Steve H. Powell & Company

Asset Quality Update – Q1 2020 Edition

Trends in Asset Quality – Average Levels

Based on Steve H. Powell & Company client data, during the First Quarter 2020, 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 1.83% of total assets and 17.19% of tier-one capital plus loan loss reserve as compared to 1.95% of total assets and 18.25% of tier-one capital plus loan loss reserve while problem loans averaged 2.08% of total loans as compared to 2.12% of total loans during the Fourth Quarter 2019.

TRENDS IN ASSET QUALITY
AVERAGE LEVEL OF ADVERSELY GRADED ASSETS

	1st 17	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19	2nd 19	3rd 19	4th 19	1st 20
- Adversely Graded Assets / Total Assets	3.13%	2.97%	2.90%	2.77%	2.66%	2.51%	2.41%	2.39%	2.27%	2.15%	2.07%	1.95%	1.83%
- Adversely Graded Loans / Total Loans	3.24%	3.11%	3.10%	2.91%	2.84%	2.63%	2.55%	2.57%	2.48%	2.41%	2.31%	2.12%	2.08%
- Adversely Graded Assets / Tier 1 Cap' + LLR	33.56%	32.11%	30.57%	29.37%	27.46%	26.11%	25.04%	24.70%	22.07%	19.88%	19.29%	18.25%	17.19%

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 2020 has decreased to 10.5% of tier-one capital plus loan loss reserve as compared to 11.75% during Q4 2019. Note the downward trend as overall asset quality continues to improve.

TRENDS IN ASSET QUALITY
MEDIAN LEVEL OF ADVERSELY GRADED ASSETS

	1st 17	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19	2nd 19	3rd 19	4th 19	1st 20
- Adversely Graded Assets / Total Assets	2.31%	2.15%	2.25%	2.20%	2.08%	1.96%	1.74%	1.85%	1.87%	1.73%	1.58%	1.44%	1.43%
- Adversely Graded Loans / Total Loans	2.37%	2.32%	2.38%	2.28%	2.27%	1.93%	1.85%	1.85%	1.84%	1.61%	1.66%	1.61%	1.72%
- Adversely Graded Assets / Tier 1 Cap' + LLR	19.83%	18.23%	18.84%	18.27%	16.72%	15.31%	14.65%	14.62%	14.93%	13.30%	13.30%	11.75%	10.50%

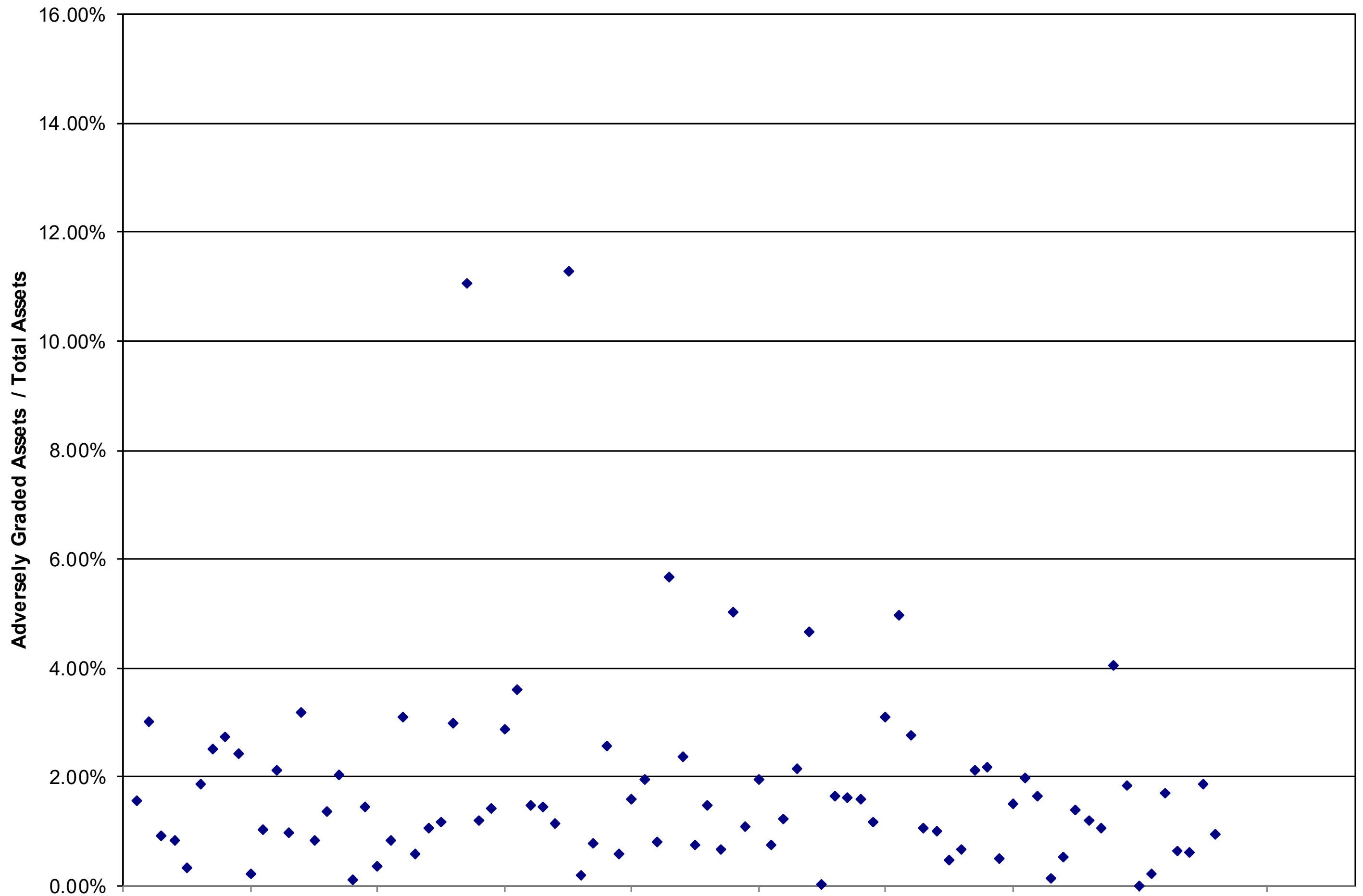
Historical Comparisons

During Q1 2020, increases in problem assets, as measured by adversely graded assets divided by tier-one capital plus loan loss reserve, were noted in approximately 23% of our clients. This quarter's increase compares to:

- 13% during the Fourth Quarter 2019
- 11% during the Third Quarter 2019
- 17% during the Second Quarter 2019
- 24% during the First Quarter 2019
- 10% during the Fourth Quarter 2018

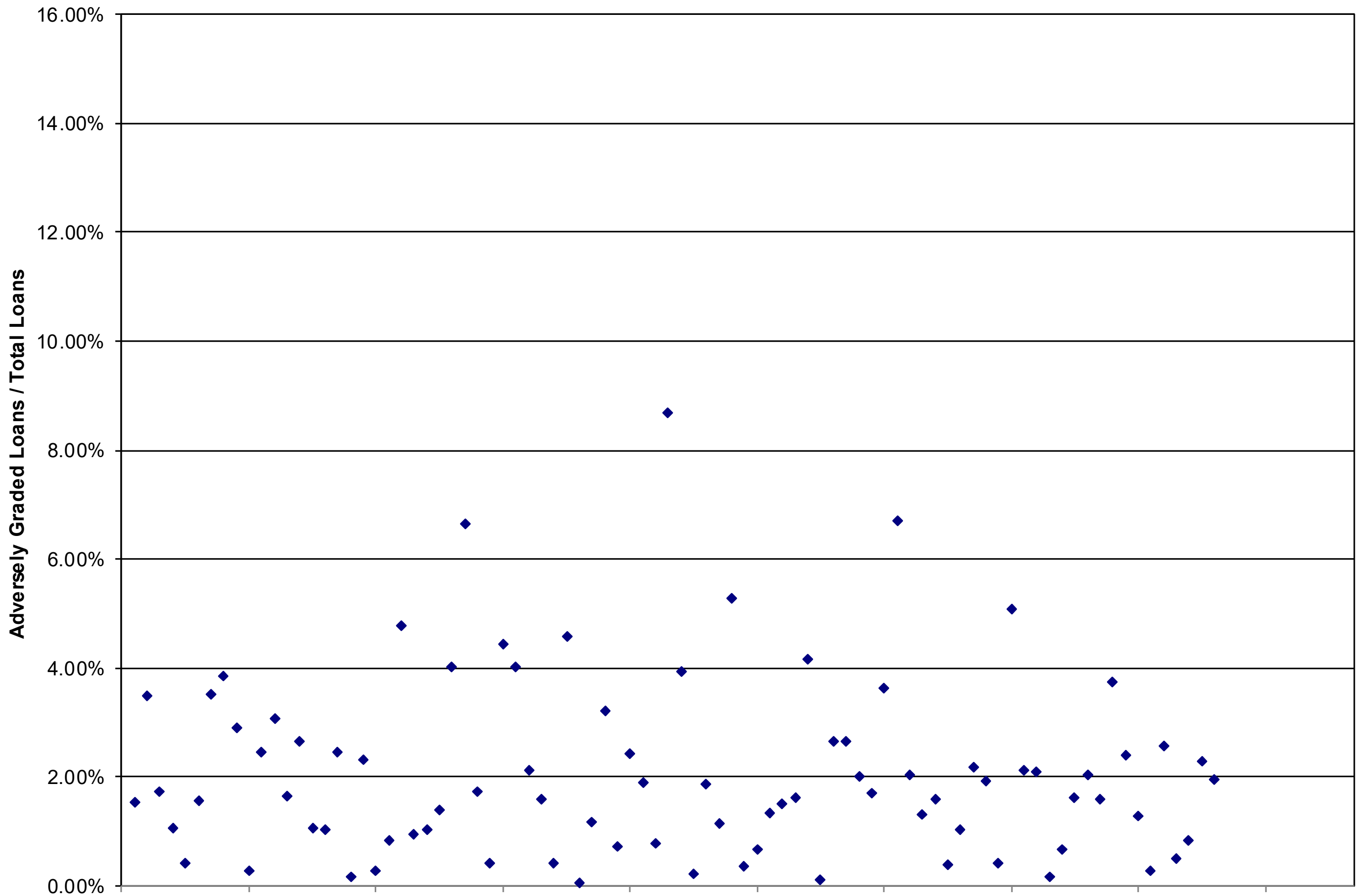
A higher level of volatility in the percentage of increases may be expected as overall asset quality stabilizes; however, increases may indicate a rise in portfolio risk.

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.

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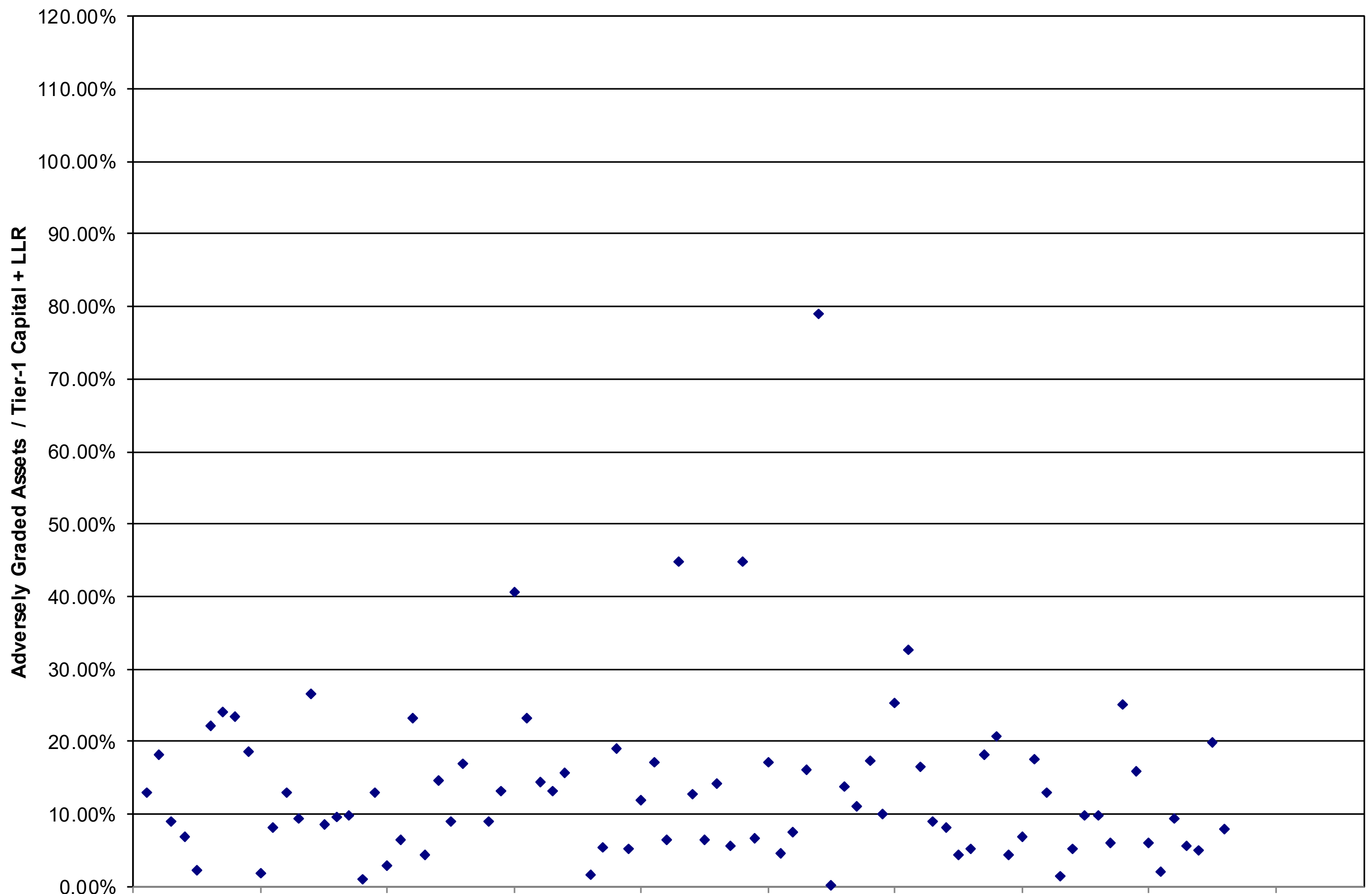
Dispersion of Problem Assets – as a Percentage of Tier-One Capital & Reserves



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

Historical Comparisons

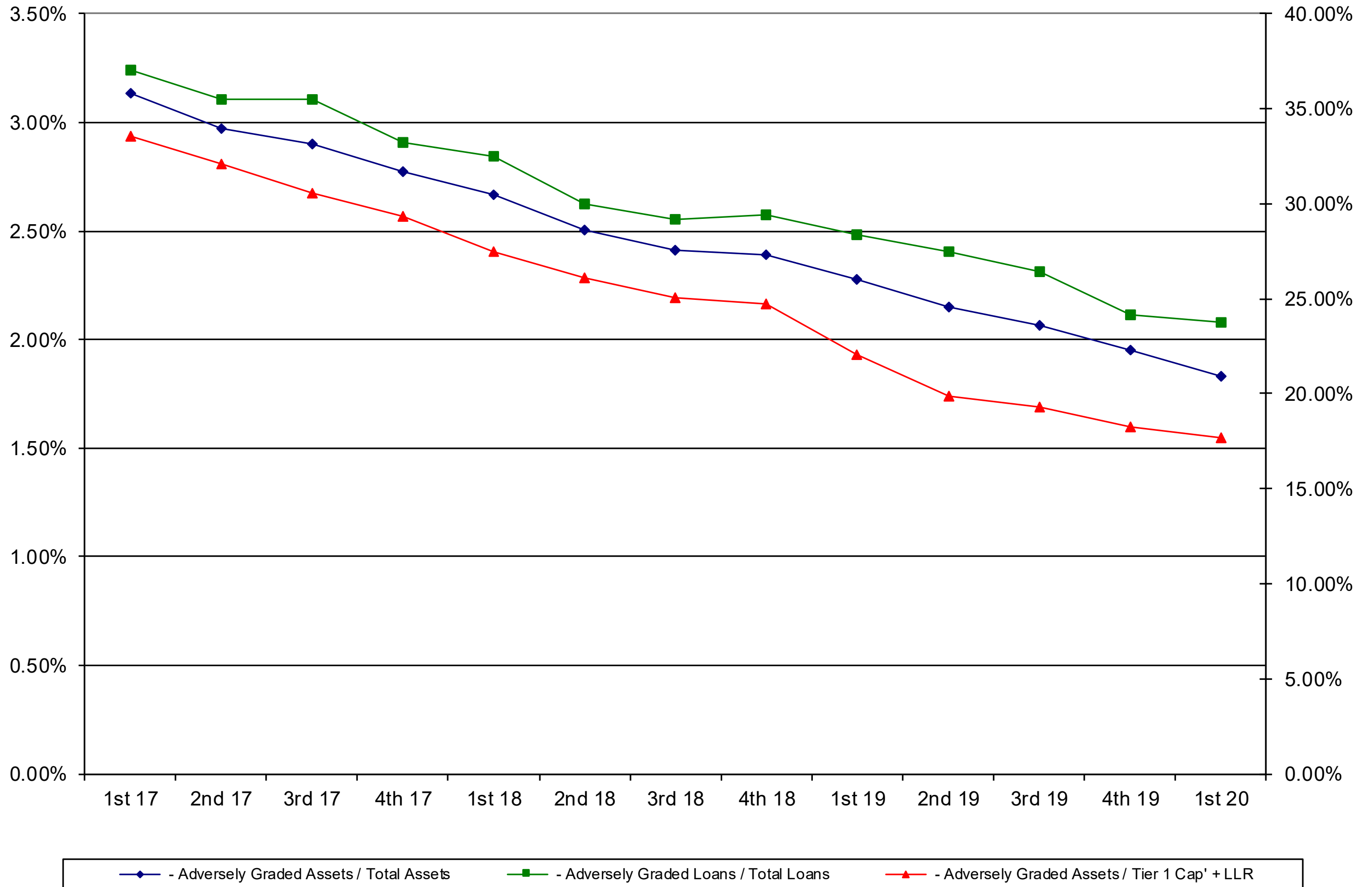
Our sample group includes three (3) banks with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

- Four (4) during the Fourth Quarter 2019
- Five (5) during the Third Quarter 2019
- Five (5) during the Second Quarter 2019

Two (2) 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 Fourth Quarter 2019
- Four (4) during the Third Quarter 2019
- Four (4) during the Second 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.

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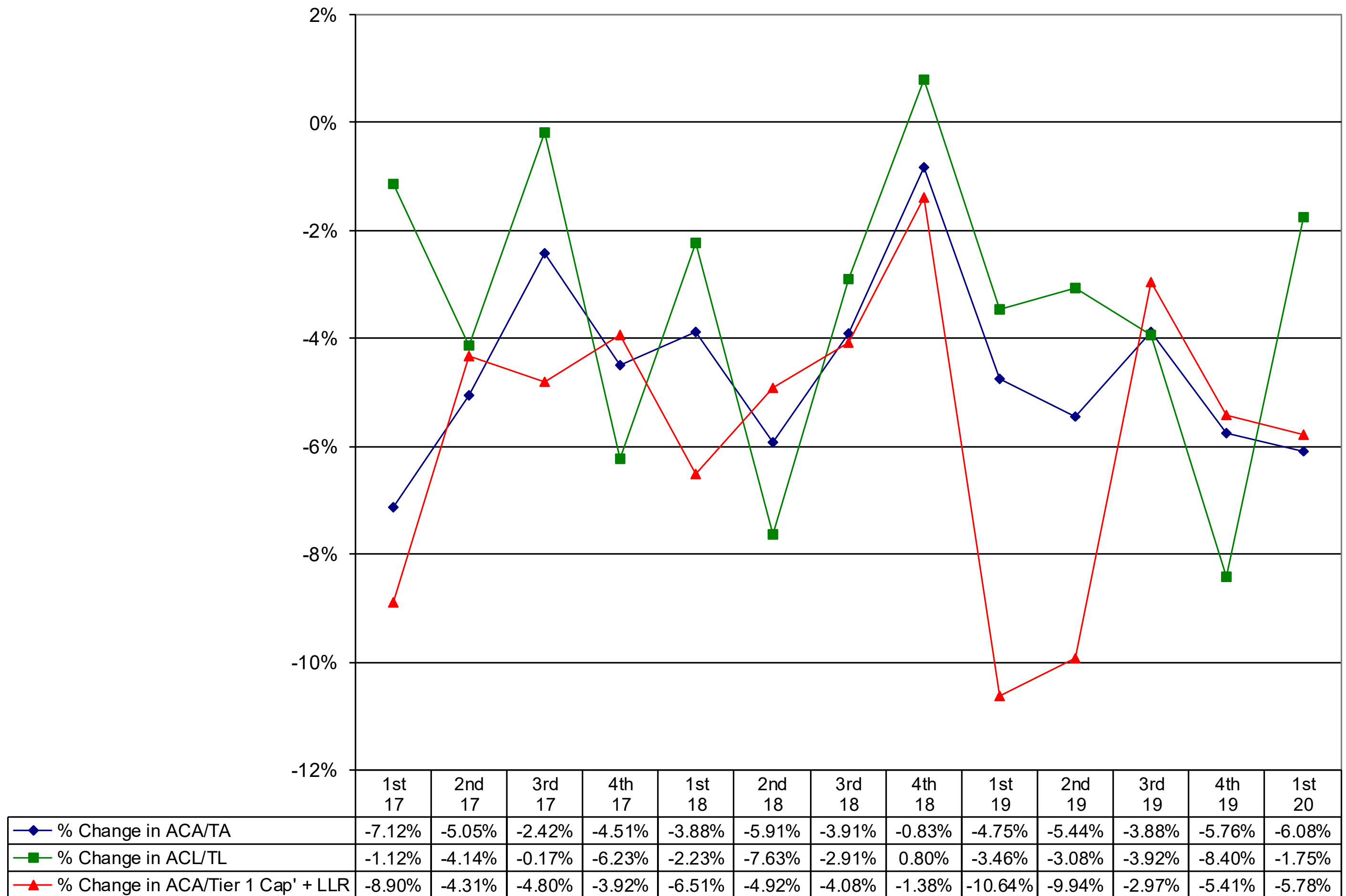
Problem Asset Comparative Change Analysis



	1st 17	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19	2nd 19	3rd 19	4th 19	1st 20
% Change in ACA/TA	-7.12%	-5.05%	-2.42%	-4.51%	-3.88%	-5.91%	-3.91%	-0.83%	-4.75%	-5.44%	-3.88%	-5.76%	-6.08%
% Change in ACL/TL	-1.12%	-4.14%	-0.17%	-6.23%	-2.23%	-7.63%	-2.91%	0.80%	-3.46%	-3.08%	-3.92%	-8.40%	-1.75%
% Change in ACA/Tier 1 Cap' + LLR	-8.90%	-4.31%	-4.80%	-3.92%	-6.51%	-4.92%	-4.08%	-1.38%	-10.64%	-9.94%	-2.97%	-5.41%	-5.78%

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 1.63% of total assets, 2.04% of total loans, and 13.19% of tier-one capital plus loan loss reserve. First Quarter 2020 modified data compares to the following Fourth Quarter 2019 modified average data set:

- 1.75% of total assets
- 2.06% of total loans, and
- 14.4% of tier-one capital plus loan loss reserve

Coronavirus (COVID-19): Payment Modifications, Regulatory Compliance Considerations and Best Practices

In mid-March 2020, Steve H. Powell and Company compiled interagency publications and information to assist financial institutions in dealing with the unfolding economic situation. The following is republished.

Steve H. Powell & Company has received numerous calls and emails with questions regarding potential borrower repayment difficulties resulting from the COVID-19 pandemic. As a result of this unprecedented situation, we have compiled the following information to assist financial institutions in dealing with the unfolding economic situation.

Most of the questions we have received involve lending issues; specifically, payment deferrals, extensions, and debt restructures for affected borrowers. The predominant question "How much relief can we give without triggering a Troubled Debt Restructuring (TDR)?". Regulatory guidance exists to help make the determination, yet no concrete, or absolute, definitions are available.

In the FDIC's Statement on Financial Institutions Working with Customers Affected by the Coronavirus and Regulatory and Supervisory Assistance letter dated March 13, 2020 the Corporation indicates, in part,

> *"Modifications should be based on the facts and circumstances of each borrower and loan. Prudent efforts to modify the terms on existing loans for affected customers of FDIC-supervised banks will not be subject to examiner criticism. Modifications of existing loans should be evaluated to determine whether they represent troubled debt restructurings (TDRs). According to accounting standards, a modification triggers a TDR only if the institution grants a concession to the borrower which it would not otherwise grant because a borrower is experiencing financial difficulties. This could, for example, include extending the term of a loan for a borrower that otherwise meets the institution's underwriting standards, but is experiencing a temporary liquidity shortage due to COVID-19-related economic conditions."*

In addition, FDIC FIL 61-2009 - Policy Statement on Prudent Commercial Real Estate Loan Workouts indicates:

> *"The determination of whether a restructured loan is a TDR requires consideration of all of the facts and circumstances surrounding the modification. No single factor, by itself, is determinative of whether a restructuring is a TDR. An overall general decline in the economy or some deterioration in a borrower's financial condition does not automatically mean that the borrower is experiencing financial difficulties. Accordingly, lenders and examiners should use judgment in evaluating whether a modification is a TDR."*

Coronavirus (COVID-19): (Cont.)

The underlying accounting guidance most relevant to this discussion is found in the Accounting Standards Codification (ASC) 310-40-15-17. As per the ASC code:

> "A restructuring that results in only a delay in payment that is insignificant is not a concession. The following factors, when considered together, may indicate that a restructuring results in a delay in payment that is insignificant:
>
> a. The amount of the restructured payments subject to the delay is insignificant relative to the unpaid principal or collateral value of the debt and will result in an insignificant shortfall in the contractual amount due.
> b. The delay in timing of the restructured payment period is insignificant relative to any one of the following:
> 1. The frequency of payments due under the debt
> 2. The debt's original contractual maturity
> 3. The debt's original expected duration."

From the regulatory and accounting guidance discussed above, it is clear that some amount of payment relief may be granted without qualifying as a TDR. It is ultimately the responsibility of your institution to determine whether a change in terms constitutes a TDR. To support each restructuring, the loan file should be documented with an updated financial analysis performed. A sample loan modification questionnaire is provided as a resource. In some cases, payment relief resulting in TDR classification may be necessary and prudent. In these situations, the loans should be properly identified and tracked as TDR's.

Accounting guidance requires TDR's to be evaluated for impairment based on present value of future cash flows unless the loan is determined to be collateral dependent. **In many cases, where loans are evaluated based on present value of future cash flows, measured impairment will most likely be minimal unless a concessionary interest rate is granted.**

In addition to TDR status, loan risk grade should be adequately assessed. The March 13, 2020 letter from the FDIC provides some limited direction:

> *"Additionally, while a TDR designation means a modified loan is impaired for accounting purposes, it does not automatically result in an adverse classification. Many modified loans that are designated as a TDR for accounting purposes are fully performing and collectible credits. For this reason, examiners review the entirety of the lending relationship, including the duration of the borrower's cash flow, other assets, value of the collateral and other factors. FDIC examiners are directed to exercise significant flexibility in determining whether to adversely classify credits that are impacted by COVID-19, including those designated as TDRs."*

Coronavirus (COVID-19): (Cont.)

While limited written guidance exists for the current economic situation, we can draw parallels from the FDIC RMS Manual of Examination Policies relating to farm lending and carryover debt. Section 3.2 includes the following excerpt that may prove useful.

> *"When carryover debt arises, the institution should determine the basic viability of the borrower's operation, so that an informed decision can be made on whether debt restructuring is appropriate. It will thus be useful for institution management to know how the carryover debt came about: Did it result from the obligor's financial, operational or other managerial weaknesses; from inappropriate credit administration on the institution's part, such as over lending or improper debt structuring; from external events such as adverse weather conditions that affected crop yields; or from other causes? In many instances, it will be in the long-term best interests of both the institution and the debtor to restructure the obligations."*

When addressing the rating of carry over debt, Section 3.2 further indicates:

> *"There are no hard and fast rules on whether carryover debt should be adversely classified, but the decision should generally consider the following: borrower's overall financial condition and trends, especially financial leverage (often measured in farm debtors with the debt-to-assets ratio); profitability levels, trends, and prospects; historical repayment performance; the amount of carryover debt relative to the operation's size; realistic projections of debt service capacity; and the support provided by secondary collateral. Accordingly, carryover loans to borrowers who are moderately to highly leveraged, who have a history of weak or no profitability and barely sufficient cash flow projections, as well as an adequate but slim collateral margin, will generally be adversely classified, at least until it is demonstrated through actual repayment performance that there is adequate capacity to service the rescheduled obligation. The classification severity will normally depend upon the collateral position. At the other extreme are cases where the customer remains fundamentally healthy financially, generates good profitability and ample cash flow, and who provides a comfortable margin in the security pledged. Carryover loans to this group of borrowers will not ordinarily be adversely classified."*

How might this farm debt guidance be applicable to our current situation? It would appear that borrowers who have a historically proven track record of performance, operating in a sound and profitable manor would not necessarily have to be adversely rated due to disruptions, restructurings or extensions caused by the current Covid 19 pandemic, especially in the short run.

The United States is in an unprecedented economic situation and unconventional solutions may be necessary. We are hearing from some institutions that are considering offering payment holidays/extensions to all or large groups of borrowers. Given the significant disruption to the economy, this strategy may be an effective way to provide help to customers in a broad reaching way.

Coronavirus (COVID-19): (Cont.)

Outside of the obvious potential for loan repayment issues, maintaining adequate financial institution liquidity may be the most pressing financial consideration for many institutions. Lenders should be prepared for construction loans, lines of credit and other unused facilities to fully fund without the same level of payoff or churn that has been customary since the last economic downturn. Adequate liquidity is also paramount for those institutions that are considering widespread payment extensions as these extensions, if utilized by customers, will require significant internal funding on the part of the institution. Now is the time to re-visit liquidity funding plans and verify that lines of credit and other funding sources are open and readily accessible.

Regulatory Compliance Considerations

Loan modifications and extensions should be documented and applied on a consistent basis. Guidelines should be in place for ensuring fair lending and potential UDAAP issues are avoided in the review of borrower assistance. This assessment should include a review of modification and extension fees to ensure they are applied on a consistent basis. Fees should be justified and limited to the actual expense of reviewing and modifying the loan.

Institutions should ensure customers that skip payments are informed of the consequences of skipping payments such as extended maturity dates or possible final payments resulting in a balloon payment. Customers with escrow accounts should be given notice if they are required to continue making escrow payments or the effect of skipping escrow payments. Skipped escrow payments will generally result in an increased escrow payment during the next annual escrow analysis to cover the escrow shortage.

Additionally, Federal flood Insurance regulations apply to loans secured by improved real estate when a financial institution makes, increases, renews, or extends (MIRE) a covered loan. **A modification that skips a payment requires a flood determination review if the payment skip will extend the maturity date of the loan.** Life of loan flood map monitoring is generally limited to informing an institution if a specific property is remapped from a low risk zone into a special hazard flood zone. Life of loan flood map monitoring does not make updates to flood determinations that were not moved from a low risk zone to a special flood hazard zone. For this reason, it is necessary to review the flood determination when a maturity date is extended to ensure it is still 100% accurate including the date of the last map change. Lenders may have the ability to request a re-certification of the current flood determination or may simply order a new determination. Flood determinations older than 7 years old must be accompanied by a new flood determination. In addition, borrowers of loans secured by improved real estate located in a special flood hazard zone must be provided a new notice of flood insurance availability and must document it was provided at maturity extension with acknowledgement evidenced by a borrower signature. Furthermore, the institution should conduct a review of borrower's current flood insurance coverage to ensure it continues to meet minimum regulatory standards prior to maturity extension.

Coronavirus (COVID-19): (Cont.)

The follow is our list of key points to remember as we navigate the Covid 19 outbreak.

- Many borrowers will require some type of payment relief to get through this time. Most institutions will find it beneficial to work with borrowers regardless of whether the assistance granted results in a TDR. In the end, the financial and regulatory impact of making a TDR should be minimal for most institutions.
- Loan grades should be properly updated as needed although not every type of assistance will require a change in loan rating.
- Now is the time to evaluate institutional liquidity and make any additional arrangements that are necessary.
- Don't forget compliance requirements while working to meet borrower needs. Remember modifications that result in a maturity change will require a flood determination review.

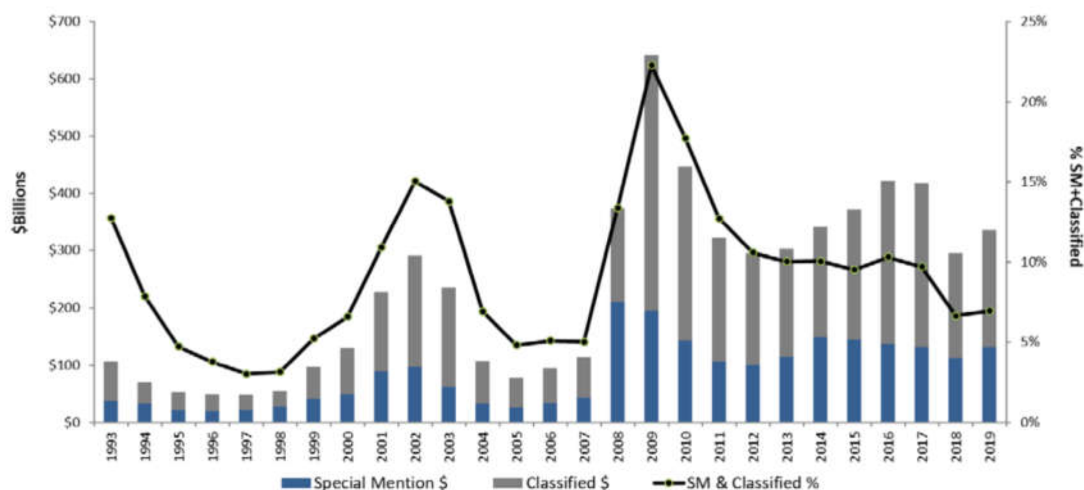
References:
March 13, 2020 FDIC Guidance - https://www.fdic.gov/news/news/financial/2020/fil20017a.pdf
March 13, 2020 OCC Guidance - https://www.occ.gov/news-issuances/bulletins/2020/bulletin-2020-15.html
March 13, 2020 NCUA Guidance - https://www.ncua.gov/files/letters-credit-unions/20-cu-02-ncua-actions-related-covid-19.pdf
March 10, 2020 SBA Guidance on Deferments for SBA 7(a) and 504 Program Loans - https://files.constantcontact.com/b80cae7f401/91c1db37-3ddc-4f29-9ce7-f32b0d81ce30.pdf
Accounting Standards Guidance on Receivables (TDR) - https://ofn.org/sites/default/files/resources/PDFs/Publications/ASU_2011-02-310.pdf
FDIC FIL 61-2009 Policy Statement on Prudent Commercial Real Estate Loan Workouts - https://www.fdic.gov/news/news/financial/2009/fil09061a1.pdf
FDIC FIL 50-2013 Troubled Debt Restructuring Interagency Supervisory Guidance - https://www.fdic.gov/news/news/financial/2013/fil13050.pdf
PART 339—LOANS IN AREAS HAVING SPECIAL FLOOD HAZARDS - https://www.fdic.gov/regulations/laws/rules/2000-6100.html
FDIC Risk Management Manual of Examination Policies – Section 3.2 (Loans) - https://www.fdic.gov/regulations/safety/manual/section3-2.pdf
Frequently Asked Questions for those Impacted by Coronavirus Disease 2019 (COVID-19) - https://www.fdic.gov/coronavirus/faq-fi.pdf
Lucro Commercial Solutions www.lucro.org - Borrower Questionnaire

Shared National Credits

Annually, when the Shared National Credit Review is published by Federal Regulators, we compare the average & median loan classifications within the SHPCO client group to adverse classifications within the SNC program. The 2019 SNC review was published during January 2020. The definition of a SNC was amended during January 2018. Previously, SNCs had been any credit facility ≥ $20 million with three or more participants. To adjust for inflation and increases in average loan size, the minimum aggregate loan commitment threshold was increased from $20 million to $100 million effective January 1, 2018.

2019 Shared National Credit Review ($ Billions)									
Year	Special Mention	Sub-Standard	Doubtful	Loss	Total Classified	Total Committed	Total Outstanding	Adverse	Special Mention
Q3 2017	$ 131.7	$ 245.1	$ 24.2	$ 16.6	$ 285.9	$ 4,304.0	$ 2,149.0	6.6%	3.1%
Q3 2018	$ 112.4	$ 173.9	$ 5.1	$ 3.4	$ 182.5	$ 4,435.0	$ 2,106.0	4.1%	2.5%
Q3 2019	$ 131.2	$ 186.3	$ 10.3	$ 7.5	$ 204.1	$ 4,830.0	$ 2,359.0	4.2%	2.7%

Classified assets totaled $204.1 billion at the 2019 review as compared to $182.5 billion in 2018 with special mention loans currently totaling $131.2 billion as compared to 2018's $112.4 billion.



For reference, corresponding SHPCO client data is presented:

Year	SHPCO Average	SHPCO Median	SNC Review
Q3 2017	3.10%	2.38%	6.60%
Q3 2018	2.55%	1.85%	4.10%
Q3 2019	2.31%	1.66%	4.20%

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Shared National Credits (Continued)

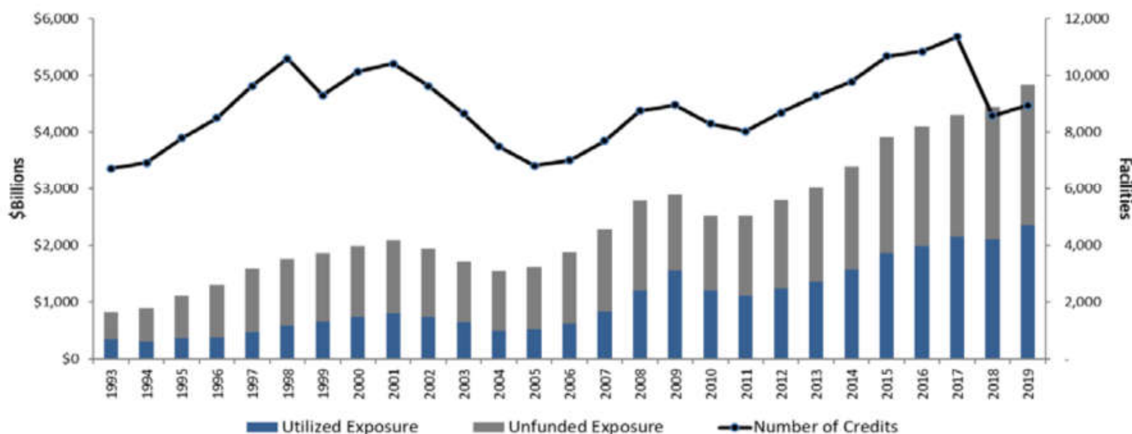
Highlights from the Shared National Credit Review:

The 2019 SNC population totaled $4.83 trillion in commitments. Total commitments increased by $395 billion, or 8.9 percent, from the third quarter of 2018 to the third quarter of 2019. Growth was concentrated in investment grade equivalent transactions.

The volume of SNC commitments with the lowest supervisory ratings (special mention and classified) rose slightly between 2018 and 2019. Total special mention and classified commitment levels remain elevated compared with lows reached during the previous periods of strong economic performance. A significant portion of special mention and classified commitments are concentrated in transactions that agent banks identified and reported as leveraged loans.

The industries within the SNC portfolio with the highest classifications include Commodities (5.0%), Distribution (5.7%), and Services (7.1%).

The credit risk associated with leveraged lending remains elevated. Leveraged loan commitments represent 83% of special mention commitments and 80% of classified commitments.



Reference:
www.occ.treas.gov/publications-and-resources/publications/shared-national-credit-report/files/shared-national-credit-report-2019.pdf

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

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