Concentration Risk:
The Rule of Diversification

By Kristina Muller, CFA, Senior Portfolio Manager at Balance Sheet Solutions, LLC, a CUSO of Alloya Corporate FCU. Kris can be reached at kristina.muller@balancesheetsolutions.org.

When managing investments, the number one rule is diversification. As we are reminded by the aphorism that cautions us not to put all our eggs in one basket, too much exposure to one area of the market could be detrimental to your portfolio. The same is true of your credit union's balance sheet – having funds focused in a few product areas may pose potential threats to your credit union. This realm of concentration risk has become a hot topic among regulators as it is a component that establishes the risk profile of your institution.

While it may seem easy to monitor your exposure to any one particular area of the balance sheet, member behavior can change very quickly and you may suddenly find yourself facing risks that you did not anticipate. Therefore, examiners are looking for credit unions to develop a regular system of monitoring the books to ensure all areas of risk are being reviewed. As established in the NCUA Letter 10-CU-03 "Supervisory Letter – Concentration Risk," it is important for credit unions to identify, measure, monitor and control these risks.

Step One: Identify the Risks

Each asset and liability at your institution carries some level of risk. It is management's job to understand these risks and avoid an overweighting in any one particular area. This may mean delving into products deeper than just an entry on the balance sheet. Credit unions need to understand how their assets will behave in certain interest rate environments, or during particular market events. Management also must try to assess the potential loss exposure should this "event risk" occur.

Some concentrations may not even be noted on your balance sheet. Dependency on one third party provider can also be considered a form of concentration risk. It is important that a credit union perform due diligence on any vendor to ensure continued service. A higher level of review may be warranted on a particular vendor if the credit union is highly dependent on their services.

Management also needs to review any overlapping risks on the balance sheet. For example, a low interest rate environment may increase the level of pre-payments in your mortgage portfolio, but this risk may also be present in your investment portfolio if you are heavily invested in option embedded securities. Reviewing your concentration risks involves understanding how products will behave in various interest rate environments and assessing the risks on both an individual and aggregate basis.

Step Two: Manage and Monitor the Risks

Once a credit union has determined their different levels of concentration risks, they will need to set up a way to regularly monitor their exposures. While many credit unions may use interest rate shock scenarios to model their balance sheet, this will not provide the whole risk profile. Asset liability modeling does not factor in areas such as credit risk or event risk – a major layoff at a local employer, for example. A credit union that has a good understanding of the financial situation of their local employer groups, housing market and general local economy should incorporate these issues into their risk analysis.

Unfortunately, economic events rarely occur in a vacuum and multiple scenarios may have to be assumed. As an example, a downturn in the local economy may mean increased unemployment and a decline in housing values. How would this impact your balance sheet? By acknowledging these worst case scenarios, the credit union should be able to see potential hazards before they develop.

Any examination of potential risk is not possible if the credit union does not have access to complete information underlying their products. Data retention is a necessary tool to help assess your level of risk exposure. In cases where there is potential concentration risk, the credit union will have to dig more deeply into their data to obtain a more complete picture of the risks. As an example, a mortgage portfolio may contain several loan types that behave differently in various interest rate environments. An examiner will want to see a thorough review of the area of concern and note that it is being regularly reviewed by both management and the board of directors. A larger credit union may also want to consider setting up a separate risk management committee to specifically oversee and review the concentration risk at the credit union on a regular basis.

When reviewing particular concentrations, management will need to decide their own philosophy and comfort level with different risk exposures. Therefore, it is in the credit union's best interest to establish a concentration policy. This policy should establish which ratios will be looked at to determine concentration risk and the thresholds for these ratios. The rationale behind these measures are also key factors for building this policy – *is the risk tolerance based on past history or modeling results*? The concentration policy should also complement the other policies on file at the credit union. A concentration policy *should not* set a limit on the amount of mortgages at the credit union not already established in your lending or ALM policy.

Step Three: Control the Risk

Should it be determined that your credit union is concentrated in one particular area, steps should be taken to help lessen the potential threat to your balance sheet. Product lines and even strategic plans may need to be altered if the possibility of concentration risk exists. In addition, management should also set up a timeline for diversifying any existing concentrations where possible.

Since we are not able to predict the future, there will always be the potential for concentration risk to occur at some point. In addition, many credit unions already face a certain level of concentration risk due to their small geographic area. However, by assessing the risks on the balance sheet, now before a problem develops, management will be more aware of where they stand and what, if any potential problems may occur in the future.

Continued…

Step Four: Continuous Review

Balance sheets can change very quickly and as a result, so can your concentration risk. The risk profile is not a static measurement but a variable that needs to be monitored on regular basis. Regular reviews are needed not only to see if the credit union is exceeding its own parameters, but to observe any particular trends. Should one particular area of the balance sheet appear to be growing, the credit union may be able to take steps to reduce the risk before a problem develops. A review of your third party providers should be done on a regular basis to ensure that no changes have occurred that could affect the credit union's level of service.

An examiner's focus on concentration risk is meant to help the credit union establish a thorough monitoring system to prevent a potential crisis from developing. Taking the proper steps to monitor your concentration risk today should help prevent a problem from occurring in the future.