Concentration Risk

I. PURPOSE

Examiners must evaluate all measures, policies, and procedures credit union officials have in place to identify, measure, monitor, and control concentration risk. Examiners must ensure concentration risk is managed in conjunction with credit, interest rate and liquidity risks; as a negative event in any category may have significant consequences on the other areas, as well as strategic and reputation risks.

II. PRIMARY REGULATIONS/REFERENCES

1. Michigan Credit Union Act
   - **a.** Section 342(3)(b): Establishing maximum amount of secured and unsecured loans
   - **b.** Section 401(2)(gg): CUSO investment limitations
   - **c.** Section 401(2)(hh): Land and building limitations
   - **d.** Section 423(11): Loan limits to one borrower
   - **e.** Section 431(2): Investment limitations
2. NCUA Letter 10-CU-03: Concentration Risk

III. MINIMUM PROCEDURES

A risk concentration is any single exposure or group of exposures with the potential to produce losses large enough (relative to capital, total assets, or overall risk level) to threaten a financial institution's health or ability to maintain its core operations. Avoiding concentrating too much in any single product or service is a core tenet of effective risk management. Examiners should:

1. Ensure the Board of Directors has established an appropriate concentration policy. The policy must:
   - **a.** Address the Board's philosophy on concentration risk commensurate with the strategic plan;
   - **b.** Identify outside forces which may affect the ability to manage concentration risk;
   - **c.** Establish concentration risk limits commensurate with net worth levels; and
   - **d.** Establish parameters specific to each portfolio and include limits on loan types, share types, third party relationship exposure, etc.
     - i. Risk limits should correlate to those in related policies

ii. Concentrations that exceed 100% of net worth must be monitored carefully, and the Board must document adequate rationale for undertaking that level of risk.

iii. Risk limits should be established on both an individual and aggregate basis.

2. Determine if management has developed appropriate procedures to ensure compliance with Board approved policies.

3. Determine if management has assessed the adequacy of net worth based on the aggregate potential exposure to all forms of concentration risk, while also considering the potential credit, interest rate, and liquidity risk impact on net worth.

4. Determine if the Board and management have considered the various types of concentrations and their interrelationship, particularly between asset classes or common products and service characteristics, which may present higher risk when aggregated.

5. Determine if the Board and management have considered the "event risks" which may expose the institution to financial loss for each asset class, quantified the risk, and established appropriate risk tolerance limits based on the probability and potential impact from each event.

6. Ensure management provides the Board of Directors regular reports on the individual and aggregate exposure to concentration risk.

7. Ensure management has predetermined actions to take when risk limits are reached and appropriate action is taken, as necessary. A potential red flag is a Board simply raises the established limit when it is reached without advanced analysis supporting the rationale for the change in policy.

8. Determine if management systems for identifying, measuring, monitoring, and controlling concentration risk are commensurate with the level of potential concentration risk exposure.

9. If an institution has significant loan concentrations, determine if management maintain reports and perform analysis of the following:

a. Origination and portfolio trends by product, loan structure, originator channel, credit score, LTV, debt-to-income ratio (DTI), lien position, documentation type, property type, appraiser, appraised value, and appraisal date;

b. Delinquency and loss distribution trends by product and originator channel with accompanying analysis of significant underwriting characteristics, such as credit score, LTV, and DTI;

c. Vintage tracking (i.e., static pool analysis);

d. The performance of third-party (brokers, auto dealers, and correspondents) originated loans; and,

e. Market trends by geographic area and property type to identify areas of rapidly appreciating or depreciating housing values.

10. If an elevated level of concentration risk is identified, examiners should determine if the Board of Directors and management have triggers and action plans in writing for any material risk area. If the monitoring activities identify concerns with a concentration, the Board and/or management must respond accordingly. If management has not properly quantified and mitigated the risk, examiners should require corrective actions of management that include, but are not limited to:

a. Expanding the review of the risk environment for the particular sector(s);

b. Performing elevated scenario and sensitivity analyses;

c. Expanding the review of performance of existing borrowers;

d. Reviewing growth and limitations for new business lines; and/or

e. Reviewing risk mitigation options and timeframes for reduction of risk, if necessary.