Managing Concentration Risk

A Community Bank Perspective

Concentration management is on the regulatory radar screen. An organized program can help you focus attention on where the risk resides and how it is trending.

BY JEREMY TAYLOR

It is by now well appreciated that banks don't fail because they miss a loan here or there. The real danger is correlated credit exposure.

No matter how tight the underwriting guidelines, how close the ongoing credit monitoring, or how vigilant the loan review, if credit conditions deteriorate across an industry, property type, or geography, banks with high concentrations in loans to such borrowers will inevitably suffer. Debt-servicing capacities will erode—not randomly, but systematically—as will collateral values. And those friendly, cooperative borrowers will soon forget where they put your phone number.

This, then, is the essence of portfolio risk—and of why concentrations matter. Economic capital models back this up. Models

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populated from detailed loan-loss databases and constructed on the differentiation between expected and unexpected loss find that a typical commercial bank's capital-at-risk is dominated, to the tune of 60-70%, by credit risk capital. The rest is roughly evenly split between market risk (interest rate risk and liquidity risk) and operational risk (systems, reputation, and strategic risks, plus everything else).

Credit capital-at-risk is overwhelmed by correlation effects. Assuming that credit underwriting and administration is performed with appropriate controls and discipline, loan-level risk can be handled effectively. But if too much of it is with the same type of borrower in the same group of industries or counties, those concentrations can weaken collateral values, guarantors' enthusiasm, and more.

Many borrowers and industries exhibit broad sensitivity to swings in the macroeconomy. Higher-beta industries such as construction, capital goods, autos, and luxury items are, of course, highly sensitive. For such borrowers, a dip in the economy can translate into a considerably more pronounced dip in revenues and earnings. To the extent a bank has a concentration in loans to such an industry, it becomes more worrisome.

Community banks are almost by definition less diversified than their larger brethren. The geographic dimension overlaid on any industry can be dangerous and challenging. Whatever ails businesses and households in one part of the local market may well ail others.

Because geographic concentration is a fact of life for a community bank, it tends not to get as much attention as commercial real estate (CRE) and other sources of concentration risk. But it should, and we'll consider here some more proactive measures that can be taken to address it, beyond the more passive (though certainly important) monitoring and reporting activities.

In directing our comments more to a community bank, we are sensitive to the various constraints facing such an institution in regard to budget, data, MIS, in-house expertise, board and management familiarity, market access, and other considerations. But the basic approach and principles below have broad applicability across financial institutions.

The Relevant Regulatory Guidance

In addition to the guidance provided in the *Commercial Bank Examination Manual,* we have drawn on two publications specific to the issue at hand.

The better known of the two is the December 2006 *Interagency Guidance on Commercial Real Estate Lending* (FIL 104-2006), which was motivated by concerns at the time over the dangers of CRE concentrations. It identified CRE exposure thresholds (as a percentage of capital) beyond which banks were expected to enhance their risk management practices. The guidance statement

discussed those practices, which have been incorporated into what follows.

The other publication is arguably the more useful of the two, in part because it is not confined to CRE exposure. The OCC's *Comptroller's Handbook: Concentrations of Credit* was issued in December 2011 and provides a more organized and systematic approach to the subject.

Not Just Credit Risk

The discussion below focuses on the credit dimensions of concentration risk. In fact, it's even narrower than that: the loan side only. We should certainly recognize that the investment portfolio, to the extent that it goes beyond Treasury and agency securities, brings in similar sources of concentration concern but also diversification opportunities to offset loan portfolio imbalances.

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The OCC handbook recognizes that concentrations have other risk dimensions beyond credit. It points out liquidity risk that may arise from a pool of loans having similar funding demands, potentially straining an institution's liquid resources when circumstances result in elevated funding needs for those correlated borrowers. We should also recognize that community banks often display some degree of large-depositor concentration, together with overdependence on a limited number of backup (contingent) liquidity sources.[1]

The handbook also points out the interest-rate-risk implications of loans (or securities) having similar patterns in terms of maturity or re-pricing characteristics. To the extent that an industry or other concentration segment might have typically longer-term funding needs, making loans to such borrowers would exacerbate any underlying liability or sensitivity in the bank's balance sheet.

To this list could be added operational risk, which may manifest itself in pressure points on a bank's servicing or administrative resources should the pool of loans in question pose operational demands that are common across the pool but less so for other loan segments. We could also posit reputation risk (from external perceptions of difficulties in managing a loan concentration), though this is perhaps better viewed as a second-order risk flowing from credit or any of the other risk sources suggested here.

The key point is not to ignore other dimensions of concentration risk. Correlated default and loss behavior may be the dominant source of risk to a financial institution, but it doesn't end there.

The Components of a Concentration-Management Program

The regulatory statements indicated above don't provide a road map in the same way that, for example, FIL 52-2003[2] does for a compliance program. Nevertheless, these documents do help identify key components. As regards FIL 104-2006 and the CRE-specific aspects, attached to this article is a template outlining the various pieces we look for in assessing compliance with that particular guidance.

The remainder of this article walks through what we consider the necessary components of a concentration-management program. The subject is important enough for institutions with CRE or other portfolio concentrations to warrant an organized presentation (for example, a hard-copy binder with separate tabs for each section discussed below to share with regulators, directors, or other interested parties).

1. Concentration-Management Policy: This will be a section of the general loan policy manual. Any policy document should be subject to annual board review and approval, but especially one as pivotal as this. The policy should address the following topics:

- Definitions.
- Sources of concentration risk by loan (and security) type.
- Sources of concentration risk by type of risk (including noncredit).
- Roles and responsibilities (board and management).
- Concentration limits (see point 2 below).
- Other tools for managing concentration risk (as addressed further in point 3).
- Reporting (see point 4).
- Exception approval.

2. Concentration Limits: As emphasized in all the relevant regulatory statements, a matrix of limits and sub-limits—expressed as a percentage of capital—is an essential component of a concentration-management program (and of the accompanying policy document). As lending strategy, risk appetite, or other key considerations change, so should limits. They should address all of the material sources of concentration risk identified in the policy, whether by loan type, industry, or geography.

Don't overlook single-name risk. How many times have we heard, "We would have been fine if it hadn't been for those couple of big loans that got into trouble"? Don't take legal lending limits as gospel; for many banks, they may be too high. Nor should the 100/300% thresholds contained in the 2006 CRE guidance be taken blindly as hard-and-fast limits. They are intended to be triggers for more robust risk management, but CRE limits for a bank don't have to tie to them and should be supported by more detailed sub-limits, assuming there's a material amount of CRE exposure overall.

Limits need teeth that come from monitoring, reporting, and appropriate follow-up action as required. Make sure your board (or DLC) minutes show substantive discussion of this topic, especially where limits may be exceeded or approached.

3. Concentration-Management Strategy: It is incumbent on the board to adopt strategies for managing concentrations that are consistent with the concentration-management policy and with other strategy statements already in place—for example, for lending, investing, and funding. The strategy must recognize that concentrations pose risks beyond pure credit risk, such as interest rate, funding, and the operational risks discussed above. It should also recognize that concentrations will typically arise from a specialized lending strategy that offers enhanced profitability (higher margins, higher growth) in addition to the associated concentration risk.

Setting appropriate limits is certainly part of strategy, but so are tools for more active portfolio management, particularly for addressing situations of limit pressure. Strategic options may include the following:

- **Origination strategy:** This is the obvious starting point. The formulation of lending strategy can and should take account of the existing portfolio's composition and risk profile and how the bank would like to modify them over time. If concentrations are deemed excessive in any particular area, the board and management can take steps in concert with other actions to discourage new lending in those areas (for example, through changes in pricing guidelines and underwriting requirements) and to promote it elsewhere.
- **Loan participations and purchases/sales:** These can be valuable tools, but are not without risks of their own. Selling or out-participating loans is a way to capitalize on a competitive advantage (for example, a specialized lending strategy) developed in a certain area or industry—or with a large individual relationship—without having to hold all the resultant credit exposure on the balance sheet. Origination and servicing fees can be earned, and funding and capital can be freed up to go out and do more.

  Likewise, loan purchases or in-participations can be a means for diversifying a portfolio. While they are tools for managing concentration risk, they do, as mentioned, pose other kinds of risk. Possibilities include reputational risk (such as reliance on another institution's underwriting, monitoring, and reporting; or broader exposure in the event of problems arising with a loan you've originated) and marketing/strategic risk (for example, if competitors get a foot in the door with a good client of yours and try to build on that). All of this is in addition to the obvious credit-related risks associated with new lending in a place where the bank doesn't already have a presence. It's the flip side of the specialization argument. Diversifying into new geographies and industries provides diversification benefits, but that doesn't mean the bank will be good at it.

  A strategy presentation needs to go beyond identification of options. In this case, it should be supported by an assessment of secondary market appetite (for sales, out-participations) that would obviously include past (preferably recent past) activity of that type. There should be discussion of the types of loans being originated for potential sale, including their underwriting and structural characteristics and how all of this plays to market appetite. Similarly, if loans or positions are being acquired, your bank must be comfortable with the seller of the loan and that bank's ability to meet your standards and expectations.
- **Credit derivatives:** While not something community banks are likely to engage in, it's appropriate, for completeness, to include credit derivatives as a tool for managing exposure—one that (like sales and participations) allows for the potent combination of specialization (in marketing, underwriting, administering, monitoring) with portfolio diversification (using derivatives to hedge the buildup in credit exposure). Derivatives now have a somewhat toxic reputation, which isn't likely to change in the short term. But a credit default swap is a straightforward and useful instrument, and with passage of time (and memories) a broader and more accessible market could conceivably emerge.
- **The investment portfolio:** As noted earlier, the credit risk assumed in a bank's lending activities can be balanced to some extent by its investment decisions. We should start by recognizing that typical security holdings, especially for a community bank, are dominated by Treasury and agency issues. These reflect much broader national and global influences than the localized industry and real estate exposure that generally shows in the loan portfolio. Going beyond that to private-label mortgage-backed securities, municipals, corporates, and so on, the opportunity to pick complementary (that is, nonlocal) credit exposure becomes even more important. Again, it's critical to acknowledge the noncredit aspects of concentration risk and to look at both securities and

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loans from a broader perspective that takes account of the full range of risks.

Finally, the articulation of concentration-management strategy must also emphasize the need for appropriate monitoring and reporting of the risks represented by those parts of the portfolio. This is addressed in the next three points.

4. Concentration Reporting: Where exposure has accumulated in a given property type, industry, geography, or other segment, it's important for the bank to monitor performance of that segment via regular, informative, and consistent reporting: at least quarterly to the board and—for certain items—on a monthly basis to management. For community banks, this typically will center on CRE concentrations, although the OCC's *Concentrations of Credit* handbook rightly emphasizes that this should not be the sole focus of a concentration-management program.

Regulatory guidance does not prescribe a menu of reports. The selection of reports will vary according to factors such as the size of the institution and the importance of its concentrations. In our view, reporting should reveal any 1) longer-term trends impacting individual concentration segments, 2) notable recent developments including changes in trends, and 3) peer comparisons, where available. The latter most obviously comes into play for variables reported by the FDIC in its Uniform Bank Performance Reporting peer group data. Reporting should also usefully include brief written comments, either an accompanying memo or text boxes right on the charts or tables to highlight important information. Trend information is generally better communicated by chart than by table (with the goal being a higher ratio of pictures to numbers).

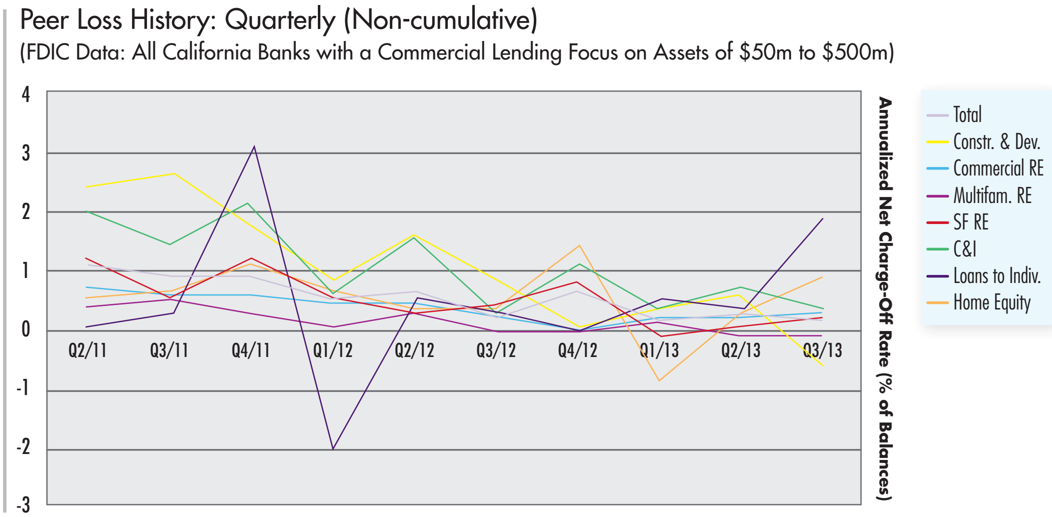
Another suggestion is that the specific selection of charts and tables be put together based on input and feedback from the intended audience of directors and management. The volume of information always involves a tricky trade-off between keeping them informed versus snowing them under. Even if a large selection of information is being presented, taking time to walk board members through it carefully the first time will make them more comfortable with it each time they see it.

Although concentrations are generally the key driver of a bank's risk profile, they're extremely difficult to quantify, even for large banks with a wealth of data and sophisticated MIS capabilities. The reality is that, as important as concentration reporting is, it's not going to provide a solid, quantified foundation for the selection of concentration segments beyond an aggregation of exposure as a percentage of capital. It won't get into correlation measures and other statistical analysis, but instead will be more subjective and qualitative in assessing the danger to the bank.

Still, there can certainly be an opportunity to communicate the extent to which a segment shows variability in its loss patterns (based on internal and/or external data), including how closely they move with changes in the macroeconomy. While losses are the most relevant variable to focus on, other data such as revenues or earnings can also shed light.

A chart that displays correlations over time (for example, the connection between an industry's loan losses and changes in GDP or employment) doesn't translate into concentration segments or limits. However, it can be helpful in communicating the critical concept of cyclical vulnerability: When the economy at large is struggling, which segments will be hit especially hard? The figure shown here can help. It was put together using the Statistics on Depository Institutions (SDI) utility on the FDIC site to cover a particular peer group: All California banks with a commercial lending focus and assets of $50m to $500m.

5. Stress Testing: Most bankers have long performed stress testing at the individual loan level as part of underwriting to assess a borrower's ability to withstand stresses—in particular, higher interest rates. What has changed recently is the rising expectation of portfolio-level stress testing, which is percolating down from the



larger institutions. The 2006 CRE guidance required it for the CRE portfolios of any institution that exceeded percentage-of-capital thresholds. Stress testing is quickly becoming a part of the concentration-risk-management toolbox. While not yet a formal requirement for all banks below $10 billion in assets, such a regulation may not be far off as the topic gets more and more attention (as in the FDIC's Summer 2012 *Supervisory Insights*).

Concentrations are a threat owing to the risk of correlated credit loss. Stress testing is intended to identify the trigger variables for losses and to assess the institution's vulnerability to possible downside scenarios for those key variables. Given the assumptions and nuances involved—as well as the resource requirements—setting up a stress test can be daunting, which is why many smaller institutions opt to outsource. Whatever the approach, the concentration-management program should address this need, and the results should be reported regularly to the board with a summary explanation of their implications.

6. Market Analyses: These can be viewed as another component of the regular reporting on a bank's concentrations, but they should not be thrown in their entirety at directors. Rather, they represent external sources of information to be collected regularly and drawn on for analysis and reporting. What is important, for governance purposes, is an appropriate range of sufficiently detailed and timely information to assist in this process. RMA's *eMentor*® service is a great source (for industry status and outlook), as are government publications and websites, consultant reports, and real estate brokers. If some type of binder is assembled, then only the most recent reports from these various sources need be inserted.

7. Other: Additional tabs for a binder with comprehensive program information could include 1) written procedures (the who/what/when/how) applying to the monthly and quarterly monitoring and reporting regimen, and 2) printouts of the two key regulatory statements as discussed earlier. A first tab could introduce the concentration-management program itself. This could briefly address the rationale for putting a formal program in place, including any pertinent history such as a past loss experience or regulatory order. It would explain the importance of the issue to justify the effort to document it.

Conclusion

It's no surprise that, after a period of extended and extensive credit losses across the banking industry, concentration management is on the regulatory radar screen. This is particularly so for community banks that face geographic concentration risk—and probably other risk varieties as well, given the limited size of their portfolios.

This being the case, there are advantages to setting up an organized program to manage the risk. Apart from getting a jump on regulatory mandates to come, it focuses directors' and management's attention on where the risk resides and how it is trending. Putting in place a well-structured and well-presented program for managing this risk will not make it go away or become less of a threat. But it will encourage understanding and discussion, including consideration of strategic options for reducing or mitigating the adverse effects that concentrations can have while—as much as possible—retaining the benefits.

After all, the flip side of concentration is specialization, and specialized lending can mean better understanding of borrowers' needs and risks and a more profitable lending strategy as long as the attendant concentrations are duly managed. ❖

APPENDIX
COMPLIANCE MATRIX FOR FIL 104-2006

ABC Bank's Compliance with FIL 104-2006 Interagency CRE Guidance Statement Requirements

	ABC's Current Practice	Major Gaps vs. Guidance Requirements
1. Board & Senior Management Oversight		
Annual review & approval of CRE strategy, limits, other policies		
Periodic review of compliance with strategies and policies		
Periodic review of interagency guidance ratios, FDICIA ratios		
Periodic review of market conditions, trends		
Periodic review of CRE portfolio risk mgmt.		
2. Portfolio Management		
Strategies for managing concentrations		
Periodic assessment of portfolio's marketability		
3. MIS		
Ability to stratify CRE portfolio along multiple dimensions		
Ability to aggregate exposure to individual client		
Overall MIS adequacy as CRE portfolio grows, changes		
Timely and accurate reporting of:		
Changes in the portfolio's risk profile		
Changes in portfolio concentrations		
Risk grade migration		
Ad hoc events		
4. Market Analysis		
Periodic reports and forecasts on market conditions		
Periodic reporting on market performance (key data items)		
5. Credit Underwriting		
Written CRE underwriting policy		
Project underwriting standards		
Sensitivity analysis/stress testing (at loan level)		
Valuations and appraisals		
Environmental risk assessments		
Construction loan administration		
Policy exceptions (monitoring, reporting)		
6. Portfolio Stress Testing		
Impact on DCR, LTV of:		
Changes in interest rates		
Changes in cap rates		
Changes in NOI		
7. Credit Review		
Independent credit review function		
Integrity of loan grade system		

Jeremy Taylor is CEO, Insight Risk Consulting, and president, AuditOne LLC. He can be reached at jeremy.taylor@auditonellc.com.

Notes

1. This was a focus of FIL 18-2010 on correspondent concentration risk. It expanded on the Regulation F limitations on credit exposure to correspondents by also recognizing exposure on the liability side; concentration risk can arise as well from undue reliance on too narrow a range of liquidity sources.
2. This FIL, entitled *Overview of the Compliance Examination*, shows as "inactive," although in fact it provides useful guidance, in particular for the direction it gives examiners in evaluating a compliance management system comprised of board and management oversight, as well as a compliance management program (CMP) and a compliance audit. The CMP in turn breaks down into policies and procedures, training, monitoring, and consumer complaint response.