CONCENTRATION RISK

WEBINAR 25 • HOSTED BY REX JOHNSON

"This webinar will help get your Credit Union prepared for the Concentration Risk Supervision. The NCUA will not back down on this; We must be prepared when examiners come in and we must take them seriously."

Rex Johnson
President & Founder LSCI

Lending Solutions Incorporated CONSULTING

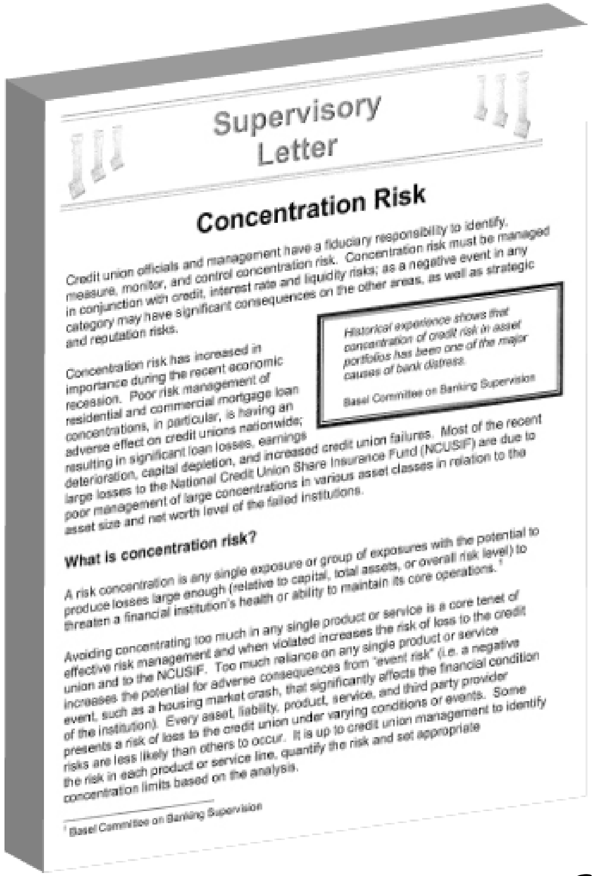
UNIVERSITY OF LENDING

Why the NCUA Insists on Concentration Risk

CU Case Study

- This credit union was located in California where the real estate market had collapsed
- They were involved in <u>sub-prime lending</u>
- They previously were involved in <u>indirect lending and it did not work out</u>
- They then switched to HELOC participations involving sub-prime lending with <u>weak underwriting</u>
- One employee, the C.F.O., had total control
- They had dramatic growth, jumping from 4.6 million to 357 million in 4 years
- HELOC Loans made up <u>88% of total loans</u>
- A liquidity crisis occurred once the California real estate market began to crash
- WesCorp then called in their LOC and reduced the LOC from 90 million to 25 million
- All real estate loans were in the California market and the credit union was using stated income on the majority of these loans
- The credit union failed due to the extremely high concentration of indirect HELOCs in a very weak market

Sent to the Supervisory Committee



Supervisory Letter

Concentration Risk

Credit union officials and management have a fiduciary responsibility to identify, measure, monitor, and control concentration risk. Concentration risk must be 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.

> Historical experience shows that concentration of credit risk in asset portfolios has been one of the major causes of bank distress.
>
> Basel Committee on Banking Supervision

Concentration risk has increased in importance during the recent economic recession. Poor risk management of residential and commercial mortgage loan concentrations, in particular, is having an adverse effect on credit unions nationwide; resulting in significant loan losses, earnings deterioration, capital depletion, and increased credit union failures. Most of the recent large losses to the National Credit Union Share Insurance Fund (NCUSIF) are due to poor management of large concentrations in various asset classes in relation to the asset size and net worth level of the failed institutions.

What is concentration risk?

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.[1]

Avoiding concentrating too much in any single product or service is a core tenet of effective risk management and when violated increases the risk of loss to the credit union and to the NCUSIF. Too much reliance on any single product or service increases the potential for adverse consequences from "event risk" (i.e. a negative event, such as a housing market crash, that significantly affects the financial condition of the institution). Every asset, liability, product, service, and third party provider presents a risk of loss to the credit union under varying conditions or events. Some risks are less likely than others to occur. It is up to credit union management to identify the risk in each product or service line, quantify the risk and set appropriate concentration limits based on the analysis.

[1] Basel Committee on Banking Supervision

Analysis of NCUA's March 2010 Supervisory Letter

Responsibility

Credit Union Officials & Management Have a Fiduciary Responsibility to:

- *Identify*
- *Measure*
- *Monitor*
- *Control Concentration Risk*

Concentration Risk Must be Managed in Conjunction With:

- *Credit or Default Risk*
- *Interest Rate Risk*
- *Liquidity Risk*
- *Reputation Risk*

What is Concentration Risk?

What is Concentration Risk?

Concentration Risk is:

Any single exposure or group of exposures that could or have the potential to produce large losses and threaten a credit union's health or ability to maintain its core operation

The NCUA Wants Credit Unions to:

Avoid too much reliance on any single exposure or product such as:

- *Limits set on how much exposure the credit union is willing or should take, these limits will be determined by management and the Board of Directors*
- *Analysis must be done to determine the limits management is comfortable with*

Types of Concentration Risk

Asset classes (i.e. Residential real estate loans, Business loans, Auto loans, and Loan participations or investments)

Concentration Within a Class of Assets are:

Residential Real Estate Loans

- *Collateral type*
- *Lien position*
- *Geographical area (unemployment, etc…)*
- *Unusual terms (i.e. interest only payments, balloon payments)*
- *Very little requirements on documentations*
- *Loan to value above the norm*

Member Business Loans

- *Purchase of real estate*
- *Providing working business capital*
- *Credit cards*
- *Collateral type (is it difficult to dispose of)*
- *Special terms*
- *Loan to value*
- *Geographic area*

Types of Concentration Risk

Continued…

Types of Loan Participations May Include:

- *Residential real estate*
- *Member business loans*
- *Consumer loans*

Type of Investments May Include:

- *Treasury securities*
- *C.D.s*
- *Mortgage back securities (Be very careful given the losses corporates have had)*
- *Collateral type*
- *Interest rates*
- *Issuers (Public or private)*
- *Brokers*

Liabilities *(i.e. Rate sensitive share deposits or callable borrowings)*

Third Party Providers *(i.e. CUSOs, Indirect loan partners, Mortgage broker firms, etc…)*

Service Provided to other Parties

- *Loan underwriting*
- *Loan servicing*
- *Insurance needs*
- *Investment consultation*

Types of Concentration Risk

Continued…

Common Event Risk

Examiners will be looking for the types of loans and characteristics that may exist such as:

- *The credit union makes real estate loans and holds them in their portfolio*
- *The credit union also buys mortgage back securities*

Both of the above types of assets have common risk

Measuring Exposure

Where Do Credit Unions Have the Most Exposure Now in their Portfolio? *(as of December 31, 2009)*

- *Real Estate (fixed rate) = 54% (217 billion)*
- *Investments in mortgage backed securities = (58.7 billion)*
- *Member Business loans = (35 billion)*
- *Loan Participations = (12.4 billion)*
- *Construction and Development loans = (2.4 billion)*

These five different type loans and investments, plus indirect lending are definitely on the NCUA's radar screen.

Identifying & Measuring Concentration Risk

Management Must Perform and Document:

- *A risk assessment*
- *That the credit union understands the risk of the products and services they offer*
- *What the potential loss exposure is*
- *Document why you think it's a reasonable risk*

Credit Unions Who Have Substantial Amount of their Money Loaned Out in Certain Loan Products Must:

- *Have a thorough analysis of that portfolio*
- *Due diligence conducted on a third party provider (i.e. corporate, LSI, etc…)*
- *On-going monitoring has to be done where there is high concentration, just doing it once will not be enough*

Identifying & Measuring Concentration Risk

Continued…

What Will the NCUA Look For?

- *Loan type*
- *What percentage of your portfolio it represents*
- *Interest rate yield*
- *Will the rate reset*
- *Payment shock (the potential increase in payment from interest rates changing)*
- *Credit scores (original scores and new score update)*
- *Conversion (interest only resetting to interest and principle)*
- *Collateral value and changes*
- *Market value*
- *Collateral information*

Note: The NCUA, in their letter to the supervisory committee, makes it clear that this is not an all inclusive list.

Identifying & Measuring Concentration Risk

Continued…

Maintaining Comprehensive and Accurate Data

The credit union should have a data processing system capable of warehousing data on various lines of business. Commensurate with its size and complexity, the NCUA expects you to provide them with information such as:

- *Loan type*
- *Interest rate*
- *Interest rate reset dates*
- *Payment amount*
- *Payment shock*
- *Impact of rate conversion*
- *Credit scores (time of loans and updates)*
- *Collateral description and value*

Risk Rating System

- *Management must develop an effective, accurate and timely risk rating system*
- *Risk rating should be objective and sensitive to change*
- *Must be validated via an independent review function*
- *Loan participation must be reviewed using the credit union's own internal rating system, management should not rely on the origination institutions system*

Reporting

Management Reporting Must Be Periodic & Timely. It Will Largely Be Driven By:

- The size of the loan portfolio
- The credit union should focus where it is or has been heavily concentrating on or which certain loans that may prove to be more risk such as:
  - Mortgages
  - Business loans
  - Participation loans
- Loans that are somewhat complex to do
- Loans that the credit scores suggest the credit union is taking on far more risk
- The credit union will be expected to obtain updated scores
- Larger portfolios should be checked quarterly

Managing Concentration Risk

How Should You Manage Concentration Risk?

- NCUA auditors will be focusing on a credit union's net worth vs. the risk the credit union is taking
- The Board of Directors has the ultimate responsibility
- The Board of Directors has to be actively aware of other risk such as:
  - Default or credit risk
  - Reputation risk
  - Interest rate risk
  - Liquidity risk, etc…

All these risks can impact net worth!

Board Policy & Concentration Risk Limits

- The Board of Directors must establish and approve a policy on Concentration Risk
- The Board of Directors must look at the net worth of the credit union in determining what's an acceptable level of risk
- The Board of Directors must consider outside forces such as the economy and unemployment
- The Board of Directors should not begin or expand on a mortgage program that allows high loan to values at the height of the real estate loan bubble, such as 2006 when the market peaked that lead to significant losses
- Parameters the Board of Directors must set:
    - ***Must include limits on loan types***
    - ***Share types***
    - ***Third party relationship exposure***
- Concentrations that exceed 100% of net worth must be monitored carefully. (Note: this does not say you cannot go over 100%) If a Board of Director selects to go over 100% they must justify why and then document it. In addition, you must look at your vender relationship and focus on:
    - ***How long they have been in business***
    - ***Nature of services provided***
    - ***Level of expertise***

Due diligence must be an ongoing process with venders. **Note:** *Your venders should be able to provide you with evidence of the above at least annually.*

How Concentration Risk is Monitored & Controlled

Once Your Policy is Complete & Approved by the Board of Directors, it is Essential that:

- *Monitoring and oversight becomes routine functions at the senior management level*
- *Management must regularly report to the Board of Directors and this should be documented in the Board minutes that the credit union is in compliance*
- *Management must implement appropriate internal controls including segregation of duties*

Credit Unions with Large Complex Loan or Investment Programs Should:

- *Establish a specific risk management committee*
- *Should be made up of a small number of senior executives and one or more members of the Board of Directors*
- *Agenda of meetings should be limited to risk management issues, especially Concentration Risk*

Other Risk that Should be Discussed at the Meetings:

- *Credit risk (default)*
- *Interest rate risk*
- *Liquidity risk*
- *Financial performance*

Note: the above must be noted in the credit union minutes.

How Concentration Risk is Monitored & Controlled

Continued…

Common risk characteristics and "what if" test. Credit unions should discuss items and the impact if certain changes happen such as:

- *Unemployment doubled*
- *Housing values drop 25%*
- *Interest rate reset*
- *The level of 30 year fixed rate mortgage that the credit union cannot re-price if rates go up*
- *The impact of earnings*

These items should be documented in the minutes of the Risk Management Committee meetings

What Are Examiners Looking for When They Visit Your Credit Union?

Concentration Risk taken to this level is all new. It's reasonable to expect examiners will note in their report that you have taken it seriously and are willing to work on it.

There are some items you can count on. If you have high concentration in areas such as:

- *First mortgages*
- *Business loans*
- *Participation loans*
- *Indirect lending*

Be prepared to show you have good net worth and a profitable portfolio that is performing very well.

What they will be looking for is:

- *Do you have a Concentration Risk Policy?*
- *The level and nature of inherent risk on the balance sheet*
- *Management expertise*
- *Risk management practices*
- *Market conditions*
- *Adequacy of reserves allocated for Concentration Risk*

What Examiners Are Looking for When They Visit

Continued…

In addition, they will want to see:

- Has the credit union established acceptable risk limits for all products and services, both individually and aggregate?
- Has management assessed the adequacy of net worth based on the exposure the credit union is taking?
- Has the credit union looked at the concentration and the interrelationship between asset classes that may create problems such as their own first mortgage loan portfolio and if the credit union has mortgage back securities they have invested in as they are interrelated.
  - ***First mortgages***
  - ***Mortgage back securities***
- Has the credit union considered "big events" such as plant closings, loss of jobs, etc.?
- Does the Board of Directors see regular updates on aggregate exposures to concentration risk?
- Does the Board of Directors and Senior Management have an action plan when certain limits are reached? The examiners will be looking to see if you kept the Board of Directors informed and your strategy makes sense, especially if you are changing your policies.
- Do you have a system that will
  - ***Identify ?***
  - ***Measure?***
  - ***Monitor and control concentration risk?***

What Examiners Are Looking for When They Visit

Continued…

You will need to convince the examiner that you know what's going on and:

- You are maintaining reports to show you are focusing on Concentration Risk
- Loan originations and portfolio trends by product, loan structure, scores, LTVs, debt to income, appraised values, list of appraisers, etc…
- Delinquencies and loss distribution trends by product, underwriting guidelines such as credit scores, LTV and debt to income
- Performance of third parties (i.e. car dealers, underwriters such as LSI, CUDL, etc…)
- Market trends by geographic area and properly type to identify
  - ***Rapidly appreciating areas***
  - ***Rapidly depreciating areas***

You must have evidence these controls are in place, you are knowledgeable and can support the above.

What Are Your Options When the Credit Union or Examiner Identifies Elevated Concentration Risk?

Options a credit union has when the credit union or examiners see there is a problem.

- The Board of Directors and Management should have triggers and action plans in writing
- The Board must react when management or the examiners identifies concerns with Concentration Risk

In addition, examiners may require from management, when they identify there is Concentration Risk, the following:

- *Expanding the review of risk*
- *Performing sensitivity analysis*
- *Expanding reviews of performance of borrowing members*
- *Growth and limitations of new business lines or*
- *Reviewing risk mitigation options and timeframes for reduction of risk, if necessary*

What are the Management responsibilities when elevated Concentration Risk is identified?

Management must consider the following:

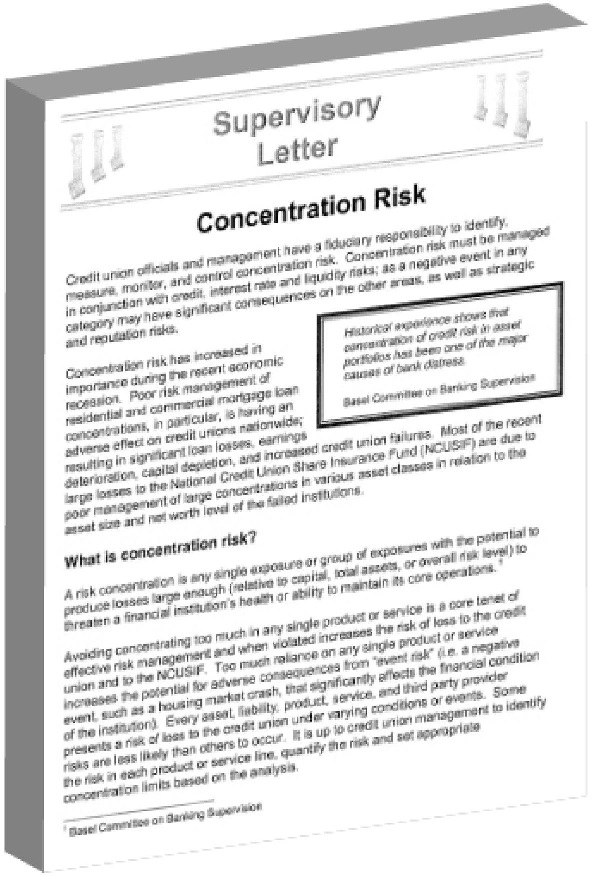
- *Reducing limits*
- *Reducing exposure to new business lines*
- *Transferring risk to other parties by selling directly or as part of securitization transaction and possibly ceasing the product line*

NCUA's Conclusion

It is the Fiduciary Responsibility of Management and Officials to:

- ✓Identify
- ✓Manage
- ✓Monitor
- ✓Control the risk facing the credit union, including Concentration Risk

Examiners need to ascertain whether the Board of Directors and Management understand and actively manage this risk management should minimize the risk and significant financial decline.



Supervisory Letter

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Concentration Risk Policy

Statement of Purpose

Could Be You FCU **recognizes the importance of having a Concentration Risk Program given what has happened in the economy and the massive losses credit unions and other financial institutions have suffered.**

Our credit union manages Concentration Risk by dedicating the necessary resources, monitoring and controlling all risk such as:

- *Concentration Risk*
- *Default Risk*
- *Interest Rate Risk*
- *Liquidity Risk*
- *Collateral Risk*
- *Capital Risk*
- *Event Risk*

This policy shall be in conjunction with:

- *Asset liability policy*
- *Investment policy*
- *Loan policy*
- *Business lending policy, etc…*

We understand the need for a Concentration Risk Policy and we know that it will take some time to get everything in place with our I.T. systems, etc… We will put all our resources that are available, to make this happen as quickly as possible. We do not want to forget our mission which is to make as many loans as possible to our members. This entails taking some risk and we will make sure our employees are well trained to handle this risk. While we will continue to use credit scores to provide us with some direction, we will not deny a loan due to a credit score. We still believe lending is and always has been a judgment business.

I. Policy Focus

The credit union’s policy will focus on:

a. Net worth

b. Outside Forces

- Economy
- Unemployment
- Market risk conditions

c. What’s an acceptable level of risk for

- Loans
- Investments

II. Senior Management Responsibility

Senior Management will have the following responsibilities

- Monitor this policy
- Report to the Board of Directors on the results of our Concentration Risk as outlined in this policy
- Ensure there is a segregation of duties
- Oversee:
  - *Loans*
  - *Investments*

III. The Credit Union Will Establish a Risk Management Committee Consisting of:

a. Small number of executives with expertise in the required areas

b. Senior Management

c. A Board of Directors Representative

This Risk Management Committee will report to the Board of Directors on a quarterly basis with their findings and recommendations.

IV. Duties of the Risk Management Committee

a. Adopt an agenda that focuses on Concentration Risk in

- ***Lending***
- ***Investments***

b. Document their discussions

c. Copy the Board of Directors on their discussions and findings

d. In addition, the committee will look at:

Financial Performance
- Gross loan yield
- Net loan yield
- Profitability by product type

Credit/Defaults Risk
- Delinquencies
- Charge offs by product type
- Gross and Net Yield

Interest Rate Risk
- Percent of fixed rate
  - Over 15 years
  - 10-15 years
- Extended terms on auto loans, etc…

Liquidity Risk

Lines of credit with Corporates, etc…

V. Examiner Relationships

The NCUA introduced Concentration Risk to credit unions as a result of:

- Huge losses driven by the economy
- A collapse in the real estate market
- Rapid growth
- Very lax controls in many financial institutions

Our Credit Union respects the need to make changes to ensure that we learn not only from our mistakes, but other financial institutions. As a result, we believe it's important that we:

- **Meet with examiners on the first day of the exam and explain:**
  - Where we are on Concentration Risk
  - Show them our policy
  - What we are measuring
  - Discuss our net worth
  - Show them where our greatest level of Concentration Risk is
- **Focus on**
  - Net worth
  - First mortgages
  - Business loans
  - Participation loans
  - Indirect loans
- **Other Factors**
  - Management's level of expertise
  - Adequacy of reserves
  - Risk limits and terms on

First Mortgages	***Business Loans***	***Participation Loans***	***Indirect Lending***

- **Interrelated products**
  - Mortgage loan participations
  - Investments secured by mortgage back securities
  - Higher yielding investments that may have a "call feature"
- **Big events in our market such as:**
  - Unemployment (by county)
  - Plant closing, etc…

It is our belief that we should be upfront and open with examiners, provide them with the information they need to get their job done and make them aware of our strategies to serve *ALL* our members.

VI. Communications, Risk Management Committee, Senior Management and Board of Directors

We have set standards on communication to keep the Board of Directors informed.

The Risk Management Committee will:

a. Meet monthly
b. Meet quarterly with the Board of Directors
c. Document their findings
d. Copy the Board of Directors and Management on these findings as well as their recommendations
e. Steps taken, as a result of the recommendations, must also be documented if they relate to Concentration Risk

VII. Systems

a. The credit union will go over the systems capabilities
b. A recommendation will be given to Management and the Board of Directors when the system doesn't support the credit union's need
c. This will all be documented

VIII. Results

The credit union will document and make available to the examiners the results in key areas such as:

a. Loan originations

b. Gross Loan Yield by

- *Product*
- *Grade of paper*
- *Percent of portfolio*

c. Charge offs/Delinquencies

- *Product*
- *Grade of paper*
- *Percent of portfolio*

d. Net Loan Yield

- *Product*
- *Grade of paper*
- *Percent of portfolio*

IX. FICO Scoring Ranges

The credit union has adopted the following ranges for FICO scores:

730+	=	A+
680 – 729	=	A
640 – 679	=	B
600 – 639	=	C
550 – 599	=	D
549 and below	=	E

The credit union also uses the HYLS Underwriting Score, which focuses not only on the member's credit, but other important factors such as:

- *Income*
- *Debt to income ratio*
- *Loan to value*
- *Term*
- *Length of employment*
- *Length of address*
- *Past history with credit union*
- *Direct deposit*
- *Equity in a home*
- *Savings balance*

We feel all of these factors (plus others not included in the FICO score) are critical in decision making and will help us serve all our members.

X. Credit Scores (Should be updated every six months)

The credit union will show the examiners their trends in credit scores by:

Product Type	Grade of Paper	12/2010	6/2011	12/2011	6/2012	12/2012
	A+					
	A					
	B					
	C					
	D					
	E					

XI. Underwriting Guidelines on all Products such as:

a. *Loan to value*
b. *Debt to income*
c. *Max loan amount*
d. *Terms*

The credit union is prepared to justify its strategy on the above

XII. Third Party Relationships

Our credit union understands the importance and need to rely on third parties. We will monitor our relationships and focus on key third parties such as:

a. Auto dealers
b. Third parties supporting indirect lending
c. Corporate central credit unions
d. Technical support
e. Outsourcing
   - *7/24 loan support*
   - *Attorneys*
   - *Repo agencies*
   - *Collections*
   - *Appraisers*

We will maintain a file on:

- *Length of relationship*
- *Key players*
- *Our experience, etc*

XIII. Action Plans that Require Immediate Attention

The credit union will be prepared to move quickly when Concentration Risk suggests we must immediately address concerns. Our policy will identify those triggers items and:

- **What trigger items require immediate action**

  ____

  ____

  ____

- **How the review or risk will be expended based on the trigger items**
  - Introducing new products
  - Raising limits such as LTV, etc
  - Ceasing product lines
  - Transferring risk to third parties

  Note: The credit union will be very cautious not to:

- **Expand mortgage or business lending parameters without first:**
  - Determining the direction the economy and market are headed
  - If the market is falling, the credit union will be less aggressive with LTV, terms, etc
  - If the market is strengthening along with the economy, the credit union will be willing to consider taking more risk

XIV. Expectations of the Board of Directors

Parameters must be presented by Management and approved by the Board of Directors. Examples are:

- *Limits on all our loan types*
- *Share types*
- *Third party relationships*

Any product, where the Concentration Risk exceeds 100% of net worth, needs to be monitored by Management, reported to the Board of Directors and the Board of Directors must approve and justify the strategy.

XV. Vendor Relationships

The credit union will focus on the following in determining what vendors to use:

a. *How long they have been in business*
b. *Nature of service provided*
c. *Level of expertise*
d. *How financially solvent the vendor is*
e. *How successful the relationship has been with the credit union*

The credit union will review the above with each vendor on an annual basis.

XVI. Loan Participations

The credit union will use extreme caution when investing in loan participations. The Board of Directors will approve these participations. The credit union will focus on:

a. **Underwriting - what is the level of expertise of the underwriters**
b. **Collateral - what are the underwriting policies on:**
   i. *Loan to value*
   ii. *Terms*
   iii. *Risk scores, etc…*
c. **Performance of previous portfolios**
   i. *Delinquencies*
   ii. *Charge offs*
   iii. *Gross and net yield*
d. **Are policies consistent with credit union's current underwriting**
e. **Risk – how does the credit union measure risk before investing**

Examples of Mortgage Parameters

1. Fixed rate mortgages that are closed end in over 15 years will not exceed	20% of assets
2. Second mortgages with closed end fixed rates with not exceed	10% of assets
3. Total first and second mortgages will not exceed	50% of assets
4. Construction loans will not exceed	10% of assets
5. Land loans will not exceed	10% of assets
6. Variable rate 2nd mortgages & equity HELOCS will not exceed	30% of assets

Consumer Loan Limits
Outstanding Parameters

Maximum limitation on higher risk tiers will be:

- *"C" tier = 30% of our loan portfolio*
- *"D" tier = 20% of our loan portfolio*
- *"E" tier = 10% of our loan portfolio*

Where to Start

1. Adopt a policy and have the Board of Directors approve
2. Appoint a Risk Management Committee
3. Have the Risk Management Committee read the NCUA Supervisory letter. (Note: We have tried to simplify it in this packet.)
4. Have the Risk Management Committee look at your loan and investment portfolio and determine:
   - *Do we have a concentration risk problem (i.e. 50% of loans are 1st mortgage loans with 30 year fixed rates)*
   - *Are our investments all callable without notice*
   - *Can we cannot currently identify what the yield, both gross and net, is on our loans by loan type and grade of paper*
   - *Do we know what environmental risk we have such as unemployment, etc..*
   - *Are we sure of the capabilities of our I.T. system in providing the information we need*
5. Once we have had our first meeting, we will document our concerns, then make a presentation to the Board of Directors as to our priorities should be.

This will get you started and you can show the examiner, when they arrive, that you are taking this very seriously.

Conclusion

We understand this process will be labor intensive for all credit unions. Those with weak Capital must alternate efforts to put this in place right away. There is no question that you will be on the NCUA's radar screen.

All credit unions, regardless of Capital, will have to demonstrate to the examiners that they are taking this very seriously and moving ahead.

We believe what we have presented to you today will give you a good framework to get started. The examiners need to see you are making every effort possible given your resources – this is vital!

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