



Office of Thrift Supervision

Department of the Treasury

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MEMORANDUM FOR: CHIEF EXECUTIVE OFFICERS

FROM:

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SUBJECT:

Risk Management: Asset and Liability Concentrations

The Office of Supervision (OTS) has conducted internal reviews of recent savings association failures and has identified concerns regarding asset and liability concentrations and related risk management practices. Higher-risk asset and liability concentrations contributed significantly to the increase in “problem banks” and recent resulting failures. OTS is issuing this memorandum to re-emphasize important risk management practices for financial institutions’ boards of directors and management and to encourage institutions to revisit their existing concentration policies given the current economic environment.

Each board of directors should approve and implement a sound risk management framework to identify, measure, and control the level of concentration risk commensurate with the size and complexity of its institution. This framework should include: specific board and management oversight reports; standards for portfolio monitoring and management; appropriate management information systems and data collection; market analysis; strong credit underwriting standards; readily understood stress testing and sensitivity analysis; and a robust asset risk review function.

Concentration risk management and mitigation is essential regardless of economic conditions. OTS’s longstanding expectation is for financial institutions to develop risk management systems to ensure prudent underwriting and investment standards including explicit, board-approved, reasonable limits for higher-risk (and higher risk weighted) asset concentrations and higher-risk liability concentrations. The board should review the risk management systems on a scheduled basis, including adjusting and refining concentration limits.

The board should establish limits based on a percentage of the savings association’s capital (in most cases, Tier 1 (core) capital plus allowances for loan and lease losses (ALLL)). The board should set concentration limits at lower levels as a percentage of capital for business activities that pose significant risk. For example, non-traditional mortgage loan products, particularly those with layered risk features, should have lower limits than traditionally underwritten, prime,

one- to four-family mortgage loans. OTS will monitor all concentrations and will closely review institutions that establish high internal limits, particularly if they exceed 100 percent of core capital plus the ALLL.

OTS exam teams review an institution's risk management practices in relation to concentrations that pose significant risk. For example, when there is significant exposure to purchased loans from third parties who control the servicing, disbursement, and collection processes, this relationship requires a more intensive review of the controls. OTS encourages the use of an independent, qualified third-party to review and monitor these relationships. The third-party can comprise internal or external staff, but should retain its independence. An independent review is particularly important when: a) the relationship involves higher-risk loans or investments and b) the institution lacks a strong internal audit department or risk management system.

The following list summarizes lessons learned from recent examinations and recommendations pertaining to concentration risk and risk management practices from failed bank reviews. OTS examiners will consider these lessons and recommendations while assessing financial institutions' risk management systems.

- Market pressures and competition have compelled some institutions to lower underwriting standards and loan terms to maintain market share or origination volume. Concentrations of loans originated under lowered standards increase risk.
- Loans originated for sale to third parties may suggest that all risks are transferred to the purchaser. In reality, institutions that sell loans often retain material risk long after the loans are sold due to default provisions, fraud, and technical deficiencies in loan documents or sales and servicing agreements.
- Higher-risk activities and concentration risks can be masked by financial success during periods of favorable economic conditions. Institutions with concentration levels in higher risk activities should maintain sufficient capital buffers in excess of Prompt Corrective Action "well capitalized" levels to compensate for the higher risk.
- Rapid growth in asset concentrations should be monitored carefully and should be periodically targeted for audit or loan review sampling. Detection of underwriting deficiencies and loan performance weaknesses often occurs after the portfolio risk has grown to an excessive level.
- Credit-related models are not likely to perform as well in a rapidly deteriorating environment. ALLL provisioning methodologies are often based on historic loan performance resulting in reserve levels that do not keep pace with current loan performance and losses. During economic fluctuations, management should shorten the "lookback" period for portfolio performance to ensure sufficient ALLLs (see also [CEO Memo #304](#) dated May 22, 2009).

- Financial institution staff should understand the loss mitigation process. Management should ensure sufficient staffing to handle the increased level of delinquencies, foreclosures, and loan modifications. In addition, the institution needs to be prepared to handle elevated compliance, accounting, and consumer issues arising from an increased level of problem loans.
- Aggressive growth plans funded by brokered deposits, high rate certificates of deposit, or other volatile liabilities, often lead to higher risk lending activities, including:
 - Weakened underwriting standards
 - Loan documentation deficiencies
 - Inadequate credit administration and collection practices
 - Developing excessive concentrations in short periods
 - Loan losses that exceed business plan projections
- Institutions providing warehouse financing may see their risk rapidly increase in a market disruption since counterparties may suffer severe financial stress.
- Counterparty risk should be thoroughly analyzed and limits should be established for risk exposure to federal funds sold to other financial institutions.
- Institutions within a holding company structure should also evaluate the potential risk exposure to the savings association when affiliates have exposures to concentrations. In such cases, the thrift's concentration exposure may need to be aggregated with those of affiliates in order to evaluate the potential risk from the consolidated holding company's concentrations.
- The cost, duration, stability, and reliability of funding sources should be thoroughly considered in relation to anticipated used of funds and liquidity management practices.

OTS encourages savings associations to provide credit to qualified borrowers for consumer and business purposes, provided that such credit is extended in a safe and sound manner. Institutions must also document each borrower's willingness and ability to repay. Such documentation should be commensurate with the size and risk of the respective extensions of credit. Financial institutions should ensure they adhere to prudent underwriting practices, particularly for loan portfolios with higher risk concentrations. Financial institutions should not allow competitive pressures to erode the quality of underwriting.

OTS examiners will closely review and scrutinize higher risk concentrations during examinations. These reviews will assess management and the Board's ability to establish appropriate concentration limits and implement effective risk management systems. OTS will exercise supervisory discretion in limiting or curtailing activities to prevent and limit unsafe and

unsound business activities. OTS will pursue appropriate corrective action or enforcement action when an institution does not maintain appropriate concentration limits or takes excessive risks.

For additional information, the OTS Examination Handbook discusses concentrations of credit in [Section 201, *Overview: Lending Operations and Portfolio Risk Management*](#). The Handbook also discusses liability concentrations in [Section 530, *Liquidity Management*](#). If you have questions regarding this memorandum, please contact Managing Director for Supervision, Lori Quigley at 202-906-6265.