# QUESTIONS AND ANSWERS RELATED TO THE NEW CAMELS RATING SYSTEM

The Department will be implementing the revised Uniform Financial Institutions Rating System (UFIRS or CAMELS rating system). The revised rating system will be used on all examinations beginning on or after September 1, 2014.

In anticipation of questions that might be raised by credit unions and examiners regarding the revised rating system, the Department has developed this document. The questions and answers are designed to help credit unions and examiners understand certain aspects of the rating system for its consistent and uniform implementation. Further guidance will be provided, as necessary.

1. How will the new Sensitivity to Market Risk (S) component rating be determined?

   The rating assigned to the S component should reflect a combined assessment of both the level of market risk and the ability to manage market risk. Low market risk sensitivity alone may not be sufficient to achieve a favorable S rating. Indeed, credit unions with low risk, but inadequate market risk management, may be subject to unfavorable S ratings. Conversely, credit unions with moderate levels of market risk and the demonstrated ability to ensure that market risk is, and will remain, well controlled may receive favorable S component ratings.

2. Will credit unions be expected to have formal, sophisticated risk management processes in order to receive the favorable ratings for the S component?

   The sophistication of a credit union's risk management system is expected to be commensurate with the complexity of activities and appropriate to its specific needs and circumstances. Credit unions with relatively noncomplex activities may be able to rely on relatively basic and less formal risk management systems. If the procedures for managing and controlling market risks are adequate and well understood by all relevant parties, these basic processes may, when combined with low to moderate levels of exposure, be sufficient to receive a favorable rating for the S component.

   Credit unions with more complex activities and business structures may require more elaborate and formal market risk management processes in order to receive ratings of 1 or 2 for the S component.

3. How much weight should be placed on the S component in determining the composite rating?

   The weight attributed to any individual component in determining the composite rating should vary depending on the degree of supervisory concern associated with the component. The composite rating does not assume a predetermined weight for each component and it does not represent an arithmetic average of assigned component ratings. As a result, for most credit unions where market risk is not a significant issue, less weight should be placed on the S component in determining a composite rating than on other components.

4. How should the S component rating be applied when evaluating small credit unions with limited asset/liability management processes?

   For most small credit unions, sensitivity to market risk will primarily reflect interest rate risk. Regardless of the size of a credit union, the quality of risk management systems must be commensurate with the nature and complexity of its risk-taking activities, and management's ability to identify, measure, monitor, and control risk. Evaluation of this component will be based on the degree to which interest rate risk exposure can affect the credit union's earnings and capital, and the effectiveness of the credit union's asset/liability or interest rate risk management system, given its particular situation.

5. Does the increased emphasis on market risk management practices place new requirements on credit unions or examiners?

   The updated rating system incorporates examination considerations that were not explicitly noted in the prior rating system. Under the prior rating system, examiners considered market risk exposure and risk management practices when assigning component and composite ratings. Consequently, examiners are not required to perform any additional procedures, and credit unions are not required to add to their management procedures or practices, solely because of the updated rating system.

6. Will the revised rating system, with the addition of the new Sensitivity to Market Risk (S) component and increased emphasis on the quality of risk management practices, result in a change in a credit union's composite rating?

   The revised rating system generally should not result in a change in the composite rating assigned to a particular credit union simply because of the addition of the new component and the increased emphasis on risk management practices. The level of market risk has traditionally been taken into consideration when evaluating a credit union's capital, earnings, and liquidity. The quality of a credit union's risk management practices has also traditionally been considered by examiners when assessing a credit union's condition and assigning ratings, particularly in the Management component.

7. How much weight should be given to risk management practices versus the level of exposure, as measured by specific ratios, when assigning a component rating?

   The CAMELS rating system assesses a credit union's overall condition based on both quantitative and qualitative elements. Quantitative data such as the level of delinquent loans remain an integral part of that measurement. Qualitative elements, such as the adequacy of board and senior management oversight, policies, risk management practices, and management information systems are also central to the evaluation of components. The relative importance given to the qualitative considerations for each component depends on the circumstances particular to the credit union. Risk management systems should be appropriate for the nature and level of risk the credit union assumes. However, unacceptable risk levels or an unsatisfactory financial condition will often outweigh other factors and result in an adverse component rating.

8. Department policy requires examiners to discuss with senior management and the board of directors the evaluation factors they considered in assigning component ratings and a composite rating. Are examiners limited to only those evaluation factors listed in the revised rating system and must each evaluation factor be addressed when assessing a component area?

   No. Examiners have the flexibility to consider any other evaluation factors that, in their judgment, relate to the component area under review. The evaluation factors listed under a component area are not intended to be all-inclusive, but rather a list of the more common factors believed relevant to fully support the rating being assigned by the examiner, and addressed in the report and in discussions with senior management and the board.

9. With multiple references to some items across several components, such as market risk and management's ability to identify, measure, monitor, and control risk, is the Department "double counting" these and other items when assigning a rating?

   Each component is interrelated with one or more of the other components. For example, the level of problem assets in a credit union is a primary consideration in assigning an asset quality component rating. But it is also an item that affects the capital and earnings component ratings. The level of market risk and the quality of risk management practices are elements that also can affect several components. Examiners consider relevant factors and their interrelationship among components when assigning ratings.

10. To what extent should market risk be carved out of the earnings and capital evaluation? Should credit unions with high market risk receive an adverse rating in the earnings or capital components as well as the market sensitivity component?

    Market risk is evaluated primarily under the new S component and is only one of several evaluation factors used to assess the earning and capital components. Whether the credit union's exposure to market risk results in an unfavorable rating for earnings or capital, however, is based on careful analysis of the effect of this factor in relation to the other factors considered under these components. The capital component is evaluated based on the risk profile of a credit union, including the effect of market risk, and whether the level of capital supports those risks. The earnings component evaluates the ability of earnings to support operations and maintain adequate capital after considering factors, such as market risk exposure, that affect the quantity, quality, and trend of earnings. The importance accorded to an evaluation factor should thus depend on the situation at the credit union.

11. How do the revised rating system and the Department's supervision by risk program interrelate?

    They exist in tandem. The revised rating system now makes direct references to the various types of risk categories that are considered within each component area, as well as the quality of risk management practices. The CAMELS rating system remains a measurement of the credit union's current, overall financial, managerial, operational, and compliance performance. Supervision by risk prospectively assesses not only quality of risk management and the quantity of risks, but also the direction of risk. The Department's supervision by risk program allows examiners to plan future examination activities and the scope of those activities based on the credit union's quantity of risk, quality of risk management, aggregate risk, and direction of risk.

12. The revised rating system appears to put more emphasis on the adequacy of a credit union's policies. How will the revised rating system affect conducting examinations in noncomplex credit unions?

    It should not have a significant effect on noncomplex credit union examinations. Examiners will continue to use existing procedures to review credit union activities and assess the credit union's condition based primarily on the credit union's performance. As is currently the case, examiners use the results of the performance-oriented examination to reach conclusions on the risk management practices of the credit union. Thus, there is no need to obtain additional information or perform additional examination procedures to determine a credit union's component and composite ratings. For areas of higher risk in these credit unions, examiners continue to have the option to expand examination procedures for those activities or areas, as needed.