SUPERVISORY LETTER

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

DATE: **August 2006** **Supervisory Letter No.: 06-01**

TO: **All Field Staff**

SUBJECT: **Evaluating Earnings**

The determination of an adequate earnings level is a complex facet of credit union supervision. Lower earnings are being observed nation-wide. This trend is the result of rising interest rates, a flat yield curve, and some credit unions incurring costs to position themselves strategically. There is no simple metric for determining what a credit union's retained earnings level should be. However, as emphasized in NCUA Letter to Credit Unions 03-CU-04 (March 2003), *CAMEL Rating System*, CAMEL ratings are not automatically determined by matrix ratios. Striving for an arbitrary one percent Return on Average Assets just to achieve a CAMEL 1 rating based on the CAMEL matrix is not an acceptable argument, especially in the current economy, for a well capitalized credit union. Each credit union's earnings level must be evaluated relative to net worth needs, financial and operational risk exposures, the current economic climate, and the institution's strategic plans.

Net worth goals involve both immediate considerations, as well as strategic ones related to future risks and expansion plans. The officials have to balance the immediate return of earnings to the members in various forms (e.g., dividends, lower loan rates, etc.) with the retention of earnings to fund future member benefits. Thus, NCUA must take a balanced approach to assessing earnings. We must be careful not to inadvertently undermine a credit union's ability to achieve long-term success with an unduly conservative or short-term focused approach to supervision. An overly simplistic focus on one measure of earnings performance could drive unsafe and unsound behavior. In fact, attempting to bolster earnings in the current environment is very likely to involve strategies that necessitate excessive risk-taking.

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

Sincerely,

/s/

David M. Marquis,
Director, Office of Examination and Insurance

Supervisory Letter

Evaluating Earnings in Credit Unions

Credit Unions are Not-For-Profit

Credit unions are not-for-profit cooperative financial institutions. Groups of people sharing a common bond form credit unions to pool their resources to provide access to affordable financial services designed to meet their needs. As a cooperative not-for-profit organization, a credit union’s mission is to provide financial services to their members, not to earn a profit for stockholders. Any economic value generated by the credit union that is undistributed (i.e., not used to absorb costs or provide an immediate return to the members) is held on behalf of and owned by the members.

Though not-for-profit, credit unions must generate revenue for two primary reasons: (1) to cover the costs of providing members with financial services, and (2) to maintain a safe and sound level of net worth. Net worth is necessary to provide protection against unexpected future costs and a foundation for member service growth and initiatives, as well as to meet regulatory capital standards. In order to build and maintain appropriate net worth levels, credit unions must retain earnings (i.e., have a net income sometimes referred to as a “profit”).[1]

NCUA’s mission statement is “*to foster the safety and soundness of federally insured credit unions and better enable the credit union community to extend financial services for provident and productive purposes to all who seek such service while recognizing and encouraging credit unions’ historical emphasis on extension of financial services to those of modest means…”* This mission statement highlights a balance that both NCUA and credit unions must strive to maintain: balancing safety and soundness with the mission of extending financial services. Perhaps the most notable way this challenge manifests itself is in determining the “right” level of net worth.

[1] Other financial institutions have the ability to utilize forms of equity other than retained earnings. Except for low-income designated credit unions authorized to employ secondary capital instruments, credit unions manage net worth levels exclusively via retained earnings. The standard measurement for net income for credit unions is the Return on Average Assets ratio (ROA).

Net worth is essential to credit unions. Not only does it protect against uncertainties, but also provides a foundation for the long-term viability of the credit union, ensuring continued credit union service for current and subsequent generations of members. When net worth is too low, an institution is exposed to a high risk of failure. On the other hand, when net worth is too high members may not be receiving all the benefits and services that could be safely provided and/or the credit union may not be taking advantage of opportunities to position itself to expand member benefits in the future. Despite a natural tendency to err on the side of conservatism, NCUA's supervisory oversight must support credit unions' efforts to balance net worth needs with providing value and achieving longer-term strategic goals.[2]

Earnings Assessment Framework

As the purpose of retaining earnings for credit unions is to build or maintain net worth, the analysis of earnings is fundamentally linked with the net worth needs of the credit union. This is reflected in NCUA's CAMEL rating system (Letter 03-CU-04, CAMEL Rating System) which lists the net worth level and sufficiency of earnings for necessary capital formation as key factors to consider when assessing earnings. In fact, earnings needs in credit unions are a function of the net worth ratio goal, which in turn is affected by asset growth levels.[3] Thus, retained earnings goals set independently, as if net income is an aspect of a credit union's financial performance that has merit in and of itself, run the risk of being incompatible with other organizational goals.

Further, there is distinct time dimension to any analysis of earnings. This is due to the following:

- Net worth goals involve both immediate considerations, as well as strategic ones related to future risks and growth and member service expansion plans. The officials have to balance the immediate return of earnings to the members in various forms (e.g., dividends, lower loan rates, etc.) with the retention of earnings to fund future member benefits.

> *"Examiners evaluate "core" earnings: that is the long-run earnings ability of a credit union discounting fluctuations in income and one-time items."* – Letter 03-CU-04, CAMEL Rating System

- Variations over time in economic conditions affecting a credit union's cost structure and rates on loan and share products.

[2] The issue of capital adequacy is explored in more detail in Supervisory Letter 05-01, Examiner Guidance – Evaluating Capital Adequacy.
[3] The Net Worth Ratio (NWR), the standard measurement for net worth levels in credit unions, 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.

There is no simple metric for determining what an individual credit union's ROA level should be. A 1-percent ROA level has served as the "rule-of-thumb" for good performance for financial institutions for some time. The establishment of the CAMEL matrix in 1987 canonized for credit unions a 1-percent ROA by tying it to a CAMEL 1 component rating for Earnings.[4] However, as emphasized in NCUA Letter to Credit Unions 03-CU-04 (March 2003), CAMEL Rating System, CAMEL ratings are not automatically determined by matrix ratios. Each credit union's earnings level must be evaluated based on the credit union's unique needs, as well as overall economic trends affecting financial institutions.

> *"Fixation on a profitability target established in a vacuum (e.g. striving for a 1% ROA for the sake of meeting this rule-of-thumb) often leads to poor decision-making with negative long-term consequences for the institution."* - Supervisory Letter 05-01, Evaluating Capital Adequacy

For example, consider contemporary economic trends. In 2005, aggregate credit union ROA dropped to 85 basis points, the lowest level in at least 20 years. Interest rates have been rising steadily since mid-2004, with the Federal Reserve raising interest rates for the 17th consecutive time. As a result, the net interest margin declined to 3.24 percent, its lowest level in at least 20 years. The low net interest margin, and thus reduced ROA, is a direct result of both a rising rate environment and a flat yield curve.[5] Credit unions partially offset the pressure on earnings with increased fee and other income, with this source of income playing an increasingly larger role.

Ratio (% Average Assets)	As of 2000	As of 2005	Effect on ROA
Net Interest Margin	3.77%	3.24%	- 53bp
+ Fee & Other Income	0.94%	1.22%	+ 28bp
- Operating Expenses	3.39%	3.24%	+ 15bp
- PLLL	0.32%	0.40%	- 8bp
+ Non-Operating Income	0.01%	0.03%	+ 2bp
= ROA	1.01%	0.85%	- 16bp

However, credit unions' aggregate net worth ratio is at record levels and actually increased 30 basis points to 11.24 percent. Despite a decline in ROA, net worth growth of 7.59 percent outpaced the modest asset growth of 4.90 percent. Consistent with the purpose of net worth, credit unions are well positioned with ample net worth levels to accept lower ROA levels during the current economic climate that has resulted in reduced net interest margins. Consider that, on average, the modest asset growth levels credit unions have experienced over the last 10 years require an ROA of only 55 basis points to maintain net worth levels at their current strong level.[6]

[4] The 1% ROA rule-of-thumb has been tenacious, still serving under the current CAMEL guidance as the benchmark for a CAMEL 1, despite the CAMEL rating system having undergone several revisions since its adoption in 1987 for credit unions.
[5] Given the maturity and repricing differences between assets and liabilities, financial institutions experience reduced earnings when short-term rates rise or when the difference between short-term rates and long-term rates declines.
[6] Over the last 10 years, which includes the extraordinary growth levels experienced in 2001 and 2002 due to the weak stock market performance and post-9/11 flight to safety, the median and mean levels of annual asset growth for credit unions have been 4.53% and 5.33% respectively. Mathematically, a credit union with an 11% net worth ratio and asset growth of 5% only needs an ROA of 55 basis points to maintain the net worth ratio.

Thus, credit unions need not engage in reactive or extraordinary measures simply because earnings levels decline as a result of broader economic conditions when net worth levels meet or exceed their needs. In fact, such measures likely involve significant risks, either in terms of accepting greater risks to generate higher returns, and/or in terms of short-sighted trade-offs (e.g., increasing fees, selling “less profitable” business lines, engaging in high risk lending) affecting the longer-term strategic positioning of the credit union.

Examiner Assessment of Earnings

> *“No analysis of profitability is complete without considering the quality of earnings by gaining a thorough understanding of the strategies employed by management to achieve the level of profitability. For example, it is 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.”* – Supervisory Letter 05-01, Evaluating Capital Adequacy

Examiners do not evaluate earnings globally with peer ratios or CAMEL benchmarks; earnings are evaluated on a case-by-case basis unique to each credit union’s circumstances.[7] An examiner’s review of earnings is in relation to each credit union’s risk profile, operational context, and strategic plans.

The ROA level is not the primary focus of an examiner’s assessment of earnings. Historical earnings levels are somewhat relevant to assessing management’s record in managing earnings. However, it is quite possible for a credit union to have impressive profitability ratios by assuming an unacceptable degree of risk. Thus, examiners assess management’s capability in managing the risk versus reward trade-off, evaluating earnings by considering the:

- Quality of the earnings structure.
- Fit with the overall strategies of the credit union.
- Future direction of earnings performance.
- Ability of the credit union to realize an adequate level of earnings in a safe and sound manner.

Lower ROA levels will be viewed positively if they are the result of a sound and well-executed strategy to balance risk exposure or incur costs to position the credit union to achieve longer-term growth and member service objectives. In addition, examiners recognize that the purpose for credit unions retaining earnings is maintaining appropriate, but not excessive, net worth levels relative to the risk profile of the credit union. In fact, executing a sound plan to return excess capital to the membership or utilize capital to achieve longer-term strategic objectives can contribute greatly to the long-term success of the credit union. Examiners also positively incorporate such strategies into their evaluation of earnings and capital.

[7] Certainly there is value in NCUA and the credit union community reviewing performance ratios on a global basis to understand trends in the industry; however, this does not mean all credit unions should be operating at the same levels.

> *"Keystone Bank appeared to be the nation's most profitable community bank for the three years prior to and including the year it failed. The loss to the insurance fund is estimated at $750 million. The American Banker reported that in 1995, BestBank was "the best performer among U.S. banks." The bank failed in 1998 with a projected loss of $223 million to the insurance fund."* – FDIC Symposium *Why Do Banks Fail*?

Earnings Red Flags

Examiners need to evaluate the level of earnings in relation to the credit union's risk profile and the current economic environment. Below are examples of red flags that trigger a more in-depth review of a credit union's earnings performance. Note that inordinately high earnings levels can be just as much a sign of a problem as low earnings levels.

Inordinately high net income could indicate:

- ☑ Taking on additional risk in the investment or loan portfolio.
- ☑ Not providing competitive dividend or loan rates.
- ☑ Not providing adequate services for the membership.
- ☑ Not planning for new services or infrastructure to support the credit union in the future.
- ☑ Undue reliance on fee income to support operations.
- ☑ Management or board goals for high net income levels given ties (implicit or explicit) to bonuses, salaries, or performance evaluations.
- ☑ Management believes their examiner will not tolerate or accept lower earnings and/or net worth, even with a solid plan.

Inordinately low net income could indicate:

- ☑ Inefficient operations resulting in high or out of control expenses to the detriment of the membership. Examiners will continue to address high operating expenses as a problem area if they do not involve an intentional increase in the credit union's investment in infrastructure (technology, new services, increased training, etc.) as part of a documented, sound strategic plan.
- ☑ Exorbitant compensation systems misaligned with member benefits and the mission of the credit union.
- ☑ Inadequate pre-planning for new services.
- ☑ High level of non-earning assets not aligned with the strategic needs of the credit union.
- ☑ Economic disruption impacting the field of membership.
- ☑ Unsafe dividend levels attracting volatile share growth.
- ☑ High loan losses due to poor credit quality loans.

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 examiners to thoroughly review the credit union's earnings structure to determine the underlying factors that result in the performance. Examiners assess these factors in relation to the credit union's overall condition, consistency with the mission of the credit union, and congruence with the credit union's strategic plans and budgets.

"The CAMEL rating is not automatically determined by matrix ratios alone. The matrix ratios for the capital, asset quality, and <u>earnings</u> components provide minimal guidance for the examiner's final assessment of the individual component rating…When evaluating the CAMEL components, examiners will consider both the quantitative and qualitative considerations outlined in the Enclosure before a final rating is determined." - Letter 03-CU-04, CAMEL Rating System

Conclusion

Earnings is one of the five component ratings, contributing to the overall composite rating, examiners assign under the CAMEL rating system.[8] Further, the quality of the credit union's earnings structure and underlying strategies is one of the key considerations in assignment of risk ratings in the seven areas of risk under the risk-focused examination program.[9] The determination of the CAMEL composite and component ratings, as well as the risk ratings in the seven areas of risk, is a judgmental process and necessitates the examiner take into account all of the subjective and objective variables that affect a credit union's financial and operational condition, as well as their interrelationships. The key interrelationship examiners take into consideration for the Earnings CAMEL component rating is the net worth needs of the credit union.

It is incumbent on credit unions to proactively develop and document sound strategic plans. These plans need to articulate the balance the officials of the credit union are seeking in terms of net worth levels and the actions affecting earnings to achieve the mission of the credit union in both the short and long-term. In the absence of documented and sound plans, attempting to justify poor earnings performance after the fact is considered not only a weakness in the Earnings component of CAMEL, but the Management component and relevant risk ratings in the seven areas of risk as well.

Given their not-for-profit nature, an analysis of Earnings in credit unions is admittedly challenging. It requires factoring in the role earnings plays in credit unions fulfilling their mission of providing *financial services for provident and productive purposes to all who seek such service.* The elected officials seek to balance the return of current earnings to the members with retaining earnings to provide an adequate "safety net" and a base for better, lower-cost, and expanded services in the future. These, along with a variety of other factors such as the contemporary decisions affecting the direction of the risk in a credit union's balance sheet, require examiners to exercise a high degree of professional judgment when evaluating earnings.

Thus, it is essential credit union management and examiners have an open and ongoing dialogue on the strategic direction of the credit union in relation to earnings. Credit union officials and examiners should welcome any sincere debates that occur on the efficacy of a credit union's plans. A healthy dialogue will help ensure credit unions are able to fine-tune and execute their strategies effectively as well as enable NCUA to balance our mandates of protecting the share insurance fund with supporting credit unions in fulfilling their mission.

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[8] **C**apital Adequacy, **A**sset Quality, **M**anagement, **E**arnings, and **L**iquidity Management.
[9] The seven areas of risk are credit, interest rate, liquidity, transaction, compliance, strategic, and reputation.

References

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www.ncua.gov/letters/2003/03-CU-04.pdf

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

3. NCUA *Examiner's Guide*:
   - Chapter 1 – Risk-Focused Program
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4. FDIC *Risk Management Manual of Examination Policies*, Chapter 5.1 – Earnings
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5. OCC *Comptroller's Handbook*, Analytical Review of Income and Expense (Section 401)
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