The BakerGroup

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Concentration Risk Management: A Modern Framework for Community Banks

Concentration risk appears to be an increasing regulatory priority for the banking agencies. The number of questions from our clients in this area continues to trend higher—particularly over the second half of 2025. It does not come as a huge surprise given the agencies' 2025 priorities, where several noted accelerating risk in credit cards, used auto loans, and junior-lien 1-4 family real estate. These carry higher loss volatility, weaker collateral protection, and greater sensitivity to economic and household-financial stress.

Regulators have long emphasized that concentrations pose heightened safety-and-soundness risks, not because of average performance but because of their tail-loss potential. The FFIEC's Interagency Guidance on Concentrations in Commercial Real Estate (2006) stresses the need for robust identification, measurement, monitoring, and control systems. The OCC's Concentrations of Credit Handbook further directs banks to evaluate how these concentrations behave "under stressed conditions." Given the current macro environment, regulators are placing greater scrutiny on whether banks understand how adverse credit conditions could affect portfolios that are growing faster than historical norms.

Developing a Sound Approach to Concentration Limit Setting

A strong concentration-risk framework incorporates both quantitative analysis and peer-informed calibration, ensuring that policy limits are not arbitrary but grounded in demonstrated capacity to absorb losses. While approaches vary by bank, regulators expect sound methodologies to include the following elements:

1. **Identify a severe but plausible credit-loss scenario**
   A fundamental step is to establish a stress-case net charge-off rate for each major concentration. Banks often use:
   - Their own historical worst-year charge-off rates
   - Peer-group percentile losses
   - Scenario-based adjustments informed by macroeconomic outlook

   This aligns with the FFIEC's expectation of using stress scenarios that reflect adverse economic outcomes and portfolio-specific vulnerabilities.

2. **Apply the stress-loss rate assuming the concentration reaches its policy limit**
   Regulators consistently remind banks that concentration limits should reflect potential exposure, not just current balances. The FDIC and OCC emphasize evaluating exposure at limit, meaning the stress loss should be modeled as if the portfolio grows to the maximum amount permitted by policy.

   This provides a forward-looking measure of whether the bank could withstand losses if the concentration expands to the boundary approved by the board.

3. **Assess capital impact and compare to risk-tolerance thresholds**
   The stress losses are then applied against current capital to calculate metrics such as:
   - Capital at Risk (bps impact)
   - Stressed Capital Ratio
   - Post-stress Net Worth or Leverage Ratio

   These metrics help boards determine whether current (or proposed) limits are supportable given the bank's capital strength, earnings capacity, and broader risk profile.

4. **Compare policy limits against peer percentiles to avoid outlier status**
   A well-designed framework also benchmarks the bank's limits against peer concentrations for each portfolio type. This comparison provides two important benefits:
   - Regulatory defense: Supervisors frequently flag banks whose limits far exceed peer norms, especially when not accompanied by enhanced monitoring or underwriting practices.

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- Strategic calibration: Ensures the limit reflects competitive posture, portfolio objectives, and the bank's balance-sheet diversification strategy.

Peer alignment is explicitly supported in FFIEC guidance, which states that limits should be commensurate with the bank's capital, management expertise, and market environment.

Governance, Monitoring, and Ongoing Review

Regardless of the quantitative approach used, regulators expect strong governance practices, including:

- Clear board-approved limits tied to risk appetite
- Quarterly reporting of concentration levels, growth trends, and stress-based capital impacts
- Annual review and recalibration of limits based on updated losses, peer data, and capital position
- Documentation demonstrating board understanding and approval of the methodology

Guidance emphasizes that concentration-risk management must be integrated with capital planning, CECL, ALM, liquidity planning, and strategic planning. It should not be treated as a stand-alone compliance exercise.

Loan Participations as a Tool to Manage Risk

More and more community banks are using loan participations as a primary tool for managing concentration risk. Participations enable banks to sell portions of higher-growth segments that are approaching policy limits, while also purchasing exposure to asset classes that improve diversification. When aligned with the concentration-limit framework described above, participations serve as a flexible balance-sheet adjustment mechanism—allowing banks to rebalance risk and support prudent growth without relying solely on organic runoff or tightened underwriting.

Conclusion

We expect concentration risk management to remain a key theme going into 2026 and beyond. To navigate this environment effectively, banks should adopt a stress-based, peer-informed, capital-aligned framework for setting and managing concentration limits.

By identifying severe but plausible loss rates, evaluating exposures at the policy limit, measuring capital impact, and ensuring alignment with peer norms, boards and executives can confidently demonstrate that their concentration limits reflect both regulatory expectations and prudent risk appetite. This approach enhances safety and soundness, strengthens capital planning, and positions banks for more constructive and credible examinations.

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