Steve H. Powell & Company

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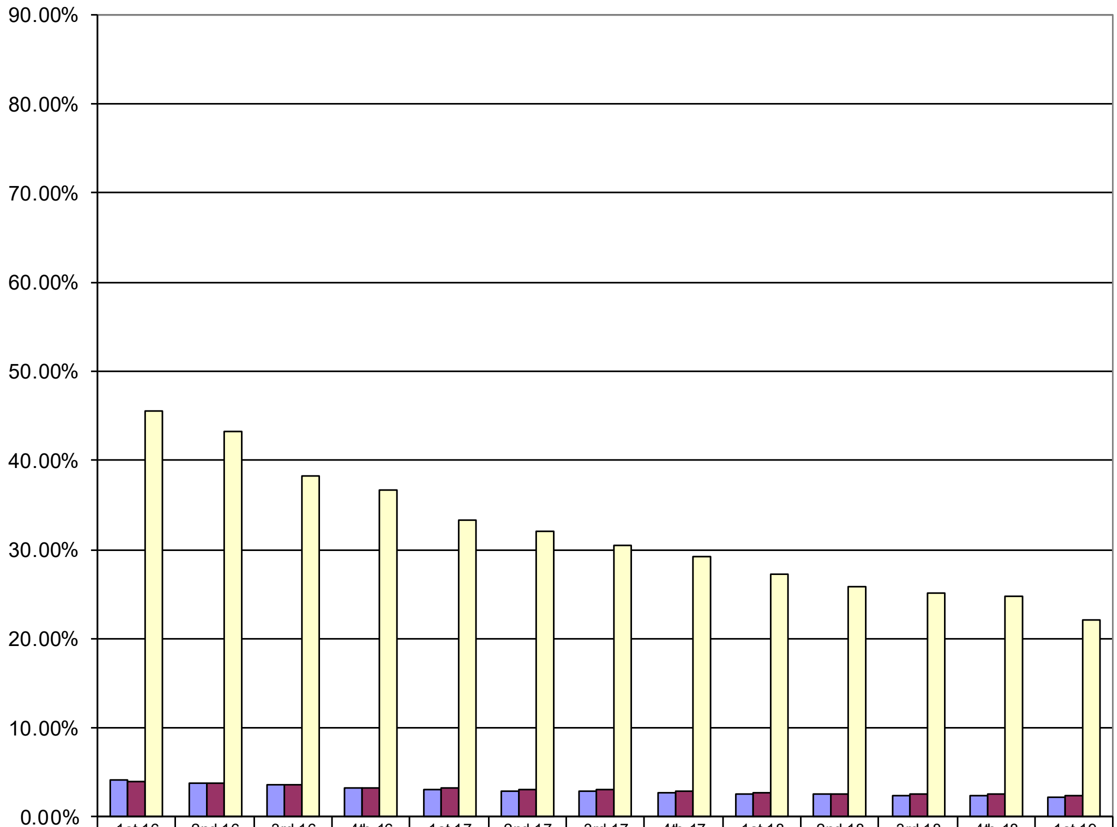
Asset Quality Update – Q1 2019 Edition

Trends in Asset Quality – Average Levels

Based on Steve H. Powell & Company client data, during the First Quarter 2019, the average level of adversely graded assets decreased as a percentage of total assets, loans, and capital. Problem assets averaged 2.27% of total assets and 22.08% of tier-one capital plus loan loss reserve as compared to 2.39% of total assets and 24.72% of tier-one capital plus loan loss reserve while problem loans averaged 2.47% of total loans as compared to 2.56% of total loans during the Fourth Quarter 2018.

TRENDS IN ASSET QUALITY
AVERAGE LEVEL OF ADVERSELY GRADED ASSETS

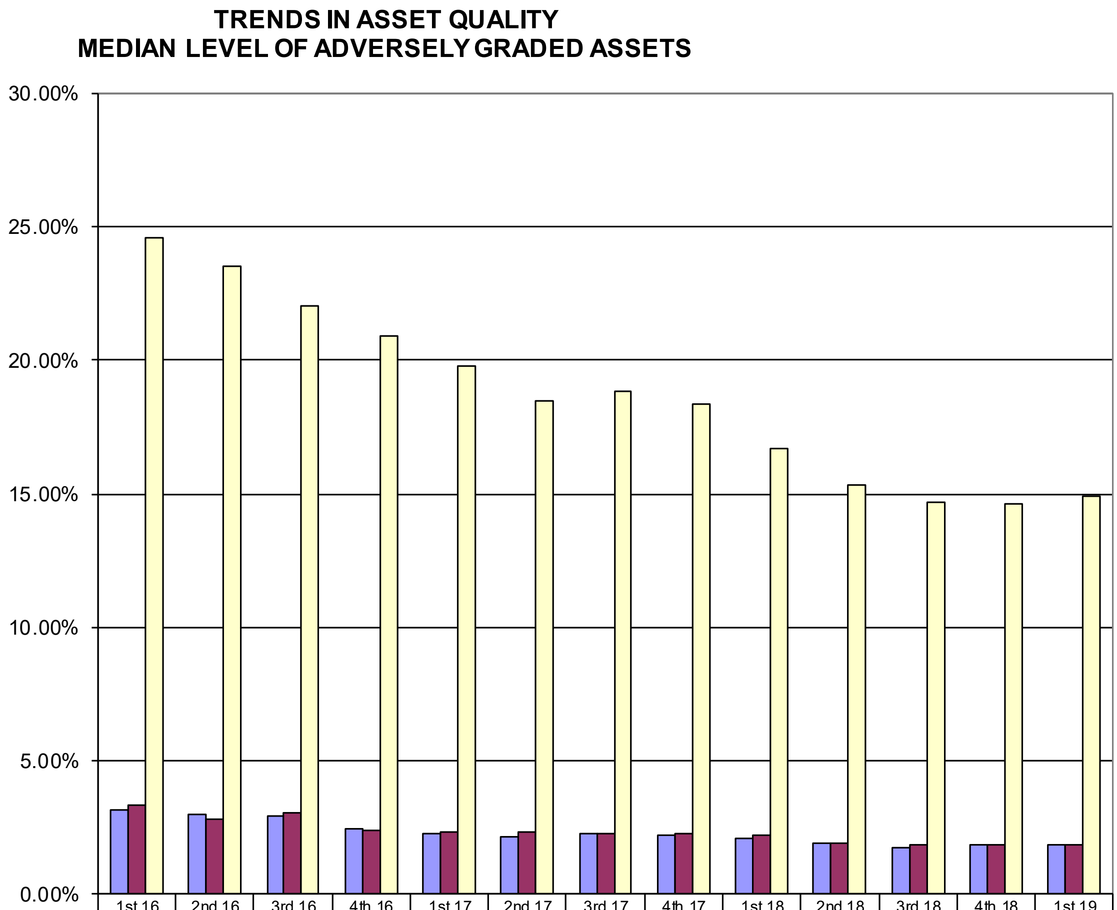


	1st 16	2nd 16	3rd 16	4th 16	1st 17	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19
- Adversely Graded Assets / Total Assets	4.09%	3.78%	3.57%	3.36%	3.12%	2.97%	2.90%	2.77%	2.65%	2.49%	2.41%	2.39%	2.27%
- Adversely Graded Loans / Total Loans	4.06%	3.74%	3.55%	3.27%	3.23%	3.10%	3.09%	2.90%	2.82%	2.61%	2.55%	2.56%	2.47%
- Adversely Graded Assets / Tier 1 Cap' + LLR	45.62%	43.28%	38.23%	36.65%	33.39%	31.99%	30.45%	29.26%	27.27%	25.92%	25.04%	24.72%	22.08%

Steve H. Powell & Company was founded in August of 1993 by former banker and regulator, Steve H. Powell. With the goal of providing unparalleled asset quality monitoring and regulatory compliance services, the company's clientele base has grown and now exceeds 100 different financial institutions. We also provide our clients with bank charter consulting, due diligence support, regulatory applications, financial analysis, and strategic planning. The staff of Steve H. Powell & Company is comprised of former bankers & regulators who understand the complexities of today’s regulatory environment. The unique skill sets possessed by our specialists are derived from extensive review experience in institutions of various sizes and charter types.

Trends in Asset Quality – Median Levels

The median level of problem assets as of Q1 2019 increased to 14.93% of tier-one capital plus loan loss reserve as compared to 14.62% during Q4 2018.



	1st 16	2nd 16	3rd 16	4th 16	1st 17	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19
- Adversely Graded Assets / Total Assets	3.14%	2.96%	2.91%	2.47%	2.28%	2.15%	2.27%	2.22%	2.08%	1.90%	1.74%	1.85%	1.87%
- Adversely Graded Loans / Total Loans	3.37%	2.84%	3.03%	2.42%	2.34%	2.35%	2.30%	2.27%	2.22%	1.93%	1.85%	1.84%	1.83%
- Adversely Graded Assets / Tier 1 Cap' + LLR	24.60%	23.51%	22.03%	20.91%	19.77%	18.48%	18.81%	18.34%	16.68%	15.31%	14.65%	14.62%	14.93%

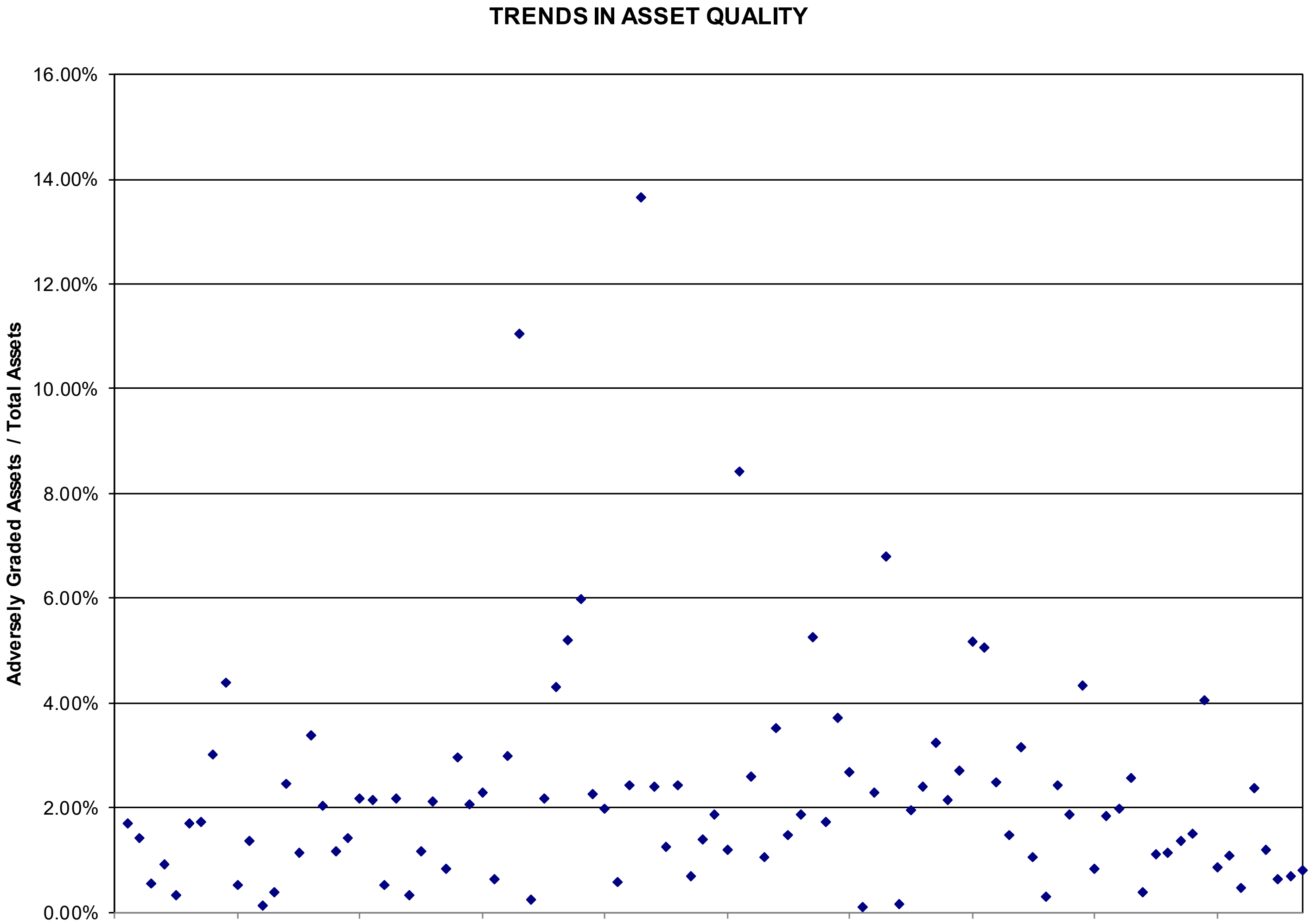
Historical Comparisons

During Q1 2019, increases in problem assets, as measured by adversely graded assets divided by tier-one capital plus loan loss reserve, were noted in approximately 24% of our clients. This quarter's increase compares to:

- 10% during the Fourth Quarter 2018
- 16% during the Third Quarter 2018
- 20% during the Second Quarter 2018
- 15% during the First Quarter 2018
- 21% during the Fourth Quarter 2017

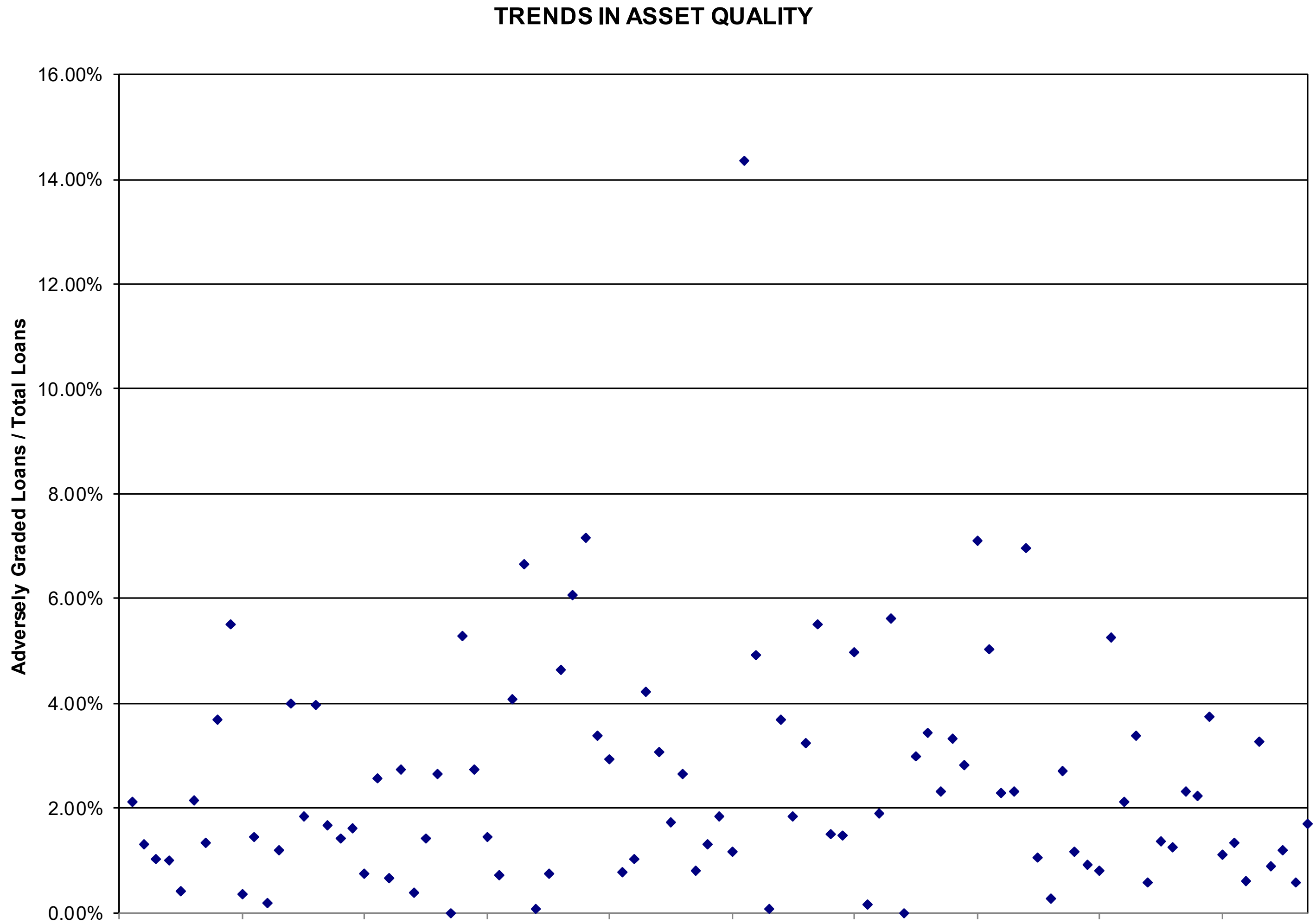
A higher level of volatility in the percentage of increases may be expected as overall asset quality stabilizes; however, increases may indicate a rise in portfolio risk.

Dispersion of Problem Assets – as a Percentage of Total Assets



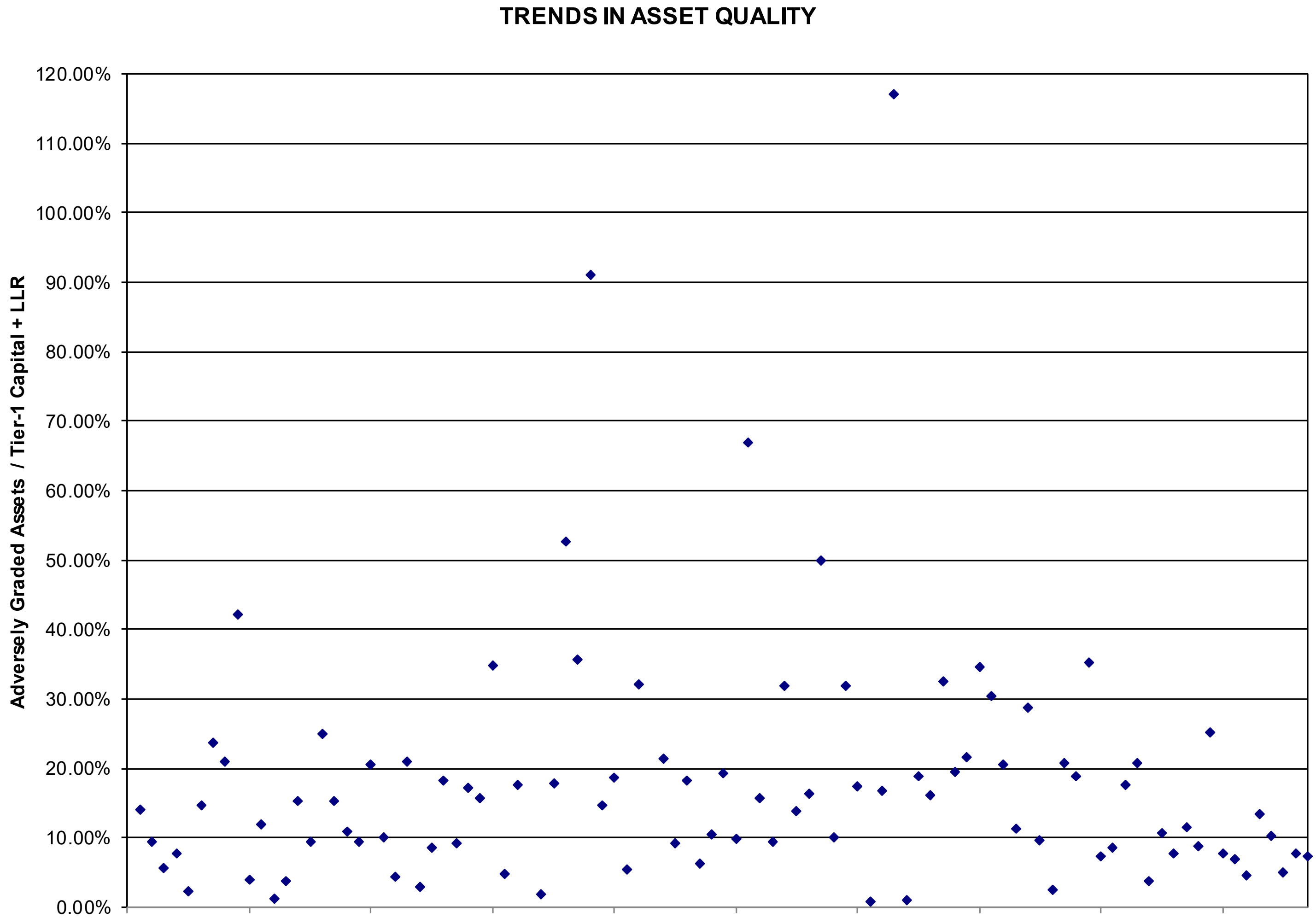
The above graph shows the dispersion of problem assets as a percentage of total assets. A traditional benchmark for significant asset quality concern is adversely graded assets that exceed 10% of total assets.

Dispersion of Problem Loans – as a Percentage of Total Loans



A traditional benchmark for significant asset quality concern is adversely graded loans that exceed 10% of total loans.

Dispersion of Problem Assets – as a Percentage of Tier-One Capital & Reserves



Note that two data points exceeding 120% are not included in the graph above for aesthetic reasons.

Historical Comparisons

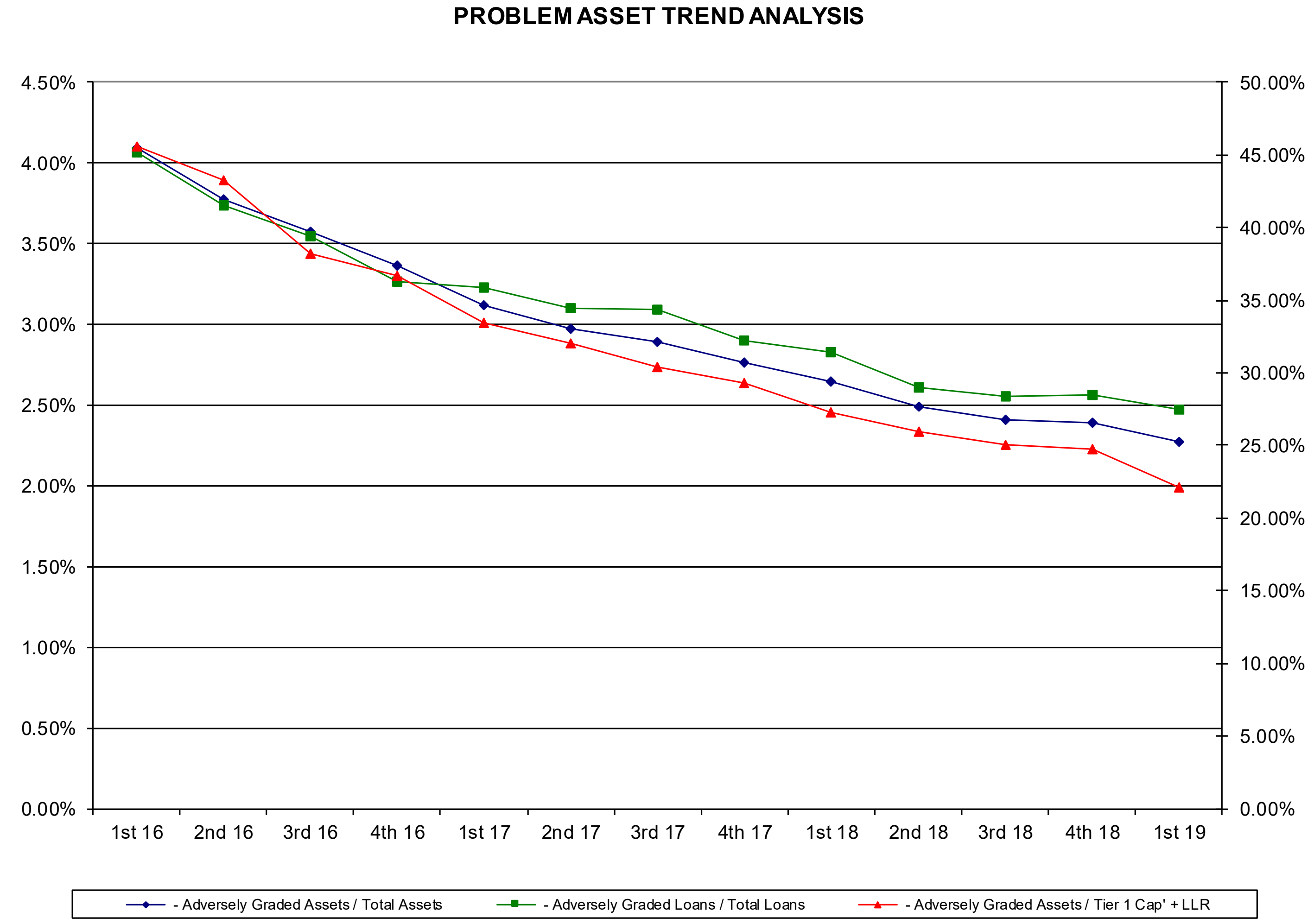
Our sample group includes five (5) banks with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

- Six (6) during the Fourth Quarter 2018
- Six (6) during the Third Quarter 2018
- Seven (7) during the Second Quarter 2018

Four (4) banks now exceed 80% of tier-one capital plus loan loss reserve – a level normally associated with some form of formal regulatory action – as compared to:

- Six (6) during the Fourth Quarter 2018
- Five (5) during the Third Quarter 2018
- Five (5) during the Second Quarter 2018

Problem Asset Trend Analysis



The above graph again shows the trend in asset quality over the past three years as measured by adversely graded assets to total assets, adversely graded loans to total loans, and adversely graded assets to tier-one capital plus LLR.

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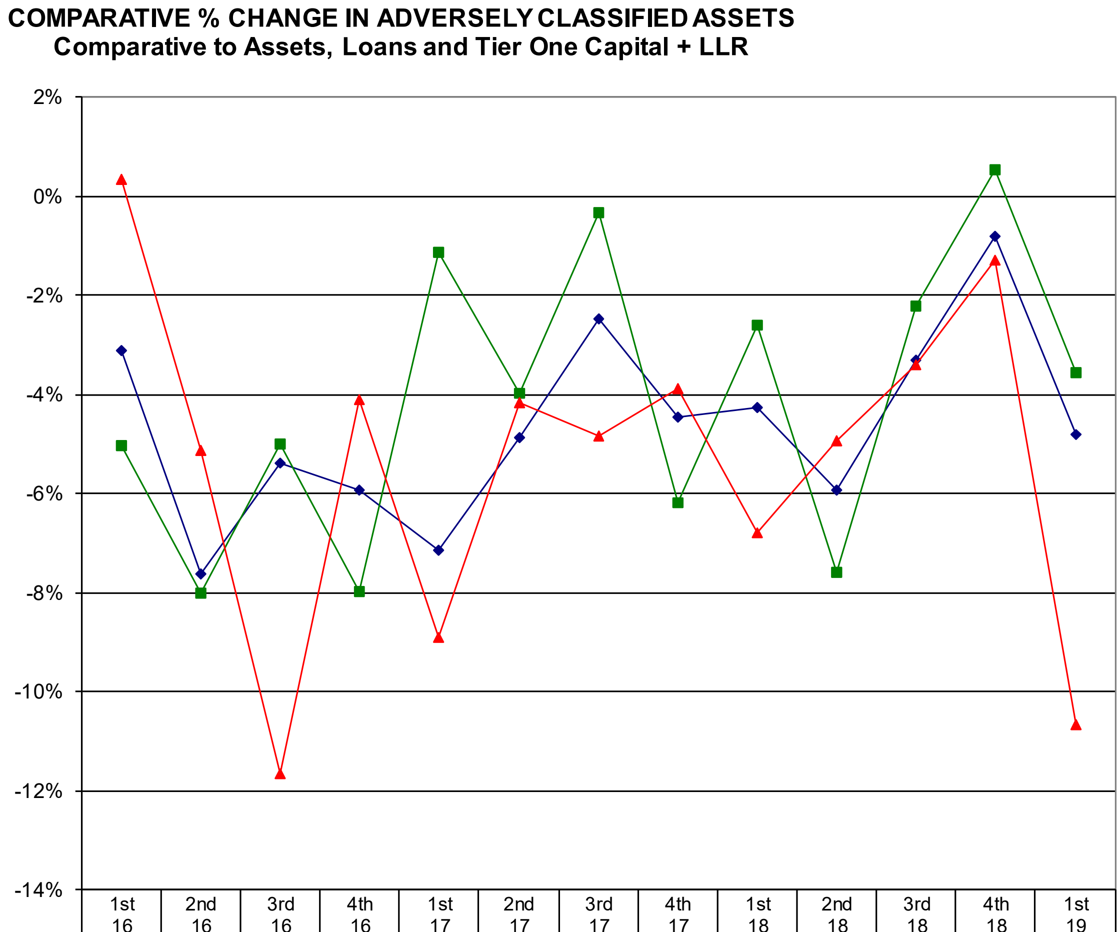
Problem Asset Comparative Change Analysis



	1st 16	2nd 16	3rd 16	4th 16	1st 17	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19
% Change in ACA/TA	-3.13%	-7.62%	-5.40%	-5.94%	-7.14%	-4.89%	-2.48%	-4.47%	-4.28%	-5.93%	-3.30%	-0.82%	-4.81%
% Change in ACL/TL	-5.04%	-8.02%	-5.01%	-7.99%	-1.13%	-3.98%	-0.35%	-6.19%	-2.61%	-7.60%	-2.21%	0.54%	-3.57%
% Change in ACA/Tier 1 Cap' + LLR	0.35%	-5.13%	-11.66%	-4.12%	-8.90%	-4.19%	-4.83%	-3.90%	-6.81%	-4.93%	-3.39%	-1.29%	-10.68%

The above graph shows the pace of asset quality deterioration or improvement. The calculation is based on the percent change of problem asset levels from one quarter to the next. The graph indicates a favorable trend in asset quality ratios. Please note any data points below 0% indicate improvement in asset quality.

Modified Peer Data Analysis

We again performed an analysis in which six data points were excluded – the three lowest and the three highest data points, as based on classifications as a percentage of tier-one capital plus loan loss reserve.

With the excluded data points, problem assets (or loans when compared to total loans) averaged 2.06% of total assets, 2.45% of total loans, and 17.36% of tier-one capital plus loan loss reserve. First Quarter 2019 modified data compares to the following Fourth Quarter 2018 modified average data set:

- 2.15% of total assets
- 2.50% of total loans, and
- 18.89% of tier-one capital plus loan loss reserve

Other Real Estate Holdings

Roughly a decade after the Great Recession, several recent client bank examinations have highlighted issues with Other Real Estate holding periods. State chartered banking regulations address the period ORE can be held, and Federal Regulations exist placing additional constraints on ORE holding periods – establishing a holding period equivalent to that established for national banks.

During FDIC examinations, client banks have been cited for exceeding ORE holding periods dictated within Par 362 Subpart A (with emphasis added):

> **PART 362—ACTIVITIES OF INSURED STATE BANKS AND INSURED SAVINGS ASSOCIATIONS**
> **Subpart A—Activities of Insured State Banks**
> **§ 362.1 Purpose and scope.**
> (a) This subpart, along with the notice and application procedures in subpart G of part 303 of this chapter, implements the provisions of section 24 of the Federal Deposit Insurance Act (12 U.S.C. 1831a) that restrict and prohibit insured state banks and their subsidiaries from engaging in activities and investments that are not permissible for national banks and their subsidiaries. The phrase "activity permissible for a national bank" means any activity authorized for national banks under any statute including the National Bank Act (12 U.S.C. 21 et seq.), as well as activities recognized as permissible for a national bank in regulations, official circulars, bulletins, orders or written interpretations issued by the Office of the Comptroller of the Currency (OCC).
> (b) This subpart does not cover the following activities:
> (1) Activities conducted other than "as principal," defined for purposes of this subpart as activities conducted as agent for a customer, conducted in a brokerage, custodial, advisory, or administrative capacity, or conducted as trustee, or in any substantially similar capacity. For example, this subpart does not cover acting solely as agent for the sale of insurance, securities, real estate, or travel services; nor does it cover acting as trustee, providing personal financial planning advice, or safekeeping services;
> (2) Interests in real estate in which the real property is used or intended in good faith to be used within a reasonable time by an insured state bank or its subsidiaries as offices or related facilities for the conduct of its business or future expansion of its business or used as public welfare investments of a type permissible for national banks; and
> (3) Equity investments acquired in connection with debts previously contracted (DPC) if the insured state bank does not hold the property for speculation and takes only such actions as would be permissible for a national bank's DPC. **The bank must dispose of the property within the shorter of the period set by federal law for national banks or the period allowed under state law. For real estate, national banks may not hold DPC for more than 10 years.** For equity securities, national banks must generally divest DPC as soon as possible consistent with obtaining a reasonable return.

Please note the holding period dictated within the Regulation – the shorter of that allowed within the state law or no more than ten years. Discussion would seem to indicate charging the ORE property off may not be enough, and the ORE would need to be liquidated / removed from the bank's balance sheet.

For more information about Steve H. Powell & Company, please visit us on the web at www.shpco.net.

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