SUPERVISORY LETTER

NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF EXAMINATION AND INSURANCE
1775 DUKE STREET, ALEXANDRIA, VA 22314

DATE: **November 2009** **Supervisory Letter No.: 09-03**

TO: **All Field Staff**

SUBJECT: **Reviewing Adequacy of Earnings**

The determination of an adequate earnings level continues to be a complex facet of credit union supervision.

As emphasized in previous guidance, including Supervisory Letter 06-01 (August 2006), *Evaluating Earnings*, examiners must evaluate each credit union's earnings level relative to net worth needs, financial and operational risk exposures, the current economic climate, and the institution's strategic plans. Because there is no simple metric for determining what an individual credit union's earnings level should be, NCUA staff must continue to utilize a balanced approach in assessing earnings. This letter serves to re-emphasize the importance of the evaluation of earnings in relation to the overall credit unions' risk profile.

If you have any questions on this issue, please direct them to your immediate supervisor or regional management.

Sincerely,

/s/

Melinda A. Love,
Director, Office of Examination and Insurance

Supervisory Letter

Reviewing Adequacy of Earnings

The current economic environment has created pressure on credit unions' ability to generate consistent, positive earnings. The trends for all federally insured credit unions for earnings (ROA)[1] and net worth ratio (NWR)[2] have materially fluctuated as noted:

	Initially Reported 2008	Adjusted 2008	June 2009
ROA	0.31%	-0.03%	0.28%
NWR	10.93%	10.62%	10.03%

Recent events highlight the need for examiners to look beyond the ratios and review the actual income and expense structure of the operations to assess the adequacy of earnings. Following the submission of the December 31, 2008 call reports, credit unions reported an aggregate ROA of 0.31% and net worth of 10.93%. After the NCUA Board approved and publicized the corporate stabilization efforts and the associated premium charges, many credit unions restated their call report for December 31, 2008, accounting for the expenditure in different ways. The impact of the restatements was to reduce the reported ROA for December by 34 basis points and reduce net worth by 31 basis points. The impact on income and inconsistency in reporting continues into 2009. These material changes and the fact the earnings impact spans several reporting periods will make the evaluation and trending of earnings more challenging.

This letter emphasizes previous guidance to examiners regarding the review of earnings adequacy. It also stresses the importance of communication with credit union officials and management regarding earnings deficiencies.

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[1] The standard measurement for earnings for credit unions is the Return on Average Assets Ratio (ROA). ROA is annualized net income divided by average assets for the period and includes the NCUSIF Stabilization Expense and NCUSIF Stabilization Recovery Pass-Back Income.

[2] The standard measurement for net worth levels for credit unions is the Net Worth Ratio (NWR). NWR is calculated by dividing net worth by total assets. Mathematically, the NWR is affected by both changes in net worth (numerator), which are caused by net income (loss) levels, and by asset growth (denominator), which is predominantly driven by share growth.

Examiner Assessment of Earnings

An examiner's review of earnings must consider the risk profile, operational structure, and strategic plans of the credit union. When assessing management's ability to manage earnings, examiners should consider the:

- Adequacy of net worth given the risk profile of the credit union;
- Quality and sources of the earnings structure;
- Fit with the overall strategies of the credit union;
- Future direction of earnings performance and adequacy of budget process;
- Adequacy of the Allowance for Loan and Lease Losses; and
- Ability of the credit union to realize an adequate level of earnings in a safe and sound manner.

The fact that a credit union's net income level is relatively high or low is not by itself evidence there is a problem. Rather, it is merely a trigger for a thorough review of the credit union's earnings structure to determine the underlying factors driving the performance. Letter to Federal Credit Unions 06-FCU-04 (August 2006), *Evaluation of Earnings*, provides examples of red flags which should trigger a more in-depth review of a credit union's earnings performance.

Lower ROA levels may be indicative of a sound and well-executed strategy to balance risk exposure. The credit union may have incurred costs that position the credit union to achieve longer-term growth and member service objectives consistent with their strategic plan. While there can be sound reasons for lower earnings, there also are unsound reasons. A credit union may have made strategic decisions that will adversely affect earnings and net worth over the long-term. This could include an unsound level of fixed assets that the earnings structure cannot support. It also could include a fundamental shift in the balance sheet resulting in depressed net interest margin insufficient to cover the cost of core operations.

Higher ROA levels could be the result of successfully executed strategic plans. Conversely, it is also possible for a credit union to record strong profitability levels in the short-term by assuming an unacceptable degree of credit or interest rate risk, which could negatively impact future earnings. Whatever the case may be, simply rating earnings on the level of ROA without a full evaluation is not adequate.

Effect of Corporate Stabilization Efforts

In 2009, the NCUA Board approved a series of actions designed to stabilize and support the corporate credit union system. These actions ultimately resulted in a premium assessment in 2009 for all federally insured credit unions. The timing and amount of future premiums is unknown and will be based on a number of factors. Examiners must consider the effect of these actions when evaluating a credit union's earnings.

The evaluation of earnings focuses on many factors as noted above, and exception to the amount of earnings resulting solely from these NCUA Board actions should not be taken. A credit union's earnings structure should generate sufficient earnings to maintain or grow net worth to a level commensurate with the credit union's risk profile. Examiners should address a credit union's inability to maintain sufficient earnings and net worth relative to their risk profile, after considering these premiums. When properly addressed, any earnings issues should be due to an overall weakness in the credit union's earnings capabilities rather than with any NCUA Board actions.

CAMEL Rating System

The principles of the Risk-Focused Exam program set forth in Letter to Federal Credit Unions 02-FCU-09 will continue to apply when evaluating earnings adequacy, including the impact of NCUA Board actions. The CAMEL ratings reflect the risk related to the appropriate categories rather than a benchmark contained in a matrix.[3] As a reminder, the purpose of the CAMEL ratings is an internal NCUA rating system to evaluate the safety and soundness of credit unions based on the degree of risk to the share insurance fund and for identifying those credit unions that require additional supervision. Reliance solely on benchmarks without adequate risk management processes could lead credit unions to make unsafe and unsound business decisions.

Examiners must assign the CAMEL ratings based on the impact material risk(s) pose to the credit union's financial position and their risk management practices, including established strategic plans. The seven risk indicator ratings in the risk-focused examination are a forward-looking assessment and should correlate to the CAMEL ratings. The impact from items such as the corporate stabilization actions are a separate consideration from the actual risk profile of the credit union and should not result in an automatic adjustment in CAMEL ratings. Each credit union's earnings and net worth level should be evaluated based on the credit union's unique risk characteristics, as well as taking into consideration the overall economic trends. Examiners should continue to document CAMEL ratings and any material adjustments based on risk within the Scope Workbook.

Conclusion

Examiners must rely on their professional judgment in assessing earnings adequacy, considering all the quantitative and qualitative factors available that affect the credit union's financial condition.

It is essential that examiners continue to promote an open dialogue between the agency and credit union representatives regarding credit union earnings and strategic direction. A healthy dialogue will help credit unions fine-tune and execute their strategies effectively. It also enables NCUA to balance the mandate to protect the share insurance fund while supporting credit unions in fulfilling their mission, to provide financial services for provident and productive purposes to all members.

[3] CAMEL Rating System modified in 2007, eliminating the CAMEL matrix. NCUA Letter to Credit Unions 07-CU-12, December 2007, *CAMEL Rating System.*

References

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8. Supervisory Letter 05-01, August 2005, *Evaluating Capital Adequacy*

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   - Chapter 3 – Total Analysis Process
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