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White Paper

THE NEW WAY TO MANAGE CONCENTRATIONS IN A POST-PANDEMIC WORLD

A Primer for Community Banks

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The New Way to Manage Concentrations in a Post-Pandemic World: A Primer for Community Banks

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Concentration management is becoming a dynamic and data-driven process in the post-pandemic world. Community banks that have always managed their concentrations by simply throwing darts at a board will find themselves in the regulatory crosshairs if they don't adapt to the new paradigm. More importantly, their banks will be at a competitive disadvantage, missing opportunities to expand balance sheet capacity to drive earnings without having to raise additional capital or walking away from loans altogether. This white paper explains why and how concentration risk management is changing and why banks need to adopt Active Concentration Management now.

> **"Concentration management is becoming a dynamic and data-driven process."**

How the Pandemic Exposed Pitfalls in Traditional Concentration Risk Management

Most community banks have been conditioned to define a concentration based upon the 2006 interagency guidance regarding CRE and construction loans. That guidance emphasized the 300 percent and 100 percent of capital thresholds that have since guided the industry. Concentrations can include other segments besides CRE and construction. For example, agricultural banks are expected to group their Ag production and farmland loans together and measure their Ag exposure as a percentage of capital.

Regulators focus on how banks manage their concentrations for a simple reason: Excessive concentrations was a strong indicator of bank failure following the 2008 Financial Crisis. And this is true even if the individual credits within these buckets were soundly underwritten. As a result, regulators expect banks with concentrations to operate with an elevated level of risk management and capital planning infrastructure.

Perhaps the most important component of this infrastructure is the creation of policy limits and triggers relative to the size of the concentration in relation to the bank's capital. These limits and triggers, which together we will call thresholds, govern management actions to preserve capital in advance of stressed conditions. It's analogous to measuring one's cholesterol levels and making dietary changes if they are too high to hopefully preempt the development of a more serious condition such as heart disease.

Following the 2008 Financial Crisis, regulators ramped up the pressure on community banks to manage concentrations with rigor. Many banks became victims of MRAs and consent orders. While banks came a long way during this period, the 2020 pandemic revealed several critical pitfalls that have led to an overhaul in how concentrations are managed.

PITFALL #1 – HOW CONCENTRATIONS ARE IDENTIFIED

The first problem with pre-pandemic practices was the emphasis on identifying concentrations by loan categories. When the pandemic arrived, social distancing and lockdown policies created distortions in the economy that cratered certain industries such as transportation, retail, hospitality, and restaurants. Many community banks found that they had exposures to these industries across their loan portfolio, not just CRE. For example, a bank may have issued a C&I loan, an owner-occupied CRE loan (not counted in the 300 percent threshold from the 2006 interagency guidance), and perhaps a residential mortgage, to the owner of one of these businesses. In this situation, you have three loans to the same relationship that are all dependent on the same cash flow stream and liquidity, and yet none of them qualify as "CRE" per the 2006 guidance. As a result, it has become both critical and prevalent for many community banks to establish policy limits and triggers for industry exposures, not just loan categories.

Another problem is that not all CRE is considered equal. It has become increasingly important for banks to have policy thresholds determined at the property type and/or market level as well. A CRE loan for an industrial property used as a distribution center for online ordering that saw business boom from the pandemic has an entirely different risk profile than a CRE loan for an office building that became a ghost town during the pandemic and has critical tenant leases expiring in the next 12 months. Markets matter, too. A multifamily loan for an apartment building in an urban market that saw population flight during the pandemic would have a different risk profile than a loan to an apartment building in the suburbs or exurbs, which saw population growth during the pandemic.

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PITFALL #2– HOW LIMITS AND TRIGGERS ARE DERIVED

Most community banks have a policy limits sheet. That sheet may consist of only a few key loan categories, or it may include a hundred different types of loans that someone at one point dreamed up, most of which are immaterial and irrelevant to risk. On that sheet is a limit and possibly a trigger or two for each of these buckets. If you are a manager or director of a bank, have you ever asked yourself: "Who came up with these and how did they do it?" Often, the answer will blow your mind. In most cases, those triggers and limits were plucked out of thin air or based upon what another bank plucked out of thin air. And they were often done so 10 or more years ago by someone who may not even be with the bank anymore!

Another problem – the policy limits do not add up to something realistic or meaningful. One bank we work with had a total CRE concentration limit of 500 percent, but if you added up the limits for all the various CRE property types in their sheet, it would add up to 800 percent. How does this make any sense?

Perhaps the biggest issue of all is that policy limits have been determined in a mutually exclusive environment without any trade-offs relative to other limits. If a typical bank ever reached all or even some of its policy limits at the same time, it would be grossly undercapitalized. Leveraging capital is one thing, but your bank may be double or triple counting capital on top of leveraging it when determining its concentrations. Again, this does not make any sense.

PITFALL #3– FAILURE TO SYNC WITH THE BANK'S STRATEGIC PLAN

Because limits were often determined in an arbitrary manner, it was common for banks to blow through their limits in areas that were experiencing high growth. However, approaching or exceeding a limit also created a problem because management and the board would be on the hook to do something about it. To preempt this problem, management would often go to the board and request an increase in the limit. **This shifts the pressure to the directors, who are supposed to provide oversight and act as stewards of the bank's capital**. Yet in most cases, boards would approve an increase to these limits, citing factors such as lack of historical losses, but without any trade-offs as consideration for the increase. And as we all know following the 2008 Financial Crisis, historical losses are not a good predictor of future performance in banking. In this case, the optics don't look great.

But I digress. Having to increase limits on even a semi-regular basis is a symptom of the real problem, which is that most banks fail to marry their concentration limits with their strategic plans. Strategic plans often call for growth in certain areas, and those areas can change over time. The post-pandemic economy will look very different than the pre-pandemic one, with certain industries far better positioned for growth than others. As a result, bank strategic plans will have to change dramatically relative to their pre-crisis plans.

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Concentration limits and triggers should be aligned with the bank's strategic plan, and therefore need to also change. That means new concentrations at the industry level may need to be created, and many existing concentration limits should be altered. In some cases, limits need to be raised. But that should also mean that limits may need to be reduced as a trade-off.

That way, both management and the board are in a much better position because limits and triggers are being determined in conjunction with the strategic plan, and limits can be raised and reduced strategically.

THE SOLUTION: ACTIVE CONCENTRATION MANAGEMENT (ACM)

In response to the convergence of these issues, a new framework toward managing concentrations has emerged. It has a name, Active Concentration Management (ACM), and it involves a quantitative method to both identify concentrations and estimate their appropriate triggers and limits. The beauty of ACM is that it was designed to be a dynamic process that can be updated on a recurring basis.

It's also a process that seamlessly synchronizes with a bank's strategic plan, yet is agile, so it can easily adapt when those plans change. It's a process that accounts for all other limits so if added up, they can all be supported based upon an analysis of the bank's capital position. It supports the idea that a given loan could be counted in multiple buckets (a hotel loan would count toward both the Accommodation and Food Services concentration and the CRE concentration) without any confusion. It accounts for all possible trade-offs involving capital, so if a limit in one area is raised, it may need to be reduced in another. And that trade-off is not a simple "1 for 1" one, either; it considers the different risks inherent in each segment. Higher risk segments will require more capital to support them, so a 1 percent increase in such a category could require a 2 percent decrease in another segment that has less risk.

ACM also considers the diversion of capital for other activities. Planning a huge stock repurchase plan? There could be less capital as a result to support concentration limits, which may need to now be revised downward. Ditto with a capital raise that could increase limits. ACM also is a perfect tool to use to evaluate and plan for the most transformative transaction of them all, M&A. An acquisition can have a dramatic and overnight impact on a bank's concentration profile. ACM has the agility to readjust to all these moving parts with ease.

The ultimate goal of ACM is to allocate capital to all the various asset classes from a capacity standpoint, as well as any strategic decisions under consideration, without jeopardizing the safety and soundness of the bank.

WRAP UP

Concentration management is quickly evolving because of the pandemic. A new framework called Active Concentration Management has emerged that is far more dynamic and agile. It provides management with the tools to properly tailor concentration limits and triggers to its strategic plan and capital while also providing the Board of Directors with the appropriate intelligence to validate management's requests.

ACM concepts are not a regulatory requirement yet. However, those banks that wait to utilize ACM concepts until they are "required" will be making a mistake because regulators are increasingly expecting banks with concentrations to achieve the same objectives that ACM enables. But ACM's biggest benefit is the ability to optimize balance sheet capacity without impacting the bank's safety and soundness profile. It allows a bank to increase earnings without having to raise additional capital or walk away from holding loans on its balance sheet because of an arbitrarily determined internal threshold.

Resources for Further Reading

https://invictusgrp.com/2021/05/how-to-break-through-the-concentration-limit-ceiling/

https://invictusgrp.com/2021/05/the-business-case-for-dynamic-concentration-risk-management/

https://invictusgrp.com/2021/04/how-the-pandemic-has-changed-the-nature-of-managing-concentrations/

https://invictusgrp.com/2021/01/news-alert-regulatory-advice-on-what-banks-should-do-in-2021/

REGULATORY GUIDANCE

https://www.occ.gov/publications-and-resources/publications/comptrollers-handbook/files/concentrations-of-credit/index-concentrations-of-credit.html

ABOUT THE AUTHOR

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Adam Mustafa is a co-founder of the Invictus Group. He has overseen the design and implementation of fully customized capital stress testing, capital management, CECL, and strategic planning systems. He has also advised acquisitive and high growth banks, banks under enforcement actions, and de novos. Prior to joining Invictus, he had senior-level experience as a banker, financial services consultant, and corporate CFO, working at companies such as Secure Symbology Inc., BlueStone Capital, and Deloitte and Touche. He is frequently invited to speak on regulatory panels about CECL, concentration risk management and M&A. He has a BA from Syracuse University and an MBA from Georgetown University.

TO GET STARTED ON ACM:

Invictus Group has developed groundbreaking software that enables banks to actively quantify their concentration limits in a manner that optimizes their capital and complies with the ACM framework. The software uses stress testing techniques to estimate the bank's excess capital and the capital "charge" for each loan segment. Banks can select segments of their portfolio they want to set limits for, and then see how it affects their excess capital in real time. This allows banks to optimize all their concentration limits with a click of a few buttons. Please email Adam Mustafa at amustafa@invictusgrp.com for more information.

Invictus gives its clients a competitive edge in M&A, CECL, strategic intelligence, stress testing and capital planning, concentration management, and more.

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