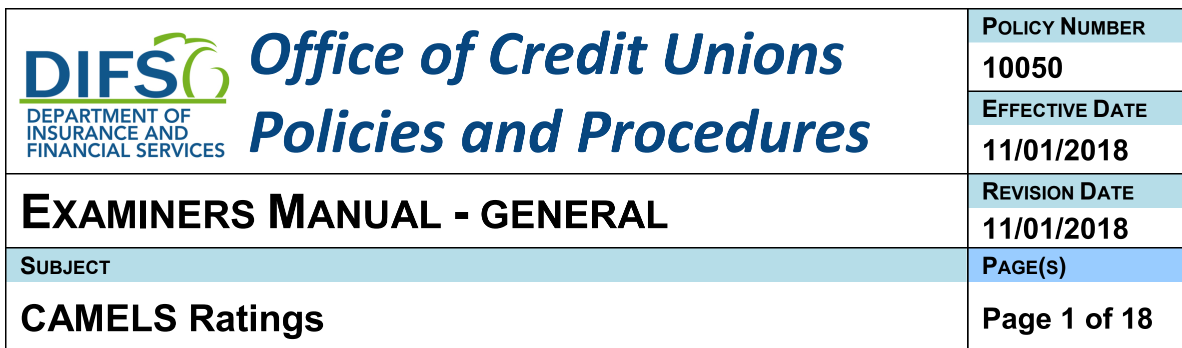


I. PURPOSE

CAMEL Rating System is used to accurately and uniformly evaluate credit unions on safety and soundness of operations, compliance with regulations, financial condition, degree of risk to the National Credit Union Share Insurance Fund (NCUSIF), and amount of supervisory attention needed. In 2014 DIFS added the use of “S” to rate market sensitivity for Michigan state chartered credit unions.

II. DEFINITIONS

The CAMELS rating system is a forward-looking, risk-based approach that evaluates a credit union’s current and potential risks in seven categories (credit risk, interest rate risk, liquidity risk, transaction risk, compliance risk, strategic risk, and reputation risk). Examiners evaluate the degree and directionality of risk in each of these seven risk categories and how these risk categories interrelate with the six critical areas of credit union operations. The CAMELS ratings are indicators of the viability of the credit union.

The six critical areas of credit union operations in the CAMELS rating system are: **C**apital Adequacy, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and Market **S**ensitivity. For each of these six critical areas of operations, examiners assign a rating from 1 to 5, with 5 indicating the highest degree of weakness and the most federal and state supervisory attention needed. Although peer ratios are provided periodically, they are to be used for informational and reference purposes only; each institution shall be assigned CAMELS ratings on their individual merit. Examiners also assign one overall composite rating for the credit union, but this rating is not necessarily a numerical average of the six component parts. Each component rating and the composite rating is assigned based upon a combination of quantitative factors and examiner professional judgment. Ratings shall be assigned based upon the credit union’s risk profile, combined with the demonstrated effectiveness of their risk control systems.

CAMELS COMPOSITE

Composite Rating 1: Reflects strong performance that consistently provides for safe and sound operations. The historical and projected performance measures are consistently positive, and are in substantial compliance with laws and regulations. Credit unions in this group are resistant to external economic and financial disturbances and are highly able to withstand unexpected conditions. Weaknesses are minor and can be handled in a routine manner. As a result, they exhibit sound performance and risk management practices relative to the credit union's size, complexity, and risk profile, and give no cause for supervisory concern.

Composite Rating 2: Reflects fundamentally sound performance that consistently provides for safe and sound operations. Both historical and projected performance should generally be positive. There is ability to withstand business fluctuations quite well; however, areas of weakness are evident which could develop into conditions of greater concern. Overall risk management practices are satisfactory relative to the credit union's size, complexity, and risk profile. These institutions are in substantial compliance with laws and regulations. There are no material supervisory concerns; supervisory response is generally limited to ensuring exceptions are resolved in the normal course of business and operations continue to be satisfactory.

Composite Rating 3: Reflects some degree of supervisory concern in one or more of the component areas; ranging from moderate to severe. Overall strength and financial capacity is present, so as to make failure only a remote probability. Historical or projected performance may be flat or negative to the extent that safe and sound operations may be adversely affected. Risk management practices may be less than satisfactory relative to the credit union's size, complexity and risk profile. Credit unions in this group are only nominally resistant to the onset of adverse business conditions and could easily deteriorate without effective corrective action; there is less ability to withstand business fluctuations and are more vulnerable to outside influences. These credit unions may be in significant noncompliance with laws and regulations. These credit unions require more than normal supervision to address deficiencies which may include enforcement actions.

Composite Rating 4: Reflects performance of serious supervisory concern; problems range from severe to critically deficient. Key performance is negative, and if left unchecked, is expected to lead to conditions that could threaten the viability of the credit union. Risk management practices are generally unacceptable relative to the credit union's size, complexity and risk profile. There may be significant noncompliance with laws and regulations. The board and management are not satisfactorily resolving the weaknesses and problems; there are serious financial or managerial deficiencies. Credit unions in this group are generally not capable of withstanding business fluctuations. A high potential for failure is present but is not yet imminent or pronounced. There may be risk posed to the NCUSIF. Credit unions in this group require close supervisory attention, and generally enforcement action is necessary to address the problems.

Composite Rating 5: Credit unions in this group exhibit extremely unsafe and unsound practices and conditions; exhibit a critically deficient performance and the need for immediate remedial action. These often contain inadequate risk management practices relative to the credit union's size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Credit unions in this group have a high probability of failure and will likely require liquidation and the payoff of shareholders, or some other form of emergency assistance, merger, or acquisition. These credit unions pose a significant risk to the NCUSIF.

CAPITAL ADEQUACY/NET WORTH

Capital provides a measure of reassurance to members that the credit union will continue to provide financial services, during periods of loss or negligible earnings, and provides a free source of funds to enable better earnings. While statutory requirements may exist, an individual credit union's operations and risk position may warrant additional capital beyond the statutory requirements. Refer to Part 702 of NCUA Rules and Regulations, which set for statutory net worth categories and requirements.

A credit union is expected to maintain capital commensurate with the nature and extent of risk to the institution and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risk on the credit union's financial condition is considered when evaluating capital adequacy. Examiners assess the strength of capital in the short and long term, based upon the credit union's plans, underlying assumptions, and review of operations. Examiners

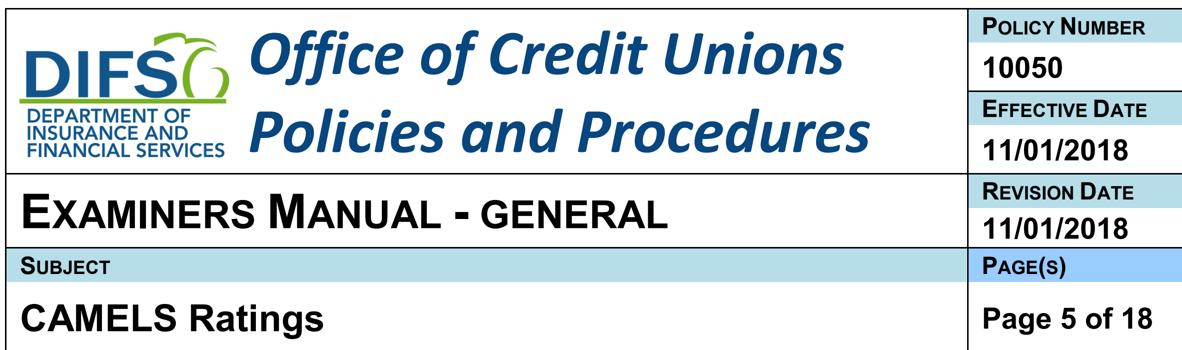
must consider *the interrelationships* with other areas. A credit union's capital adequacy is based upon, but not limited to, an assessment of:

- Capital level and trend analysis;
- Overall financial condition;
- The ability of management to address emerging needs for additional capital;
- Compliance with risk-based net worth requirements;
- Compliance with the board established Capital Policy and goals;
- Composition of capital;
- Adequacy and trend of the Allowance for Loan and Lease Losses Account;
- Interest and dividend policies and practices;
- Quality, type, liquidity, and diversification of assets, with particular reference to classified assets;
- Loan and investment concentrations;
- Balance sheet composition including the nature and amount of market risk, concentration risk, and risk associated with nontraditional activities;
- Growth plans and past experience managing growth;
- Volume and risk characteristics of new business initiatives;
- Ability of management to control and monitor risk;
- Earnings quality and composition;
- Liquidity and asset-liability management;
- Extent of contingent liabilities and existence of pending litigation;
- Field of membership; and
- Economic environment.

Capital Rating 1: Reflects a level of capital fully commensurate with the credit unions risk profile, also meeting the statutory requirement, which is able to absorb any present or anticipated losses. There should be no significant asset quality problems, earnings deficiencies or exposure to credit or interest-rate risk that could negatively affect capital.

Capital Rating 2: Reflects a level of capital not quite as strong as those of a 1 rating, but still satisfactory. There should be no significant problems that could affect the credit union's ability to remain at least "adequately capitalized". Credit unions in this category should meet their risk-based net worth requirements.

Capital Rating 3: Reflects more than ordinary levels of risk in some significant segment of operation; there may be asset quality problems, earnings deficiencies, or exposure to credit or interest rate risk threatening minimum/adequate capital levels.



These may fail to meet the risk-based net worth requirement. This rating reflects the need for improvement.

Capital Rating 4: Reflects deficient capital, but identified risks will not cause the credit union to become critically undercapitalized in the next 12 months. There is generally an insufficient level of capital compared to the risks present in the credit union's operations. In light of the credit union's current and prospective risk profile, viability of the credit union may be threatened. Financial support from external sources may be required.

Capital Rating 5: Reflects a credit union that is critically undercapitalized in light of the credit union's current and prospective risk profile, or has significant asset quality problems, negative earnings trends, or high credit or interest rate risk which 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 or otherwise threaten the credit union's viability. Immediate assistance from external sources or financial support is required.

ASSET QUALITY

The asset quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned (OREO), and other assets, as well as off-balance sheet transactions. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the allowance for loan and lease losses and weigh the exposure to counterparty issuer or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of a credit union's assets, including but not limited to the seven risk categories, should be considered.

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, including OREOs and any other assets that could adversely impact a credit union's financial condition. Interrelated to the assessment of credit risk, the examiner evaluates the impact of other risks such as interest rate, liquidity, strategic, and compliance. A credit union's asset quality is based upon, but not limited to, an assessment of the following evaluation factors:

- The quality of loan underwriting, policies, procedures, and practices;

- The internal controls and due diligence procedures in place to review new loan programs, high concentrations, and changes in underwriting procedures and practices of existing programs;
- The level, distribution, and severity of classified assets;
- The adequacy of the allowance for loan and lease losses and other asset valuation reserves;
- The level and composition of non-accrual and restructured assets;
- The quality of collection policies;
- 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 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 compared to book value of investments.

Asset Quality Rating 1: Reflects minimal portfolio risks and strong written policies and procedures relative to lending, collection and investments. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital adequacy and management's abilities. Asset quality is of minimal supervisory concern. These institutions exhibit delinquency, classified asset, and charge-off trends that are stable or positive.

Asset Quality Rating 2: Denotes satisfactory asset quality and credit administration practices, although the level and severity of classified assets are greater than in a "1" rated institution. Lending and investment policies are in writing, conducive to safe and sound operations, and are followed. Risk exposure is commensurate with capital adequacy and management's abilities. Trends will generally be stable or positive.

Asset Quality Rating 3: Indicates asset quality or credit administration practices are less than satisfactory, and a significant degree of concern based either on current or anticipated asset quality problems. There may be only a moderate level of problem assets, but negative trends, inadequate loan underwriting, poor documentation, higher risk investments, inadequate lending or investment controls, and monitoring that indicate higher or increasing risks. Historical trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity

of classified assets, other weaknesses, and risk require an elevated level of supervisory concern. There is generally a need to improve credit administration and risk management practices.

Asset Quality Rating 4: Represents increasingly severe asset quality problems that will threaten the institution's viability if left uncorrected. There may be a moderately severe level of classified assets, combined with other significant problems such as inadequate valuation allowances, high risk concentrations, poor underwriting or documentation, or poor collection or monitoring practices. Asset quality or credit administration practices are deficient.

Asset Quality Rating 5: Indicates the credit union's viability is imminently threatened due to the corrosive effects of asset problems on its earnings and level of capital.

MANAGEMENT EFFECTIVENESS

Management is the most forward-looking indicator of condition and a key determinant of whether a credit union possesses the ability to correctly diagnose and respond to financial stress. While much of management assessment is subjective, it should include consideration of the current financial condition and needs of the institution. The management rating is **not** to be determined primarily by averaging the other component ratings. The rating reflects both the board's and management's ability to identify, measure, monitor and control the risks of the credit union's activities, ensure its safe and sound operation, and ensure compliance with applicable regulations. Management practices should address all of the following risks: Credit, Interest Rate, Liquidity, Transaction, Compliance, Reputation, Strategic, and other risks related to the nature and scope of the credit union's activities.

Generally, directors need not be actively involved in daily operations; however, they provide clear guidance establishing acceptable risk exposure levels through appropriate policies, procedures, and practices. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives and risk limits into prudent operating standards. Sound management practices are demonstrated by active oversight by the board and management, competent personnel, adequate policies, processes, and controls commensurate with the size and sophistication of the credit union.

The Management Effectiveness rating should reflect the board and management's ability, as it applies to all aspects of credit union operations and activities. This includes the demonstrated ability to respond to changing business conditions, implementation of products/services and degree to which they are proactive in anticipating and addressing issues. The follow areas shall be included in the assessment of management effectiveness:

Business Strategy / Financial Performance: A systematic process that defines management's course in assuring the organization prospers in the next few years. This incorporates all areas of operations and often develops the long-term vision for the credit union and sets broad goals enabling management to make sound decisions. The strategic plan should identify risks within the organization and outline methods to mitigate concerns.

As part of strategic planning, a credit union should develop (and the board review and approve) a *business plan* addressing the next few years, including a budget which corresponds with strategic goals. Goals and objectives should be measurable. The plan should be customized to the individual credit union and commensurate with size and complexity of the institution, including contingency planning. Environmental and competitive factors as well as internal factors influencing the business must be considered. Management ratings should include an evaluation of how the plan is implemented and the credit union's performance in achieving its plan. Implementation of the plan should include: 1) communication to management and staff, 2) ensuring adherence to the plan, and 3) the allocation of sufficient resources to achieve the plan goals.

Information Systems and Technology should be included in a strategic plan. Goals, policies and procedures should be in place to address IS&T. An assessment of the credit union's risk analysis and oversight of this area, based on the size, complexity and type of e-services provided, is included in the Management rating.

Internal Controls: This is an area which plays a crucial role in controlling risk, and demonstrating management effectiveness in identifying and tracking exposure to risk. Effective internal controls enhance safeguards against system malfunction, errors in judgment and fraud. Controls are essential to ensure personnel are acting within the parameters established by board policy and management directive. Seven aspects of internal control warrant special attention:

- **Information Systems:** Effective controls to ensure the integrity, security and privacy of electronic data. Information must be able to be assembled quickly and efficiently by the data processing system. There should be a tested contingency plan in place in the event of computer system failure.
- **Segregation of Duties:** There should be adequate segregation of duties and professional resources in every area of operation. This may be limited by the number of employees in smaller credit unions; however, compensating controls such as supervisory review should be in place whenever possible.
- **Audit Program:** Audit functions and processes should be commensurate with the credit union's size, sophistication and risk. Audit functions should be independent, reporting to the Supervisory Committee, and without conflict or interference with management. Reports should be issued to management for comment and action, and forwarded to the board with management's response. An annual audit plan is necessary to ensure all risk areas are examined, with those areas of greatest risk receiving priority. Follow up of any unresolved issues is essential, and should be covered in subsequent reports. In addition, a verification of member accounts needs to be performed at least once every two years.
- **Recordkeeping:** The books should be kept in accordance with well-established accounting practices, and must reflect its actual financial condition and accurate results of operations. Records should be current and provide an audit trail which includes sufficient documentation from transaction inception to completion. Subsidiary records should be kept in balance with control accounts.
- **Protection of Physical Assets:** A principle method of safeguarding assets is limiting access to authorized personnel. Asset protection can be accomplished by developing operating policies and procedures for cash control, joint custody (dual control), teller operations, and physical computer security.
- **Education of Staff:** Staff and volunteers should be thoroughly trained in specific daily operations. A training program tailored to meet management needs should be in place and cross-training programs for office staff should be present. Risk is controlled when the credit union is able to maintain continuity of operations and service to members.

- **Succession Planning:** To be prepared for resignation, retirement or long-term absences of key management positions, there must be a detailed plan which facilitates trained management personnel to step in at a moment's notice, to preserve the stability of the credit union. Such a plan should address the CEO and other senior management positions.

Corporate Governance: The board and management have a fiduciary responsibility to the members to maintain very high standards of professional conduct, including but not limited to:

- **Compliance with applicable regulations:** Management must adhere to all applicable state and federal laws and regulations.
- **Reasonableness of compensation:** Management contracts should not contain provisions that are likely to cause undue hardship on the credit union. The board needs to ensure performance standards are in place, including annual documented evaluations, for each member of senior management.
- **Professional Ethics/Avoidance of Conflict of Interest:** Management and board members should not use the credit union for unauthorized or inappropriate personal gain. Management should act ethically and impartially in carrying out appropriate credit union policies and procedures. Policies and procedures for avoidance of conflicts of interest should be in place. Nepotism should be avoided. Preferential treatment in fact, and in appearance, should be avoided.

Other Management Considerations: The basic and other key factors to consider when assessing management include, but are not limited to:

- The adequacy of policies and procedures covering each area of credit union operations (written, board approved, followed);
- Budget performance compared with actual performance;
- The effectiveness of systems that measure and monitor risks;
- Risk-taking practices and methods of control to mitigate risks;
- Integration of risk management with planning and decision-making;
- Responsiveness to examination and audit suggestions, recommendations, and/or requirements;
- Compliance with all laws and regulations;
- Adequacy of the Allowance for Loan and Lease Losses Account and other valuation reserves;

- Appropriateness of the products and services offered in relation to the credit union's size and management experience;
- Loan to share trends and history;
- Market penetration, rate structures and cost/benefit analyses of services/products;
- Appropriateness of disaster preparedness and planning for continuity of operations; and
- Succession planning for key management positions.

Management Effectiveness Rating 1: Indicates management and directors are fully effective, and demonstrate sound risk management practices relative to the credit union's size, complexity and risk profile. Management is responsive to changing economic conditions, recognizes and addresses concerns timely, and copes successfully with identified problems.

Management Effectiveness Rating 2: Reflects satisfactory management and board practices relative to the credit union's size, complexity, and risk profile, with minor deficiencies. In general, significant risks are effectively identified, measured, monitored and controlled. Management produces a satisfactory record of performance in light of the institution's particular circumstances, and overall demonstrates the ability to promptly and successfully address existing and potential problems and risks.

Management Effectiveness Rating 3: Indicates management and board performance that needs improvement or risk management practices that are less than satisfactory given the nature of the credit union's activities. Problems and significant risks may be inadequately identified, measured, monitored and controlled. Management is either characterized by modest talent when above average abilities are needed, or is distinctly below average for the type, size and/or complexity of the credit union and its issues. Management's ability or responsiveness in correcting less than satisfactory conditions is lacking to some degree.

Management Effectiveness Rating 4: A rating of 4 indicates serious deficiency 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 management is not properly performing its fiduciary responsibilities. In these cases, problems are of such severity that management may need to be strengthened or replaced before sound conditions can be achieved. Management and board performance or risk management practices are significantly inadequate considering the nature of a credit

union's activities. The level of problems and risk exposure is excessive. Replacing or strengthening the board may be necessary.

Management Effectiveness Rating 5: Reflects critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately measured, monitored, or controlled and now threaten the continued viability of the institution. This rating is appropriate in instances where incompetence or self-dealing has been clearly demonstrated. Problems resulting from weak management 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 assets, enabling expansion, competitiveness and increased capital. This rating reflects the adequacy of current and future earnings to fund capital commensurate with the credit union's current and prospective financial and operational risk exposure, potential changes in economic climate, and strategic plans. Earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the allowance for loan and lease losses, or by market risk that may unduly expose a credit union's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on extraordinary gains or nonrecurring events. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks.

The rating of a credit union's earnings is based upon historical performance and anticipated performance. Examiners must evaluate "core" earnings: long-run earnings ability discounting temporary fluctuations in income and one-time items. A review of the reasonableness of the credit union's budget and underlying assumptions is also necessary. Examiners must also consider the interrelationships with other risk areas such as credit and interest rate risk. This rating includes, but is not limited to, an assessment of the following evaluation factors:

- Income level, growth trends, and stability of earnings, particularly the return on average assets;
- Quality and composition of earnings;

- Quality and composition of assets;
- Ability to fund capital commensurate with current and prospective risk through retained earnings;
- Adequacy of valuation allowances and their effect on earnings;
- Adequacy of budgeting systems, forecasting processes, and management information systems, in general;
- Future earnings prospects under a variety of economic conditions;
- Net interest margin and net non-operating income and losses and their effect on earnings;
- Net worth level and trend and relation to earnings;
- Earnings exposure to market risk including interest rate risk; and
- Material factors affecting the credit union's income producing ability such as fixed assets and other non-earning assets.

Earnings Rating 1: Reflects earnings that are sound, and projected to be fully sufficient to absorb losses and form capital, with due consideration to asset quality, growth and known risk factors.

Earnings Rating 2: Reflects earnings which are satisfactory (positive and relatively stable) relative to the credit union’s risk profile and capital needs.

Earnings Rating 3: Reflects earnings in need of improvement. Earnings may not fully support current and future capital and allowance funding commensurate with the credit union’s overall condition, growth, and risk factors. Earnings may be inconsistent, chronically insufficient or not meet requirements set by regulation or board established policy.

Earnings Rating 4: Reflects deficient earnings, relative to the credit union’s overall risk profile. This may be characterized by erratic fluctuations in income, the development of a severe downward trend in income, or a substantial drop in earnings from the previous period or in projected earnings. Other relevant quantitative and qualitative measures must be considered to determine if 4 is the appropriate rating.

Earnings Rating 5: Reflects earnings that are critically deficient and represent a distinct threat to the credit union’s viability. Earnings do not support current and future capital and allowance funding commensurate with the credit overall condition, growth, and risk factors. Such losses may represent a distinct threat to the credit union’s solvency through the erosion of capital; and generally expected to result in the depletion of capital within twelve months.

LIQUIDITY

Liquidity is evaluated on the credit union's ability to efficiently meet present and future cash flow needs (such as loan demands, share withdrawals, and the payment of liabilities and expenses) without adversely affecting daily operations. Failure to adequately manage liquidity can result in cash shortages, unintended borrowing at high cost, reduced balance sheet flexibility, and elevated reputation and strategic risks. Liquidity risk also encompasses poor management of excess funds. Key factors relative to liquidity risk evaluation include:

- Degree of liquidity risk and level of assets readily convertible into cash, including primary, secondary and tertiary sources of liquidity;
- Reliance on short-term, volatile sources of funds, including any undue reliance on borrowing;
- Contingency planning to meet high cash demands from unanticipated events and/or periods of excess liquidity;
- Management's competence and systems for identifying, measuring, monitoring, and controlling liquidity and management's response when risk levels exceed board established limits;
- The degree to which liquidity policies, practices and management systems are commensurate with the complexity of the credit union's balance sheet and operations;
- Integration of risk management with planning and decision-making, and timeliness of reporting to decision makers, and corrective actions;
- Business plans, budgets, projections, and board strategy;
- The adequacy of capital & earnings relative to the level of risk; and
- The degree of compliance with board established policies and parameters relative to liquidity.

Liquidity Rating 1: Reflects sound liquidity practices with no more than modest balance sheet risk. Management is considered proficient at both the measurement and management of liquidity. There is ready access to sufficient sources of funds on favorable terms to meet present and anticipated needs, without dependence on borrowed funds. Contingency plans have been established and expected to be effective. The level of earnings and capital provide substantial support for the degree of liquidity risk taken by the credit union. There is minimal potential that operations will be materially impacted by ordinary or unanticipated liquidity stresses.

Liquidity Rating 2: Reflects reasonable risk exposure and satisfactory Liquidity practices relative to the size, sophistication and operational needs of the credit union. Modest weaknesses may be evident, but overall management of Liquidity is sufficient. The credit union has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. The level of earnings and capital are reasonable relative to the level of liquidity risk present.

Liquidity Rating 3: Reflects Liquidity practices in need of improvement; risk exposure is substantial and/or liquidity may be insufficient to meet anticipated operational needs perhaps necessitating unplanned borrowing. Improvements are needed in policies, procedures, or in management's understanding of balance sheet risks. Management may not be meeting its self-imposed risk limits or is not taking timely action to bring performance back into compliance. The level of earnings and/or capital may not adequately support the degree of balance sheet risk being taken by the credit union.

Liquidity Rating 4: Reflects deficient liquidity practices; and/or unacceptably high exposure to risk. The credit union may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs. Management may have an unacceptable liquidity position or cash forecasting may indicate considerable liquidity strain is present or imminent. Immediate action is needed to improve liquidity or otherwise improve liquidity management. The level of earnings and capital may be inadequate to support the degree of risk taken by the credit union.

Liquidity Rating 5: Reflects Liquidity practices so critically deficient that the continued viability of the credit union is threatened or ability to meet ongoing cash needs is doubtful. The credit union likely requires immediate external financial assistance to meet liquidity needs. Liquidity practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the credit union.

SENSITIVITY TO MARKET

Market Sensitivity is evaluated on the credit union's ability to withstand adverse changes in market interest rates, resulting from the sensitivity and exposure of the credit union's balance sheet to such changes. Management's demonstrated ability to measure, monitor and control interest rate risk is reflected here. All other risks that may affect the value or marketability of a credit union's assets, including but not limited to the seven risk categories, should also be considered. All other risks that may affect the value or marketability of a credit union's assets, including but not

limited to the seven risk categories, should be considered. These risks can adversely affect earnings and capital adequacy. Key factors relative to interest rate risk evaluation include:

- Management's systems and effectiveness in identifying, measuring, monitoring, and controlling risk and management's response when risk levels exceed established limits;
- The degree to which ALM practices and management system are commensurate with the complexity of the credit union's balance sheet and operations;
- Integration of risk management with planning and decision-making, and timeliness of reporting and corrective actions;
- Business plans, budgets, and projections;
- Related strategic and reputation risks;
- The adequacy of capital and earnings in relation to the credit union's level of risk exposure;
- The adequacy of established policies, which should outline individual responsibilities, the credit union's risk tolerance, and require timely monitoring and reporting to decision makers;
- The degree of compliance with board established policies and parameters relative to ALM;
- The prudence of established limits, relative to the credit union's size, complexity and net worth position; and
- The balance sheet composition, including cost of funds, sources of funds, net interest margin, secondary market standards, and trend analysis.
- IRR sensitivity and exposure at the instrument, portfolio and balance sheet levels;
- Earnings and capital trend analysis over changing economic climates.

Sensitivity Rating 1: Reflects sound IRR practices and no more than modest exposure to balance sheet risk. Management is considered proficient at both the measurement and management of risk. The level of earnings and capital provide substantial support for the degree of balance sheet risk taken by the credit union. There is minimal potential that the capital adequacy or credit union viability will be materially affected by internal and external factors related to market interest rate risk.

Sensitivity Rating 2: Reflects reasonable risk exposure and satisfactory balance sheet practices relative to the size, sophistication and market risk taken by the credit union. Modest weaknesses may be evident; however, management of interest rate risk is sufficient overall. There is only moderate potential that the adequacy of

capital will be materially affected by internal and external factors such as a shift in interest rates. The level of earnings and capital provide adequate support for the degree of balance sheet risk taken by the credit union.

Sensitivity Rating 3: Risk exposure is substantial and/or improvements are needed in policies, procedures, or in management's understanding of balance sheet risks. Analyses contain deficiencies (e.g. inaccurate data and/or unrealistic or unsupported assumptions). Management may not be meeting its self-imposed risk limits or is not taking timely action to bring performance back into compliance. The level of earnings and/or capital may not adequately support the degree of balance sheet risk being taken by the credit union.

Sensitivity Rating 4: Reflects deficient ALM practices; and/or unacceptably high exposure to risk. Management does not demonstrate an acceptable capacity to measure and manage interest rate risk. Analyses contain critical deficiencies and/or modeling scenarios indicate a significant deterioration in performance is likely. Immediate action is needed to lower interest rate risk exposure and/or otherwise improve interest rate risk management. The level of earnings and capital are inadequate to support the degree of risk taken by the credit union.

Sensitivity Rating 5: Reflects ALM practices critically deficient, an unacceptable level of market risk sensitivity and/or a level of risk representing an imminent threat to the credit union's net worth sufficiency or credit union viability. IRR management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the credit union. Modeling scenarios indicate a significant deterioration in performance is inevitable. Immediate action is needed to lower interest rate risk exposure or otherwise improve risk management. The level of earnings and capital provide inadequate support for the degree of balance sheet risk being taken.

III. MINIMUM PROCEDURES

1. Review key ratios and financial performance reports, which provide lagging indicators of credit union risk.
2. Look behind the numbers to determine significance of ratios, trends, projections, operations, market forces, environmental factors, and management using the seven risk categories (credit risk, interest rate risk, liquidity risk, strategic risk compliance risk, reputation risk and transaction risk).
3. Evaluate the amount of risk in each of the seven risk categories (see Attachment 1) as high, moderate, or low, reflecting current and prospective risk to the credit union.

4. Assess directionality of risk in each of the seven risk categories as increasing, decreasing, or unchanging.
5. Focus examination time on the activities and areas posing the greatest and/or increasing risk.
6. Determine the interrelationship and impact of the seven risk categories on the safety and soundness of the credit union's six rated areas of operations (**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to Market).
7. Enter CAMELS ratings and justification in report with explanation of examination conclusions and support for each rating in the Examination Overview.
9. Disclose CAMELS composite and component ratings only to credit union officials and management. Input key examination data and conclusions into Database Input Workbook (Internal Form).

IV. PRIMARY REFERENCES / RELATED REGULATIONS

1. NCUA Letter to Credit Unions 07-CU-12 CAMEL Rating System with Appendix A: NCUA's CAMEL Rating System
2. NCUA Letter to Federal Credit Unions 02-FCU-09 Risk Focused Examination
3. Michigan Credit Union Letter 2005-CU-06 Disclosure of CAMEL ratings and Examination Findings

V. ATTACHMENTS / FORMS

1. Attachment: Seven Key Risk Categories Defined
2. Attachment: URSIT Definitions for IT Reviews/Ratings
3. Internal Form: Database Input Workbook