Steve H. Powell & Company

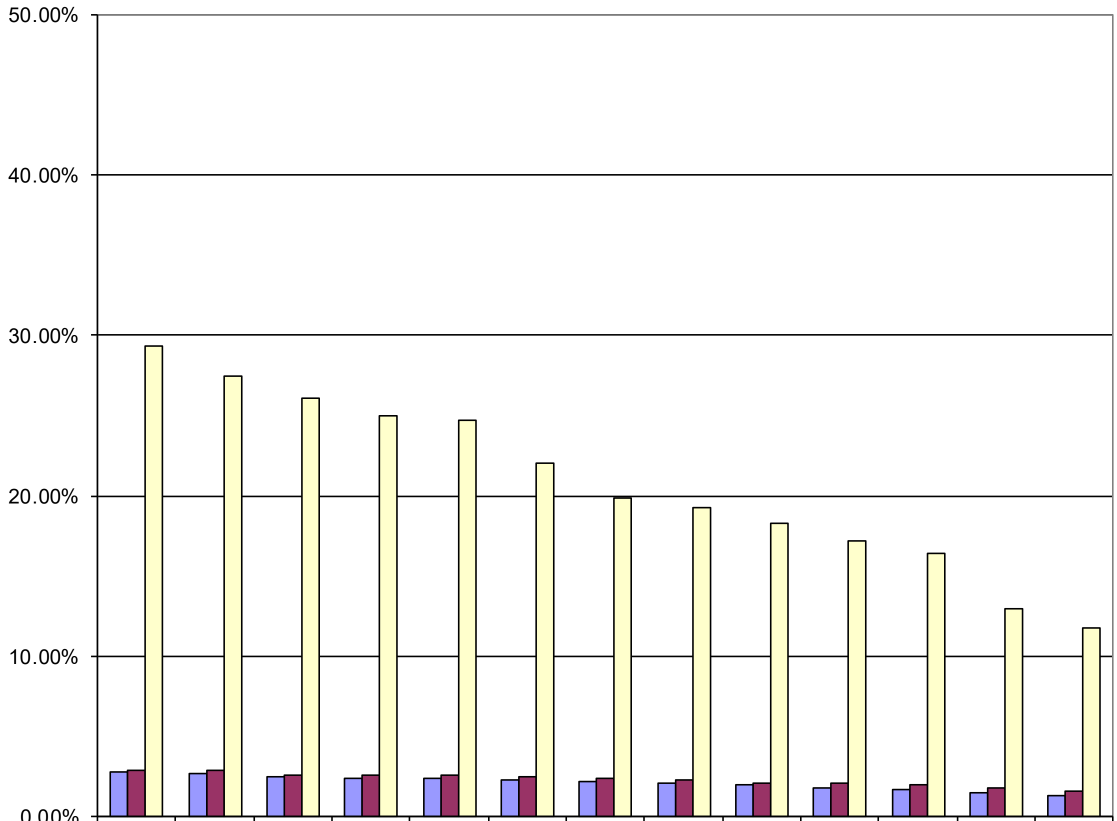
P&Co. Est. 1993

Asset Quality Update – Q4 2020 Edition

Trends in Asset Quality – Average Levels

Based on Steve H. Powell & Company client data, during the Fourth 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 1.30% of total assets and 11.76% of tier-one capital plus loan loss reserve as compared to 1.46% of total assets and 12.96% of tier-one capital plus loan loss reserve while problem loans averaged 1.59% of total loans as compared to 1.78% of total loans during the Third Quarter 2020.

TRENDS IN ASSET QUALITY
AVERAGE LEVEL OF ADVERSELY GRADED ASSETS



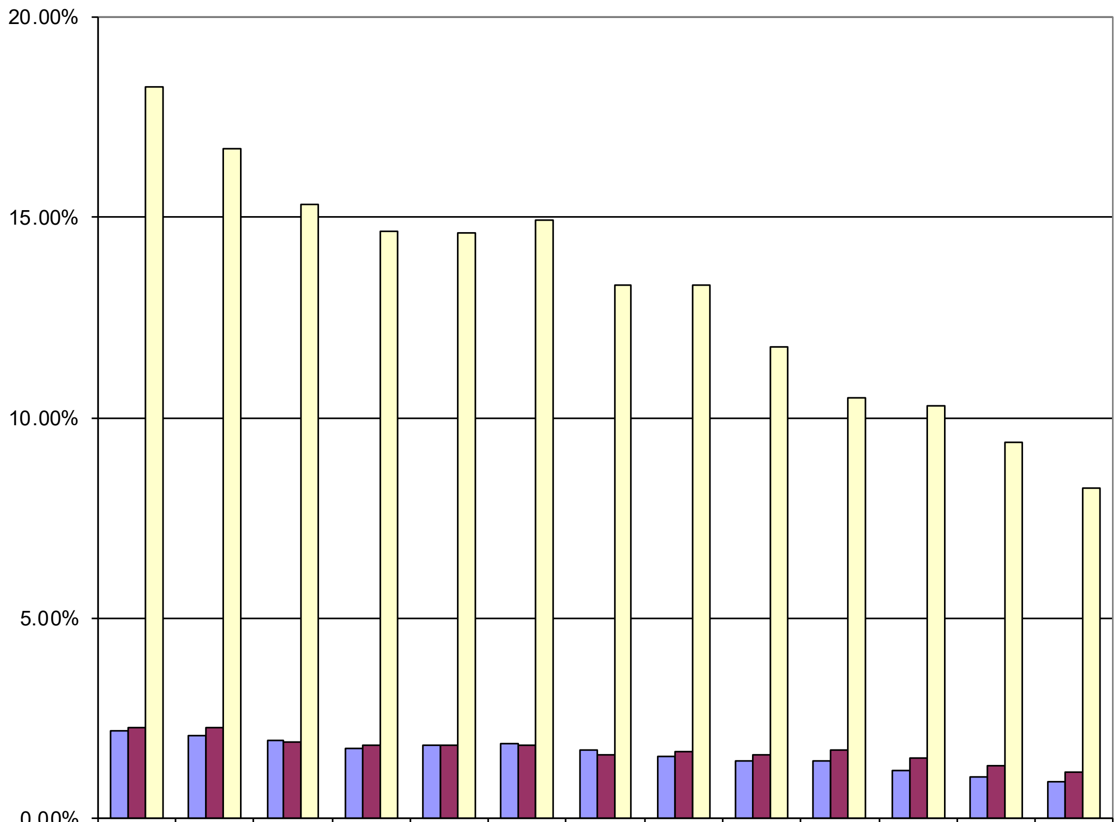
	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19	2nd 19	3rd 19	4th 19	1st 20	2nd 20	3rd 20	4th 20
- Adversely Graded Assets / Total Assets	2.77%	2.66%	2.51%	2.41%	2.39%	2.27%	2.15%	2.07%	1.95%	1.83%	1.71%	1.46%	1.30%
- Adversely Graded Loans / Total Loans	2.91%	2.84%	2.63%	2.55%	2.57%	2.48%	2.41%	2.31%	2.12%	2.08%	1.96%	1.78%	1.59%
- Adversely Graded Assets / Tier 1 Cap' + LLR	29.37%	27.46%	26.11%	25.04%	24.70%	22.07%	19.88%	19.29%	18.25%	17.19%	16.37%	12.96%	11.76%

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 2020 has decreased to 8.25% of tier-one capital plus loan loss reserve as compared to 9.4% during Q3 2020. Note the downward trend as overall asset quality continues to improve.

TRENDS IN ASSET QUALITY
MEDIAN LEVEL OF ADVERSELY GRADED ASSETS



	4th 17	1st 18	2nd 18	3rd 18	4th 18	1st 19	2nd 19	3rd 19	4th 19	1st 20	2nd 20	3rd 20	4th 20
- Adversely Graded Assets / Total Assets	2.20%	2.08%	1.96%	1.74%	1.85%	1.87%	1.73%	1.58%	1.44%	1.43%	1.20%	1.05%	0.91%
- Adversely Graded Loans / Total Loans	2.28%	2.27%	1.93%	1.85%	1.85%	1.84%	1.61%	1.66%	1.61%	1.72%	1.51%	1.33%	1.15%
- Adversely Graded Assets / Tier 1 Cap' + LLR	18.27%	16.72%	15.31%	14.65%	14.62%	14.93%	13.30%	13.30%	11.75%	10.50%	10.29%	9.40%	8.25%

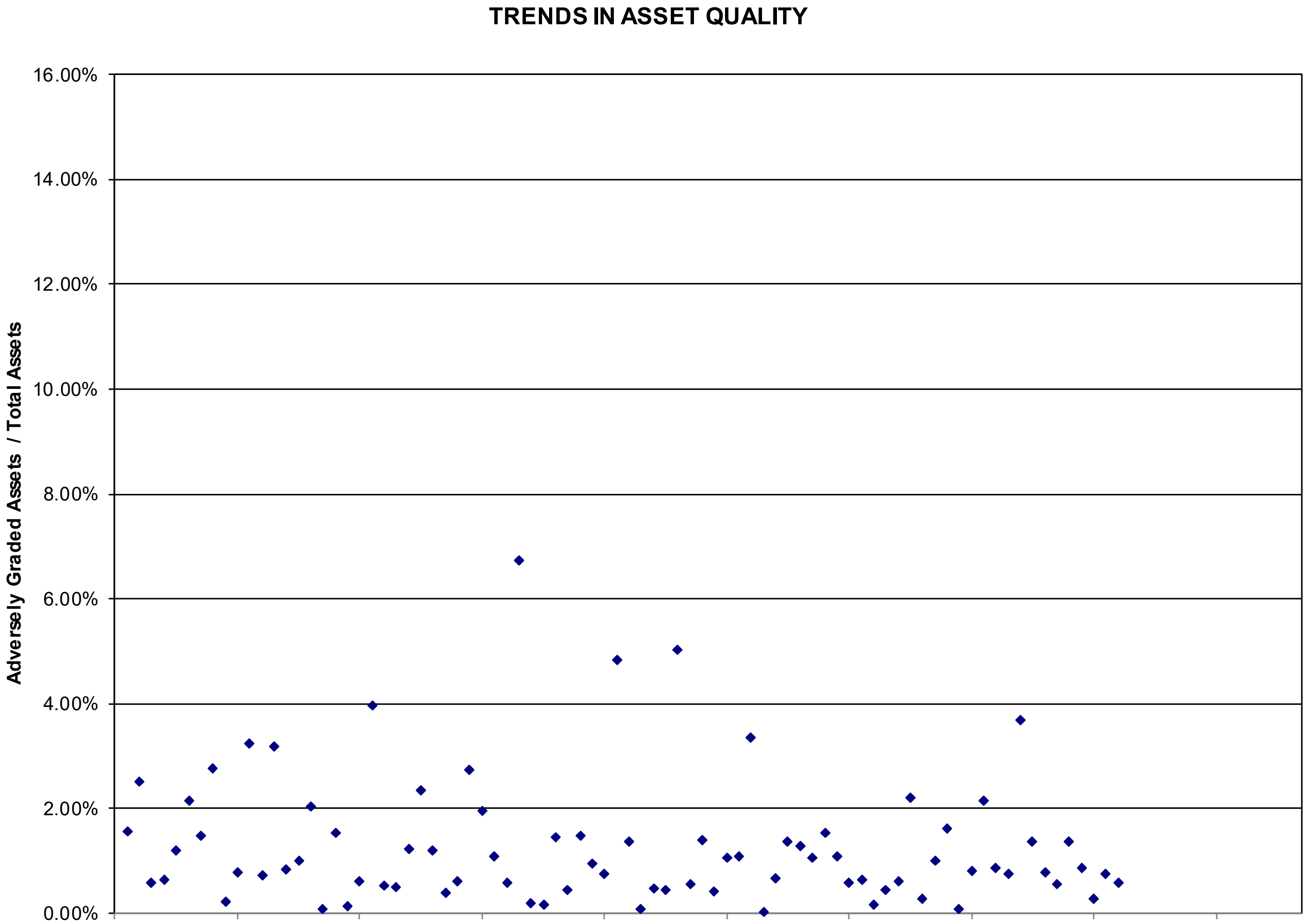
Historical Comparisons

During Q4 2020, increases in problem assets, as measured by adversely graded assets divided by tier-one capital plus loan loss reserve, were noted in approximately 9% of our clients. This quarter's increase compares to:

- 10% during the Third Quarter 2020
- 21% during the Second Quarter 2020
- 23% during the First Quarter 2020
- 13% during the Fourth Quarter 2019
- 11% during the Third Quarter 2019

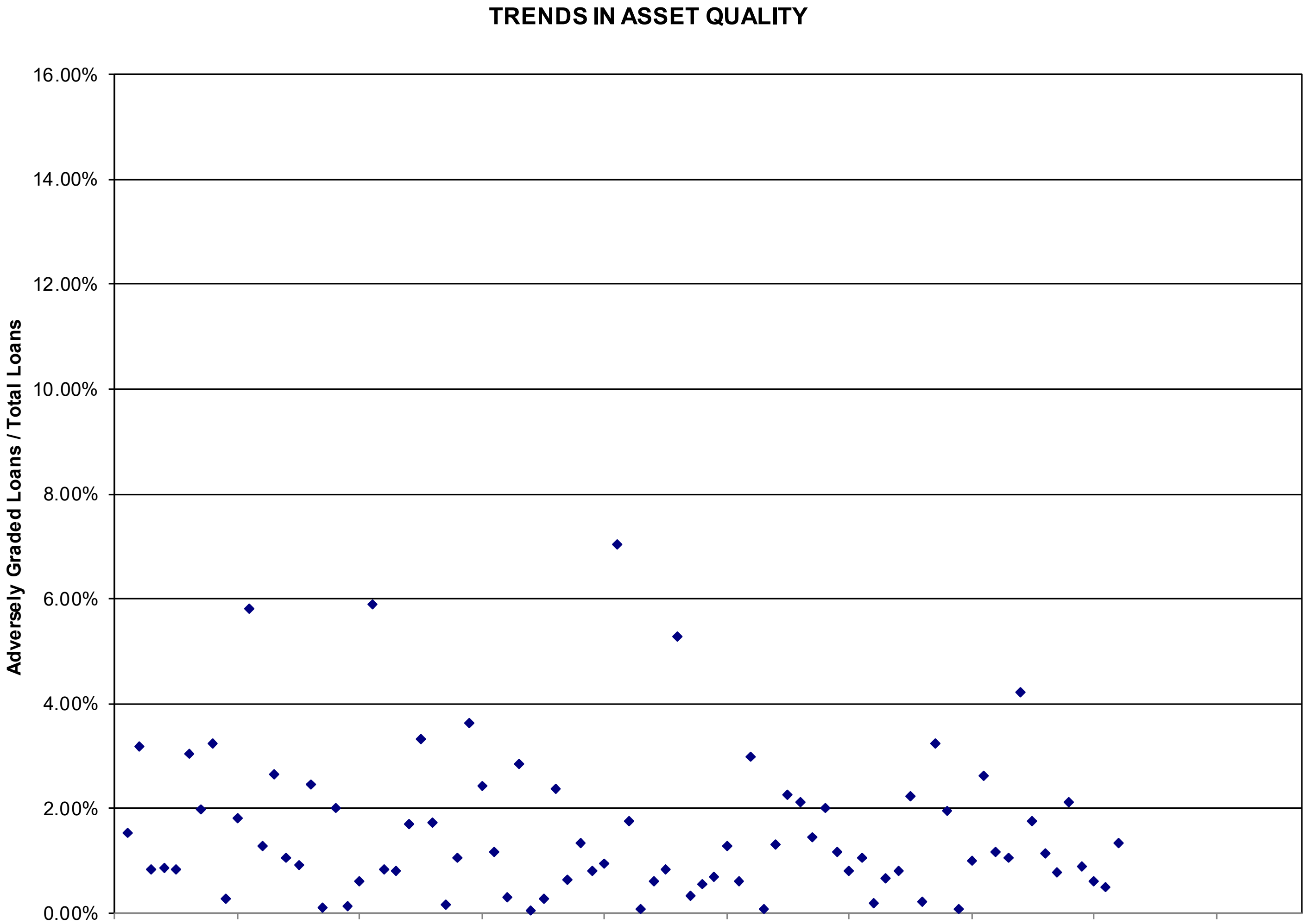
A higher level of volatility in the percentage of increases may be expected as overall asset quality stabilizes; however, increases may indicate a rise in portfolio risk.

Dispersion of Problem Assets – as a Percentage of Total Assets



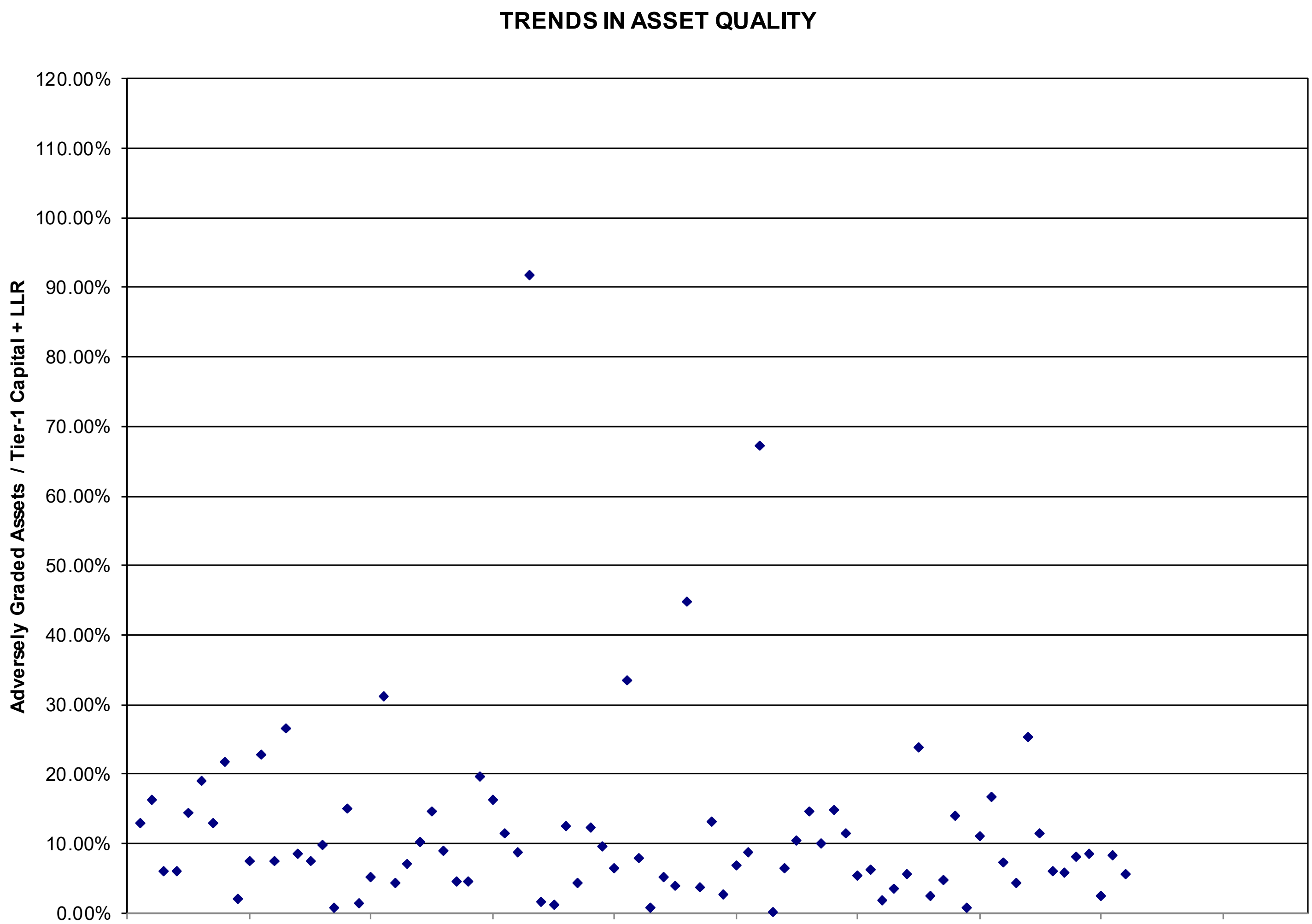
The above graph shows the dispersion of problem assets as a percentage of total assets. A traditional benchmark for significant asset quality concern is adversely graded assets that exceed 10% of total assets.

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



Historical Comparisons

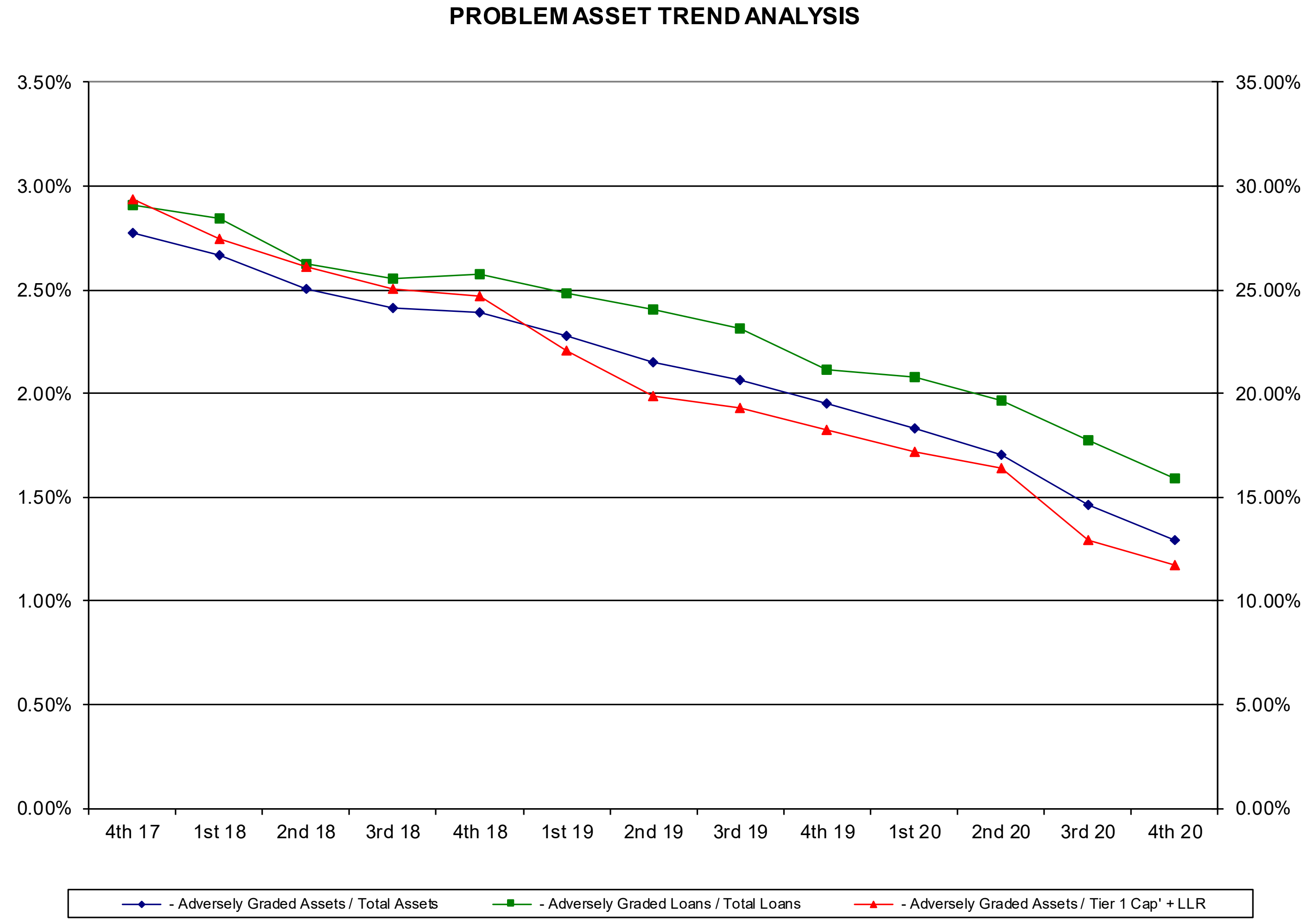
Our sample group includes two (2) clients with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

- One (1) during the Third Quarter 2020
- Three (3) during the Second Quarter 2020
- Three (3) during the First Quarter 2020

One (1) client now exceeds 80% of tier-one capital plus loan loss reserve – a level normally associated with some form of formal regulatory action – as compared to:

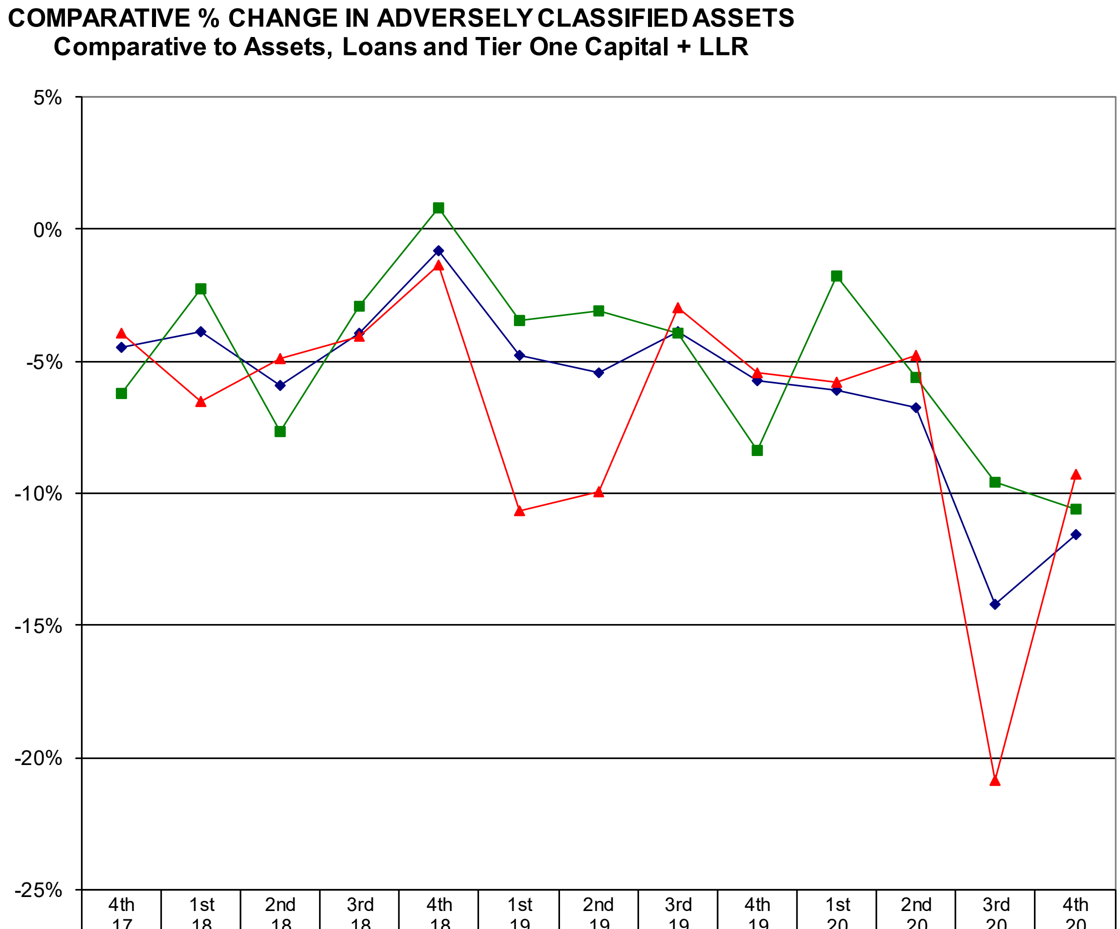
- One (1) during the Third Quarter 2020
- Two (2) during the Second Quarter 2020
- Two (2) during the First Quarter 2020

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 17	1st 18	2nd 18	3rd 18	4th 18	1st 19	2nd 19	3rd 19	4th 19	1st 20	2nd 20	3rd 20	4th 20
% Change in ACA/TA	-4.51%	-3.88%	-5.91%	-3.91%	-0.83%	-4.75%	-5.44%	-3.88%	-5.76%	-6.08%	-6.74%	-14.20%	-11.54%
% Change in ACL/TL	-6.23%	-2.23%	-7.63%	-2.91%	0.80%	-3.46%	-3.08%	-3.92%	-8.40%	-1.75%	-5.61%	-9.55%	-10.62%
% Change in ACA/Tier 1 Cap' + LLR	-3.92%	-6.51%	-4.92%	-4.08%	-1.38%	-10.64%	-9.94%	-2.97%	-5.41%	-5.78%	-4.76%	-20.86%	-9.25%

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

An analysis was performed 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 1.20% of total assets, 1.56% of total loans, and 9.98% of tier-one capital plus loan loss reserve. Fourth Quarter 2020 modified data compares to the following Third Quarter 2020 modified average data set:

- 1.37% of total assets
- 1.78% of total loans, and
- 11.32% of tier-one capital plus loan loss reserve

COVID-19 Modifications / Trouble Debt Restructuring

With ongoing market disruptions, a common asset quality topic is COVID-19 payment modifications & potential Troubled Debt Restructures (TDR). Overly simplified, for borrowers who were current on their loans, COVID-19 related payment modifications could be granted, and the modifications would not constitute a TDR.

As the COVID-19 Pandemic continues, issues that were not apparent in the early months after modification plans were started have become more evident. Regulatory guidance on COVID-19 modifications provides for two different paths, each with different requirements. One path follows the guidance / requirements of Section 4013 of the CARES Act while the other provides for non-section 4013 modifications. Generally, Section 4013 guidance provides for longer and more flexible modification terms (without TDR identification). A plain text reading of the requirement would seem to indicate that Lenders must “elect” to utilize Section 4013 guidance if they plan to follow those requirements for a particular loan. A review of COVID-19 related loan modifications across our client base finds little information in file that details the financial institution’s intention to implement a 4013 modification. Steve H. Powell & Company recommends that a credit memo, or other similar documentation, is prepared and documented in the file of record. This document should include a discussion of the Section 4013 election, especially when the cumulative extensions or modifications exceed six months. Without formally documenting this election, many of these long-term modifications could be deemed to be TDR’s by regulatory agencies.

While numerous documents provide guidance on the subject, one of the best and most concise publications is the “OCC Reference Guide: TDR Designation and COVID-19 Loan Modifications”. The chart at the bottom of the first page details the differences between Section 4013 and non-Section 4013 modifications and the flowchart on page two is a very useful tool in determining TDR status and identification. The link to the OCC Publication below is updated to include the most recent changes implemented in accordance with Section 541 of the Consolidated Appropriations Act, 2021.

www.occ.treas.gov/news-issuances/bulletins/2020/COVID-19-loan-modifications-reference-guide.pdf

Loan Grading in the COVID-19 Era

Significant regulatory guidance exists concerning TDR status and identification relating to the effects of COVID-19. While broad leeway has been granted to allow for modifications without TDR identification, this issue should be considered separate and distinct from a loan's assigned risk rating. Initial regulatory guidance indicated lenders should work with borrowers adversely affected by COVID-19 while maintaining appropriate safety and soundness standards. Unfortunately, with the pandemic recently passing its one-year anniversary, the long-term financial consequences are now becoming apparent for many borrowers.

In many cases, borrowers are experiencing significant financial stress that is no fault of their own and almost entirely linked to COVID-19. This financial stress is particularly evident in the Hospitality and Restaurant sectors, although many others have also been affected. When assessing loan grades, financial institutions are encouraged to be realistic in assessing the current financial situation of each borrower and adjust risk ratings where necessary and appropriate. Despite the financial stress being caused by COVID-19, loan grades should migrate over time to recognize the risk each transaction poses to the institution, especially in light of current economic conditions.

In a regulatory FAQ dated May 27, 2020, one question asked; "Do loans that receive payment accommodations have to be reported as nonaccrual, reflect appropriate ACL or ALLL, and be charged off?" and the following answer was provided:

> *Each financial institution should refer to the applicable regulatory reporting instructions, as well as its internal accounting policies, in determining whether to report loans with accommodations to customers affected by COVID-19 as nonaccrual assets in regulatory reports. (See also the response to questions 3 and 5). Each institution should maintain an appropriate allowance allocation for these loans, considering all information available prior to filing its reports about their collectability. As information becomes available that indicates a specific loan will not be repaid, institutions should preserve the integrity of their internal loan grading methodology and maintain appropriate accrual status on affected credits. Financial institutions should refer to the charge-off guidance in the instructions for the Consolidated Reports of Condition and Income.*

Throughout 2020, examiners were understanding of the complications caused by COVID-19. However, increased regulatory scrutiny can reasonably be expected as the pandemic stretches into 2021. Proper loan grading and impairment identification will likely be a focal point. Despite best efforts by all parties involved, some borrowers will be unable to repay their debts. Financial institutions should continue to actively manage loan portfolios and adjust risk ratings as necessary.

Garnishment

Our clients continue to manage around & through the various COVID-driven, market disruptions. Very commonly, branches are closed or are, at best, operating with reduced staffing levels.

Diminished staffing can lead to breakdowns in various procedures. Being serviced with a notice of garnishment or levy is a routine occurrence, and one that may increase if fraud is found during the government's review of various (Paycheck Protection Program) PPP loans. Be certain the institution has adequate procedures in place, and staff has had proper training regarding accepting, reporting, and answering any legal notice with which the institution may be served. While a branch manager may be well versed in the institution's procedures, does a 'stand-in' branch manager know how & what to do?

As per IRC 6331 and 6332, government can levy for past due taxes. Additionally, under 6332(d)(2), the institution could incur a substantial penalty for failing to honor the levy. Within United States v. Ruff:

> *Upon receipt of a notice of levy, such third parties are required to surrender that property to the IRS. The notice of levy 'gives the IRS the right to all property levied upon…and creates a custodial relationship between the person holding the property and the IRS so that the property comes into constructive possession of the government.' Those individuals who fail to honor the levy incur liability to the government equal to the full value of the property not surrendered.*

Under Georgia law, if a garnishment notice is not answered within 45 days of being served, the institution could be subject to a judgement for the total amount of the garnishment. Per O.C.G.A. 18-4-90 (2010) Entry of default judgment upon failure of garnishee to file answer to summons; opening of default:

> *In case the garnishee fails or refuses to file an answer by the forty-fifth day after service of the summons, the garnishee shall automatically be in default. The default may be opened as a matter of right by the filing of an answer within 15 days of the day of default and payment of costs. If the case is still in default after the expiration of the period of 15 days, judgment by default may be entered at any time thereafter against the garnishee for the amount claimed to be due on the judgment obtained against the defendant.*

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

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