

7535-01-U

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 700, 701, 703, 704, 713

RIN: 3133-AF32

CAMELS Rating System

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed rule with request for comments.

SUMMARY: The Board is proposing to add the “S” (Sensitivity to Market Risk) component to the existing CAMEL rating system and redefine the “L” (Liquidity Risk) component, thus updating the rating system from CAMEL to CAMELS. The proposal to add the “S” component will enhance transparency and allow the NCUA, State Supervisory Authorities, and federally insured credit unions to better distinguish between liquidity risk (“L”) and sensitivity to market risk (“S”). The amendment would also enhance consistency between the regulation of credit unions and other financial institutions. The Board is proposing to implement the addition of the “S” rating component and a redefined “L” rating as early as the first quarter of 2022.

DATES: Comments must be received on or before [INSERT DATE THAT IS 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER.]

ADDRESSES: You may submit comments by any of the following methods (**Please send comments by one method only**):

- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.
- NCUA website: http://www.ncua.gov/RegulationsOpinionsLaws/proposed_regs/proposed_regs.html. Follow the instructions for submitting comments.
- E-mail: Send messages to regcomments@ncua.gov. Use the subject line: “[Your name] Comments on Notice of Proposed Rulemaking Regarding CAMELS Rating System.”
- Fax: (703) 518-6319. Include “[Your name] Comments on Notice of Proposed Rulemaking Regarding CAMELS Rating System” on the cover page.
- USPS/Hand Delivery/Courier: Address to Melane Conyers-Ausbrooks, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.

PUBLIC INSPECTION: All public comments will be made available on the NCUA’s website (<http://www.ncua.gov/Legal/Regs/Pages/PropRegs.aspx>) as submitted, except for those we cannot post for technical reasons. The NCUA will not edit or remove any identifying or contact information from the public comments submitted.

FOR FURTHER INFORMATION CONTACT: Thomas Fay, Director of Capital Markets at (703) 518-1179 or Robert Bruneau, Senior Capital Markets Specialist at 703 945-2491, Office of Examination and Insurance, or Marvin Shaw, Staff Attorney Office of General Counsel at (703) 518-6554.

SUPPLEMENTARY INFORMATION:

I. Background

The NCUA adopted its current rating system, known as CAMEL, in 1987.¹ The current CAMEL rating is based upon an evaluation of five critical elements of a credit union's operations: capital adequacy, asset quality, management, earnings, and liquidity and asset-liability management. CAMEL is designed to take into account and reflect all significant financial, operational, and management factors examiners assess in their evaluation of a credit union's performance and risk profile.

Under this system, the NCUA assigns each credit union a composite CAMEL rating based on the agency's evaluation and rating of five components of an institution's financial condition and operations. As specified in the 2007 Letter to Credit Unions,² these components address a credit union's:

- Capital adequacy;
- Asset quality;
- Management;
- Earnings; and

¹ NCUA Letter No. 93. Letter to Credit Unions, (September 25, 1987)

² NCUA Letter to Credit Unions 07-CU-12 (Dec. 2007)

- Liquidity and asset liability management.

Examiners assign composite and component CAMEL ratings using a scale that ranges from “1” to “5.” The highest rating is a “1,” indicating the strongest performance and risk management practices, and the least degree of supervisory concern. The lowest rating is a “5,” indicating the weakest performance, inadequate risk management practices, and the highest degree of supervisory concern. When evaluating these components, examiners use their professional judgement and consider both qualitative and quantitative factors when analyzing a credit unions performance.

In 1997, members of the Federal Financial Institution Examination Council (FFIEC),³ with the exception of the NCUA, proposed and subsequently adopted revisions to the Uniform Financial Institutions Rating System (UFIRS) and a Policy Statement that reaffirmed the five CAMEL rating system components and added a sixth component, Sensitivity to Market Risk (“S”), to address price and interest rate risks (IRR).⁴ The NCUA opted not to use the “S” component and retained its existing CAMEL rating system based on the relative lack of complexity in the consolidated balance sheets of credit unions at the time. However, since 1997, credit unions have increased in size and complexity by significantly increasing their mortgage-related assets from 19 percent of total assets to 42 percent at September 2020.

The NCUA has made several pertinent modifications to the CAMEL rating system since 1997. These involve changes to financial ratios,⁵ adding and subsequently eliminating a

³ At the time, the FFIEC was comprised of the Federal Deposit Insurance Corporation (FDIC), the Board of Governors of the Federal Reserve (Federal Reserve), and the Office of Comptroller of the Currency (OCC), the NCUA, and the Office of Thrift Supervision (OTS). OTS merged into OCC as a result of the Dodd Frank Wall Street Reform and Consumer Protection Act. *See* Section 312 of Pub.L 111-203.

⁴ 62 FR 752, (Jan. 6, 1997.)

⁵ Letter to Credit Unions 00-CU-08 (Nov. 2000)

CAMEL matrix,⁶ accommodating the adoption of Prompt Corrective Action (PCA),⁷ and incorporating the NCUA's risk-focused exam approach.⁸

As balance sheets of credit unions have become larger and more complex, the NCUA consistently provided supervision and guidance regarding exposures to market risk to the credit union industry. The NCUA also advised credit unions that IRR was a supervisory priority from 2012 through 2019.

Since 2012, the Board implemented regulations that introduced standards and expectations affecting examiner procedures and the NCUA's IRR assessment requirements. The NCUA's IRR rule became effective for credit unions in September 2012.⁹ The rule requires credit unions that have more than \$50 million in assets to maintain a written IRR policy and an effective risk management program. The NCUA also finalized its derivatives rule in April 2014 providing authority for qualified federal credit unions to use financial derivatives to conduct hedging activities to better optimize their interest rate risk management.¹⁰

The NCUA also implemented its revised IRR supervision program in January 2017¹¹ incorporating the regulatory requirements from parts 741 (IRR) and 703 (derivatives), enhancing examiner guidance, improving the consistency of IRR ratings, and to identify outlier credit unions with excessive risk levels.

⁶ NCUA Letter to Credit Unions 07-CU-12 (Dec. 2007)

⁷ In 1998, Congress enacted the Credit Union Membership Access Act ("CUMAA"). (Pub.L. 105-219, 112 Stat. 913 (1998)). CUMAA amended the Federal Credit Union Act ("the Act") to require the NCUA to adopt, by regulation, a system of prompt corrective action (PCA) consisting of minimum capital standards and corresponding remedies to improve the net worth of federally-insured "natural person" credit unions.

⁸ NCUA Letter to Credit Unions -03-CU-04 (March 2003)

⁹ 77 FR 5155 (Feb. 2, 2012)

¹⁰ 79 FR 5228 (Jan 31, 2014)

¹¹ Revised Interest Rate Risk Supervision | National Credit Union Administration (ncua.gov) 16-CU-08 / October 2016

II. Rationale for Proposed Rule

The NCUA's existing CAMEL rating process addresses both sensitivity to market risk and liquidity risk within the "L" component.¹² While there is an interrelationship between sensitivity to market risk and liquidity risk, there are also differences that support separating the risks into distinct components. The proposed rule would enhance the existing CAMEL rating system by adding an "S" component to assess sensitivity to market risk and modify the "L" component to include only liquidity evaluation content and rating criteria.

Adding an "S" component and modifying the "L" component will provide greater clarity and transparency regarding credit unions' sensitivity to market risk and liquidity risk exposures. The proposed addition would make the NCUA's rating system more consistent with the other financial institution regulators' ratings system both at the federal and state levels.¹³

Separating the "S" and "L" component ratings will allow NCUA to enhance the:

- Monitoring of sensitivity to market risk and liquidity risk in the credit union system;
- Communication of specific concerns to individual credit unions; and
- Allocation of resources.

Evaluating, rating, and disclosing assessments of interest rate and liquidity risks to credit union management is a long-standing examination procedure at the NCUA. The proposed change to add the "S" provides greater transparency into the NCUA's evaluation and conclusions regarding these two risks.

¹² NCUA Letter to Credit Unions 07-CU-12, *CAMEL Rating System*. (Dec.. 2007)

¹³ The banking regulators (Federal Reserve, FDIC, and OCC) each include the "S" component to evaluate sensitivity to market place risk. In addition, 24 state supervisory authorities adopted the "S" component.

In 2015, the NCUA Office of Inspector General (OIG) recommended the addition of an “S” component to better capture a credit union’s sensitivity to market risk and improve clarity and transparency in the CAMEL rating system.¹⁴ The NCUA OIG also recommended the NCUA revise its “L” component rating to reflect only liquidity factors.

Also in 2015, the NCUA initiated a comprehensive restructuring of its supervision activities through the Enterprise Solution Modernization program (ESM). The ESM is a multi-year introduction of emerging and secure technology solutions supporting the NCUA’s examination, data collection, and reporting efforts to improve key, integrated business processes. The NCUA planned the implementation of the OIG’s 2015 CAMELS recommendations as part of the development of a new examination platform, known as the Modern Examination and Risk Identification Tool, or MERIT. The NCUA anticipates completing the transition from its legacy examination software to MERIT (which has been configured to support the “S” in “CAMELS”) in 2021. Other revisions to examiner supervision guidance and procedures will also be updated as part of the transition.

In general, the NCUA Board expects that adopting a sixth CAMELS rating component will not have any adverse effect on a credit union’s CAMEL composite rating. The proposed separation of sensitivity to market risk and liquidity risk into individual CAMELS rating components will reduce potential rating inconsistencies. Currently, examiners combine the risk evaluation of these related, but separate, risk areas into the “L” component. The separation into two components provides greater clarity of the assessment of each risk area. The Board anticipates the agency can make this transition smoothly and without significant disruption to the exam process or agency operations as early as the first quarter of 2022.

¹⁴ OIG-15-11 *Review of NCUA’s Interest Rate Risk Program*.

III. Summary of the Proposed Rule

The Board is proposing to add the “S” component to the existing CAMEL rating system and redefine the current “L” component. Evaluation of these as individual components will enhance the communication and monitoring of credit unions’ sensitivity to market risk and liquidity risk. The Board is requesting comments on this proposal, such as, but not limited to, the definitions of both the “L” and “S” components and the criteria for each of the specific 1-5 assigned ratings. For example, the Board may consider modifying the rating descriptions used for the “L” and “S” ratings used by the other banking agencies rating system (The Uniform Financial Institutions Rating System (UFIRS)), detailed below in Sections IIA and IIB of this proposal.¹⁵

A. “S” Component for Sensitivity to Market Risk

The sensitivity to market risk reflects the exposure of a credit union’s current and prospective earnings level and economic capital position arising from changes in market prices and the general level of interest rates. Effective risk management programs include comprehensive interest rate risk policies, appropriate and identifiable risk limits, clearly defined risk mitigation strategies, and a suitable governance framework.

Sensitivity to Market Risk ratings are based on, but not limited to, the following evaluation factors:

- Sensitivity of a credit union's current and future earnings and economic value of capital to adverse changes in market prices and interest rates;

¹⁵ <https://www.fdic.gov/regulations/laws/rules/5000-900.html>

- Management’s ability to identify, measure, monitor, and control exposure to market risk considering a credit union’s size, complexity, and risk profile; and
- The nature and complexity of interest rate risk exposure.

Examiners will rate a credit union’s “S” CAMELS rating component on a scale of “1” to “5” using the same rating descriptions for “S” as the other banking agencies.

“S” Rating	Description
1	<ul style="list-style-type: none"> • Market risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected; • Risk management practices are strong for the size, sophistication, and market risk accepted by the institution; and • The level of earnings and capital provide substantial support for the degree of market risk taken by the institution
2	<ul style="list-style-type: none"> • Market risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected; • Risk management practices are satisfactory for the size, sophistication, and market risk accepted by the institution; and • The level of earnings and capital provide adequate support for the degree of market risk taken by the institution
3	<ul style="list-style-type: none"> • Control of market risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected;

	<ul style="list-style-type: none"> • Risk management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution; and • The level of earnings and capital may not adequately support the degree of market risk taken by the institution
4	<ul style="list-style-type: none"> • Control of market risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected; • Risk management practices are deficient for the size, sophistication, and level of market risk accepted by the institution; and • The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution
5	<ul style="list-style-type: none"> • Control of market risk sensitivity is unacceptable or that the level of market risk taken by the institution is an imminent threat to its viability; and • Risk management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the institution

The Board also requests comments on the proposal to describing the “L” component and the criteria used in determining the 1-5 assigned ratings.

B. “L” Component for Liquidity Risk

In evaluating the adequacy of a credit union’s liquidity profile, examiners consider the current and prospective sources of liquidity compared to funding needs and the adequacy of liquidity risk management relative to a credit union’s size, complexity, and risk profile. A credit

union’s liquidity risk management practices should ensure the credit union maintains sufficient liquidity to timely meet its financial obligations and member share and loan demands. These practices should reflect the credit union’s ability to manage unplanned changes in funding sources, changes in market conditions affecting its ability to quickly liquidate assets with minimal loss, ensure liquidity is maintained at a reasonable cost and limit reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

A credit union’s liquidity risk management practices should also be commensurate with the complexity of the balance sheet and its capital adequacy. This includes evaluating the reporting mechanisms in place to monitor and control risk, management’s response when risk exposure approaches or exceeds the credit union’s risk limits, and the prescribed corrective action taken when necessary.

Examiners will rate a credit union’s “L” CAMELS rating component on a scale of “1” to “5” using the same rating descriptions for “L” as the other banking agencies.

“L” Rating	Description
1	<ul style="list-style-type: none"> • Strong liquidity levels and well-developed funds management practices; and • The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs
2	<ul style="list-style-type: none"> • Satisfactory liquidity levels and funds management practices; • The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs; and

	<ul style="list-style-type: none"> • Modest weaknesses may be evident in funds management practices
3	<ul style="list-style-type: none"> • Liquidity levels or funds management practices in need of improvement; and • Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices
4	<ul style="list-style-type: none"> • Deficient liquidity levels or inadequate funds management practices; and • Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs
5	<ul style="list-style-type: none"> • Liquidity levels or funds management practices so critically deficient that the continued viability of the institution is threatened; and • Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs

The CAMEL rating system is not set forth in a separate section or part in the NCUA’s regulations. Rather, references to CAMEL appear in several parts in the Code of Federal Regulations (CFR). NCUA regulations regularly refer to CAMEL composite “1” or “2” rated credit unions, which indicate the ability to safely support additional regulatory flexibility, or CAMEL composite “4” or “5” rated credit unions, which warrant increased regulatory scrutiny.

The Board is planning technical amendments to the following sections in which the term “CAMEL” appears by changing the term to “CAMELS.” These sections include:

- Section 700.2 definition of “Troubled condition”

- Section 701.14 Change in official or senior executive officer in credit unions that are newly chartered or are in troubled condition
- Section 701.23 Purchase, sale, and pledge of eligible obligations
- Section 703.13 Permissible investment activities
- Section 703.14 Permissible investments
- Section 703.108 Eligibility
- Section 704.4 Prompt corrective action
- Section 713.6 Fidelity Bond and Insurance Coverage for FCUS - What is the permissible deductible?

In addition to amendments in the CFR, the Board notes the agency will modify certain documents and systems related to its supervisory activities to reflect the addition of the “S” CAMEL rating component.

IV. Regulatory Procedures

A. Regulatory Flexibility Act

The Regulatory Flexibility Act requires the NCUA to prepare an analysis to describe any significant economic impact a regulation may have on a substantial number of small entities.¹⁶ For purposes of this analysis, the NCUA considers small credit unions to be those having under \$100 million in assets.¹⁷ This rule would not affect FCUs regardless of asset size because it is

¹⁶ 5 U.S.C. 603(a).

¹⁷ Interpretive Ruling and Policy Statement (“IRPS”) 03–2, 68 FR 31949 (May 29, 2003) *as amended by* IRPS 13-1, 78 FR 4032 (Jan. 18, 2013).

not adding any substantive requirement. Accordingly, the associated cost is minimal. The NCUA certifies the rule will not have a significant economic impact on small credit unions.

B. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (“PRA”) applies to rulemakings in which an agency by rule creates a new paperwork burden on regulated entities or modifies an existing burden.¹⁸ For purposes of the PRA, a paperwork burden may take the form of either a reporting or a recordkeeping requirement, both referred to as information collections. This proposed rule imposes no new paperwork-related requirements. Therefore, this proposed rule will not create new paperwork burdens or modify any existing paperwork burdens.

C. Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. In adherence to fundamental federalism principles, the NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order. This rule will not have a substantial direct effect on the states, on the connection between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. The NCUA has determined this rule does not constitute a policy that has federalism implications for purposes of the executive order.

D. Assessment of Federal Regulations and Policies on Families

¹⁸ 44 U.S.C. 3507(d); 5 CFR part 1320.

The NCUA has determined that this proposed rule will not affect family well-being within the meaning of Section 654 of the Treasury and General Government Appropriations Act, 1999.¹⁹

List of Subjects

12 CFR part 700

Credit unions.

12 CFR part 701

Credit unions. Insurance. Reporting and recordkeeping requirements.

12 CFR part 703

Credit unions. Investments. Reporting and recordkeeping requirements.

12 CFR part 704

Corporate Credit Unions, Prompt Corrective Action

12 CFR part 713

Bonds. Credit unions. Insurance.

By the National Credit Union Administration Board on January 14, 2021

Melane Conyers-Ausbrooks

Secretary of the Board

¹⁹ Public Law 105-277, 112 Stat. 2681 (1998).

For the reasons discussed above, the Board proposes to amend 12 CFR parts 700, 701, 703, and 713 as follows:

PART 700 - DEFINITIONS

1. The authority citation for part 700 continues to read as follows:

Authority: 12 U.S.C. 1752, 1757(6), 1766

700.2 [Amended]

2. Amend the definition of “troubled condition” in § 700.2 by removing “CAMEL” and add in its place “CAMELS” each time it appears.

PART 701 — ORGANIZATION AND OPERATION OF FEDERAL CREDIT

UNIONS

3. The authority citation for part 701 continues to read as follows:

Authority: 12 U.S.C. 1752(5), 1755, 1756, 1757, 1758, 1759, 1761a, 1761b, 1766, 1767, 1782, 1784, 1786, 1787, 1789. Section 701.6 is also authorized by 15 U.S.C. 3717. Section 701.31 is also authorized by 15 U.S.C. 1601 et seq.; 42 U.S.C. 1981 and 3601-3610. Section 701.35 is also authorized by 42 U.S.C. 4311-4312.

701.14 [Amended]

4. Amend § 701.14(b) (3) (i) and (ii) by removing “CAMEL” and add in its place “CAMELS.”

5. Amend § 701.14(b) (4)(i) and (ii) by removing “CAMEL” and add in its place “CAMELS.”

6. Amend § 701.23(b)(2) by removing “CAMEL” and add in its place “CAMELS.”

PART 703 – INVESTMENT AND DEPOSIT ACTIVITIES

7. The authority citation for part 703 continues to read as follows:

Authority: 12 U.S.C. 1757(7), 1757(8), and 1757(15).

8. Amend § 703.13(d)(3)(iii) by removing “CAMEL” and add in its place “CAMELS.”

9. Amend § 703.14(i) by removing “CAMEL” and add in its place “CAMELS.”

10. Amend § 703.14(j)(4) by removing “CAMEL” and add in its place “CAMELS.”

PART 704 – CORPORATE CREDIT UNIONS

11. The authority citation for part 704 continues to read as follows:

Authority: 12 U.S.C. 1766(a), 1781, and 1789.

12. Amend § 704.4(d)(3)(ii) by removing “CAMEL” and add in its place “CAMELS.”

PART 713 – FIDELITY BOND AND INSURANCE COVERAGE FOR FEDERAL CREDIT UNIONS

13. The authority citation for part 713 continues to read as follows:

Authority: 12 U.S.C. 1761a, 1761b, 1766(a), 1766(h), 1789(a)(11).

14. Amend § 713.6(a)(1) by removing “CAMEL” and add in its place “CAMELS.”

15. Amend § 713.6(c) by removing “CAMEL” and add in its place “CAMELS” each place it appears.