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Emphasis Remains on Developing Strategies to Avoid Concentration Risks

Four Key Questions Can Help Identify Potential Problems

Plano, TX – This holiday season, credit union executives making their 2012 investment wish lists and checking them twice should consider these four questions for wise lending and investing:

- What is the potential loss of principal?
- What is the impact on liquidity?
- What is the expected return?
- What is the long-term impact on earnings?

The answers to these four questions are critical for balancing risk and return, said Brian Turner, director of the Advisory Service for Catalyst Strategic Solutions. Turner said this balance is an important financial principle for every financial institution and the impetus for credit union examiners' focus on concentration risk.

In a recent letter to credit unions (11-CU-16 [State of the Credit Union Industry](#) October 2011), NCUA noted the need for concentration risk mitigation strategies. These strategies have become necessary as a result of an elevated percentage of real estate loans to total loans, in combination with declining real estate values nationwide.

While Turner agrees with the underlying notion that credit unions need to be mindful of concentration risk, he cautions against an overly simplistic approach to identifying concentrated risk exposure.

Turner said some credit union managers and examiners identify product concentration risk with basic allocation ratios. This perspective is reflected in an NCUA supervisory letter that identifies variables with broad labels, such as “real estate loans,” “member business loans” and “investments in mortgage-related securities.” These labels identify certain asset classes rather than aggregate risk, he said.

“Concentration risk assessment should go beyond simply evaluating whether a credit union has ‘all their eggs in one basket,’” Turner said. “It should encompass all areas of risk—namely credit, liquidity, earnings and capital—to determine the true extent of risk associated with each principle product and how combined product risk affects the overall balance sheet.”

Turner offered these examples: A credit union with a relatively low loans-to-assets ratio might be in a position to absorb a higher level of interest rate risk because it retains a lower level of credit risk and a stronger liquidity profile. In a case where two institutions might have the same percentage allocation of fixed-rate mortgages, one institution’s portfolio could have an average loan-to-value (LTV) of 50 percent, an average FICO score of 760 and a demographic distribution across multiple regions. The other might have an average LTV of 90 percent, an average FICO of 680 and be demographically isolated within two counties. These two credit unions most likely do not have the same risk profile and should devise different risk strategies.

It’s important for a credit union to establish a balance sheet structure that produces a stable earnings stream through a variety of economic and interest rate cycles. “That stability depends entirely on the relationship between the credit union’s earning assets and funding base,” Turner said.

Catalyst Strategic Solutions can help credit unions establish a comprehensive perspective when assessing concentration risk exposure. To develop concentration risk mitigation strategies tailored for individual credit unions, the Catalyst Strategic Solutions advisors “apply a reality-driven strategic approach that goes beyond textbook theory,” Turner said. “Total balance sheet risk management is especially important during this unprecedented environment when traditional ALM strategies may not apply.”

“Providing more than an empirical measure of the balance sheet, Catalyst Strategic Solutions can determine whether certain allocations truly constitute reasonable loss potential or diluted value to capital,” he added.

For more information regarding concentration risk mitigation strategies, contact Mike McGinnis at Catalyst Strategic Solutions at 800-301-6196.

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