 CODE 2 CODE 3

Net Capital/Assets >9.5% >5.5 - 9.5% >3 - 5.5% Capital/Assets >11%>8 - 11% >4 - 8%

CODE 4 CODE 5

Net Capital/Assets >.5 - 3%< or = .5% Capital/Assets >1 - 4% < or = 1%

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2. ASSET QUALITY CODE 1CODE 2 CODE 3

Delinquent Loans/Loans <1.5% 1.5 - 3.5% >3.5 - 7% Net Charge Offs/Avg. Loans <.25% .25 - .75% >.75 - 1.75%

CODE 4 CODE 5

Delinquent Loans/Loans >7 - 9.5% >9.5% Net Charge Offs/Avg. Loans >1.75 - 2.5% >2.5%

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3. EARNINGSCODE 1 CODE 2 CODE 3

Return on Avg. Assets >1.25% .9 - 1.25% .4 - <.9%

CODE 4 CODE 5

Return on Avg. Assets .2 - <.4% <.2%

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

1. CAPITALCODE 1 CODE 2 CODE 3

Net Capital/Assets >8% >6 - 8% >3 - 6% Capital/Assets >9% >7 - 9% >4 - 7%

CODE 4 CODE 5

Net Capital/Assets >1 - 3% < or = 1% Capital/Assets >1 - 4% < or = 1%

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2. ASSET QUALITY CODE 1CODE 2 CODE 3

Delinquent Loans/Loans <1.5% 1.5 - 3.5% >3.5 - 5% Net Charge Offs/Avg. Loans <.25% .25 - .75% >.75 - 1.5%

CODE 4 CODE 5

Delinquent Loans/Loans >5 - 8.25%>8.25% Net Charge Offs/Avg. Loans >1.5 - 2.5% >2.5%

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3. EARNINGS CODE 1CODE 2 CODE 3

Return on Avg. Assets >1% .8 - 1% .35 - <.8%

CODE 4 CODE 5

Return on Avg. Assets .15 - <.35% <.15%

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

1. CAPITAL CODE 1CODE 2 CODE 3

Net Capital/Assets >7% >5 - 7%>3 - 5% Capital/Assets >8% >6 - 8%>3 - 6%

CODE 4 CODE 5

Net Capital/Assets >.5 - 3% < or = .5% Capital/Assets >1 - 3% < or = 1%

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2. ASSET QUALITY CODE 1 CODE 2 CODE 3

Delinquent Loans/Loans <1.25% 1.25 - 2.5% >2.5 - 3.5% Net Charge Offs/Avg. Loans <.25%.25 - .75% >.75 - 1.5%

CODE 4 CODE 5

Delinquent Loans/Loans >3.5 - 5.5% >5.5% Net Charge Offs/Avg. Loans >1.5 - 2%>2%

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3. EARNINGSCODE 1 CODE 2 CODE 3

Return on Avg. Assets >1%.8 - 1%.35 - <.8%

CODE 4 CODE 5

Return on Avg. Assets .2 - <.35%<.2%

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

1. CAPITAL CODE 1 CODE 2 CODE 3

Net Capital/Assets >7% >5 - 7% >3 - 5% Capital/Assets>8% >6 - 8% >3.5 - 6%

CODE 4 CODE 5

Net Capital/Assets >.5 - 3% < or = .5% Capital/Assets>1 - 3.5% < or = 1%

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2. ASSET QUALITY CODE 1CODE 2CODE 3

Delinquent Loans/Loans <1.25%1.25 - 2.25% >2.25 - 3.25% Net Charge Offs/Avg. Loans <.25% .25 - .6% >.6 - 1.2%

CODE 4 CODE 5 Delinquent Loans/Loans >3.25 - 4.75% >4.75% Net Charge Offs/Avg. Loans >1.2 - 1.8% >1.8%

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3. EARNINGS CODE 1 CODE 2 CODE 3

Return on Avg. Assets>1% .8 - 1%.35 - <.8%

CODE 4 CODE 5

Return on Avg. Assets.2 - <.35% <.2%

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