

Addressing Concentration Limits

Six Critical First Steps

By c. myers corporation

With the release of NCUA Letter to Credit Unions [10-CU-03](#) on concentration risk, many in the credit union industry are wondering what strategic ramifications could result from this guidance.

Concentration risk can be described as excessive reliance or exposure from individual or groups of products and services. For purposes of this introductory article, we'll be examining concentration risk from a credit and interest rate risk perspective.

Introduction

Consider the following excerpt from the letter:

*Effective risk management practices would not only include tying the limits of each product or service to net worth, but also **consolidating the risks** in products and services and measuring the **totality** of the risks **against net worth**.*

We agree with NCUA's objective of consolidating risk and measuring it in totality against net worth. However, if you limit your method to balances as a percent of

net worth¹, you will not be able to achieve the objective.

If you have tried using balance as a percent of net worth, as suggested in the guidance, to measure risk in *totality* (summing the limits for products and services), you probably found the total number to be meaningless. We recommend the steps outlined below as an alternative.

Regardless of the method used to aggregate risk, as management is working through this process, it is critical to keep the board informed. Ultimately, the board needs to reach consensus on the limits and have a solid understanding of the rationale used.

Critical First Steps

Step 1: Reach consensus on minimum net worth ratio

This is the net worth ratio below which you never want to fall should really bad things happen. It is not a target. In other words, the credit union would not plan strategy/operations to achieve

¹ Balances as a percent of net worth example: If you have \$40M of new autos and \$10M of net worth, your new autos would be 400% of net worth.

this ratio. This is simply a worst-case floor.

Step 2: Quantify worst-case credit risk

a) Create a story of a "worst-case" credit environment. Keep in mind – bad things rarely happen in isolation. Descriptors might include:

- Our major SEGs are laying off 20 percent of their workforces and cutting all overtime for remaining employees

And...

- There is a downturn in the local economy that is causing the unemployment rate to double in a year

And...

- Property values have declined 25 percent after rising 15 percent over a short period of time. This is causing loan-to-value ratios to be materially higher than when the loans were made

And...

- Gas prices have jumped to \$4 per gallon

- b) Identify hot-spots under your description of “worst case.” Hot spots are those categories that could cause extra heartburn if your scenario were to come true. Examples may include high loan-to-value real estate loans, indirect autos, etc.
- c) Reach consensus on methodology to represent potential losses under your worst-case scenario. Document the rationale/reasoning for the methodology, which may vary by category
- d) Calculate dollars of potential losses using agreed upon methodology
- e) Convert the calculated dollars of worst-case losses to a net worth ratio at risk. To do this, total all potential losses (which are net worth dollars at risk) and divide by total assets to arrive at a net worth ratio at risk from your worst-case credit risk scenario. For example, this process may result in a 2.10 percent net worth ratio at risk from your worst-case credit risk story

Step 3: Quantify interest rate risk

- a) Determine the range of rates for which you want to protect net worth. We suggest using a sliding-scale approach, as this will help to adjust your view of risk as economic conditions and external forces change
- See the table to the right for an example.

- b) Use your A/LM model to quantify the potential risks to earnings and net worth in the stress test rate environments and divide the dollars of losses (which are net worth dollars at risk) by total assets to convert to a net worth ratio at risk. For example, simulations may show that you have dollars of losses that equate to a 2.5 percent net worth ratio at risk if rates go up 500 basis points

Step 4: Measure the totality of risk against net worth

Combine your net worth ratio at risk from both your worst-case credit risk scenario and interest rate risk and add to your minimum acceptable net worth ratio.

Example:

Minimum Net Worth Ratio (Step 1)	6.00%
+Additional Worst-Case Credit Risk (Step 2)	2.10%
+Risks to Earnings – Interest Rate Risk (Step 3)	2.50%
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=Total Net Worth Required	10.60%

In this example, if net worth is at least 10.60 percent, then it is sufficient to cover the totality of risks. There are other stress tests that you may want to incorporate, such as higher costs of corporate stabilization and/or threats to non-interest income. Again, the focus of this article is on credit risk and interest-rate risk.

Step 5: Establish triggers

Consider establishing triggers/limits for areas of additional uncertainty. For many of these, it is reasonable to set as a balance relative to net worth. Examples include:

- Limiting annual growth for a rapidly growing or new portfolio

Example Sliding Scale

If current short-term rate is:	Rate change to be applied:	
	Up	Down
0% - 2%	500bp	200bp
3% - 5%	400bp	300bp
6% - 9%	300bp	400bp

- Limiting loans made when property values are escalating by more than __% in a 12-month timeframe
- Limiting high loan-to-value loans regardless of credit score or collateral
- Setting a limit on loan exceptions
- Setting a limit for a single member/entity

Step 6: Develop policy expectations

Clearly set policy expectations on the process that will be followed if a limit is exceeded.

Ongoing

- Regularly quantify risks to make sure you are within your limits
- Prior to implementing any material changes in structure or strategy, test to make sure you will continue to be within your limits
- Report regularly on any trigger/limit you establish
- At least annually, review rationale

Protecting Against Other Risks

While business sustainability and third-party risk are not a focus of this article, they should be addressed. An example of business sustainability might be too much reliance on indirect auto loans, which can be easily taken away by a competitor.

Participation loans and auto dealers are examples of third-party risk.

If You Only Remember 3 Things...

1. There is *no magic formula*
2. Any process that does not capture the aggregate risk will most likely **invite risk** or **limit viable opportunities**. If concentration limits are set without assessing the totality of risk, it could create a false sense of security as an institution could be within their concentration limits but have too much total risk exposing the institution to potential failure. The opposite can also occur where total risk is very low and could justify more exposure than a concentration risk limit might allow
3. *Don't settle for the easy answer as it may hurt you in the long run.* Implementing policy limits that haven't been thoroughly tested and thought through could limit business opportunities or create a false sense of security and may be difficult manage. Also, changing the limits after realizing that they are not appropriate will be a "red flag" to examiners according to NCUA guidance

This is a complex subject. We would be happy to answer any questions you might have. Please feel free to contact one of our principals at 800.238.7475 or on the Web at www.cmyers.com/contact/.

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About c. myers

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