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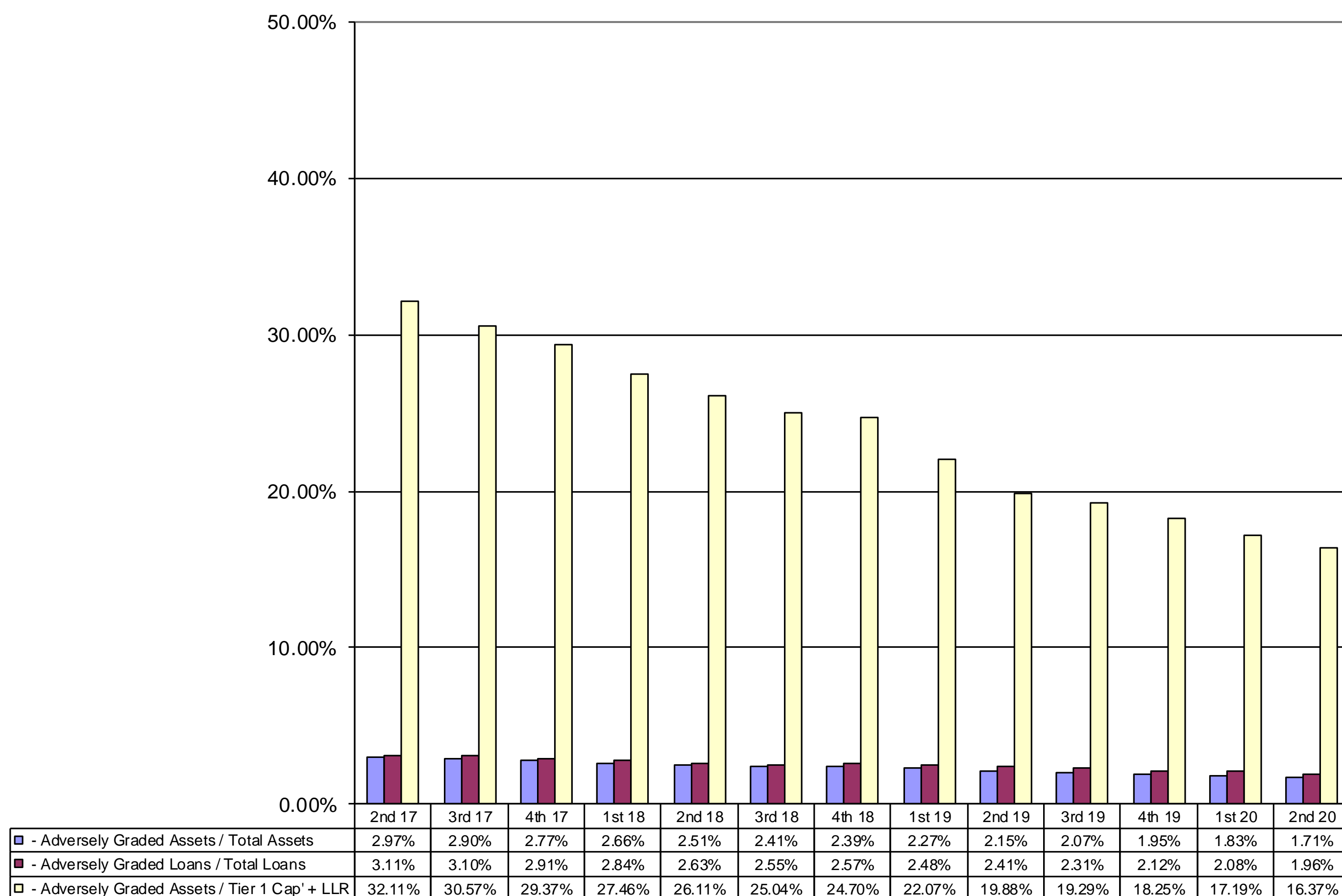
Steve H. Powell & Company

Asset Quality Update – Q2 2020 Edition

Trends in Asset Quality – Average Levels

Based on Steve H. Powell & Company client data, during the Second 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 1.71% of total assets and 16.37% of tier-one capital plus loan loss reserve as compared to 1.83% of total assets and 17.19% of tier-one capital plus loan loss reserve while problem loans averaged 1.96% of total loans as compared to 2.08% of total loans during the First Quarter 2020.



	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19	2nd 19	3rd 19	4th 19	1st 20	2nd 20
- Adversely Graded Assets / Total Assets	2.97%	2.90%	2.77%	2.66%	2.51%	2.41%	2.39%	2.27%	2.15%	2.07%	1.95%	1.83%	1.71%
- Adversely Graded Loans / Total Loans	3.11%	3.10%	2.91%	2.84%	2.63%	2.55%	2.57%	2.48%	2.41%	2.31%	2.12%	2.08%	1.96%
- Adversely Graded Assets / Tier 1 Cap' + LLR	32.11%	30.57%	29.37%	27.46%	26.11%	25.04%	24.70%	22.07%	19.88%	19.29%	18.25%	17.19%	16.37%

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 Q2 2020 has decreased to 10.29% of tier-one capital plus loan loss reserve as compared to 10.50% during Q1 2020. Note the downward trend as overall asset quality continues to improve.

TRENDS IN ASSET QUALITY
MEDIAN LEVEL OF ADVERSELY GRADED ASSETS

	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19	2nd 19	3rd 19	4th 19	1st 20	2nd 20
- Adversely Graded Assets / Total Assets	2.15%	2.25%	2.20%	2.08%	1.96%	1.74%	1.85%	1.87%	1.73%	1.58%	1.44%	1.43%	1.20%
- Adversely Graded Loans / Total Loans	2.32%	2.38%	2.28%	2.27%	1.93%	1.85%	1.85%	1.84%	1.61%	1.66%	1.61%	1.72%	1.51%
- Adversely Graded Assets / Tier 1 Cap' + LLR	18.23%	18.84%	18.27%	16.72%	15.31%	14.65%	14.62%	14.93%	13.30%	13.30%	11.75%	10.50%	10.29%

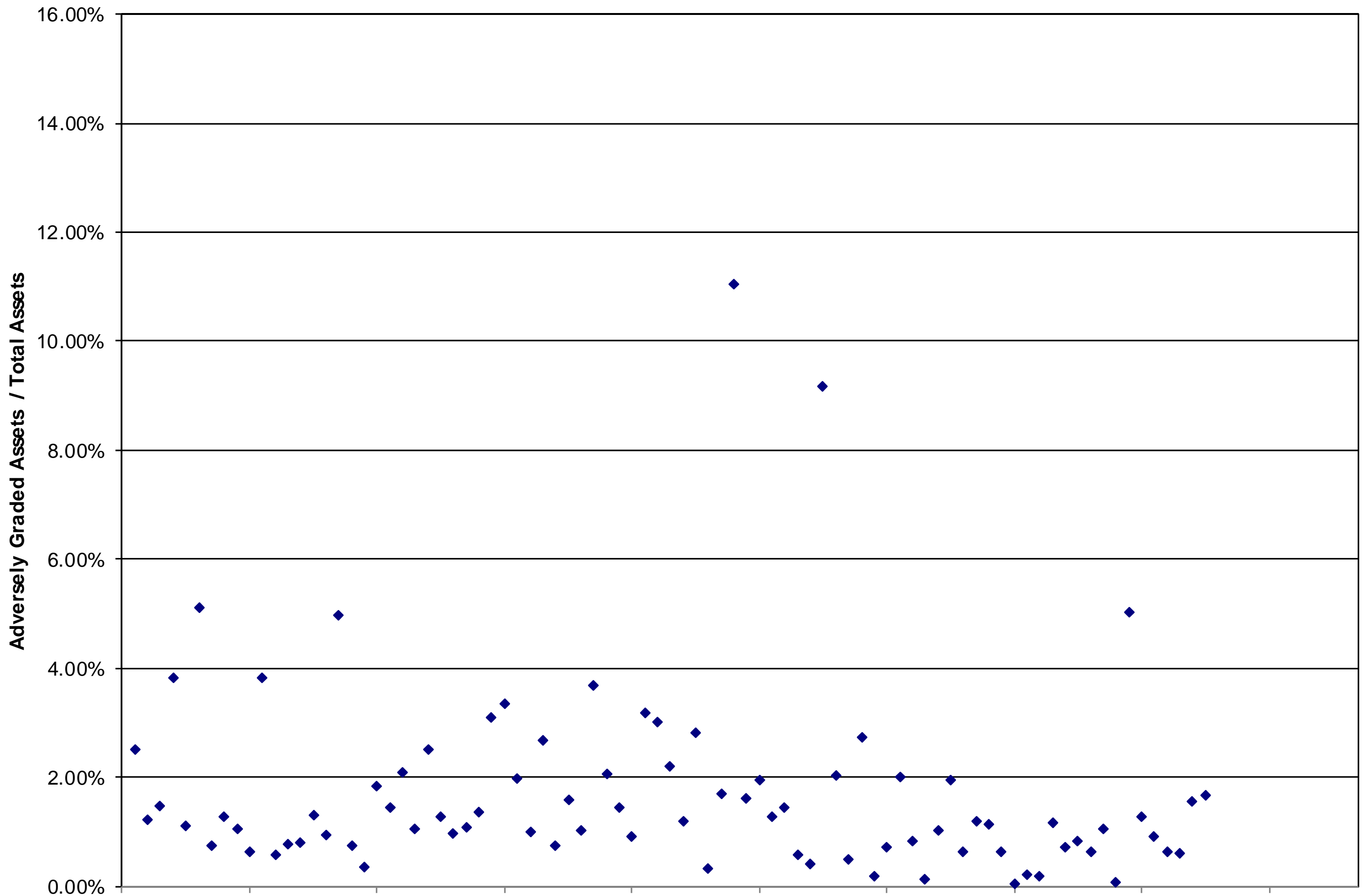
Historical Comparisons

During Q2 2020, increases in problem assets, as measured by adversely graded assets divided by tier-one capital plus loan loss reserve, were noted in approximately 21% of our clients. This quarter's increase compares to:

- 23% during the First Quarter 2020
- 13% during the Fourth Quarter 2019
- 11% during the Third Quarter 2019
- 17% during the Second Quarter 2019
- 24% during the First Quarter 2019

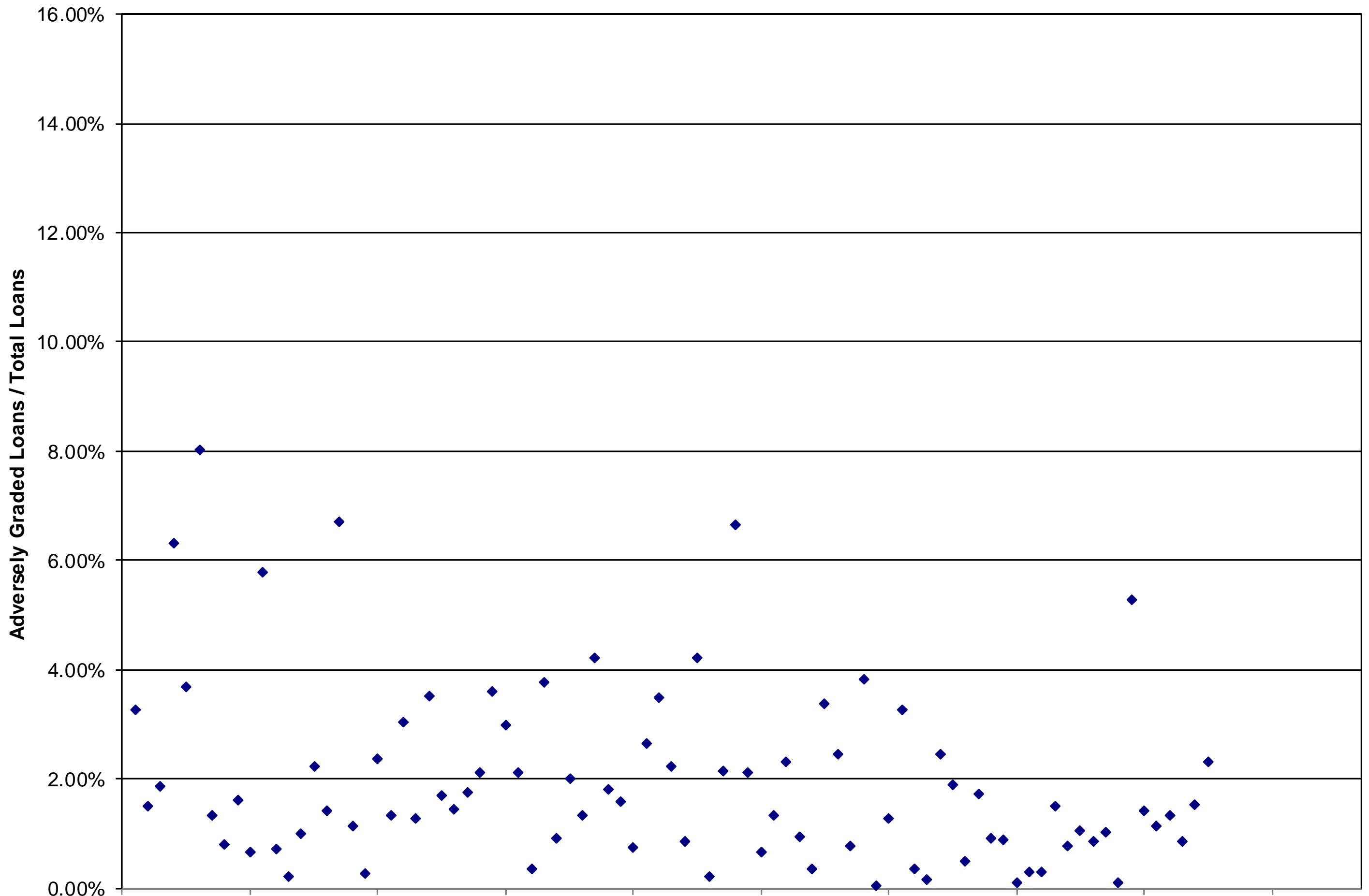
A higher level of volatility in the percentage of increases may be expected as overall asset quality stabilizes; however, increases may indicate a rise in portfolio risk.

Dispersion of Problem Assets – as a Percentage of Total Assets



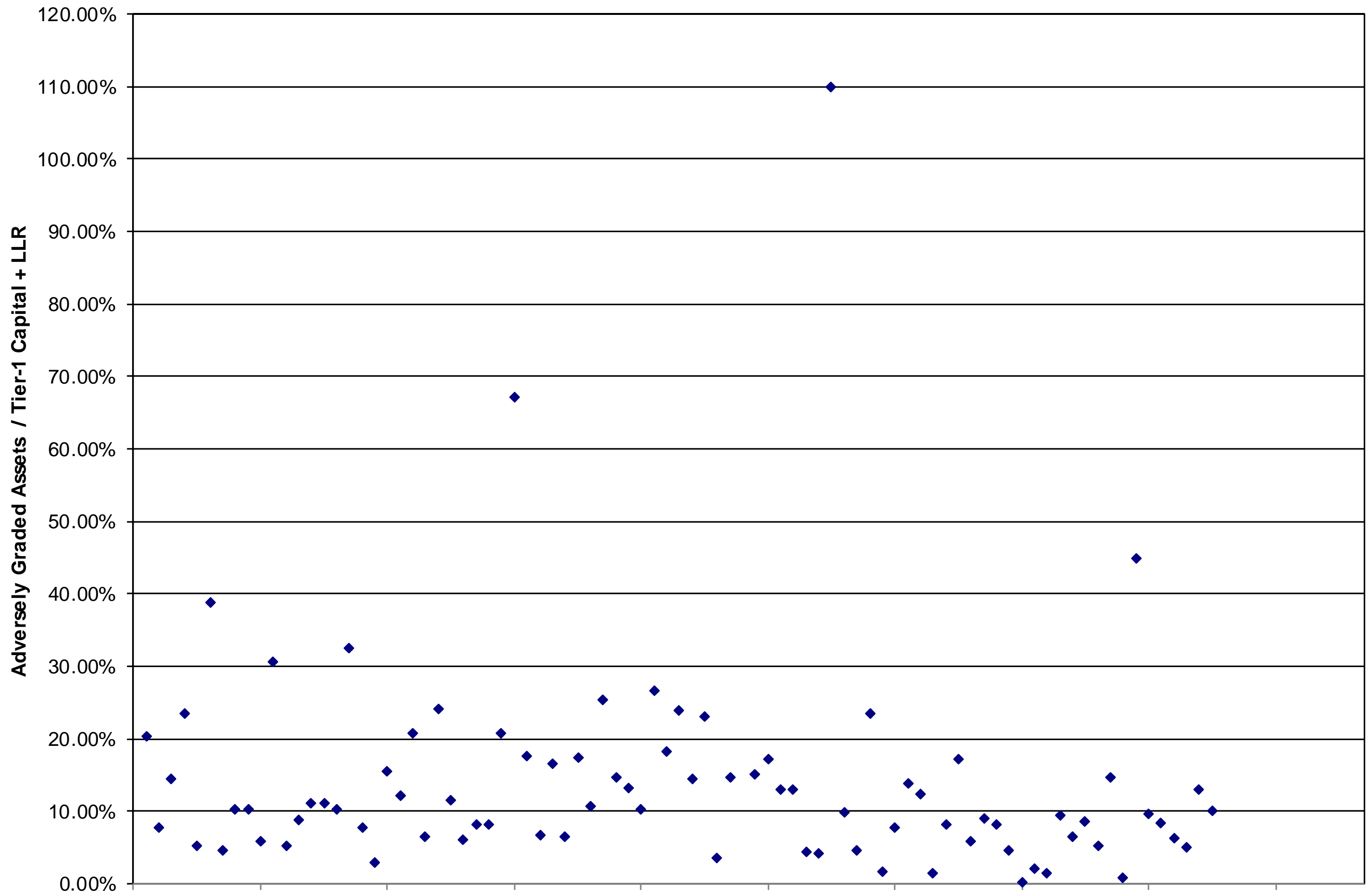
The above graph shows the dispersion of problem assets as a percentage of total assets. A traditional benchmark for significant asset quality concern is adversely graded assets that exceed 10% of total assets.

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 one data point exceeding 120% is not included in the graph above for aesthetic reasons.

Historical Comparisons

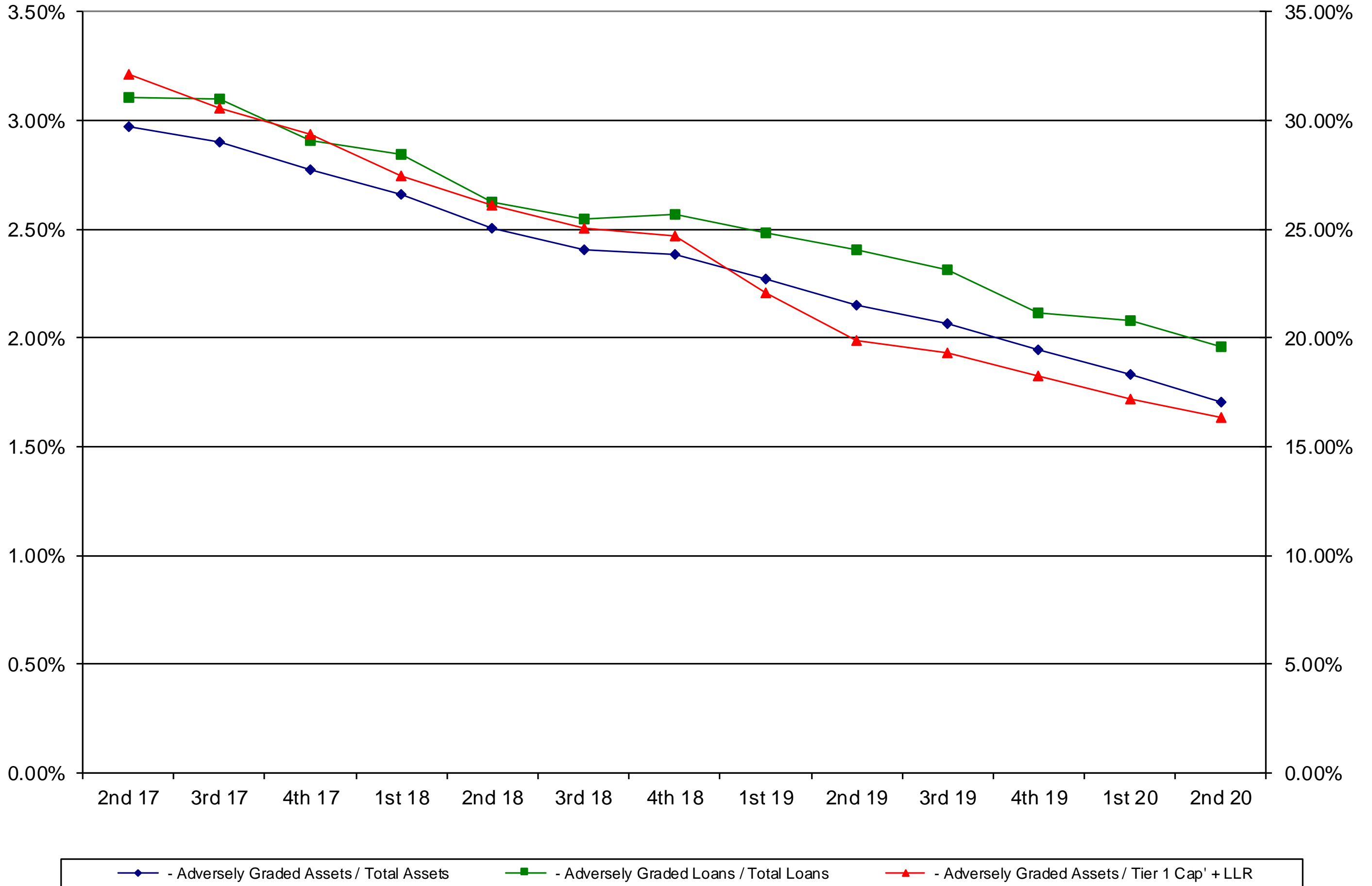
Our sample group includes three (3) banks with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

- Three (3) during the First Quarter 2020
- Four (4) during the Fourth Quarter 2019
- Five (5) during the Third 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:

- Two (2) during the First Quarter 2020
- Four (4) during the Fourth Quarter 2019
- Four (4) during the Third 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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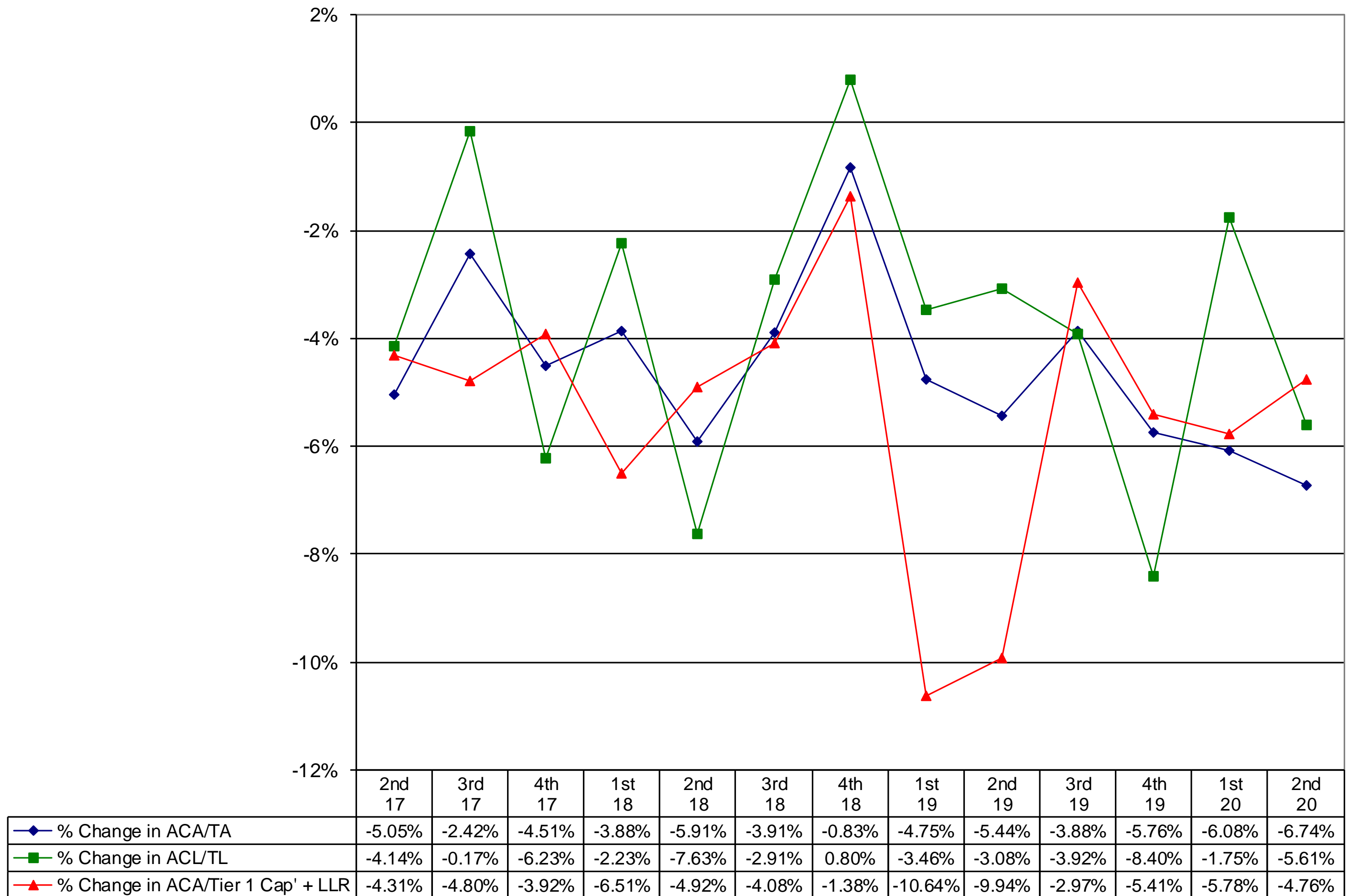
Problem Asset Comparative Change Analysis



	2nd 17	3rd 17	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19	2nd 19	3rd 19	4th 19	1st 20	2nd 20
% Change in ACA/TA	-5.05%	-2.42%	-4.51%	-3.88%	-5.91%	-3.91%	-0.83%	-4.75%	-5.44%	-3.88%	-5.76%	-6.08%	-6.74%
% Change in ACL/TL	-4.14%	-0.17%	-6.23%	-2.23%	-7.63%	-2.91%	0.80%	-3.46%	-3.08%	-3.92%	-8.40%	-1.75%	-5.61%
% Change in ACA/Tier 1 Cap' + LLR	-4.31%	-4.80%	-3.92%	-6.51%	-4.92%	-4.08%	-1.38%	-10.64%	-9.94%	-2.97%	-5.41%	-5.78%	-4.76%

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 1.53% of total assets, 1.94% of total loans, and 12.59% of tier-one capital plus loan loss reserve. Second Quarter 2020 modified data compares to the following First Quarter 2020 modified average data set:

- 1.63% of total assets
- 2.04% of total loans, and
- 13.19% of tier-one capital plus loan loss reserve

Joint Statement on Additional Loan Accommodations Related to COVID-19

On August 3, 2020, the Federal Financial Institutions Examination Council issued a joint statement with additional guidance regarding COVID loan modifications. The guidance is applicable to both commercial and consumer loans. The guidance is to be "tailored" to be suitable to an institution's size, overall complexity, as well as risk profile.

The FFIEC acknowledges that:

> *The FFIEC members have encouraged financial institutions to work prudently with borrowers who are or may be unable to meet their contractual payment obligations because of the COVID event. Specifically, the FFIEC members have stated that they view loan accommodations as positive actions, which can mitigate adverse effects on borrowers caused by the COVID event.*

The August 2020 guidance was intended to assist banks with assessing borrowers who had been granted COVID payment relief and may not be able to return to the original terms of their loans or may not be able to meet their debt service obligations. The guidance is to be viewed in light of prudent capital preservation, portfolio management regarding compliance, asset quality, and operational risks. An institution's actions:

- *Should be based on an understanding of the credit risk of the borrower*
- *Should be consistent with applicable laws and regulations*
- *Could ease cash flow pressures on affected borrowers & improve their capacity to service debt*
- *And should facilitate a financial institution's ability to collect on its loans*

In general, the guidance indicates "following an accommodation, a financial institution reassesses risk ratings for each loan based on a borrower's current debt level, current financial condition, repayment ability, and collateral". The guidance does not dissuade institutions from providing additional modifications & continuing to work with COIVD impacted borrowers, yet it does state any actions are to be "based on a *comprehensive* review of how the hardship has affected the financial condition and current and future performance of the borrower". Regulatory expectations are to have a timely assessment of a borrower's current & projected financial health and cash flow as well as an assessment of if/how current economic conditions may have affected collateral values. An adverse loan grade will not be predicated based solely on a decline in collateral margin, but loan files should be documented – again focusing on a borrower's current cash flow & debt service ability.

The majority of SHPCO client discussions of COVID payment modification revolve around any potential TDR classification and accrual status. Initial Regulatory guidance, overly simplified, allowed a six month COVID payment modification / extension period with out triggering a TDR classification or downgrade to non-accrual status. Any additional COVID modification beyond an initial six month concession, while prudent, should be carefully assessed. It would feel as if additional COVID payment modifications beyond the initial six-month-window that are not fully documented with current credit & collateral assessment could raise Regulatory scrutiny.

> For example, if the cumulative modifications for a loan are all COVID event related, in total represent short-term modifications (e.g., six months or less combined), and the borrower is contractually current (i.e., less than 30 days past due on all contractual payments) at the time of the subsequent modification, management may continue to presume the borrower is not experiencing financial difficulties at the time of the modification for purposes of determining TDR status, and the subsequent modification of loan terms would not be considered a TDR.

The August 2020 and accounting guidance indicate an institution should assess accrual status & TDR treatment as based, in part on:

- Changes in borrower financial condition
- Changes in collateral values
- Current lending practices
- Current economic conditions

It would appear current Regulatory guidance somewhat harkens to historical practices dating to the Great Recession – the most recent mass-application of Trouble Debt Restructure & non-accrual. Many institutions had AD&C borrowers who were not past due on interest only payments, yet the AD&C borrowers were subjected to Regulatory criticism and were classified as TDRs or downgraded to non-accrual. The historical loan files did not contain timely financial information, or realistic pro-formas, and the financial then available did not reflect sufficient cash flow to provide for timely debt service (on 'proper' amortization schedules rather than interest only). Additionally, many of the AD&C files did not contain an updated collateral assessment as based on prevailing market conditions.

For additional guidance & reference please see:

Proclamation 9994, “Declaring a National Emergency Concerning the Novel Coronavirus Disease (COVID-19) Outbreak,” 85 FR 15337 (March 18, 2020) “Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus (Revised)” (April 7, 2020)
ASC 310-10-35: https://asc.fasb.org/imageRoot/39/84156639.pdf
ASC 326-20-30-2: https://asc.fasb.org/imageRoot/39/84156639.pdf
“Interagency Supervisory Guidance Addressing Certain Issues Related to Troubled Debt Restructurings” (October 24, 2013)

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

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