MANAGING CONCENTRATION RISK

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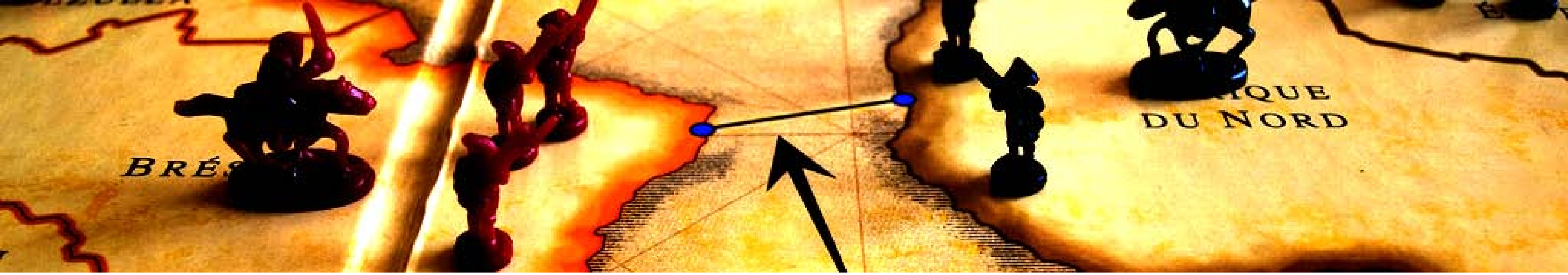
Photo by Aurelie et Herve



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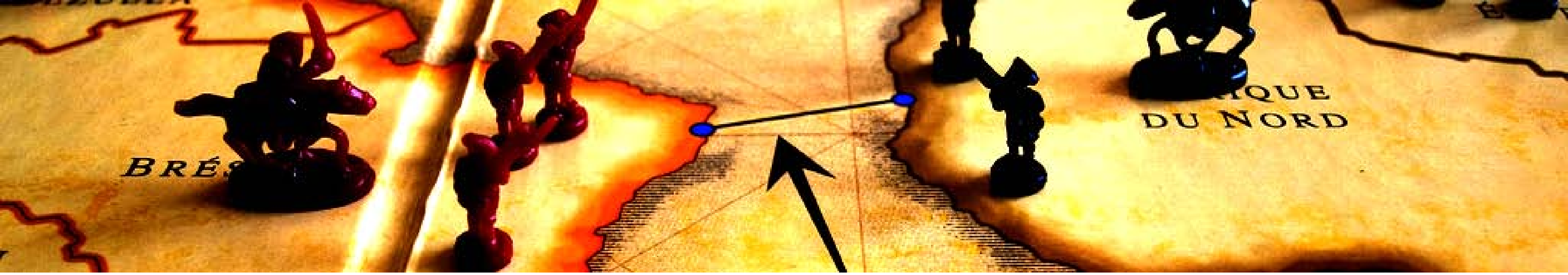
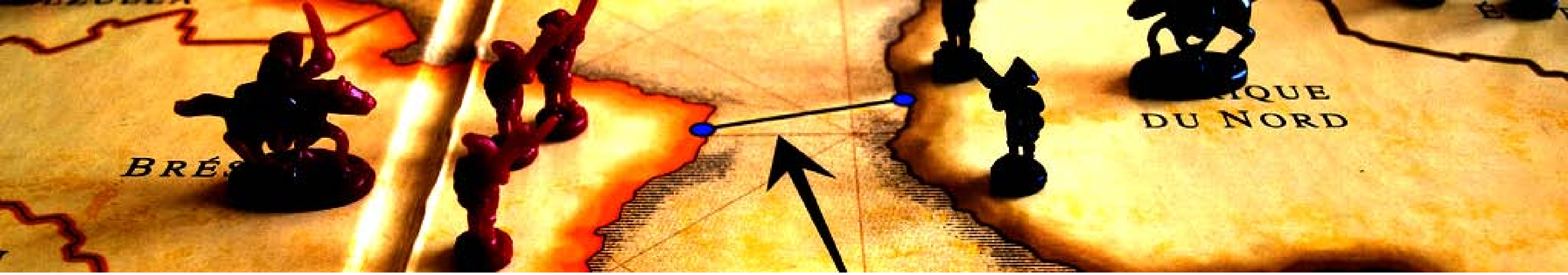


WHAT'S THE STORY BEHIND CONCENTRATION RISK?

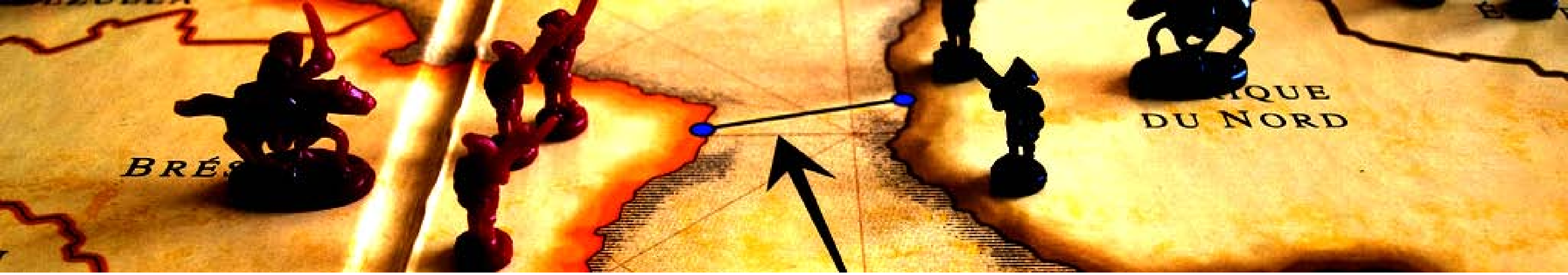
Correctly or not, concentration risk was one of the factors cited for bank and credit union failure after the crash of 2007.

Concentration risk is a villain.



THE NCUA RESPONSE

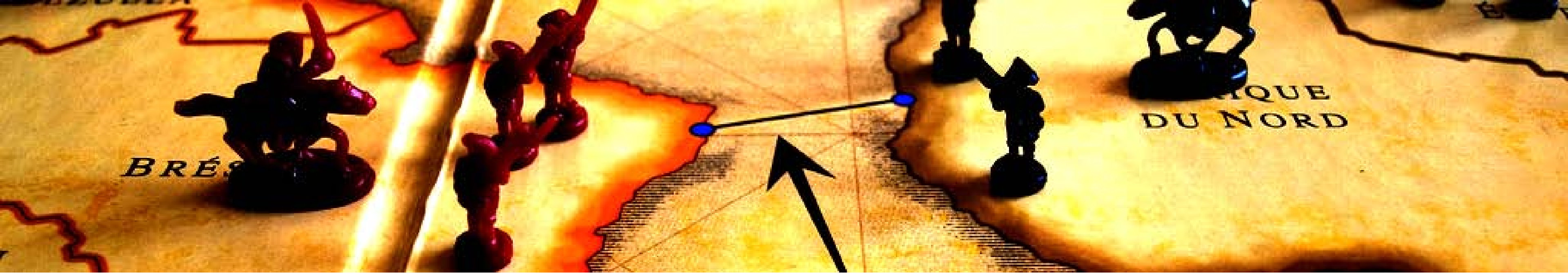
The NCUA issued letter 10-CU-03, a rather rambling document mandating that every credit union manage their risk concentrations.



WE CAN DEFINE CONCENTRATION RISK EASILY ENOUGH

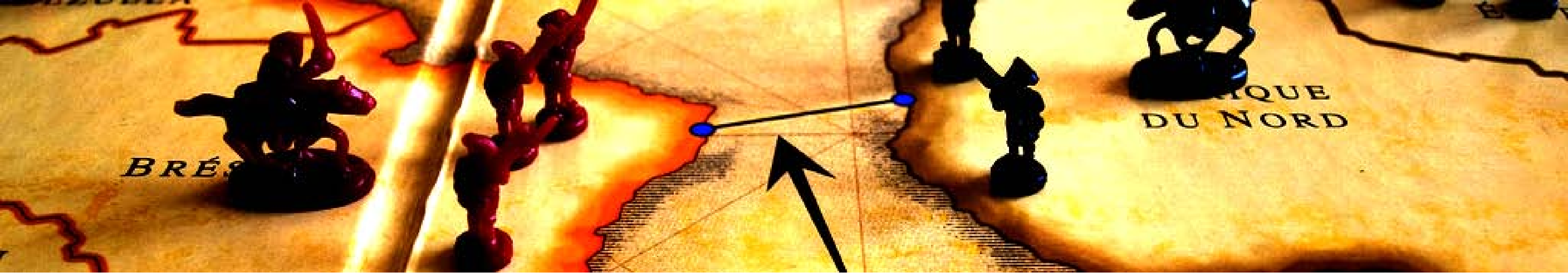
Don't have everything riding on a single product or service.

If something bad happens, the financial institution loses everything.



AN EXAMPLE

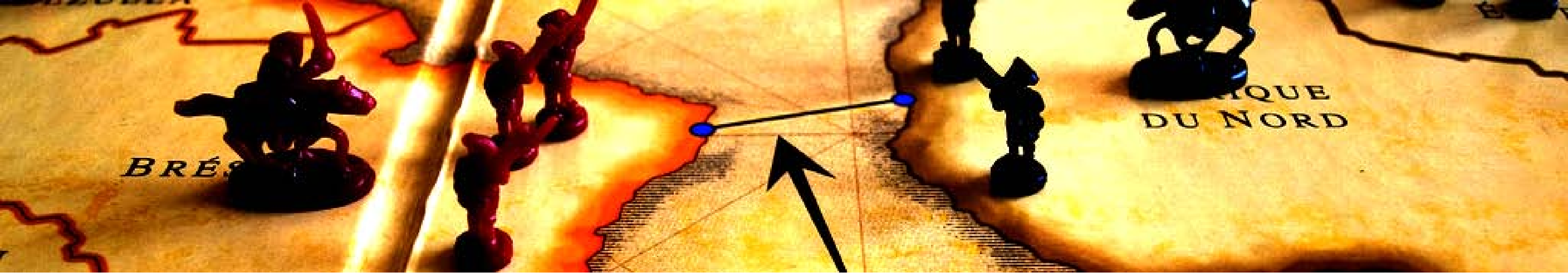
Washington Mutual Bank had significant concentrations in option arm loans to high risk borrowers. When the loans went bad, so did WaMu.



THE PROBLEM

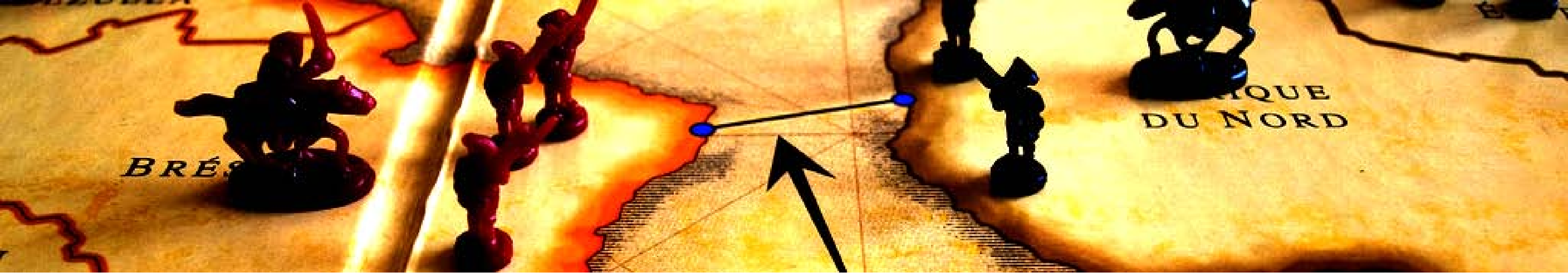
Concentration risk cannot be known, it can only be estimated.

How can you tell when a concentration poses a threat?



NOT ALL BAD

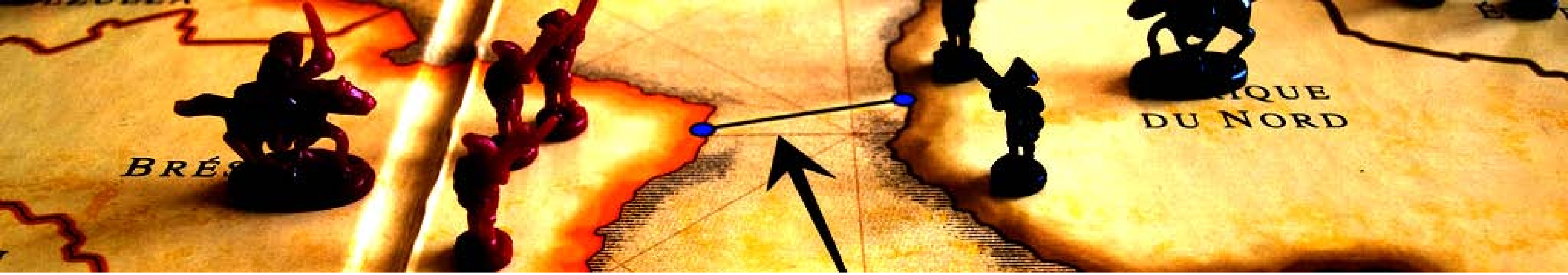
The NCUA does offer some guidance when it comes to managing concentration risk.



SEGMENTATION

You have to divide your portfolio into segments.

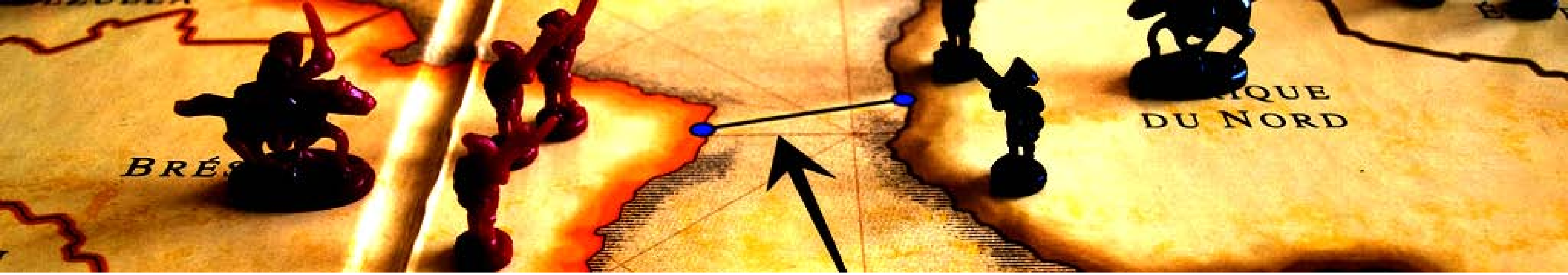
Three rules on segmentation.



SEGMENTATION RULE 1 – GROUP BY SIMILAR

Segments must be divided into loan categories that are subject to the same kind of economic shocks.

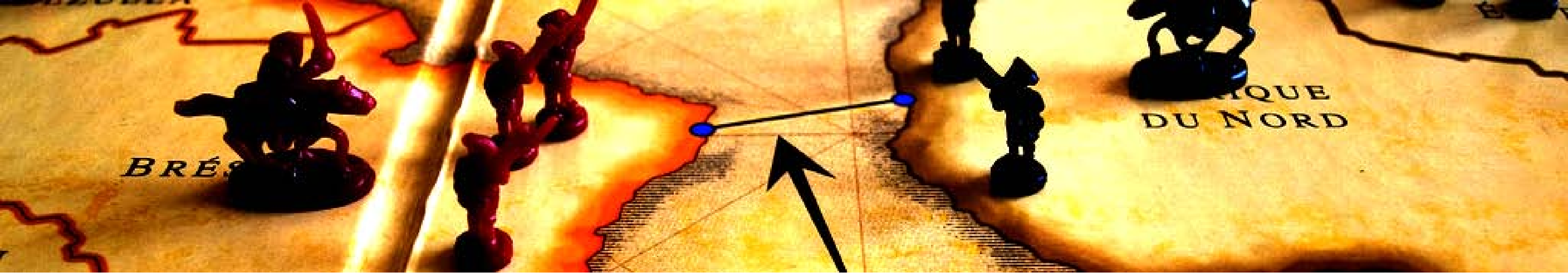
Photo by Paul Joseph



SEGMENTATION EXAMPLE

For example, you might group your first mortgages in one group, because these loans are affected by unemployment. You might divide your auto loans in another because these loans are affected by gas prices.

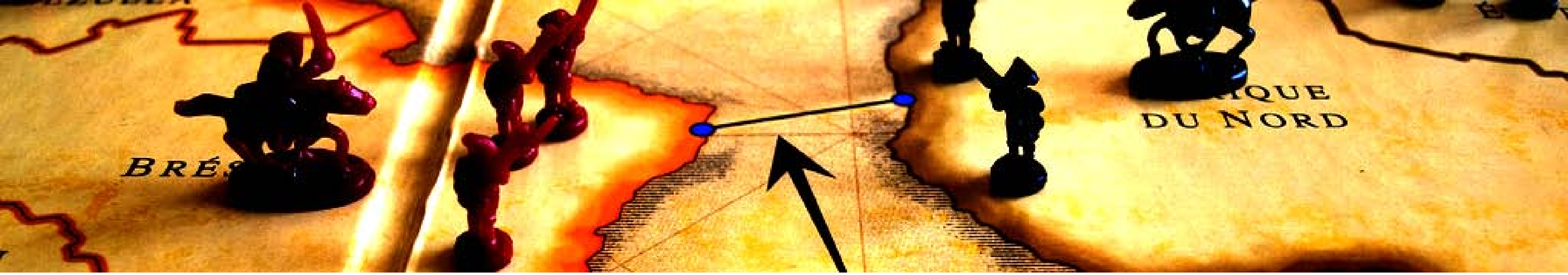
Good news: as long as you can establish reasonable justification for the segmentation, you are good to go!



SEGMENTATION RULE 2
DO NOT OVER-SEGMENT

You can't divide the portfolio up into so many segments that it appears to a trained examiner you are actually hiding concentrations.

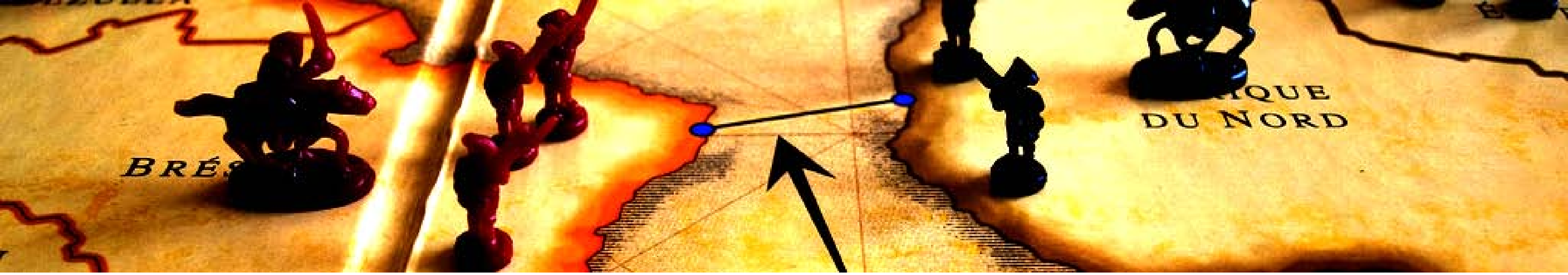
NO!



SEGMENTATION RULE 3
NAMED BORROWER AND
AGGREGATED COMMERICAL RELATIONSHIP

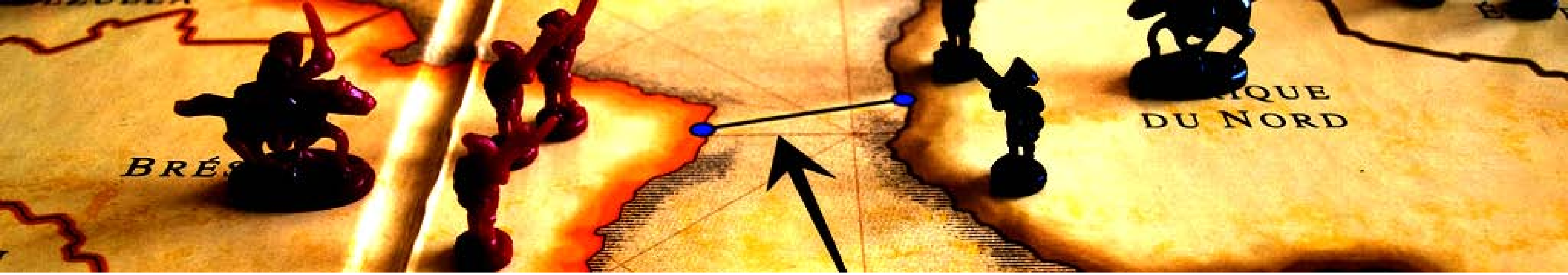
You also have to find in your portfolio named borrowers who have different types of loans in large value amounts.

If this single borrower defaulted on all their loans, would that wipe you out?



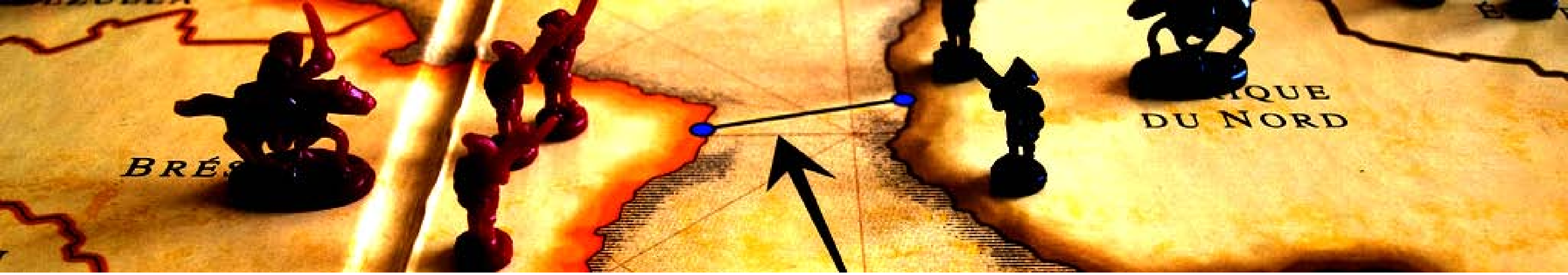
SEGMENTATION RULE 3
NAMED BORROWER

This is just a different way of having all your eggs in one basket.



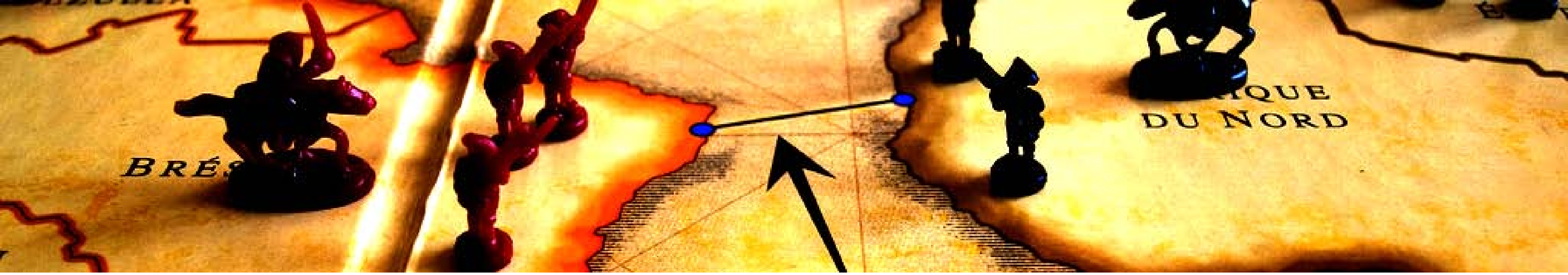
100% NET WORTH RULE

The next rule is any concentrations in your portfolio that exceed 100% of your net worth must be justified and monitored.



NET WORTH RULE – NAMED BORROWER

Named borrower is similar, but you want to monitor these at least when the concentrations reach 15% of net worth.

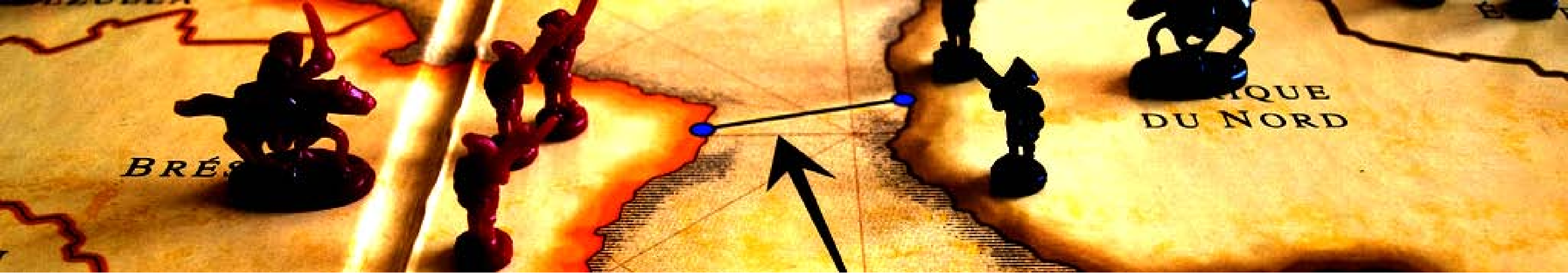


JUSTIFICATION RULE

There are many different ways to justify to an examiner a concentration over 100% of net worth.

Just avoid saying:

“We’re making a lot of money off of it!”



WAYS TO JUSTIFY CONCENTRATIONS

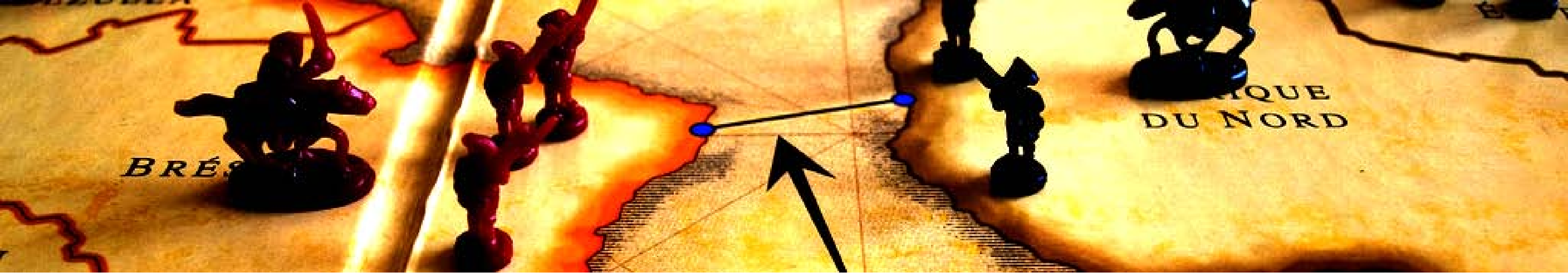
Charter

Low Delinquency Rate

Strong Underwriting

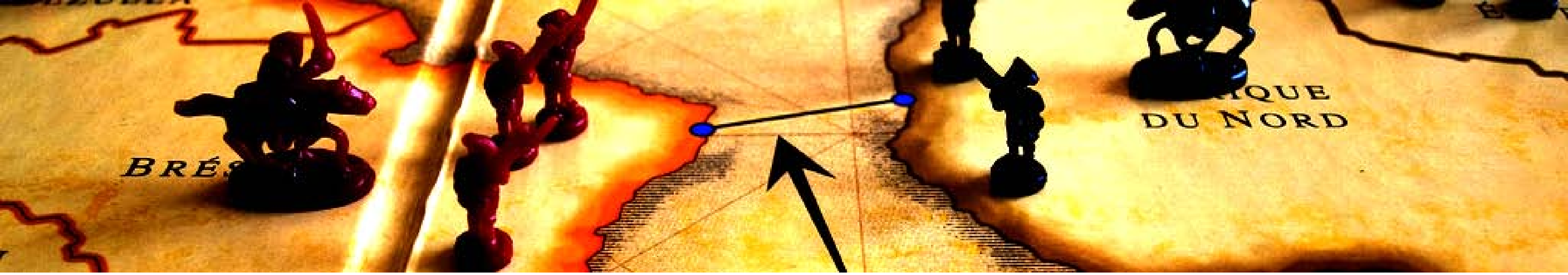
Lending History

Stress Testing



MONITORING

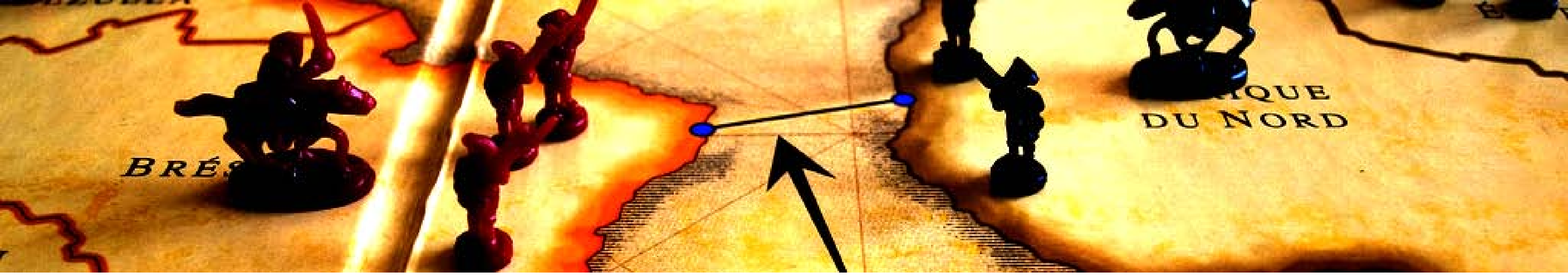
Monitoring large concentrations usually needs to be done no less than a quarterly basis.



TESTING CONCENTRATIONS

You also have to test the portfolio.

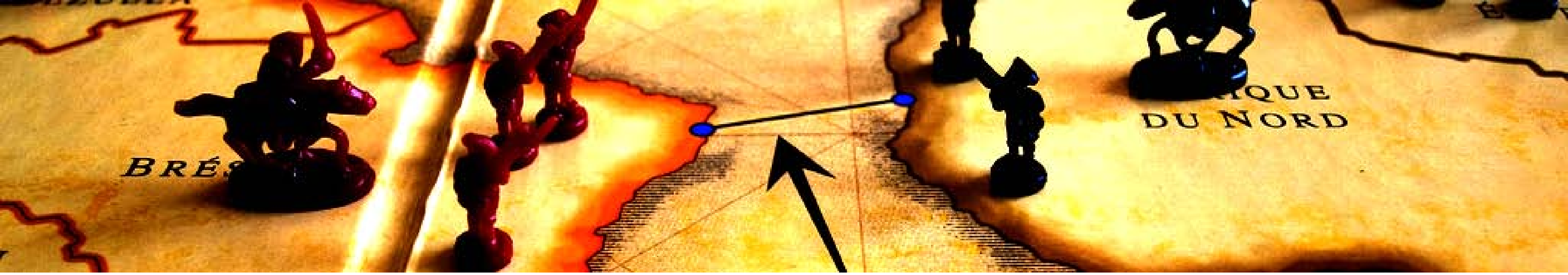
You have to develop reasonable scenarios regarding adverse economic conditions and see how the portfolio responds.



TESTING CONCENTRATIONS

The NCUA has said it will look closely at:

- Real Estate Loans
- Member Business Loans
- Loan Participations
- Construction and Development
- Investments in Mortgage-Related Securities

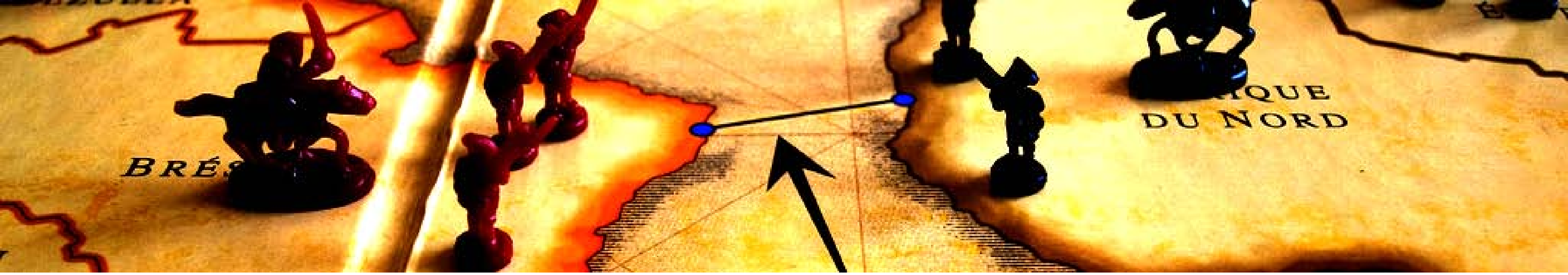


CAPITALIZATION RATIO

There are many ways to test the portfolio.

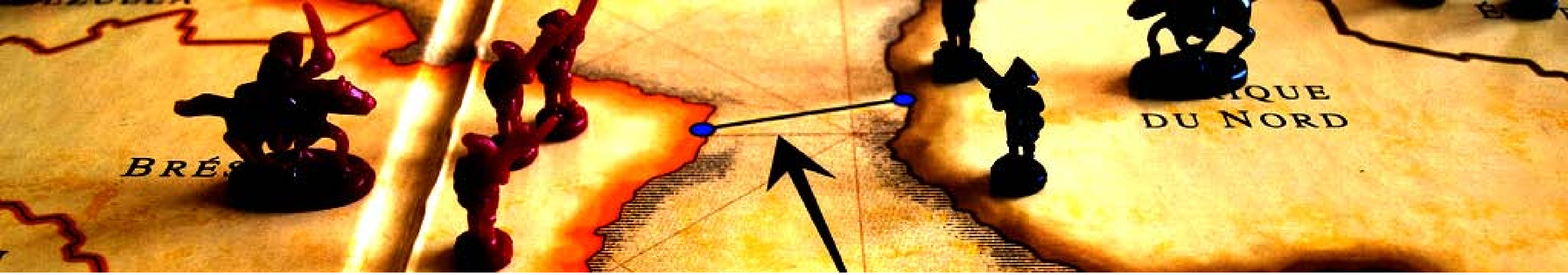
Our recommendation is to test the portfolio against the capitalization ratio of the credit union.

Two reasons.



CAPITALIZATION 1

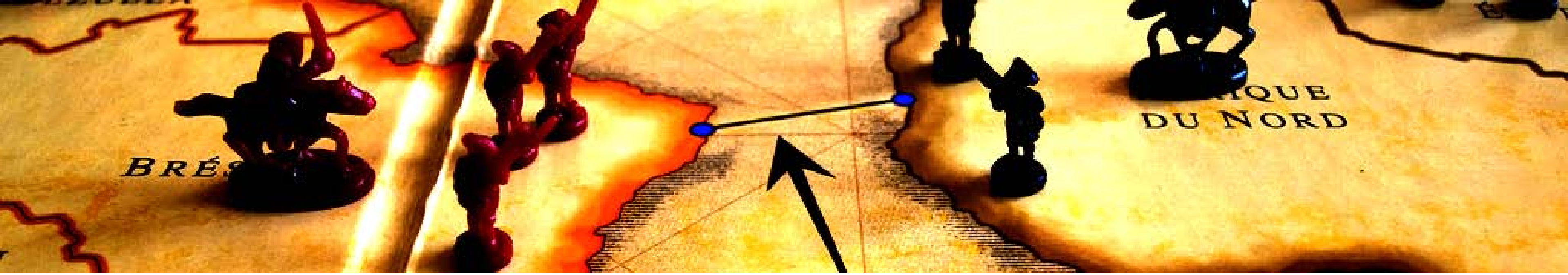
The NCUA's primary goal is to preserve the National Credit Union Share Insurance Fund ("Fund"). Concentration risk is considered a major danger to the Fund.



CAPITALIZATION 2

The capitalization ratio deeply informs the NCUA position as to the safety and soundness of the credit union.

Drop below 7% capitalization, and you can expect trouble.

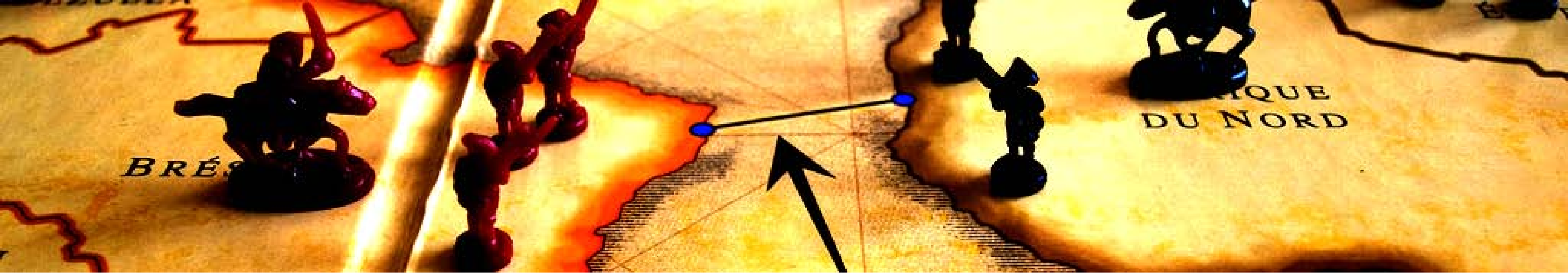


RISK LIMITS

The board of directors of each credit union is responsible for setting risk limits for each segment (for example, 125% of net worth).

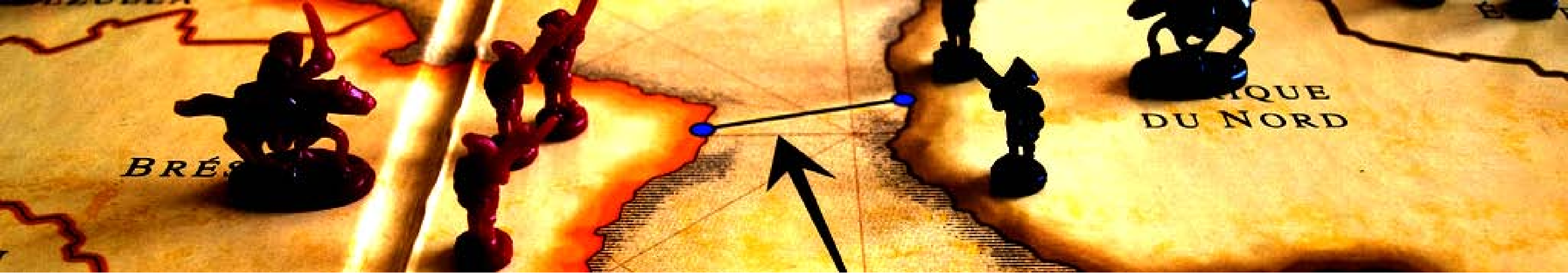
Risk limits are the maximum size the portfolio can reach before action must be taken.

Of course, there are rules for risk limits as well.



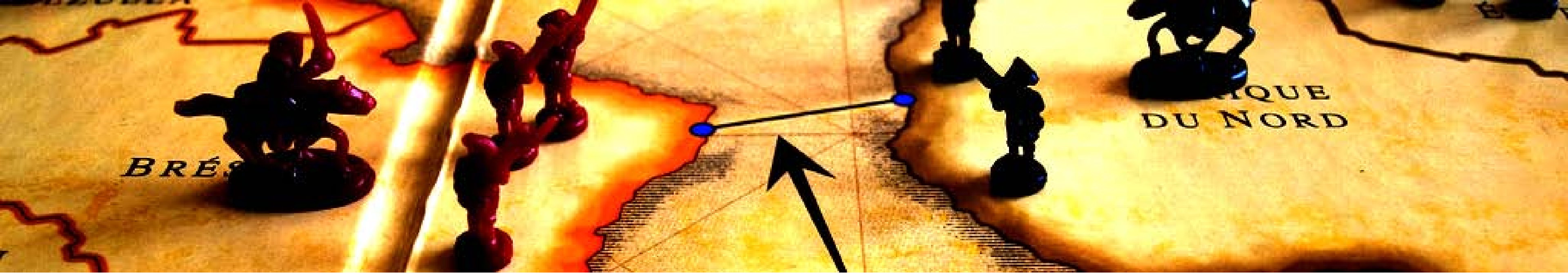
RISK LIMITS 1

The risk limits have to be reasonable; based on results of testing and not set so astronomically high that the limits can never be reached.



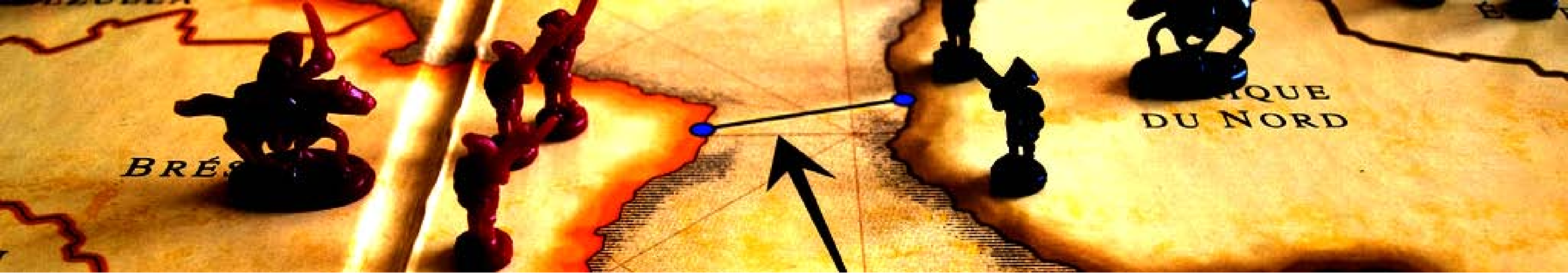
RISK LIMITS 2

Risk limits cannot be arbitrarily raised once reached; credit unions must document good reasons for upping the risk limits.



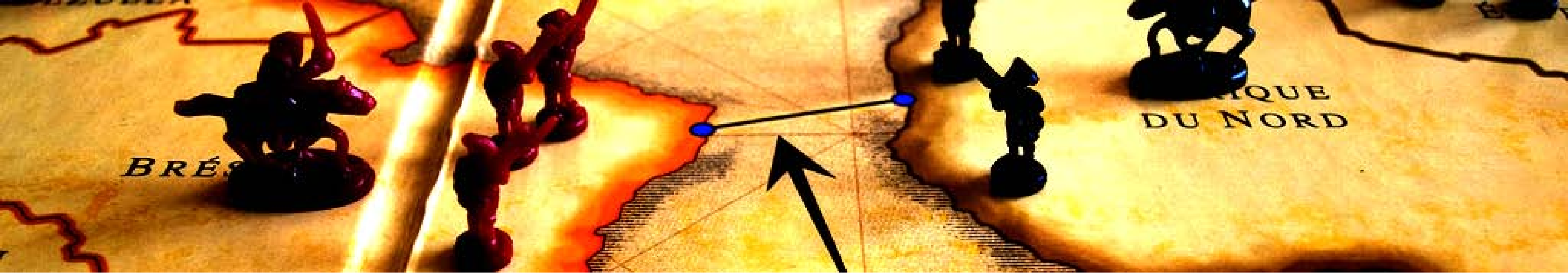
RISK LIMITS 3

Reaching risk limits means the credit union must regularly monitor and test, and determine whether to remain invested in the product line or service.



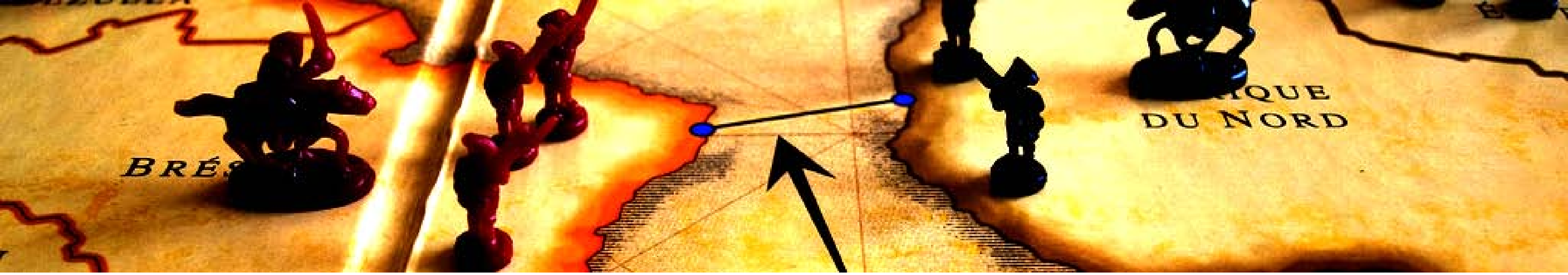
POLICY

You'll want to have a policy on concentration risk. The policy can be stand along or integrated into other risk policies such as ALM.



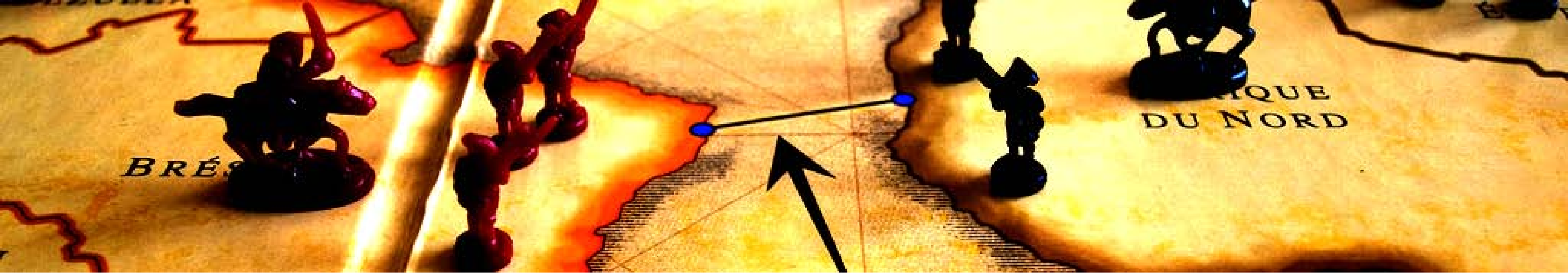
CONCENTRATION RISK AND THE RISK PROFILE OF THE CREDIT UNION

Concentration risk decisions shouldn't be made in a vacuum; they should be part of ALM, credit risk decisions, and be generally integrated into the risk decisions of the credit union.



CU*BASE

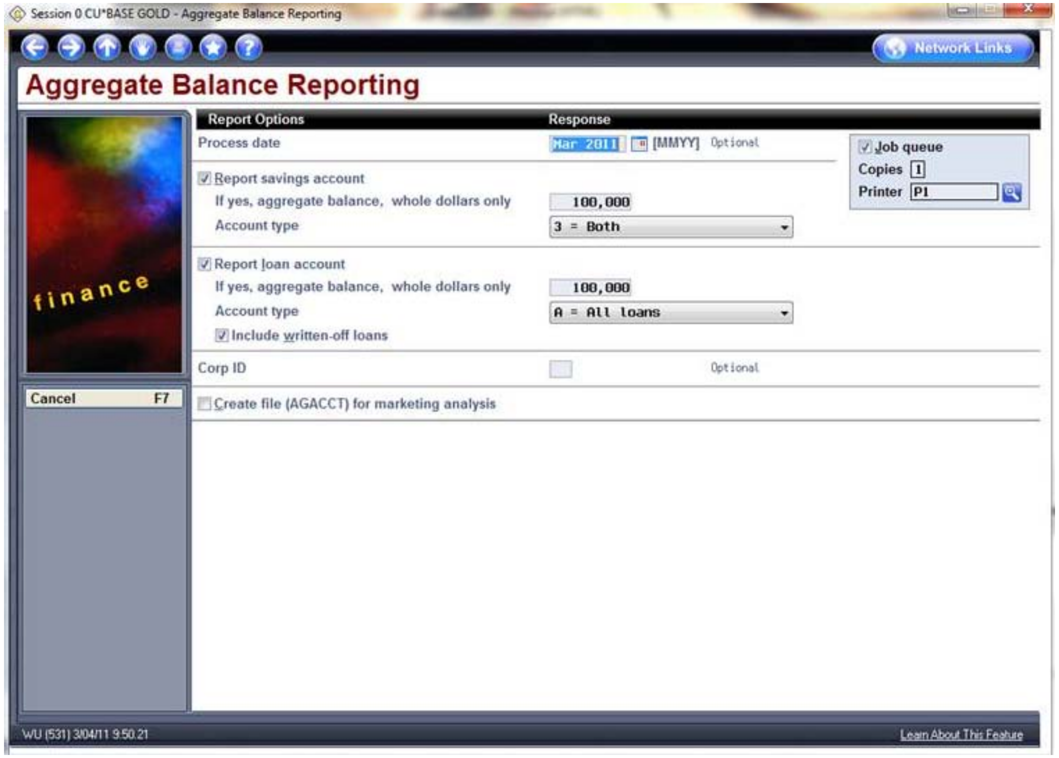
Fortunately, CU*BASE offers all of the data you need to begin managing your own concentration risk.

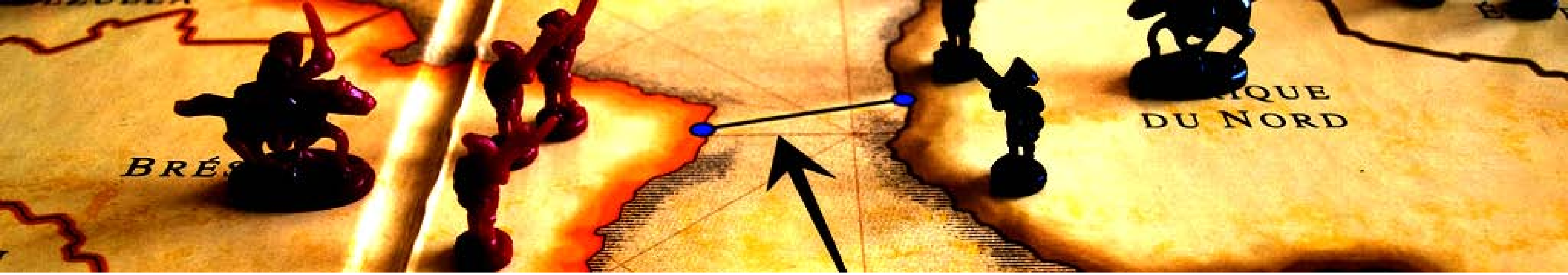


CU*BASE - SEGMENTATION

CU*BASE can help you identify segments in your portfolio.

MNRPTE

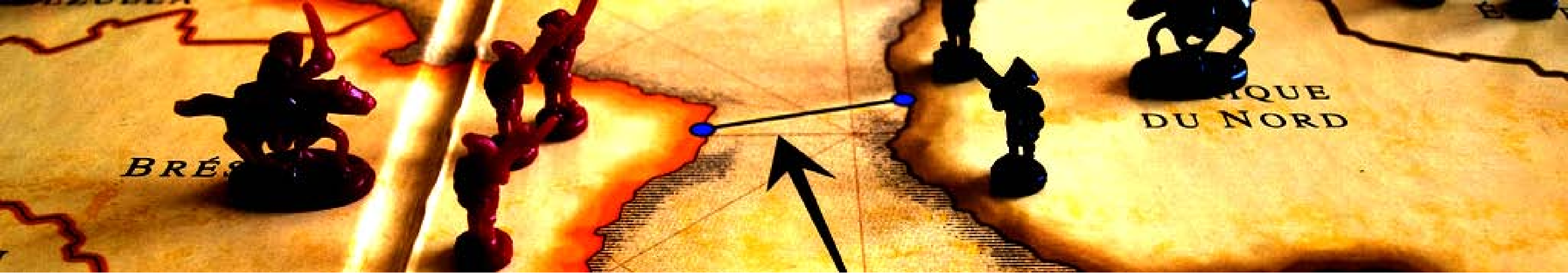




CU*BASE – NAMED BORROWER

CU*BASE can help you find named borrowers as well.

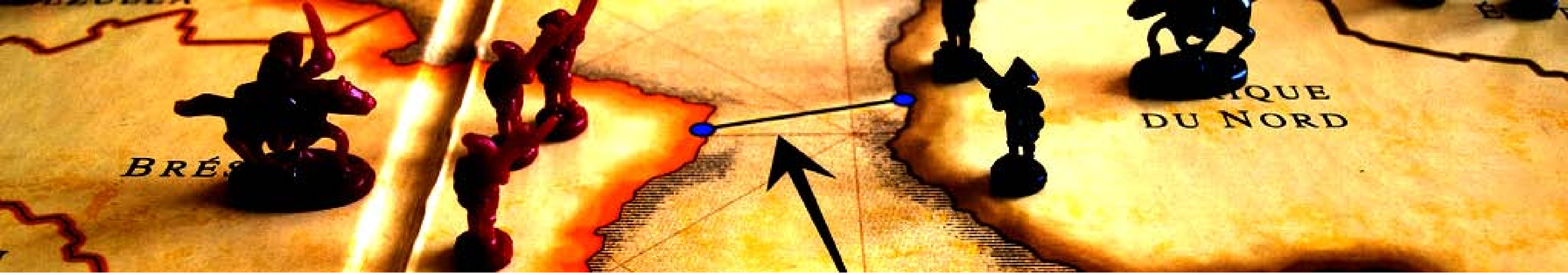
Keep in mind you may have to look at households if there are disparate SSNs.



CU*BASE – TOTAL CAPITAL AND ASSETS

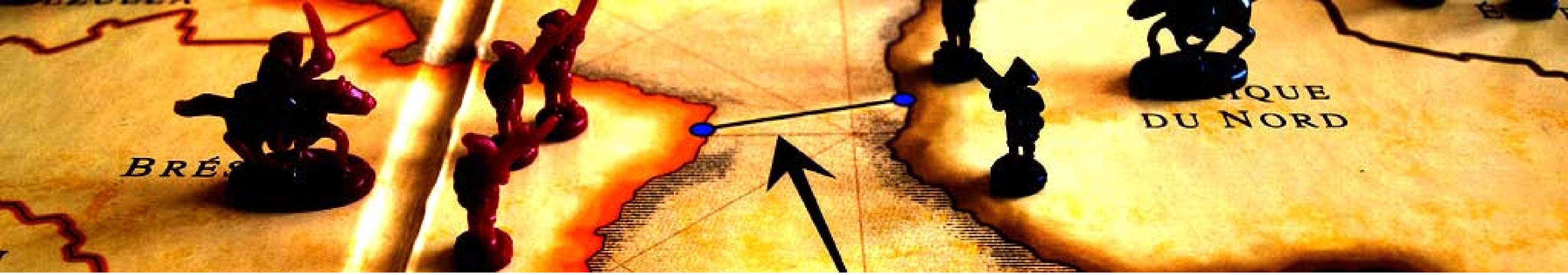
You can also find out your total capital and assets.

MNGELE



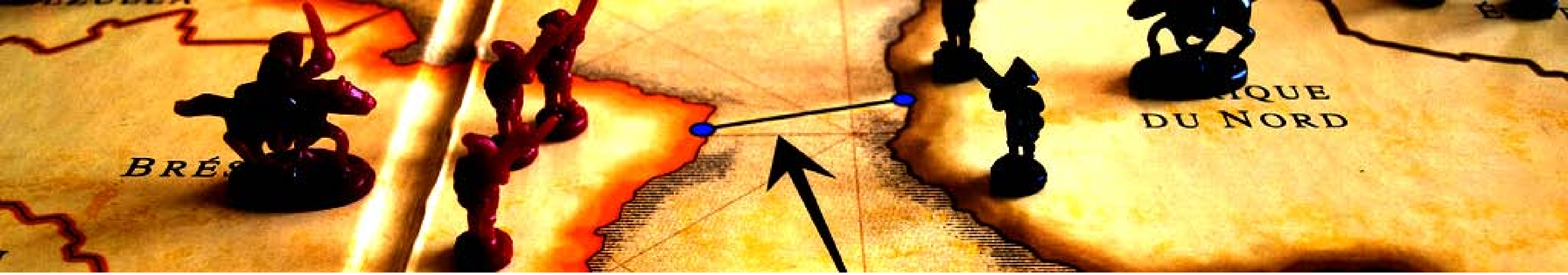
CREDIT UNION RESPONSIBLITIES

The credit union will still need to internally derive items like historical loss ratios and economic factors impacting portfolio performance.



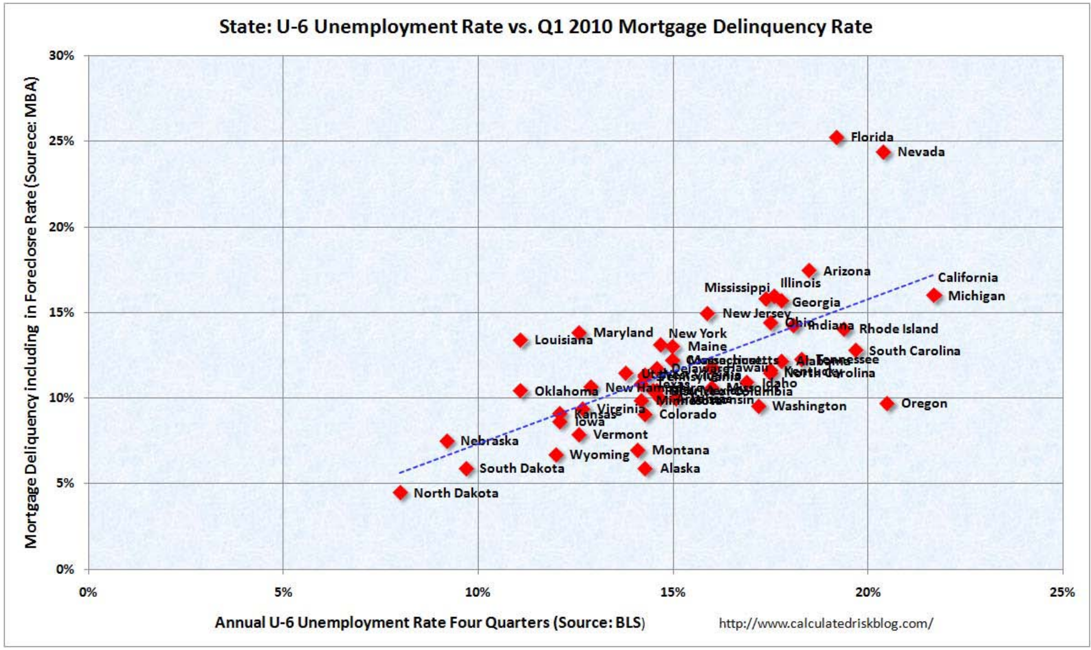
AUDIT LINK ENGAGEMENT

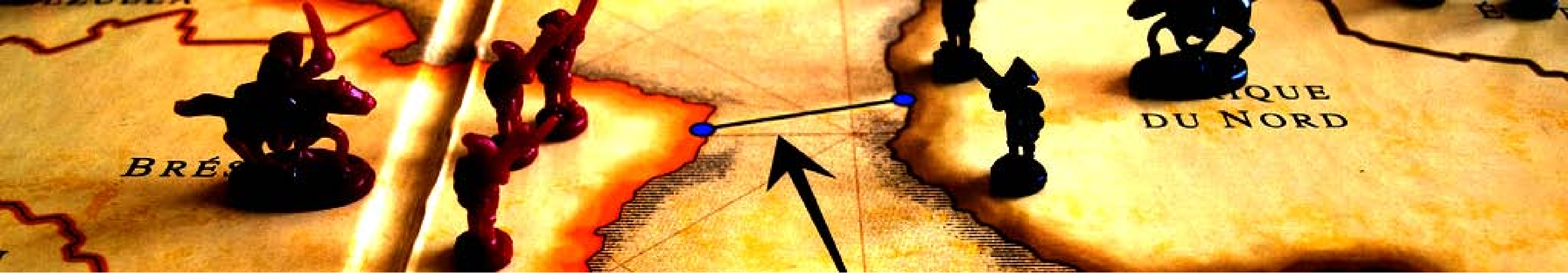
If you wish, you can engage AuditLink and we will help you develop your concentration risk report.



AUDIT LINK ENGAGEMENT

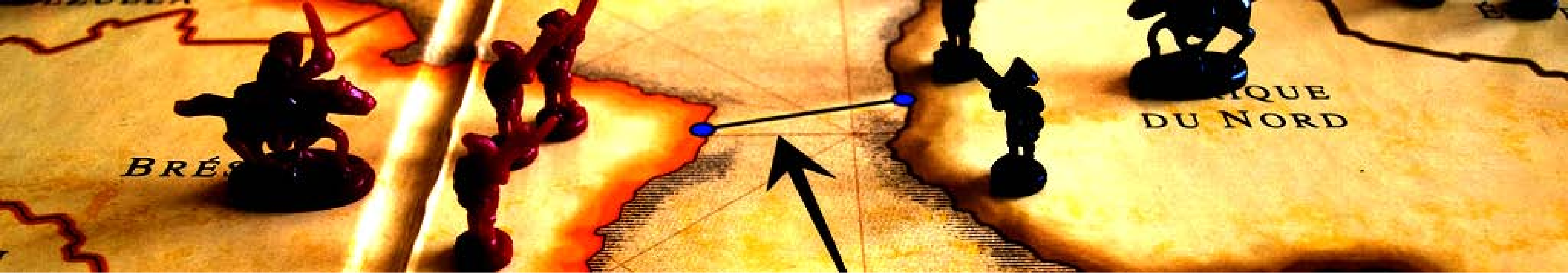
AuditLink will include data and charts to help justify our portfolio testing methodology.





AUDITLINK ENGAGEMENT

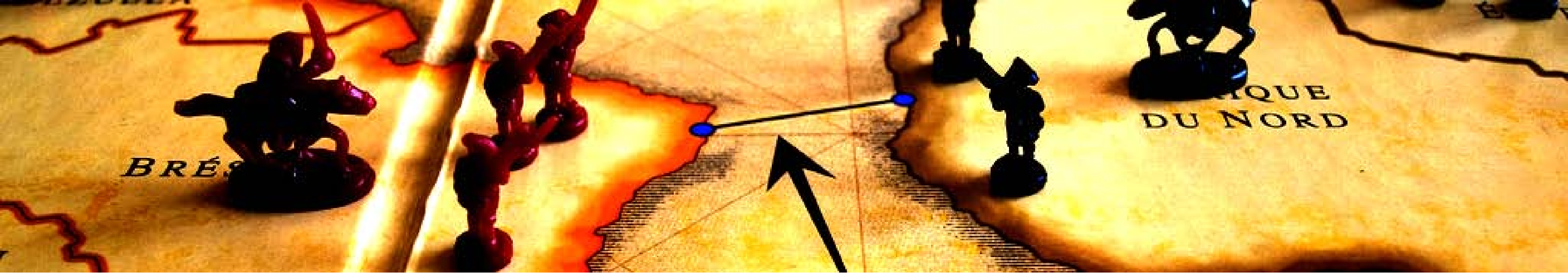
AuditLink will provide a narrative with easy to read graphics so you can tell, at a glance, the performance of your credit union.



AUDITLINK ENGAGEMENT

AuditLink's testing is thorough yet easy for you to explain to your board or an examiner.

Segment	*Total (net of participation)*	*Percentage of Net worth*	*HLR (historical loss ratio)*	*PLE potential loss exposure*	*% of CU Net worth*
Business Real Estate-Non Owner Occupied	$5,000,000.00	50.00%	0.50%	$25,000	0.25%
Business Real Estate-Owner Occupied	$6,000,000.00	60.00%	0.50%	$30,000	0.30%
Business Residential-Owner Occupied	$1,500,000.00	15.00%	0.50%	$7,500	0.08%
Aggregate Business Real Estate	**$12,500,000.00**	**125.00%**	**0.50%**	**$62,500**	**0.63%**

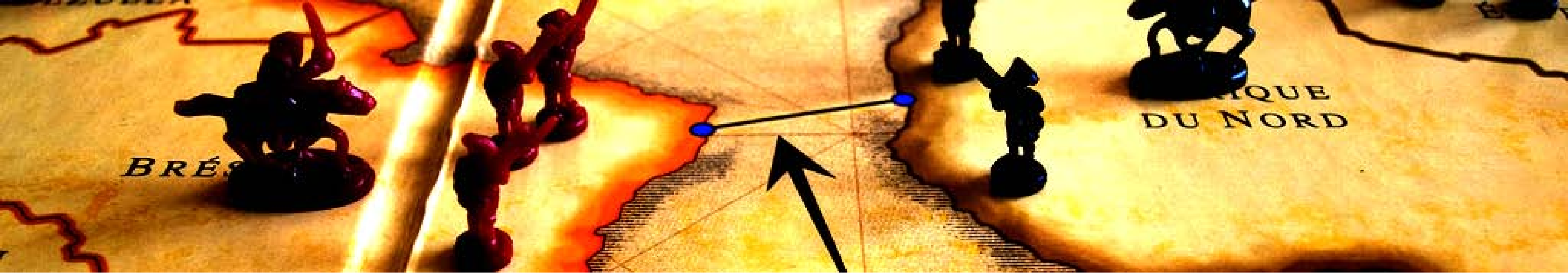


AUDITLINK ENGAGEMENT

Pricing and other details for the engagement can be found on the AuditLink website.

PRICING

Credit Union Assets	Cost
0-$50m	$1,500
$50.1m to $100m	$2,000
$100.1m to $300m	$3,000
$300.1m and above	$3,500
Annual Review	$500
Quarterly Runs	$250
Board Education and Presentation for Final Report	$250
In-person presentation (travel expenses additional)	$250



AUDIT LINK

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THANK YOU

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