Concentration Risk is Coming for You
by Charles B. Wendel

I have long thought that every 15-20 years or so the banking industry finds a new way to blow itself up. But I may have been wrong.

Yes, the terminal disease self-created by SBV relating to deposit concentration risk was a surprise to many, including me. Hedging and other methods to limit the impact of interest rate increases are hardly a new phenomenon. Naively, I assumed that banks were watching their exposure and actively mitigating it. Apparently, not at SVB.

But it is concentration risk of *all and various kinds* that continues to confound the banking industry. It always has and it always will. By their very nature, banks are subject to concentration risk:

- Community banks largely depend upon the health of their local economy whether a town in New Jersey or Arkansas. When they venture out of their local turf their lending performance often suffer due to lack of local knowledge.
- Lenders work to build reputations and growth in specialty industry and/or product areas. This can both lower origination costs and, ideally, improve risk performance based upon the deep industry knowledge they develop.
- CRE lending continues to be the man focus of many community banks.
- Banks aim to gain more wallet share from each business and consumer customer, generating more income from a small number of clients. The 80/20 customer rule highlights concentration.
- With deposits, every good banker I know wants to gather as much in “low cost” deposits from their client base as possible, and many banks pay incentives based upon deposits captured. Obviously, it’s much easier to get more deposits from a current client than to find a new client with deposits.
- Many banks depend upon a handful of IT providers.

Bank efficiency depends in part upon loan and deposit concentrations. Selling has a high fixed cost component so banks want more profit bang for each cost buck. Basic. But also, a basic risk.

Add on to this another concentration issue, as critical as those above but demanding more focus, namely, supplier concentration risk, often related to Core providers. Core companies have done a great job in building fortresses within many banks, consolidating their power and making banks dependent upon them. When banks try to supplement their Cores by bringing in the capabilities of a different and perhaps more flexible third-party provider, integration issues often arise. Or the Core may offer its own provider in that area, often the result of the vacuum-like acquisition practices of the Core. Similarly, some banks are subject to supply chain risk in areas such as network infrastructure, among others.

Bluntly, my experience in working with Core providers is that some have failed to integrate their acquisitions seamlessly and that whatever unified culture they once had it has been destroyed as deal after deal occurs. Phone or video meetings between banks and their Cores often feature Core employees introducing themselves to each other, never having met previously. That is not a confidence builder.

And the Core provider knows that for most bankers going through a Core conversion ranks with a proctology exam or a root canal. And what's the point of moving from one amorphous Core another?

In addressing bank-wide concentration risks, Step One requires management and the BOD to assess the bank's dependence on potentially excess concentrations in all key areas, whether deposits, loans, Core and IT support, supply chains, or other areas unique to the bank.

Step Two involves developing options to mitigate the risk. Oftentimes, this may involve a longer-term plan that needs to be launched as soon as possible.

Step Three may involve tracking of the bank's success in lowering the amount and relative intensity of the concentration.

Banks can thrive on exploiting revenue and profit opportunities tied to concentration. But in some cases, they can be operating on a knife's edge, with long-term risks outweighing short-erm profit opportunities.