

# NCUA LETTER TO CREDIT UNIONS

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

**DATE: DECEMBER 2007                      LETTER NO. : 07-CU-12**

**TO: Federally Insured Credit Unions**

**SUBJ: CAMEL Rating System**

**ENCL: (1) Appendix A - NCUA's CAMEL Rating System (CAMEL)**

Dear Board of Directors:

The National Credit Union Administration (NCUA) is modifying the CAMEL Rating System (CAMEL) by eliminating the CAMEL Matrix (Matrix). The Matrix measured financial ratio results against benchmarks for three CAMEL areas: Capital Adequacy, Asset Quality, and Earnings. Appendix A is updated to eliminate the Matrix and focus CAMEL evaluation on risk consistent with NCUA's Risk Focused Examination Program (RFE)<sup>1</sup>. This change will be effective with NCUA examination and supervision contacts with December 31, 2007, effective dates and thereafter.

The following information explains the background of CAMEL, the basis for eliminating the Matrix, and NCUA's plan to implement this change.

## **CAMEL Background:**

CAMEL is based on the Federal Financial Institutions Examination Council's (FFIEC)<sup>2</sup> Uniform Financial Institutions Rating System (UFIRS) commonly referred to as CAMEL<sup>3</sup>. The FFIEC developed UFIRS in 1979 to assess risk on a system wide basis. NCUA adopted CAMEL in October 1987. NCUA

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<sup>1</sup> NCUA Letter to Federal Credit Unions No: 02-FCU-09 Risk-Focused Examination Program, May 2002.

<sup>2</sup> The Federal Financial Institutions Examination Council (FFIEC) was established on March 10, 1979, pursuant to title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA), Public Law 95-630. The council is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions and to make recommendations to promote uniformity in the supervision of financial institutions.

<sup>3</sup> See 61 Federal Register 67021 (12/19/1996) – Federal Financial Institutions Examination Council-Uniform Financial Institutions Rating System.

examiners evaluate CAMEL components and overall codes based on Appendix A. CAMEL is an internal rating system used for evaluating the soundness of credit unions on a uniform basis, the degree of risk to the National Credit Union Share Insurance Fund (NCUSIF), and for identifying those institutions requiring special supervisory attention or concern. NCUA periodically modifies CAMEL to respond to changes in the financial services industry and supervisory policies and procedures. The previous CAMEL Rating System update was published in Letter to Credit Unions No. 03-CU-04, dated March 2003.

**Matrix Background** - In 1979, NCUA began rating credit unions based on UFIRS rating definitions using a system called Early Warning System (EWS). EWS assigned an overall rating of 1 to 4. NCUA's intent in adopting the Matrix was to ensure examiner consistency transitioning from a single rating EWS system to the CAMEL Rating System in 1987. After CAMEL's implementation, NCUA modified the Matrix numerous times to capture changes in credit union operations and financial markets. In 1995, the Matrix became an **optional** examiner tool when NCUA adopted Flexible Scope Examinations. The requirement examiners use the Matrix was eliminated because financial ratios alone can be a lagging indicator of changing risk. Successful performance requires credit unions measure, monitor, and control risk relative to strategic plans and goals rather than meeting predetermined ratio benchmarks.

**NCUA's Risk Focused Examinations** - RFEs introduced in 2002 focus examiner resources on risk using a forward looking perspective rather than a comparison of performance against benchmarks. Examiners look beyond current financial conditions and evaluate management's ability to recognize and adapt to changing economic conditions, competitive environments, and risk profiles. Examiners determine the significance of ratios, trends, projections, and interrelationships using seven risk categories (Credit Risk, Interest Rate Risk, Liquidity Risk, Strategic Risk, Compliance Risk, Reputation Risk, and Transaction Risk).

**CAMEL Interrelationship with the Risk Focused Examination** - In RFEs, the seven risk categories are assessed a level (high, moderate, or low) reflecting the current and prospective risk to the credit union. Material risk identified in a risk category is reflected in the appropriate CAMEL component code(s) and overall CAMEL code. CAMEL quantifies the impact material risk has on the credit union's soundness and identifies the level of NCUA supervision required.

**Basis for Eliminating Matrix:**

NCUA is concerned some credit unions may target and measure performance against the Matrix rather than focus on broader risk management. Targeting CAMEL benchmarks in the Matrix can lead to unsafe and unsound goals and may lead to poor business decisions. For example:

- The Matrix benchmark for a “1” Capital Adequacy component rating is a net worth to total assets ratio equal to or exceeding seven percent. In some cases, if risk is high and unmitigated, targeting the “1” benchmark may result in insufficient net worth relative to risk. The “1” rating benchmark may create a false sense of security when net worth should be higher. The component definition for capital adequacy targets required statutory net worth for a CAMEL “1” rating. Individual credit unions may need additional net worth above regulatory requirements based on the level of risk pursued.
- Targeting delinquency levels to a Matrix “1” rating under asset quality may limit risk based lending options and service to members.
- Striving for a “1” benchmark rating for earnings may reduce service to members, promote excessive fee structures, or encourage excessive risk taking to generate higher returns.

Sound risk management requires officials establish and measure the credit union’s and management’s performance based on internal goals and objectives rather than Matrix benchmarks.

***Impact of Eliminating the Matrix*** - Eliminating the Matrix ensures examiners focus on risk. This revision promotes and complements risk management practices in credit unions by directing attention to the seven risk categories.

The Matrix maintained an element of controversy even after it became an optional examiner tool. All credit unions do not have identical risk profiles or business models. The Matrix applied static ratio benchmarks to every credit union. Some credit unions requested NCUA eliminate the Matrix while others were comfortable with a consistent Matrix approach. Over time, NCUA revised and eliminated Matrix ratios and adjusted the benchmark parameters, but the Matrix’s value is limited as the financial services industry changes. In some cases, targeting the Matrix may contribute to a credit union pursuing unsafe and unsound practices or less than advantageous strategic goals.

By eliminating the Matrix, focus will be on evaluating a credit union’s goals and determining strategic plans are realistic, tailored to the credit union’s unique needs, reflective of the current economic environment, and ultimately, in the best interest of the membership. Eliminating the Matrix fosters discussion on risk management issues and focuses analysis on management’s evaluation and control of risk rather than predetermined benchmark performance.

***Examiner Consistency without a Matrix*** - For examination and supervision contacts with December 31, 2007, effective dates and thereafter, examiners will continue the RFE practice to assign CAMEL component and composite codes using Appendix A. Appendix A is revised to eliminate the Matrix as an optional

examiner analysis tool. Examiners will assign the “C”, “A”, and “E” component ratings without a matrix following the approach currently used for assigning the “M” and “L”. The RFE practice to disclose CAMEL component ratings and the overall rating in the Examination Report Overview will continue. When a CAMEL component or composite rating changes, examiners will inform management. Disclosing ratings facilitate understanding of NCUA’s assessment of the credit union’s overall operation.

***Oversight of CAMEL Ratings Assigned*** - CAMEL ratings receive scrutiny both internal and external to NCUA. NCUA receives an annual audit by an independent auditing firm and is subject to scrutiny from other government entities. Internally, NCUA’s risk management practices and quality control processes monitor CAMEL component ratings and overall ratings.

**Implementation Plan:**

NCUA staff that use CAMEL will receive training about this CAMEL update prior to implementation. This same training will be made available to state supervisory authority staff that needs to be aware of NCUA’s CAMEL Rating System. NCUA will continue to communicate with credit unions to ensure a thorough understanding of CAMEL's purpose and this update. In anticipation of this CAMEL update, officials are also encouraged to review the following recent NCUA resources related to CAMEL:

- NCUA Letter to Federal Credit Unions No. 06-FCU-04 Supervisory Letter-Evaluation of Earnings
- NCUA Letter to Federal Credit Unions No. 05-CU-01 Supervising Community Development Credit Unions – Examiner Guidance White Paper

This Letter supersedes Letter to Credit Unions No. 03-CU-04. Please direct any questions you may have to your examiner, supervisory examiner, regional director, or state regulator. Per NCUA Interpretive Ruling and Policy Statement

(IRPS) No. 95-1, credit unions may also discuss CAMEL disputes with NCUA's Supervisory Review Committee.

Sincerely,

/s/

JoAnn M. Johnson  
Chairman

Enclosure