CAMELS

McQueen Financial Advisors

Starting in March 2022, the NCUA will add an 'S' in CAMELS for sensitivity to market risk and redefine the 'L' component for liquidity.

"Subject to a More Rigorous Exam"

The New 'S' in CAMELS?

In October 2021, the NCUA board unanimously voted to add an 'S' for 'market sensitivity' as part of their exam rating system. This brings the agency in line with guidance already in place at approximately half of the state regulators. The rule will take effect on April 1, 2022. Previously, NCUA's CAMEL rating system included:

- (C)apital Adequacy
- (A)sset Quality
- (M)anagement
- (E)arnings and
- (L)iquidity and Asset Management

The new rating system includes two important parts:

1. The new 'S' component relates to Sensitivity to Market Risk. As credit unions have become larger and more complex, the NCUA is seeking to evaluate liquidity risk separately from market risk. The Sensitivity to Market Risk ratings will be based on 1) sensitivity of a credit union's earnings and economic value to changes in interest rates. 2) management's ability to identify, measure, monitor, and control exposure to market risk, and 3) the nature and complexity of interest rate risk exposures
2. The existing 'L' component will be modified, and include only liquidity evaluation. The evaluation will include a review of the credit union's liquidity profile, liquidity sources, funding needs, and the adequacy of liquidity management activities in relation to size & complexity.

Is McQueen's ALM Model Ready for the New 'S' Component?

Yes! You won't see any change in your reports because we have been reporting using CAMELS-compliant methods for many years. Several pages are dedicated to income and value sensitivity over a very wide range of interest rate scenarios. Our reports are fully compliant with regulatory guidance and examiner expectations.

What Does the Change Mean?

For many of our clients, the change will be minimal. State-chartered credit unions will see little if any change in their exam focus. Federally chartered credit unions will now be subject to a more rigorous exam related to the expanded liquidity component and new sensitivity component.

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Measurement Tools:

In our daily consulting work, clients share the results of their exams and the many challenges that they face. Often, credit unions with little change year-over-year are asked to expand their risk & liquidity measurement tools. The new CAMELS rule won't go into effect until April 1, 2022, so none of our clients have been subject to an exam yet. However, we already know from years of field experience that when examiners have more to look at, they generally find something. We offer a variety of products to address any potential need. Examiners may inquire about your use of multiple tools that are all part of the regulatory guidance:

"They Generally Find Something"

- Asset Liability Management/Interest Rate Risk Reporting Frequency: The NCUA uses the term ALM and IRR interchangeably. We run these reports for most clients every quarter. Less frequent reporting may result in examiner emphasis, simply because balance sheets and interest rates change regularly. Quarterly reporting is appropriate in order to understand your risk profile as it changes over time.

- Core Deposit Studies: The anticipated term and repricing sensitivity of core deposits are two of the most important model assumptions. A core deposit study measures these two factors using a look-back period of several years. The results are incorporated into future model runs. Many of our clients use generic term assumptions of 36 or 48 months because we have not yet performed this study for the specific institution. These assumptions are important model inputs because these cheap funding sources provide considerable value. If the assumed term is too short or long, value sensitivity test results will be skewed. If the repricing sensitivity assumptions are too wide or narrow, income simulations will be inaccurate. The new 'S' CAMELS component specifically relates to sensitivity, so we would expect an increased need for core deposit studies. Depending on size and complexity, these studies are generally performed every 2 to 3 years.

- Loan Prepay Speed Analysis: Loan prepay speeds are directly related to the interest rate environment. When rates rise or fall, the incentive to refinance changes. Loan prepay speed analysis is a client-specific study that measures borrower behavior. The results are then incorporated into future model runs. In the absence of a prepay speed study, we use generic prepay speeds. Generic speeds are generally acceptable for smaller and less complex credit unions. Examiners may inquire about prepay speed analysis, which is performed annually.

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"Talk To Us About Your Risk Profile"

- Assumption Sensitivity Analysis: Some degree of uncertainty is inherent in interest rate risk modeling. The goal of assumption sensitivity analysis is to understand the importance of ALM model assumptions and how the credit union's risk profile may change if future market conditions differ from what was assumed in the standard ALM report. This report is a 'what-if' re-run of the ALM model using different and less favorable assumptions. Examiners have requested this type of analysis with increased frequency. The need may grow because model assumptions have a direct impact on sensitivity to rising and falling rates.

- ALM Back Testing: Using a one-year look-back period, the objective of this analysis is to determine if the net interest income projections in the ALM report are reasonable. We compare projections from a prior report to actual results, then determine the reason for any variance. The analysis considers both volume and interest rate changes. The report is a useful management tool that provides a cross-check of ALM inputs and assumptions. Results may lead us to fine-tune model assumptions. The need for this service will certainly grow because it is important to understand how model inputs impact test results and to maintain appropriate model inputs.

- Liquidity Stress Testing: The new CAMELS rating system modifies the 'L' component which will now include only a liquidity evaluation. Even before the CAMELS rating change, examiners were concerned that some credit unions have too-few liquid assets or that volatile COVID-related stimulus funds would quickly run off. Regulatory guidance emphasizes the importance of cash flow projections, diversified funding sources, a cushion of short-term assets, and liquidity stress testing. All of this may result in heightened examiner focus. The need for liquidity stress testing is likely to grow.

Action Items:

The need for these services is somewhat dependent on your size and complexity. We have plenty of field experience and deep knowledge of regulatory guidance and examiner expectations. Even before your next exam, schedule time to talk with us about your risk profile and if the tools you currently use are sufficient.