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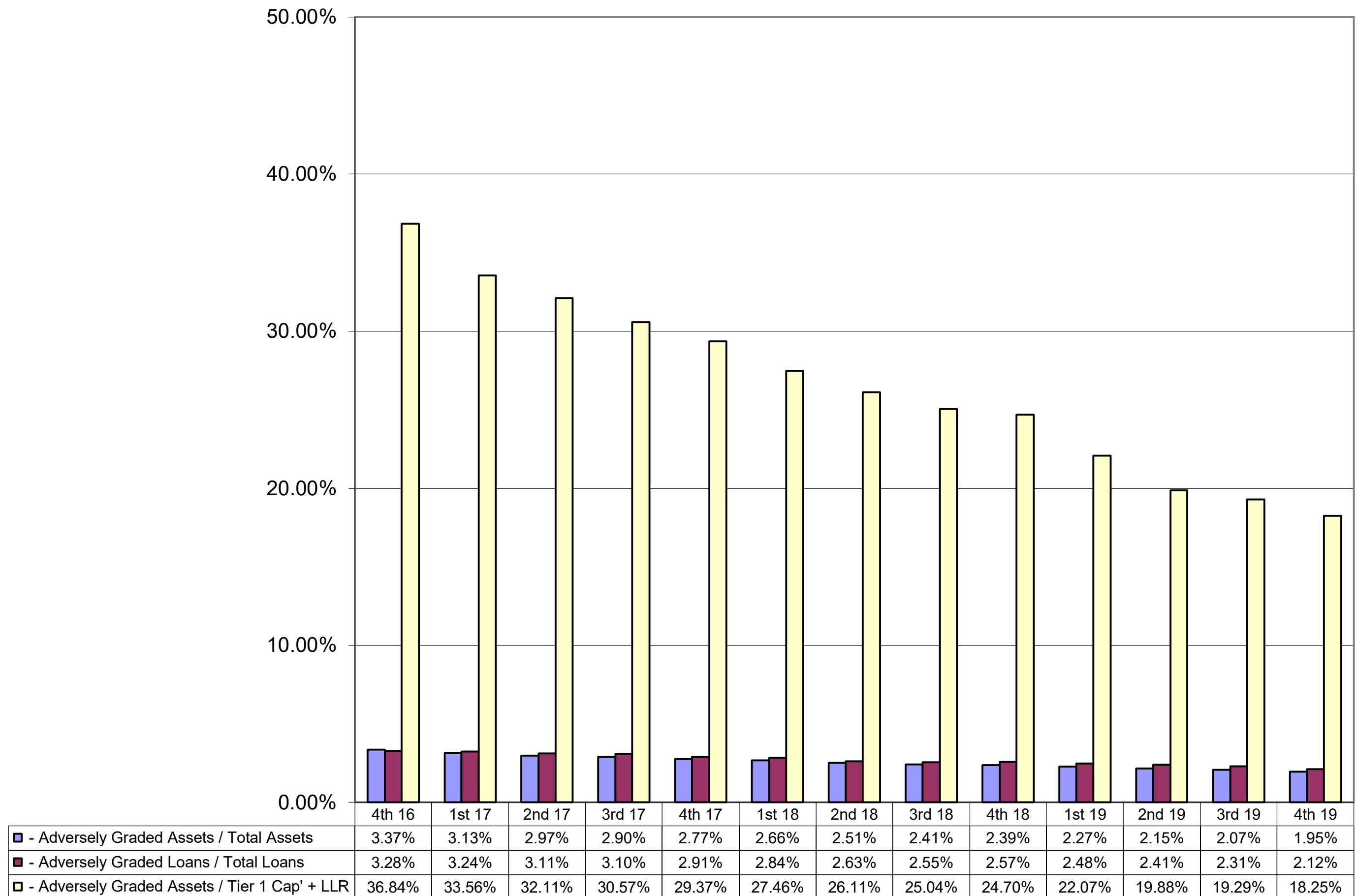
Asset Quality Update – Q4 2019 Edition

Trends in Asset Quality – Average Levels

Based on Steve H. Powell & Company client data, during the Fourth 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 1.95% of total assets and 18.25% of tier-one capital plus loan loss reserve as compared to 2.07% of total assets and 19.29% of tier-one capital plus loan loss reserve while problem loans averaged 2.12% of total loans as compared to 2.31% of total loans during the Third Quarter 2019.



	4th 16	1st 17	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19	2nd 19	3rd 19	4th 19
- Adversely Graded Assets / Total Assets	3.37%	3.13%	2.97%	2.90%	2.77%	2.66%	2.51%	2.41%	2.39%	2.27%	2.15%	2.07%	1.95%
- Adversely Graded Loans / Total Loans	3.28%	3.24%	3.11%	3.10%	2.91%	2.84%	2.63%	2.55%	2.57%	2.48%	2.41%	2.31%	2.12%
- Adversely Graded Assets / Tier 1 Cap' + LLR	36.84%	33.56%	32.11%	30.57%	29.37%	27.46%	26.11%	25.04%	24.70%	22.07%	19.88%	19.29%	18.25%

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 Q4 2019 declined to 11.75% of tier-one capital plus loan loss reserve as compared to 13.3% during Q3 2019. Note the downward trend as overall asset quality continues to improve.

TRENDS IN ASSET QUALITY
MEDIAN LEVEL OF ADVERSELY GRADED ASSETS

	4th 16	1st 17	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19	2nd 19	3rd 19	4th 19
- Adversely Graded Assets / Total Assets	2.48%	2.31%	2.15%	2.25%	2.20%	2.08%	1.96%	1.74%	1.85%	1.87%	1.73%	1.58%	1.44%
- Adversely Graded Loans / Total Loans	2.44%	2.37%	2.32%	2.38%	2.28%	2.27%	1.93%	1.85%	1.85%	1.84%	1.61%	1.66%	1.61%
- Adversely Graded Assets / Tier 1 Cap' + LLR	20.97%	19.83%	18.23%	18.84%	18.27%	16.72%	15.31%	14.65%	14.62%	14.93%	13.30%	13.30%	11.75%

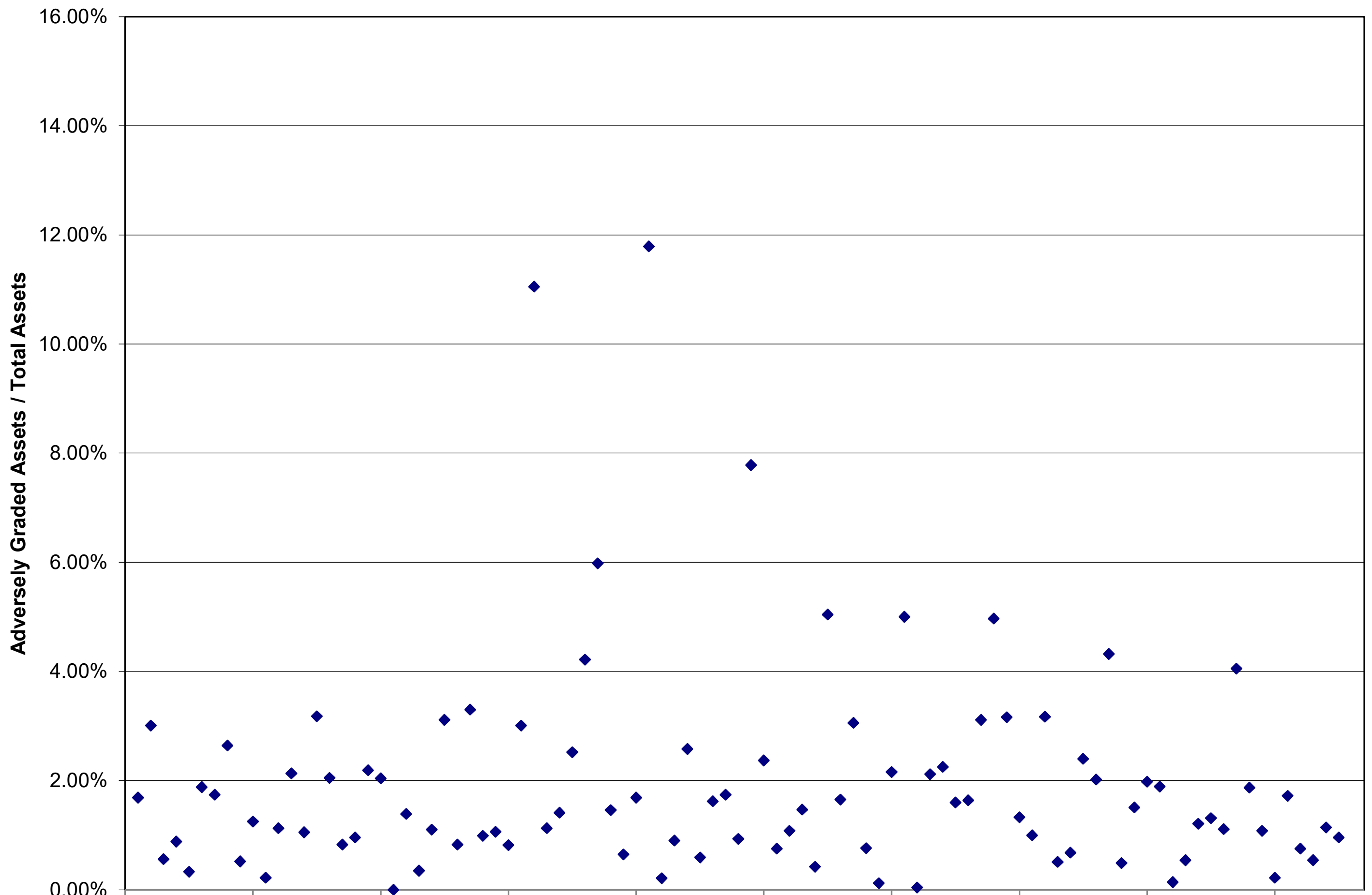
Historical Comparisons

During Q4 2019, increases in problem assets, as measured by adversely graded assets divided by tier-one capital plus loan loss reserve, were noted in approximately 13% of our clients. This quarter's increase compares to:

- 11% during the Third Quarter 2019
- 17% during the Second Quarter 2019
- 24% during the First Quarter 2019
- 10% during the Fourth Quarter 2018
- 16% during the Third Quarter 2018

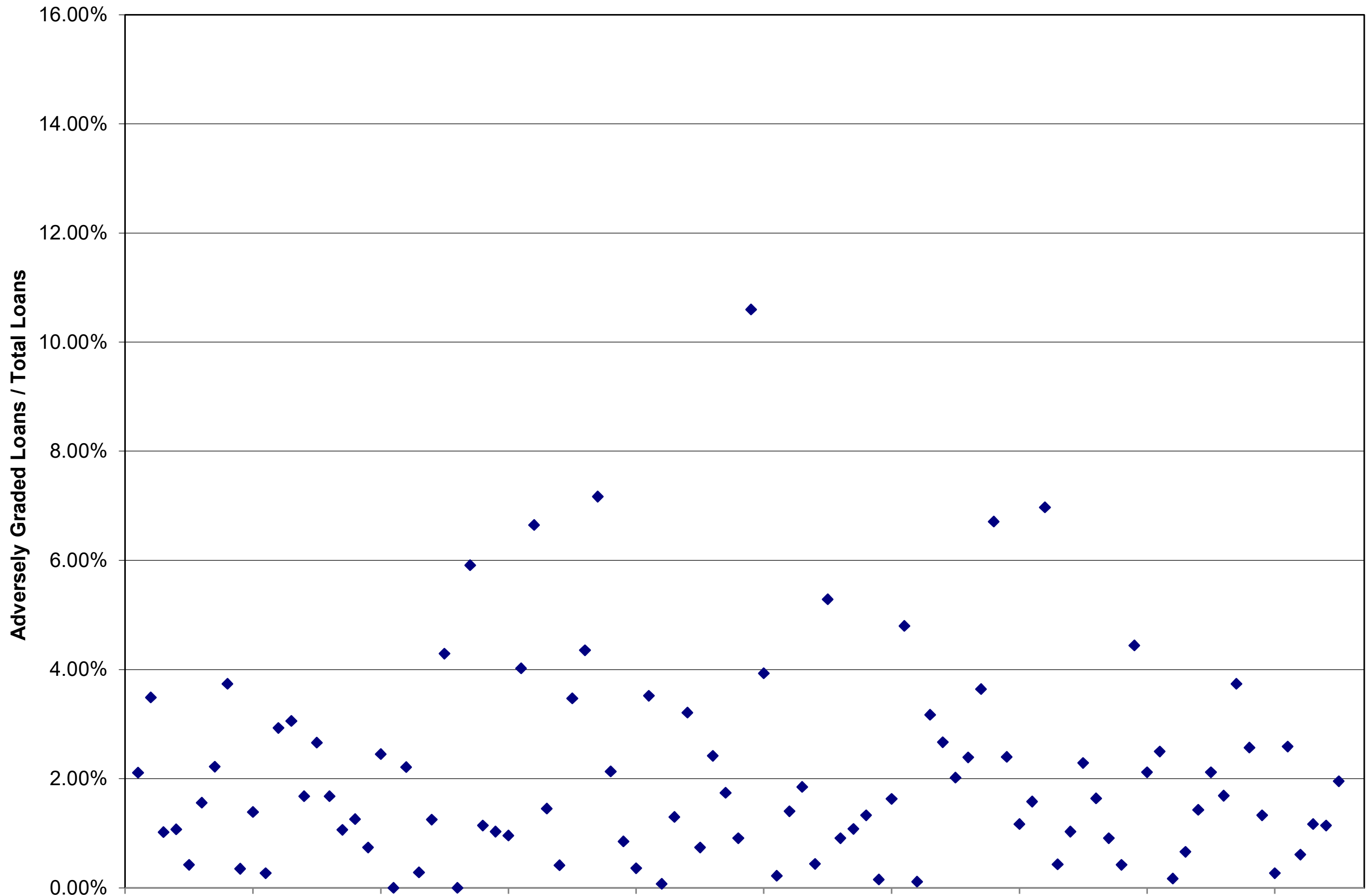
A higher level of volatility in the percentage of increases may be expected as overall asset quality stabilizes; however, increases may indicate a rise in portfolio risk.

Dispersion of Problem Assets – as a Percentage of Total Assets



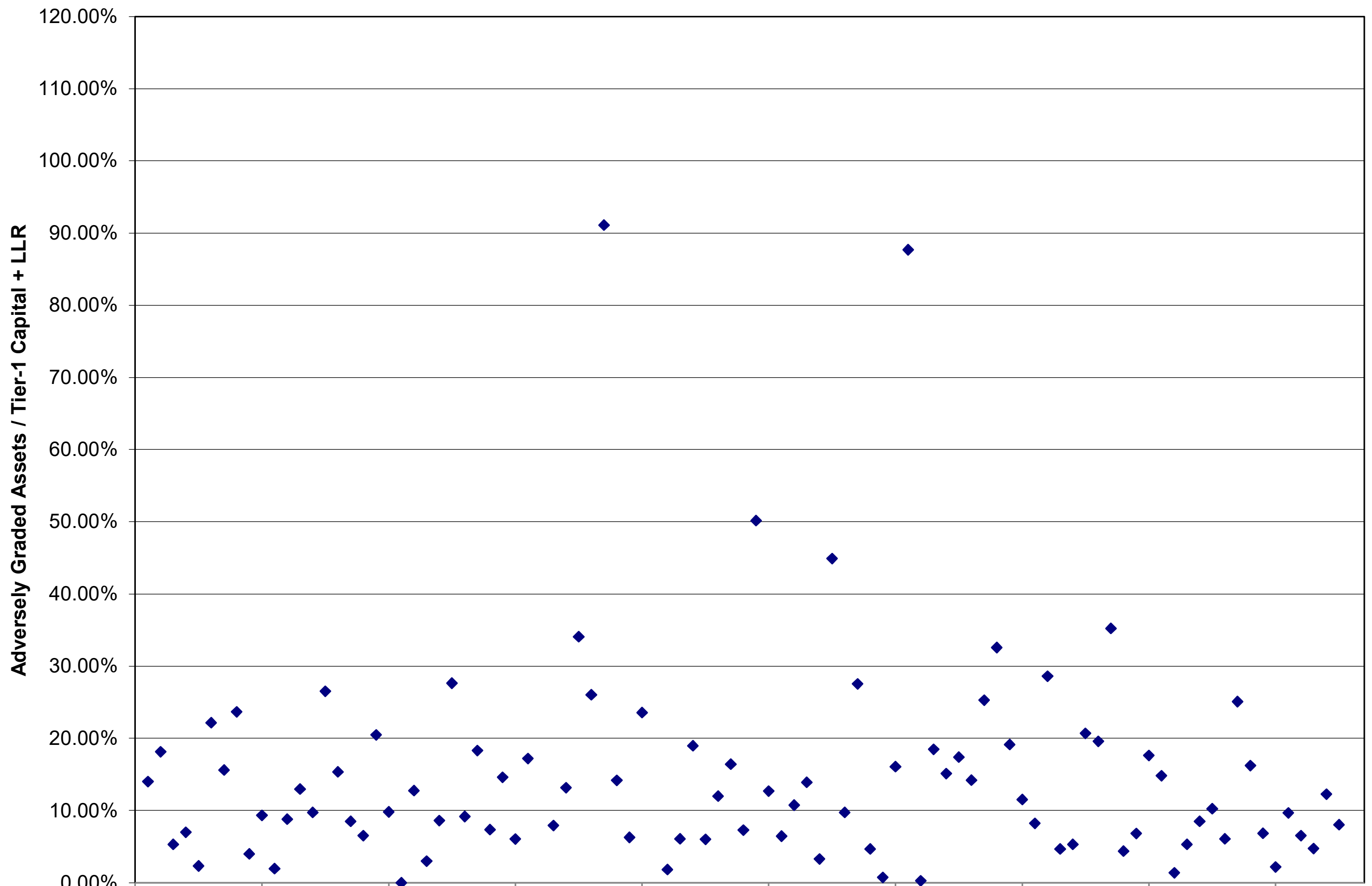
The above graph shows the dispersion of problem assets as a percentage of total assets. A traditional benchmark for significant asset quality concern is adversely graded assets that exceed 10% of total assets.

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

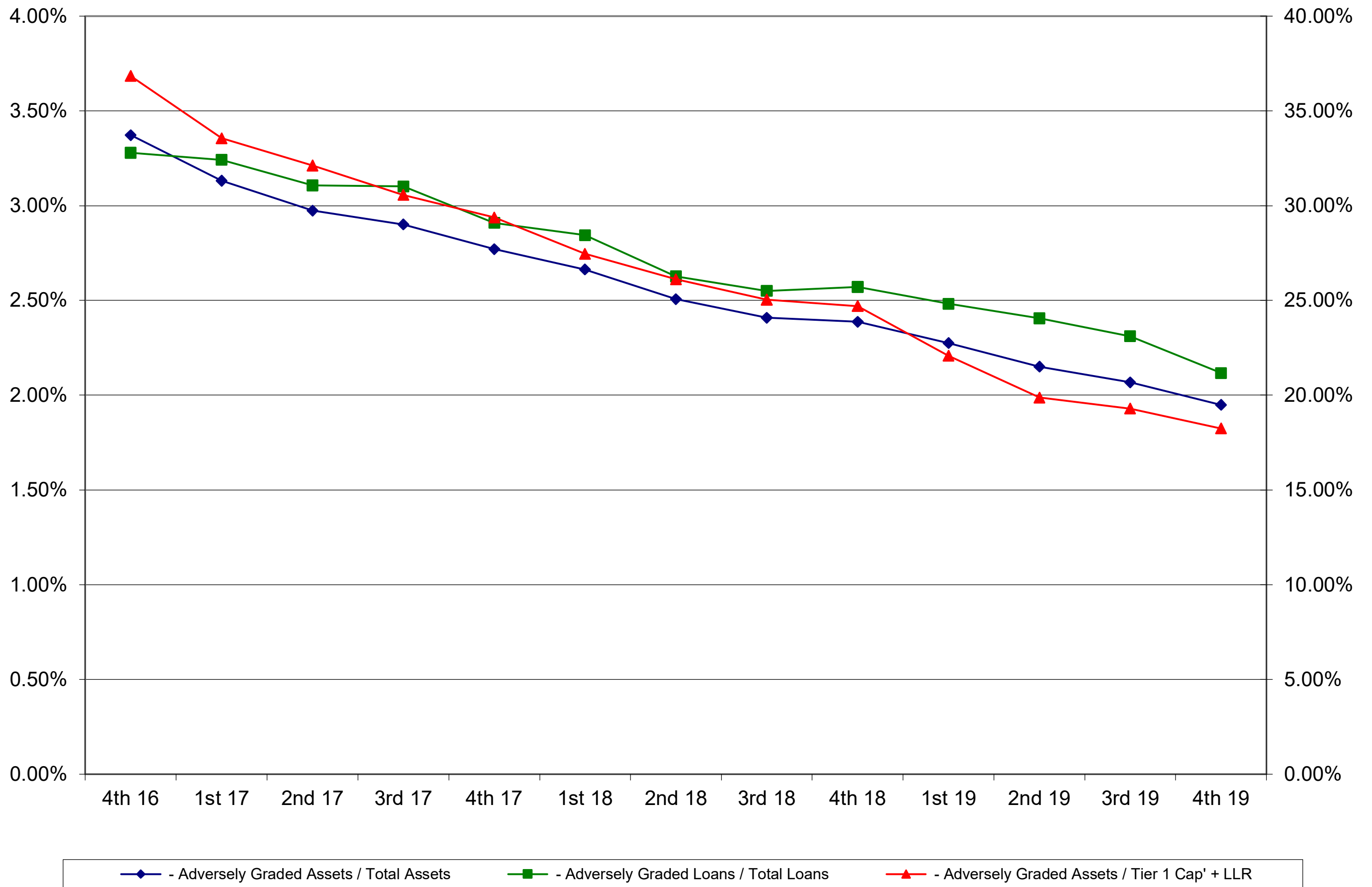
Our sample group includes four (4) banks with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

- Five (5) during the Third Quarter 2019
- Five (5) during the Second Quarter 2019
- Five (5) during the First Quarter 2019

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:

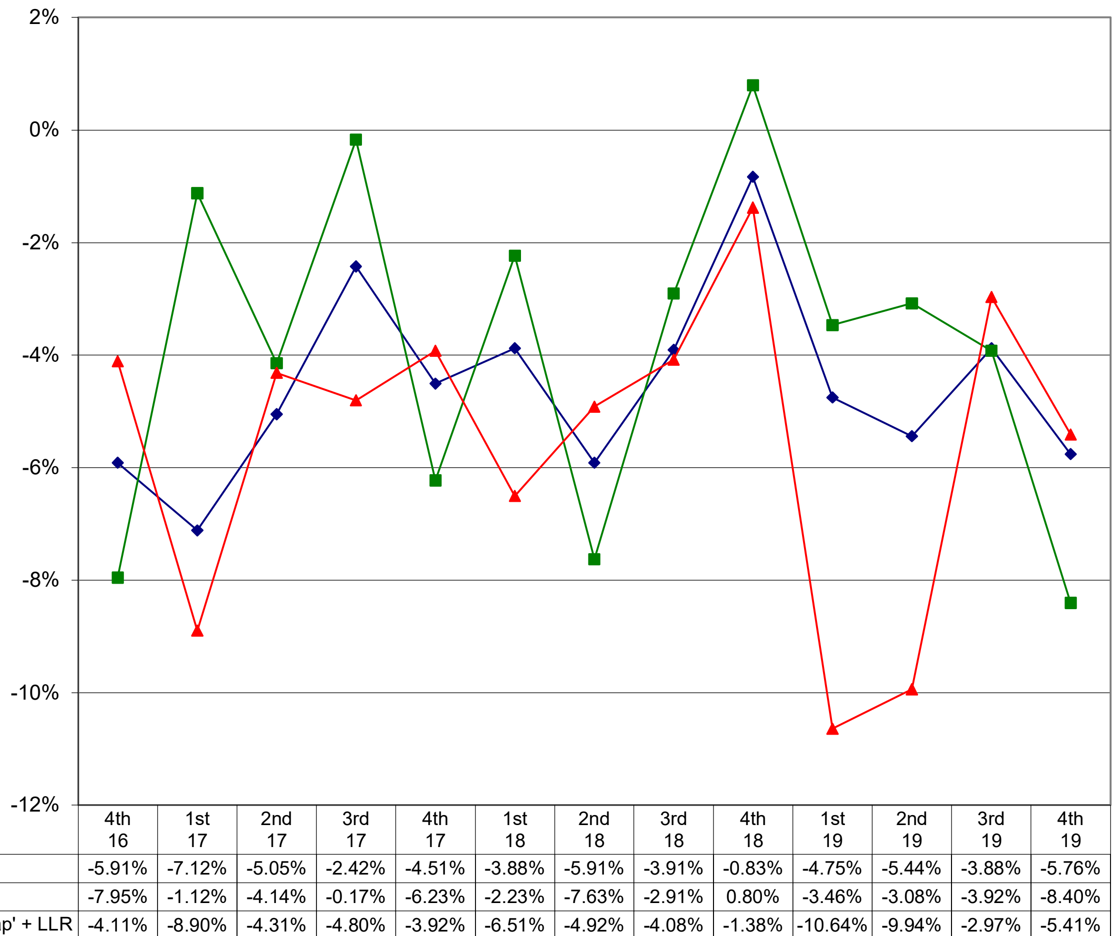
- Four (4) during the Third Quarter 2019
- Four (4) during the Second Quarter 2019
- Four (4) during the First Quarter 2019

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.

Problem Asset Comparative Change Analysis



	4th 16	1st 17	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19	2nd 19	3rd 19	4th 19
% Change in ACA/TA	-5.91%	-7.12%	-5.05%	-2.42%	-4.51%	-3.88%	-5.91%	-3.91%	-0.83%	-4.75%	-5.44%	-3.88%	-5.76%
% Change in ACL/TL	-7.95%	-1.12%	-4.14%	-0.17%	-6.23%	-2.23%	-7.63%	-2.91%	0.80%	-3.46%	-3.08%	-3.92%	-8.40%
% Change in ACA/Tier 1 Cap' + LLR	-4.11%	-8.90%	-4.31%	-4.80%	-3.92%	-6.51%	-4.92%	-4.08%	-1.38%	-10.64%	-9.94%	-2.97%	-5.41%

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 1.75% of total assets, 2.06% of total loans, and 14.50% of tier-one capital plus loan loss reserve. Fourth Quarter 2019 modified data compares to the following Third Quarter 2019 modified average data set:

- 1.86% of total assets
- 2.24% of total loans, and
- 15.43% of tier-one capital plus loan loss reserve

Supervisory Insights, Fall 2019

Commercial Real Estate Loan Concentration Risk Management

The most recent issue of Supervisory Insights (SI) included a discussion of AD&C lending and CRE concentrations. The SI assessed Second Quarter 2019 Median Data for Acquisition, Development & Construction concentrated insured institutions; Commercial Real Estate concentrated institutions, and other insured institutions.

	ADC IDIs	CRE IDIs	Other IDIs
Wholesale Funds to Total Assets	14.73%	18.49%	13.61%
Tier 1 Leverage Capital Ratio	10.26%	10.15%	11.02%
Total Capital Ratio	13.75%	12.88%	16.88%
ALLL to Total Loans	1.15%	0.99%	1.19%
Past Due and Nonaccrual Ratio	0.88%	0.60%	1.21%
Pre-tax Return on Assets	1.42%	1.38%	1.27%
Net Interest Margin	4.12%	3.78%	3.76%
One Year Total Loan Growth	7.95%	12.03%	4.58%
One Year Total Asset Growth	7.58%	12.28%	3.62%

Source: FDIC; Consolidated Reports of Condition and Income.

The study included 470 regulatory examinations (banks with composite ratings of 1, 2, or 3 at exam inception over a twenty four month period that ended March 2019. The review identified matters requiring board attention in ~24% of the entities. Items requiring additional board oversight were largely centered in: Governance and Oversight, Portfolio Sensitivity Analyses, Portfolio Management, and Funding Strategies.

- Governance and Oversight: 56% of the reviews included recommendations for additional board / management oversight, and ~27% of the recommendations included matters requiring board attention. MRBA were chiefly noted for 'inadequate' concentration limits (and sub limits), heightened loan policy exception tracking & reporting as well as strategic planning. The review indicates increased Regulatory concern for banks where concentration management & limits were addressed by 'merely had increased the policy's concentration limit(s) to avoid exceptions".
- Portfolio Sensitivity Analyses: Sensitivity analysis & stress testing will vary depending of a bank's size, complexity and other risk characteristics. Within the sampled bank, regulators recommended portfolio sensitivity analysis in ~41% banks, and 22% resulted in matters requiring board attention. A chief regulatory concern for portfolio monitoring & stress testing was not integrating the test results within oversight and planning. Additional regulatory concern was noted for apparently unrealistic or comprehensive assumptions as well as basing assumptions on overall industry data rather than the individual bank's data.
- Portfolio Management: Regulators expressed concern for concentrations risks that can 'expose an IDI to unacceptable risk if not properly managed and monitored'. Findings were noted in 37% of the reviews, and >28% of the pool involved items requiring board level attention. Matters requiring board attention were chiefly noted for lack of establishing and monitoring primary & secondary concentration limit(s). Regarding underwriting, >27% of the reviews yielded CRE underwriting related recommendations with 14% of the subset involving board attention. Findings were largely for:
  - Inadequate analyses of repayment capacity
    - Inadequate global debt service coverage analyses
  - Having problems calculating global cash flows
    - Not completing or considering global cash flow analyses at all, when it was applicable

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Source: https://www.fdic.gov/regulations/examinations/supervisory/insights/sifall19/si-fall-2019.pdf

Interagency Guidelines Establishing Standards for Safety and Soundness (Guidelines)

12 CFR part 30, Appendix A (OCC); 12 CFR part 208 Appendix D–1 (Board); 12 CFR part 364 Appendix A (FDIC); Part 723 of the NCUA Rules and Regulations.

During Q4 2019, Regulatory agencies published a notice for comments on proposed credit risk review. The existing & proposed guidance is to 'Establish and highlight the need for credit risk review and establish safety and soundness standards regarding the establishment of an independent and ongoing credit risk review'. A review of existing and proposed regulatory guidance follows.

To be effective, the loan review system should:

- Promptly identify loans with actual and potential credit weaknesses
- Appropriately validate and, if necessary, adjusts risk ratings
- Identify relevant trends that affect the quality of the loan portfolio
- Assess the adequacy of and adherence to internal credit policies and loan administration procedures
- Evaluate the activities of lending personnel
- Provide management and the board of directors with an objective, independent, and timely assessment of the overall quality of the loan portfolio.
- Provide management with accurate and timely credit quality information

Whether internal or third party review is utilized, the reviews should align with the bank's overall credit risk and loan portfolio complexity. To quote the guidance "effective reviews cover all segments of the loan portfolio that pose significant credit risk or concentrations, and other loans that meet certain institution-specific criteria". Proper, accurate, and timely loan grades are to be internally assigned. Loan / credit grades are to be reviewed by qualified & independent individuals or departments and can be performed by internal staff. The review process & grade assignment should be independent of the lending process. For smaller, more rural, institutions, if internal review is to be utilized, the staff should not be involved with originating or approving the specific credit(s) being reviewed. To ensure in-house independence, if bank staff are to be used for credit review, their compensation should not be 'influenced' by any grade changes.

An adequate scope typically includes:

- Loans over a predetermined size
- Sampling of smaller loans, new loan originations, and new loan products
- Loans with higher risk indicators (i.e. credits approved with exceptions to policy)
- Sampling of portfolios with high concentration risk and/or portfolio segments experiencing rapid growth
- Past due, non-accrual, renewed, and restructured loans
- Loans adversely rated and loans designated as warranting special attention
- Insider Loans

An integral part of the loan review process is assigning accurate loan grades. The review should include procedures for resolving any differences between the internally assigned grades and those recommended during the credit review process. The Regulatory guidance generally indicates the recommended lower credit rating should be assigned unless "internal parties identify additional information sufficient to obtain the concurrence of the independent reviewer or arbiter on the higher credit quality classification or grade". The guidance clearly indicates the bank's board of directors, or a committee, is responsible for ensuring an adequate loan review scope and ensuring sufficient review frequency.

Source: https://www.occ.gov/news-issuances/federal-register/2019/84fr55679.pdf

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

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