Department of Financial Institutions

Memo

To: North Dakota State Chartered Credit Unions

From: The ND DFI

Date: 12/14/2011

Re: Rating the Earnings Component

A declining trend in the net worth ratio has developed at several of credit unions in the state. Several factors have impacted the decline in earnings including robust deposit growth and/or weak earnings. The trend can largely be attributed to the Fed's monetary policy, strength in the oil and agricultural sectors, and share insurance assessments. While these are external factors, they are certainly problematic for credit union management as all are weighing heavily on earnings and the net worth ratio.

The declining trend in the Net Worth Ratio outlines the need and importance for strong earnings. Because it is difficult for credit unions to raise capital from outside sources, the only real way for credit union management to balance robust growth or insurance assessments is through earnings. Increasing earnings is certainly challenging in this environment and we would encourage credit union board's and management to carefully and thoughtfully review all sources of income and expense to improve profitability without taking on excessive credit or interest rate risk, as both could have a negative long term affect on earnings. This assessment should include a review of dividend rates and expense structures to ensure maximized profitability to balance the asset growth and earnings. These efforts should be well documented in the credit union's strategic plan and annual budgeting process. Further we would encourage the board of directors to review the budget by comparing it to actual earnings on at least a quarterly basis.

We would also like to clarify how examiners evaluate the risk and assign a CAMEL rating to the earnings component during an examination. As you review this information it should be clear to you that the earnings component will impact the capital component, the asset quality component, the liquidity component and of course the management component. The Department is providing the following excerpt from the Department's Examination Procedures Manual which is used as a framework for rating the earnings component. If you have any questions, please feel free to contact Chief Examiner Corey Krebs.

Earnings

Earnings are evaluated through an assessment of the following:

- The level of earnings, trends, stability, and future earnings prospects

- Quality and composition of earnings
- The credit union's capital position and trends as it relates to statutory requirements and overall risk profile
- Adequacy of the Allowance for Loan Loss account methodology, funding, and its impact on earnings
- Material factors affecting the credit union's income producing ability (Non earnings assets, overhead costs, PLL expenses, OREOs, etc.)

Rating the Earnings Factor (taken from the Uniform Financial Institutions Rating System)

After an evaluation of the credit union's earnings, the examiner will assign this CAMEL component a risk rating. The following is an explanation of the characteristics that define each rating:

Earnings rated 1 are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity and trend of earnings. Generally, credit unions rated 1 will have earnings well above peer group averages.

Earnings rated 2 would be satisfactory and sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.

Earnings rated 3 may need to improve. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. Institutions so rated may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.

A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital

Other Resources

In addition to the information presented here, the examiner may want to review other guides as well to get a better understanding of earnings and the risk rating process. The following are some recommended sources:

- NCUA's examiner's Guide
- FDIC's Risk Management Manual of Examination Policies
- http://www.federalreserve.gov/boarddocs/press/general/1996/19961224/