NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
NATIONAL CREDIT UNION SHARE INSURANCE FUND

LETTER TO CREDIT UNIONS

LETTER NO. 144
DATE: March 1993

DEAR BOARD OF DIRECTORS:

Since October 1987, the National Credit Union Administration (NCUA) has used the CAMEL Rating System to evaluate credit unions' performance in the areas of Capital adequacy, Asset quality, Management, Earnings and Liquidity. The CAMEL Rating System was designed to measure risk and is an internal tool used by NCUA to allocate resources. There have been modifications to this system, the most recent addressing the Liquidity component detailed in NCUA Letter No. 132 dated March 1992. In an on-going effort to maintain this system as a dynamic tool, revisions have once again been made. These revisions reflect changes in the credit union industry and comments from credit unions and examiners.

As noted in NCUA Letter No. 117, benchmark values were established for evaluating the CAMEL Key Ratios rather than using National Peer Averages. Benchmarks have the advantage of establishing standards, rather than a moving scale that changes with peer averages.

The most material change is that the number of CAMEL Rating System Matrix groups has been reduced from six to four. Our analysis reflects that there is no significant difference in the ratios for credit unions over \$50 million in assets than for those over \$100 million in assets. The greatest difference occurs in the less than \$10 million category. The ranges for the individual ratios in the new matrix groups have been adjusted to compensate for the reduction in the number of matrix groups. The Financial Performance Report, which is also broken down by matrix group, will be changed shortly to be consistent with the reduced number of groups.

In the Capital component, there was a change in the computation of the Net Capital ratio to reflect the inclusion of the historical loss in addition to individually classified loans as a reduction of total capital. In addition, the ratio of Total Classified Assets to Total Assets was deleted as a supporting ratio.

In the Asset quality component, the key ratio measuring Non-Earning Assets to Total Assets was revised and renamed to Fixed Assets plus OREOs (Other Real Estate Owned) to Total Assets. The new ratio eliminates the inclusion of income accruals, prepaid expenses and some other assets, some of which could materially distort the former ratio at month-end. Our initial intent with this ratio was to measure the material factors affecting the income producing ability of each credit union. The revision to this ratio will define our intent more clearly.

A key ratio in the Earnings component, Net Operating Expenses to Average Assets, was also revised. The revised ratio deducts fee income from operating expenses. This ratio was changed in view of the fact that a number of credit unions have high operating expenses because of the number of services offered. A good number of these credit unions offset a portion of the service costs by charging fees. As a result of the new net operating expense ratio, credit unions will no longer be penalized for providing numerous services to their members. Additionally, a new supporting ratio was developed, Net Interest Margin to Average Assets.

This ratio provides a comparison of Loan Interest and Investment Income to the Cost of Funds. It should also be noted that the Net Income after Reserve Transfers and the Operating Expense to Average Assets ratios have been switched from key ratios to supporting ratios.

The changes to the individual ratio ranges are reflected in Enclosure (1). Enclosure (2) identifies several ratios used during the examination, including the CAMEL key ratios, selected supporting ratios, and the formulas used in the calculation of the key ratios.

When evaluating the components of CAMEL, the examiner must look at both the qualitative and quantitative measurements related to each component. To calculate a rating for a given component, it is first necessary for the examiner to determine the initial rating from the CAMEL Rating System Matrix. Initial composite ratings are then derived by calculating the numerical average of the codes of each component and rounding off to the nearest whole number. Analysis of other supporting ratio data and qualitative factors will be the determining factors in an examiner's decision to increase or decrease a component's initial indicator. When an examiner determines that an initial indicator will be changed, discretion allows the increase or decrease by only one code. The arithmetical average derived will be overridden if either one of the two conditions exist:

a. If any component is rated 4 or 5, the composite rating cannot be higher than 3; or b. If 3 of the 5 components are rated 3 or lower, the composite rating cannot be higher than 3.

This Letter supersedes Letter No. 117 and Letter No. 132 which are hereby canceled. We have incorporated a portion of Letter No. 132 into this Letter as Enclosure (3). Enclosure (3) will continue to be used to evaluate the Liquidity area of CAMEL as this process has proven effective in measuring risk in this area.

For the National Credit Union Administration Board,

Roger W. Jepsen Chairman

Enclosures FCUs

KEY RATIOS FOR CREDIT UNIONS WITH ASSETS OF $2 MILLION OR LESS March 1993

1. CAPITAL CODE 1 CODE 2 CODE 3 CODE 4 CODE 5

Net Capital/Assets >10% >6-10% >3-6% >.5-3% <.5% Capital Assets >12% >8-12% >4-8% >1-4% <1%

2. ASSET QUALITY

Delinquent Loans/ Loans <1.25% 1.25-3% >3-7% >7-9.5% >9.5% Net Charge Offs/ Avg. Loans <.25% .25-.75% >.75-1.75% >1.75-2.5% >2.5% Fixed Assets + OREOs/Assets <.3% .3-.9% >.9-2% >2-3% >3%

3. EARNINGS

Net Income/Average Assets (before reserve transfer) >1.25 .9-1.25% .4-<.9% .2-<.4% <.2%

Net Operating Expenses/Average Assets <2.5% 2.5-4% >4-6% >6-8% >8%

ENCLOSURE (1)

KEY RATIOS FOR CREDIT UNIONS WITH ASSETS OF $2 to $10 MILLION March 1993

1. CAPITAL CODE 1 CODE 2 CODE 3 CODE 4 CODE 5

Net Capital/Assets >9% >6-9% >3-6% >1-3% <1%
Capital Assets >10% >7-10% >4-7% >1-4% <1%

2. ASSET QUALITY

Delinquent Loans/ Loans <1.25% 1.25-3% >3-5% >5-7.5% >7.5%
Net Charge Offs/ Avg. Loans <.25% .25-.75% >.75-1.5% >1.5-2% >2%
Fixed Assets + OREOs/Assets <.75% .75-1.5% >1.5-3% >3-5% >5%
3. EARNINGS

Net Income/Average Assets (before reserve transfer) >1 .8-1% .35-<.8% .15-<.35% <.15%

Net Operating Expenses/Average Assets <2.5% 2.5-3.5% >3.5-5.5% >5.5-7.5% >7.5%

KEY RATIOS FOR CREDIT UNIONS WITH ASSETS OF $10 MILLION TO $50 MILLION March 1993

1. CAPITAL CODE 1 CODE 2 CODE 3 CODE 4 CODE 5

Net Capital/Assets >7.5% >5-7.5% >3-5% >.5-3% <.5%
Capital Assets >8.5% >6-8.5% >3.5-6% >1.5-3.5% <1.5%

2. ASSET QUALITY

Delinquent Loans/ Loans <1% 1-25% >2.5-4% >4-6% >6%
Net Charge Offs/ Avg. Loans <.25% .25-.75% >.75-1.75% >1.5-2% >2%
Fixed Assets + OREOs/Assets <1% 1-2.5% >2.5-5% >5-7.5% >7.5%

3. EARNINGS

Net Income/Average Assets (before reserve transfer) >1. .8-1.0% .35-<.8% .2-<.35% <.2%

Net Operating Expenses/Average Assets <2.5% 2.5-3.3% >3.3-5.5% >5.5-7% >7%

KEY RATIOS FOR CREDIT UNIONS WITH ASSETS OF $50 MILLION OR MORE March 1993

1. CAPITAL CODE 1 CODE 2 CODE 3 CODE 4 CODE 5

Net Capital/Assets >7% >5-7.5% >3-5% >.5-3% <.5
Capital Assets >8% >6-8.5% >3.5-6% >1.5-3.5% <1.5

2. ASSET QUALITY

Delinquent Loans/ Loans <1% 1-2% >2-3% >3-4.5% >4.5
Net Charge Offs/ Avg. Loans <.25% .25-6% >.6-1.2% >1.2-1.8% >1.8%
Fixed Assets + OREOs/Assets <1.3% 1.3-3.4% >3.4-5.5% >5.5-7% >7%

3. EARNINGS

Net Income/Average Assets (before reserve transfer) >1. .8-1% .35-<.8% .2-<.35% <.2%

Net Operating Expenses/Average Assets <2.25% 2.25-3.2% >3.2-5% >5-6.8% >6.8%

CAMEL RATIOS MARCH 1993

1. CAPITAL

Key Ratios

NET CAPITAL/ASSETS

([Allowance for Loan Losses + Allowance for Investment Losses + Regular Reserve + Investment Valuation Reserve + Other Reserves + Undivided Earnings + Net Income or (Loss)] - [Loan Losses + Investment Losses + Other Identified Losses])/Total Assets

Note:

(a.) It is assumed that the Allowance for Loan Losses is accurately stated to reflect both individually classified loans plus the historical loss. Loan losses should include both individually classified loans and the calculation for the historical losses.

(b.) Investment losses are the difference between book and market values, but not greater than $0 (i.e., gains only the extent of losses).

CAPITAL/ASSETS

(Allowance for Loan Losses + Allowance for Investment Losses + Regular Reserve + Investment Valuation Reserve + Other Reserves + Undivided Earnings + Net Income or (Loss))/Total Assets

Supporting Ratios

TOTAL CAPITAL PLUS SHARES AND DEPOSITS/SHARES AND DEPOSITS

(Allowance for Loan Losses + Allowance for Investment Losses + Regular Reserve + Investment Valuation Reserve + Other Reserves + Undivided Earnings + Net Income or (Loss) + Total Shares) / Total Shares

ENCLOSURE (2)

TOTAL DELINQUENT LOANS/CAPITAL

Total Delinquent Loans/(Allowance for Loan Losses + Allowance for Investment Losses + Regular Reserve + Investment Valuation Reserve + Other Reserves + Undivided Earnings + Net Income or (Loss))

SOLVENCY EVALUATION

(Total Assets + Allowance for Loan Losses - Liabilities -Collection Problem Loans [includes both individually classified loans plus the amount calculated for the historical loss] - Other Potential Losses)/Total Shares

CLASSIFIED ASSETS/CAPITAL

(Collection Problem Loans [includes both individually classified loans plus the amount calculated for the historical loss] + Other Potential Losses)/(Allowance for Loan Losses + Allowance for Investment Losses + Regular Reserve + Investment Valuation Reserve + Other Reserves + Undivided Earning + Net Income or (Loss))

2. ASSET QUALITY

Key Ratios

DELINQUENT LOANS/LOANS

Total of Delinquent Loans More Than 2 Months/Total Loans

NET CHARGE OFFS/AVERAGE LOANS

(Total of Loans Charged Off [previous 12-month period] - Total Recoveries [previous 12 month period])/Average Loans

FIXED ASSETS + OREOs/ASSETS

(Land + Building + Other Fixed Assets + Other Real Estate Owned [OREOs])/(Total Assets)

3. EARNINGS

Key Ratios

NET INCOME / AVERAGE ASSETS (BEFORE RESERVE TRANSFERS) (annualized)

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

NET OPERATING EXPENSES/AVERAGE ASSETS (annualized)

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

Supporting Ratios

GROSS INCOME/AVERAGE ASSETS (annualized)

Gross Income/(Current Period Assets + Prior Period Assets/2)

COST OF FUNDS/AVERAGE ASSETS (annualized)

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

NET INTEREST MARGIN/AVERAGE ASSETS (annualized)

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

OPERATING EXPENSES/AVERAGE ASSETS (annualized)

(Total Operating Expenses - Provision for Loan Losses)/(Current Period Assets Plus Prior Period Assets/2)

NET INCOME/AVERAGE ASSETS (after reserve transfers) (annualized)

(Net Income [Loss] After All Operating Expenses, All Cost of Funds and Net Required Reserve Transfer)/(Current Period Assets + Prior Period Assets/2)

4. LIQUIDITY

Supporting Ratios

LONG-TERM ASSETS/ASSETS

(Long-Term Investments [remaining maturity or repricing greater than 3 years] + Real Estate Loans + Commercial Loans + Agricultural Loans + Fixed Assets)/Total Assets

NET LONG-TERM ASSETS/ASSETS

(Long-Term Investments [remaining maturity or 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] + 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

LIQUIDITY COMPONENT ANALYSIS

The ratios used in the analysis of a credit union's liquidity are being used in a subjective manner. There are no "key ratios" upon which a component rating indication is made. The ratio analysis includes, but is not limited to the following ratios:

(1) Long-term assets to assets;
(2) Net long-term assets to assets;
(3) Total borrowings to total shares and capital;
(4) Regular shares to total shares and borrowings; and
(5) Total loans to total shares.

The credit union's written policies and procedures for this area will be evaluated. Therefore, in addition to the above ratios, the following areas will be reviewed and evaluated based on the size and complexity of the credit union:

(1) Has a funds management plan been developed and implemented?

(2) Is it commensurate with the size and complexity of the credit union?

(3) Is the credit union measuring and/or monitoring its GAP position (rate sensitive assets versus rate sensitive liabilities)? Are the credit union's assumptions for this reporting mechanism reasonable and documented? Does their GAP position appear reasonable?

(4) Does the board have sufficient training in this area to understand the GAP report and its implications?

(5) Is the board using the report as a tool in their decision- making process or is the report "for the examiner" only?

(6) Are there indications of cash flow problems (e.g., habitual short-term borrowing indicating a lack of proper cash management; high ratio of non-earning cash to total assets)?

(7) Has the board established targets for loan and investment portfolio diversification? Are they reasonable considering the liability side of the balance sheet?

(8) If long-term real estate loans are made, are these loans written to standards which would make them easily salable on the secondary market?

ENCLOSURE (3)

(9) Does the credit union have a suitable mix of long- and short-term assets in relation to its size, complexity and share structure?

(Note: Some items may not be applicable for small, less complex operations, e.g., nos. (3), (4), and (5).)

The examiner should provide written analysis and comments in the Overview Section of the report supporting the code that is assigned to the Liquidity area.

Methodology:

The Liquidity component rating is designed to be more subjective than the Capital Adequacy, Asset Quality or Earnings components. It should be assigned based on the answers to the above ratio analysis and questions and using to a large extent, examiner judgment. The examiner must, however, keep the size, complexity and other component ratings of the credit union in mind when assigning the component rating.

For example, to assign a component rating of 1 for Liquidity, a small "plain vanilla" (shares and loans only) credit union should:

a. have strong capital and earnings;
b. have investments with relatively short-term maturities; or an acceptable mix based on share structure and size; and
c. have adequate cash management procedures.

A large complex credit union that offers many different services and has diverse share, loan and investment portfolios would need to address the issues specified in number (3) above. If key elements are missing, such as a funds management policy or adequate monitoring mechanisms, the component rating should be adjusted downward accordingly. Consideration of the overall financial position and managerial capabilities must weight in the decision of assigning the component rating.

The following general guidelines should be used when assigning the Liquidity component rating:

a. Component Rating 1. These credit unions must be sound in every respect and resistant to external economic and financial disturbances. Funds management policies and procedures are in place and are being used and understood by both management and officials.

b. Component Rating 2. These credit unions must also be basically sound with minor weaknesses which are easily correctable. Fine tuning of policies, procedures or reporting mechanisms may be necessary, but the basic funds management philosophy is sound and appropriate for the size and complexity of the credit union.

c. Component Rating 3. These credit unions display a combination of weaknesses which if not addressed and corrected may impair their ability to respond and adjust to fluctuating economic conditions. Failure would only be a remote possibility.

d. Component Rating 4. These credit unions have serious deficiencies in this and other component areas. For example, the long- term assets to assets ratio would be excessive, borrowing to fund short-term cash needs could be evident, and policies and procedures could be totally lacking. Strong supervisory action would be necessary to correct the problems and weaknesses.

e. Component Rating 5. Failure is imminent.