APPENDIX B

COMMON QUESTIONS AND ANSWERS ABOUT THE CAMELS RATING SYSTEM

The changes to CAMELS include the addition of a sixth component called “Sensitivity to Market Risk” (“S”) and the independent evaluation of Liquidity (“L”).

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

   The “S” component rating should reflect a combined assessment of the level of market risk and the ability to manage market risk. Low market risk sensitivity alone may be insufficient to achieve a favorable “S” rating. Credit unions with low risk, but inadequate market risk management, may be subject to worse “S” ratings. Conversely, credit unions with moderate levels of market risk and the demonstrated ability to ensure market risk is well controlled (and will remain well controlled) may receive more favorable “S” component ratings.

   In assessing the level of market risk exposure and the risk management process to control it, examiners will rely on existing supervisory guidance, including guidance issued on interest rate risk and investments.

2. **Will credit unions be expected to have formal, sophisticated risk management processes to receive a favorable rating for the “S” component?**

   Consistent with the NCUA’s existing interest rate risk supervisory guidance, the sophistication of a credit union’s risk management process is expected to be commensurate with the complexity of its level of risk exposure, balance sheet composition, off-balance sheet activities, and the credit union’s specific circumstances.

   Credit unions with relatively noncomplex balance sheet composition and activities and whose senior managers are actively involved in the daily operations may be able to rely on fairly basic and less formal risk management systems. If the risk exposure is low to moderate, procedures for managing and controlling market risks are adequate, and risk profiles are communicated clearly and well understood by all relevant parties, then basic processes may be sufficient to receive a favorable rating for the “S” component.

   Credit unions with more complex holdings, activities, and business structures may require more elaborate and formal market risk management processes to receive a rating 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 composite rating does not assume a predetermined weight for each component, and it does not represent an arithmetic average of assigned component ratings. Examiners will consider the interrelationship between CAMELS components when assigning a composite rating and generally, the composite rating will resemble the component ratings.

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4. **How should the “S” rating be applied when evaluating small credit unions with limited interest rate risk processes?**

   The NCUA’s current examination instructions allow examiners of credit unions with less than $500 million in total assets to use the automated Estimated Net Economic Value Tool (ENT). The ENT is NCUA’s estimate of Interest Rate Risk (IRR) using standard sensitivity measurements. The ENT results inform the interest rate risk category rating, which in turn, inform the “S” component rating. If interest rate risk is significant, however, other qualitative assessments are available to the examiner.

5. **If the levels of market risk change between examinations, is it always necessary to change the rating assigned to the “S” component?**

   The “S” component rating should reflect a combined assessment of both the level of market risk and the ability to manage market risk. Accordingly, changes in either quantitative or qualitative aspects of market risk exposure or management may require changes in the “S” component rating. While changes in the level of market risk between examinations may in some circumstances necessitate a change in the “S” component rating, this does not automatically imply a rating change will occur. For example, a credit union that accepts additional market risk between examinations but maintains risk management processes and earnings and capital levels commensurate with the level of risk may not experience an “S” component rating change.

6. **Does adding of the “S” component place new and burdensome requirements on credit unions or examiners?**

   The update to CAMELS provides additional insight and transparency into the examiner’s evaluation. Outside of learning the new “S” component and updated “L” component, credit unions of all sizes do not need to do anything differently to prepare for the transition to CAMELS. For example, credit unions with greater than $50 million in total assets must continue complying with the policy requirements of the IRR Rule (§ 741.3(b)(5)). Implementing the “S” component will not create a burden or significant disruption to credit unions, examiners, or the examination process.

7. **Will the update to the CAMELS rating system result in a change in a credit union’s composite rating?**

   The manner examiners use to assign a composite or component rating has not changed due to the revisions to the rating system. The composite rating is not a function of an arithmetical formula or rigid weighting of numerical component ratings. Elements of subjectivity and examiner judgment, especially in qualitative assessments, remain essential in assigning ratings.

   The revised rating system generally should not change the composite rating assigned to a particular credit union simply because of the addition of the “S” component. Examiners’ consideration of the level of interest rate risk when evaluating a credit union’s capital,

earnings, and liquidity is a routine and long-standing practice. The quality of a credit union's risk management practices remains a consideration by examiners when assessing a credit union's condition and assigning ratings, particularly in the Management component.

8. **When assigning a component rating, how much consideration should be given to risk management practices versus the level of exposure?**

   The CAMELS rating system assesses a credit union's overall condition based on both quantitative and qualitative elements. Quantitative data such as financial performance measures remain an integral part of that measurement. Qualitative elements, such as the adequacy of the board and senior management oversight, policies, risk management practices, and management information systems, are also central to evaluating the credit union's overall condition.

   The relative importance of qualitative considerations for each component depends on the credit union's particular circumstances. Risk management systems should be appropriate for the nature and level of risks the credit union assumes. Unacceptable risk levels or an unsatisfactory financial condition, however, will often outweigh other factors and result in an unfavorable component rating.

9. **Agency guidelines require examiners to discuss with senior management and, when appropriate, with 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 commonly considered factors under that component. Only those factors believed relevant to fully support the rating being assigned by the examiner must be addressed in the report and discussions with senior management.

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

    Each component is interrelated with other components. For example, a credit union's level of problem assets 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 can also affect several components. Examiners consider relevant factors and their interrelationship among components when assigning ratings.

    Market risk is evaluated primarily under the new "S" component and is only one of several evaluation factors used to assess the earnings 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 a careful analysis of this factor's effect in relation to the other factors considered under these components.

11. **To what extent should market risk be carved out of the earnings or 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?**

    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 credit union's particular situation.