Steve H.
Powell & Company

Asset Quality Update – Q3 2019 Edition

Trends in Asset Quality – Average Levels

Based on Steve H. Powell & Company client data, during the Third Quarter 2019, the average level of adversely graded assets decreased as a percentage of total assets and capital. The average level of adversely graded loans decreased as a percentage of total loans. Problem assets averaged 2.07% of total assets and 19.29% of tier-one capital plus loan loss reserve as compared to 2.15% of total assets and 19.88% of tier-one capital plus loan loss reserve while problem loans averaged 2.31% of total loans as compared to 2.41% of total loans during the Second Quarter 2019.

TRENDS IN ASSET QUALITY
AVERAGE LEVEL OF ADVERSELY GRADED ASSETS

	3rd 16	4th 16	1st 17	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19	2nd 19	3rd 19
- Adversely Graded Assets / Total Assets	3.58%	3.37%	3.13%	2.97%	2.90%	2.77%	2.66%	2.51%	2.41%	2.39%	2.27%	2.15%	2.07%
- Adversely Graded Loans / Total Loans	3.56%	3.28%	3.24%	3.11%	3.10%	2.91%	2.84%	2.63%	2.55%	2.57%	2.48%	2.41%	2.31%
- Adversely Graded Assets / Tier 1 Cap' + LLR	38.41%	36.84%	33.56%	32.11%	30.57%	29.37%	27.46%	26.11%	25.04%	24.70%	22.07%	19.88%	19.29%

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 Q3 2019 have held steady at 13.3% of tier-one capital plus loan loss reserve as compared to 13.3% during Q2 2019. Note the downward trend as overall asset quality continues to improve.

TRENDS IN ASSET QUALITY
MEDIAN LEVEL OF ADVERSELY GRADED ASSETS

	3rd 16	4th 16	1st 17	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19	2nd 19	3rd 19
- Adversely Graded Assets / Total Assets	2.92%	2.48%	2.31%	2.15%	2.25%	2.20%	2.08%	1.96%	1.74%	1.85%	1.87%	1.73%	1.58%
- Adversely Graded Loans / Total Loans	3.03%	2.44%	2.37%	2.32%	2.38%	2.28%	2.27%	1.93%	1.85%	1.85%	1.84%	1.61%	1.66%
- Adversely Graded Assets / Tier 1 Cap' + LLR	22.23%	20.97%	19.83%	18.23%	18.84%	18.27%	16.72%	15.31%	14.65%	14.62%	14.93%	13.30%	13.30%

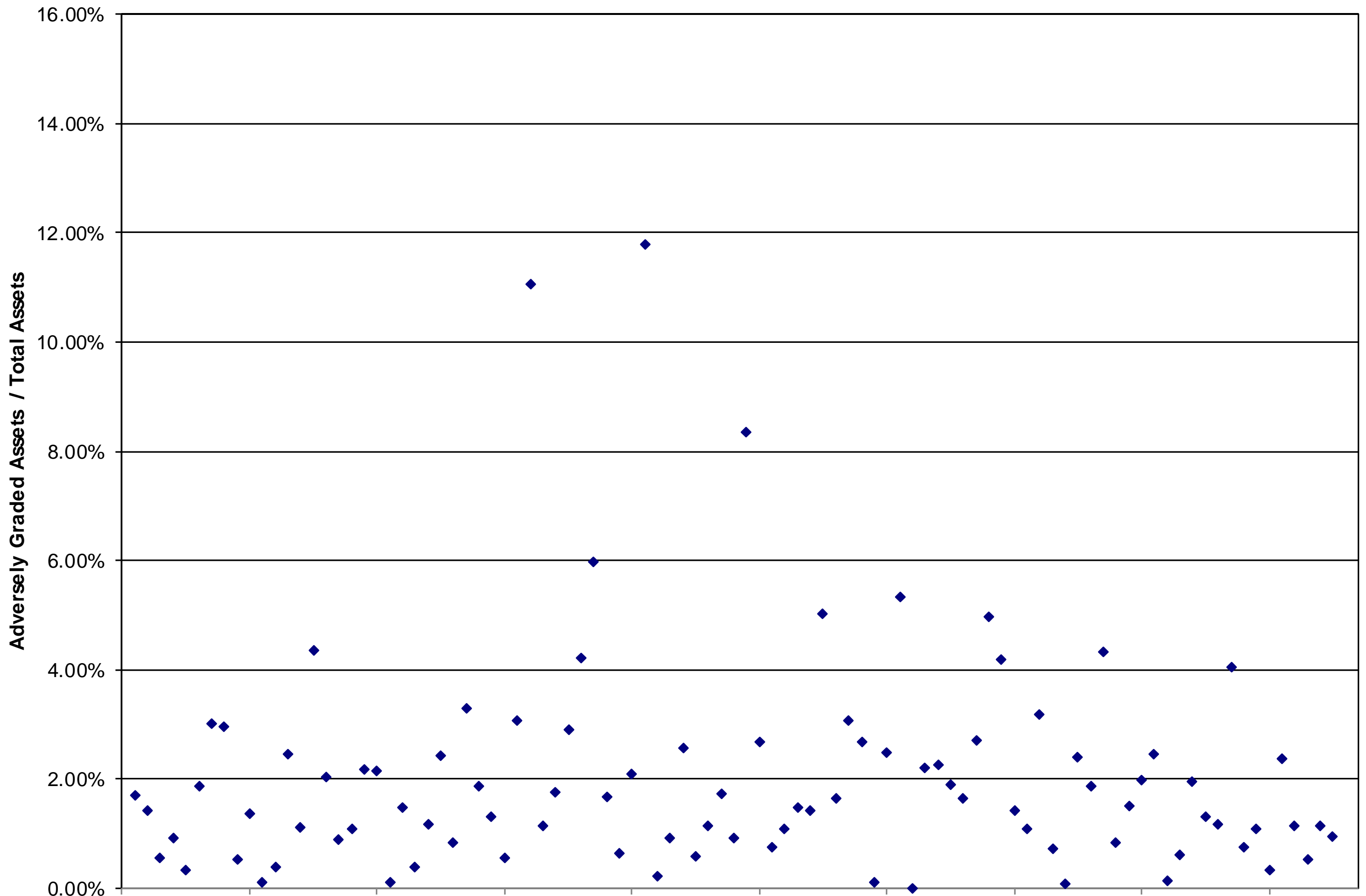
Historical Comparisons

During Q3 2019, increases in problem assets, as measured by adversely graded assets divided by tier-one capital plus loan loss reserve, were noted in approximately 11% of our clients. This quarter's increase compares to:

- 17% during the Second Quarter 2019
- 24% during the First Quarter 2019
- 10% during the Fourth Quarter 2018
- 16% during the Third Quarter 2018
- 20% during the Second Quarter 2018

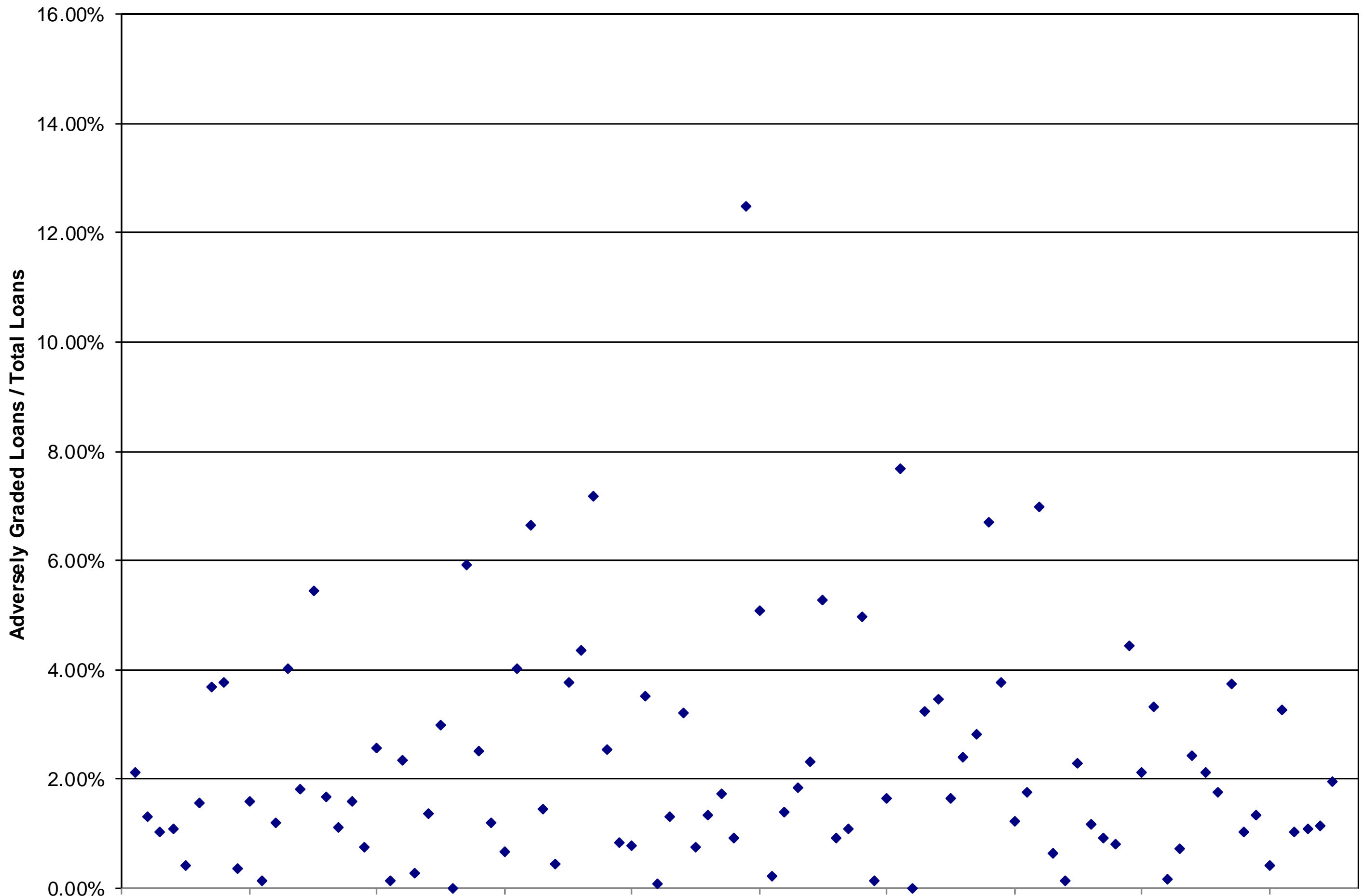
A higher level of volatility in the percentage of increases may be expected as overall asset quality stabilizes; however, increases may indicate a rise in portfolio risk.

Dispersion of Problem Assets – as a Percentage of Total Assets



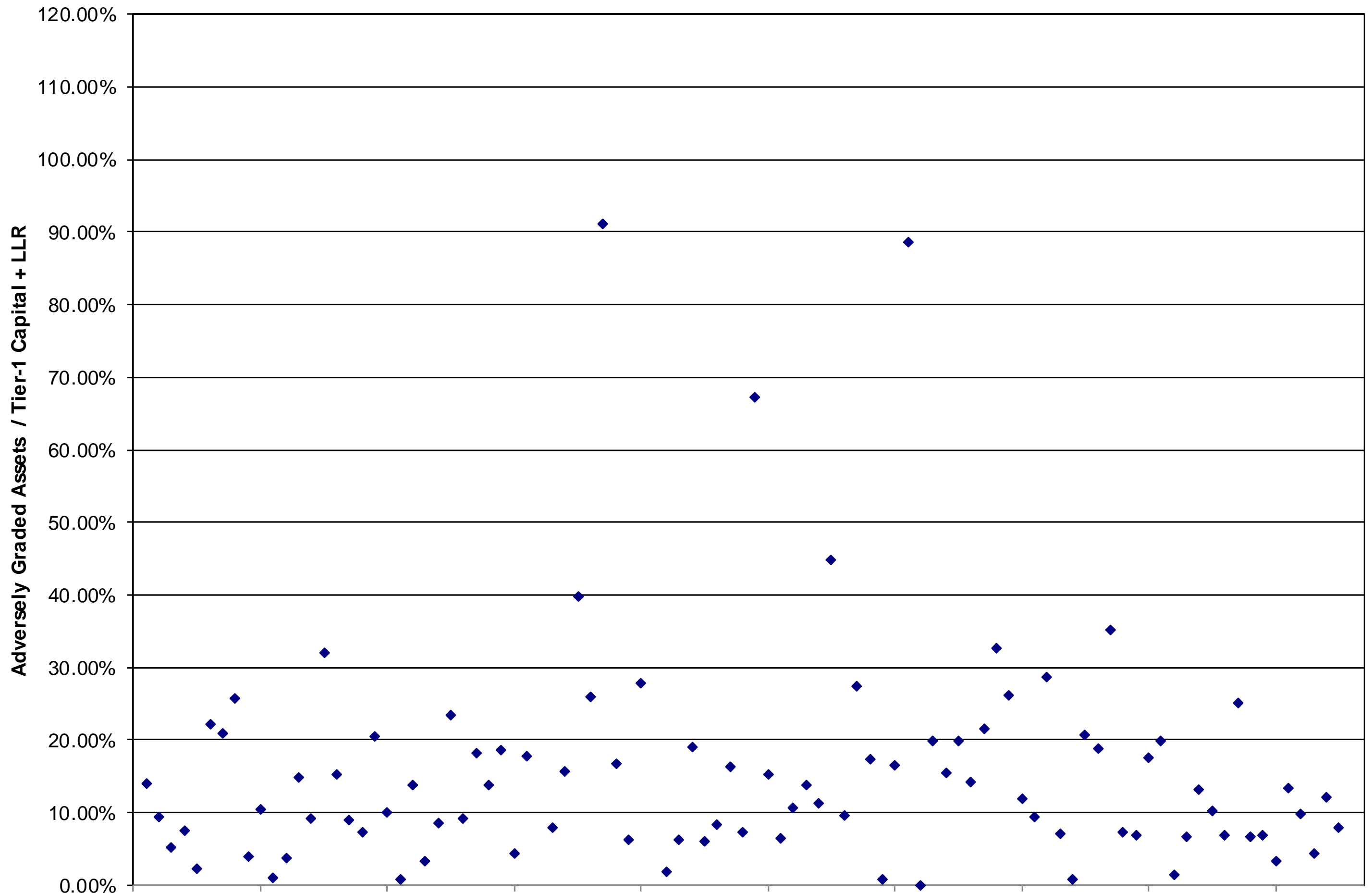
The above graph shows the dispersion of problem assets as a percentage of total assets. A traditional benchmark for significant asset quality concern is adversely graded assets that exceed 10% of total assets.

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

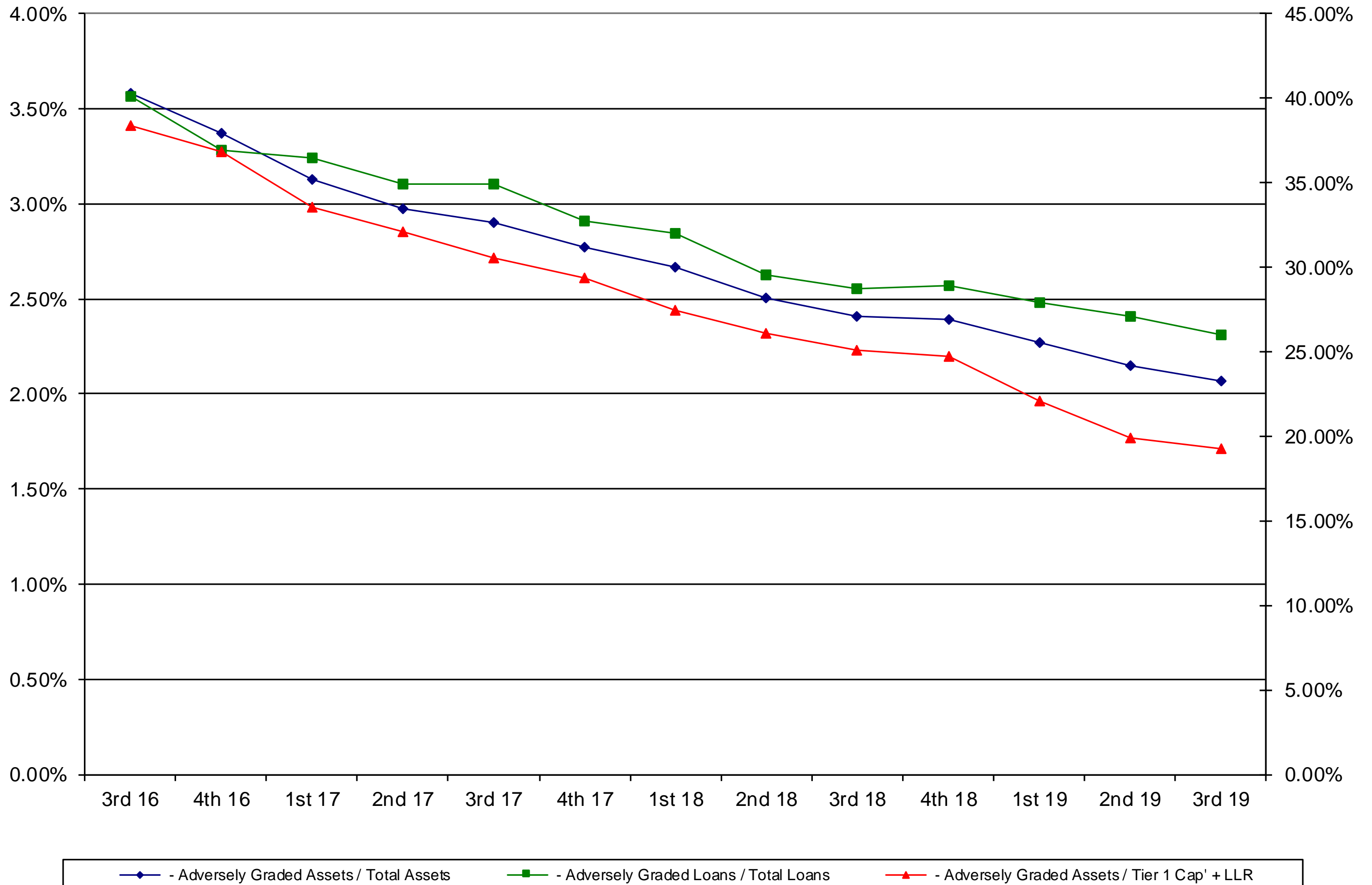
Our sample group includes five (5) banks with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

- Five (5) during the Second Quarter 2019
- Five (5) during the First Quarter 2019
- Six (6) during the Fourth 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:

- Four (4) during the Second Quarter 2019
- Four (4) during the First Quarter 2019
- Six (6) during the Fourth 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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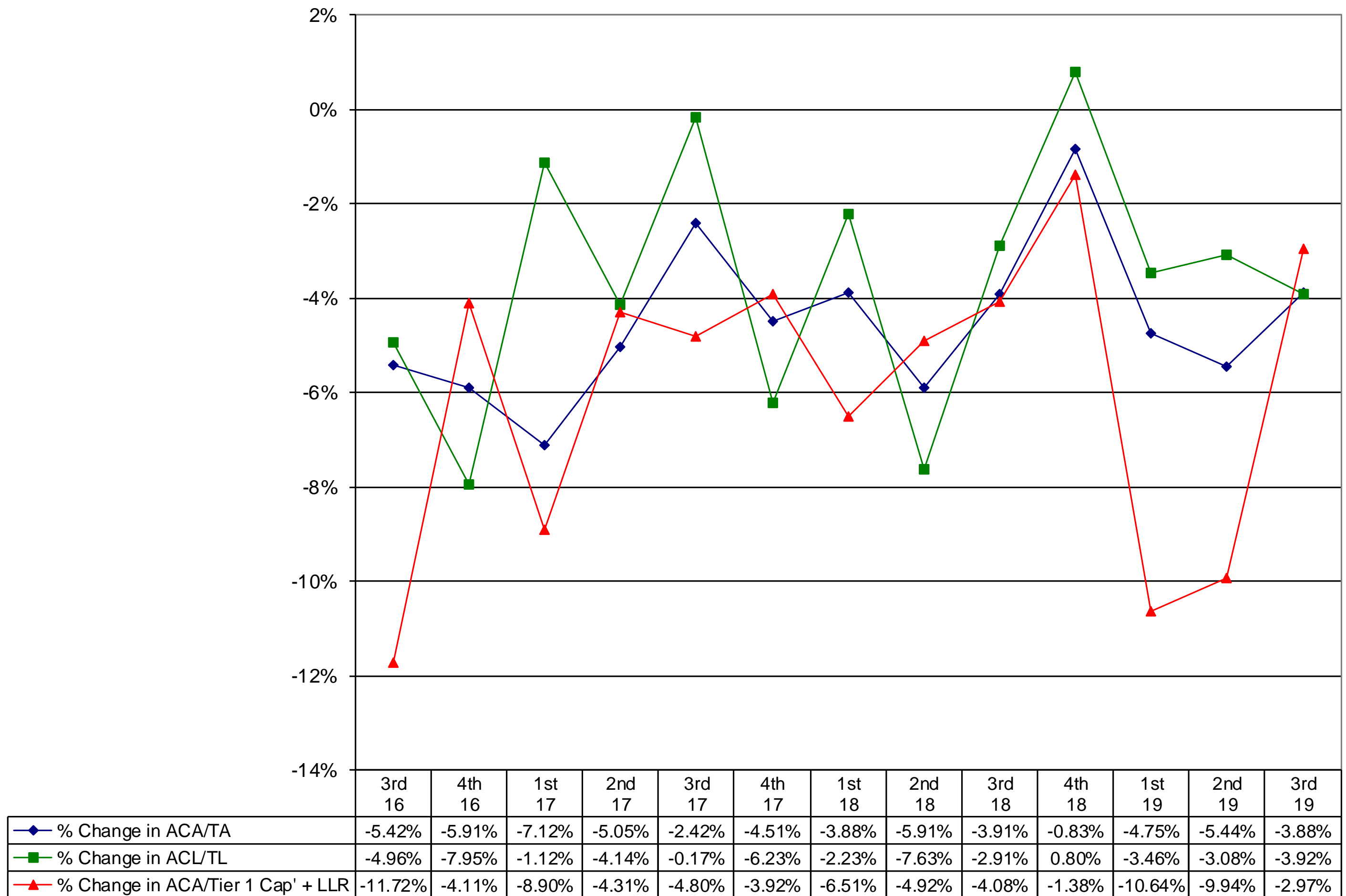
Problem Asset Comparative Change Analysis



	3rd 16	4th 16	1st 17	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19	2nd 19	3rd 19
% Change in ACA/TA	-5.42%	-5.91%	-7.12%	-5.05%	-2.42%	-4.51%	-3.88%	-5.91%	-3.91%	-0.83%	-4.75%	-5.44%	-3.88%
% Change in ACL/TL	-4.96%	-7.95%	-1.12%	-4.14%	-0.17%	-6.23%	-2.23%	-7.63%	-2.91%	0.80%	-3.46%	-3.08%	-3.92%
% Change in ACA/Tier 1 Cap' + LLR	-11.72%	-4.11%	-8.90%	-4.31%	-4.80%	-3.92%	-6.51%	-4.92%	-4.08%	-1.38%	-10.64%	-9.94%	-2.97%

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 1.86% of total assets, 2.24% of total loans, and 15.43% of tier-one capital plus loan loss reserve. Third Quarter 2019 modified data compares to the following Second Quarter 2019 modified average data set:

- 1.93% of total assets
- 2.32% of total loans, and
- 15.91% of tier-one capital plus loan loss reserve

Part 34, Subpart E (OREO) / Holding Period (§ 34.82)

As of December 1, 2019, The OCC will adopt and amended its regulations pertaining to Other Real Estate Owned (OREO). Amongst the chief change is the holding period for OREO for Federal savings banks. The change will establish the same holding period for National banks as well as FSBs. In short:

The final rule establishes an initial holding period for Federal savings associations of five years after commencement of the holding period to ensure the safe and sound management of OREO holdings. If the Federal savings association has not disposed of the OREO within the initial five-year holding period, the savings association may request OCC approval to continue to hold the real property as OREO for up to five additional years. These provisions are consistent with the rules that apply to national banks.

For additional details regarding Part 34 E changes, please refer to:
https://www.federalregister.gov/d/2019-22823/p-3

Please refer to the SHPCO historical newsletter for discussion of OREO holding periods for State chartered institutions.
http://www.shpco.net/uploads/1/1/0/5/110567951/2019_q1_asset_quality_update.pdf

FDIC Risk Review

During October 2019, the FDIC issued its 2019 Risk Review. The document highlights several areas the Regulator sees increased as key risks, and they include: Agriculture, Commercial Real Estate, Housing, and Interest Rate Risk. The Risk Review could be viewed as future regulatory 'hot buttons' within examinations.

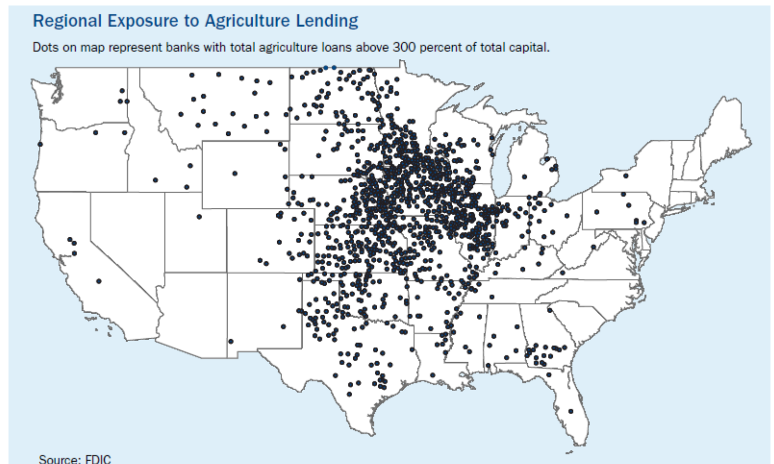
A reading of the publication, as well as historical regulatory publications, seems to indicate higher concentration levels within loan types, and continued expanding concentrations, could result in increased regulatory scrutiny. Highlights from the review follow.

Agriculture

- The agricultural economy is now in its sixth year of low commodity prices and farm incomes, and agricultural exports are under pressure from trade uncertainties and slowing global growth.

- Strong farmland equity has enabled farmers to restructure loans to manage operating losses and replenish working capital, keeping reported credit problems low at insured institutions.

- Farm bank asset quality and liquidity measures are lower in 2018 than recent years but remain stronger than the levels reported during the 1980s farm bank crisis.



Commercial Real Estate

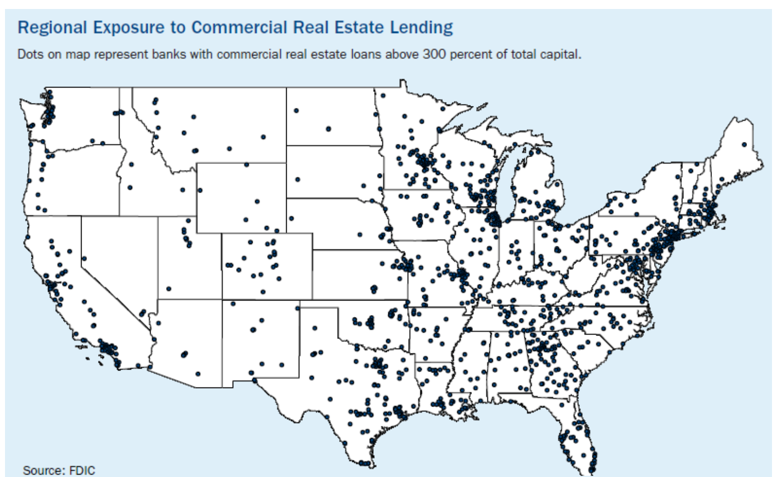
- Commercial real estate (CRE) market conditions remain favorable as the economic cycle matures.

- Modest oversupply concerns are emerging for multifamily and industrial CRE property types, while retail CRE is facing long-term challenges related to shifts in consumer shopping behavior.

- FDIC-insured institutions have grown their CRE loan portfolios, primarily with loans for existing properties rather than loans for construction and development projects.

- CRE loan performance metrics at FDIC-insured institutions are strong, although institutions with CRE concentrations may be vulnerable to economic changes.

- Competition for quality CRE loans poses challenges for institutions operating in the CRE sector.



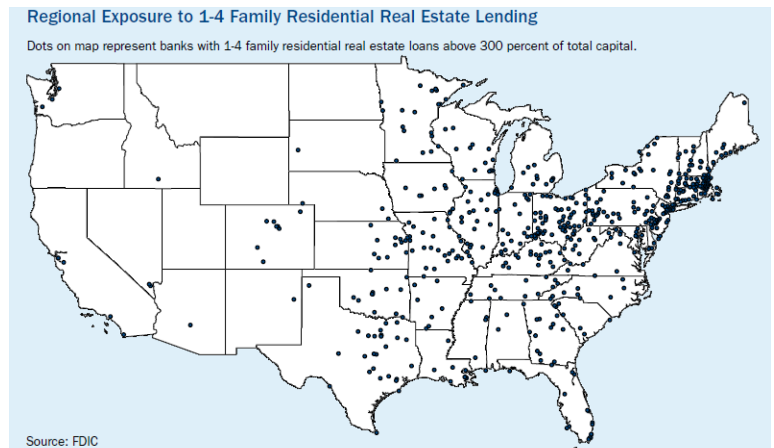
FDIC Risk Review – Continued

Housing

- Signs of a slowdown in sales are emerging in the housing market even as house prices continue to rise across most of the nation.

- Affordability is a growing concern as income growth lags the rise in house prices and mortgage payments.

- Among FDIC-insured institutions, the condition of the residential mortgage portfolio is favorable, but some banks report significant loan concentration levels and increased competition

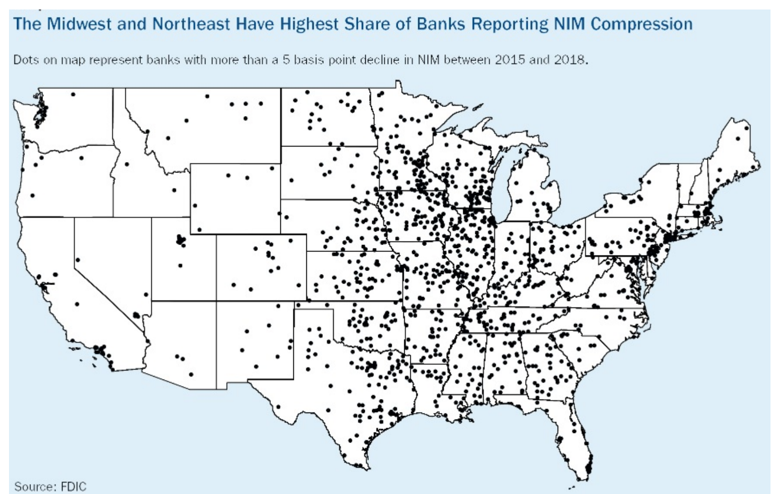


Interest Rate Risk

- Rising interest rates and competitive pressures are headwinds to deposit growth.

- Rising rates and deposit competition have begun pushing deposit costs higher and are affecting the mix of deposits, particularly at noncommunity banks.

- Most banks continue to report net interest margin growth, but banks with rising funding costs and a high proportion of long-term assets may face near-term margin pressure.



Source: https://www.fdic.gov/bank/analytical/risk-review/index.html

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

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