Steve H.
Powell & Company

Asset Quality Update – Q3 2021 Edition

Trends in Asset Quality – Average Levels

Based on Steve H. Powell & Company client data, during the Third Quarter 2021, 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 1.03% of total assets and 9.69% of tier-one capital plus loan loss reserve as compared to 1.12% of total assets and 10.42% of tier-one capital plus loan loss reserve while problem loans averaged 1.54% of total loans as compared to 1.61% of total loans during the Second Quarter 2021.

TRENDS IN ASSET QUALITY
AVERAGE LEVEL OF ADVERSELY GRADED ASSETS

	3rd 18	4th 18	1st 19	2nd 19	3rd 19	4th 19	1st 20	2nd 20	3rd 20	4th 20	1st 21	2nd 21	3rd 21
- Adversely Graded Assets / Total Assets	2.41%	2.39%	2.27%	2.15%	2.07%	1.95%	1.83%	1.71%	1.46%	1.30%	1.15%	1.12%	1.03%
- Adversely Graded Loans / Total Loans	2.55%	2.57%	2.48%	2.41%	2.31%	2.12%	2.08%	1.96%	1.78%	1.59%	1.52%	1.61%	1.54%
- Adversely Graded Assets / Tier 1 Cap' + LLR	25.04%	24.70%	22.07%	19.88%	19.29%	18.25%	17.19%	16.37%	12.96%	11.76%	10.79%	10.42%	9.69%

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 2021 has decreased to 6.4% of tier-one capital plus loan loss reserve as compared to 7.18% during Q2 2021. Note the downward trend as overall asset quality continues to improve.

TRENDS IN ASSET QUALITY
MEDIAN LEVEL OF ADVERSELY GRADED ASSETS

	3rd 18	4th 18	1st 19	2nd 19	3rd 19	4th 19	1st 20	2nd 20	3rd 20	4th 20	1st 21	2nd 21	3rd 21
- Adversely Graded Assets / Total Assets	1.74%	1.85%	1.87%	1.73%	1.58%	1.44%	1.43%	1.20%	1.05%	0.91%	0.80%	0.71%	0.70%
- Adversely Graded Loans / Total Loans	1.85%	1.85%	1.84%	1.61%	1.66%	1.61%	1.72%	1.51%	1.33%	1.15%	1.11%	0.97%	1.10%
- Adversely Graded Assets / Tier 1 Cap' + LLR	14.65%	14.62%	14.93%	13.30%	13.30%	11.75%	10.50%	10.29%	9.40%	8.25%	7.18%	7.18%	6.40%

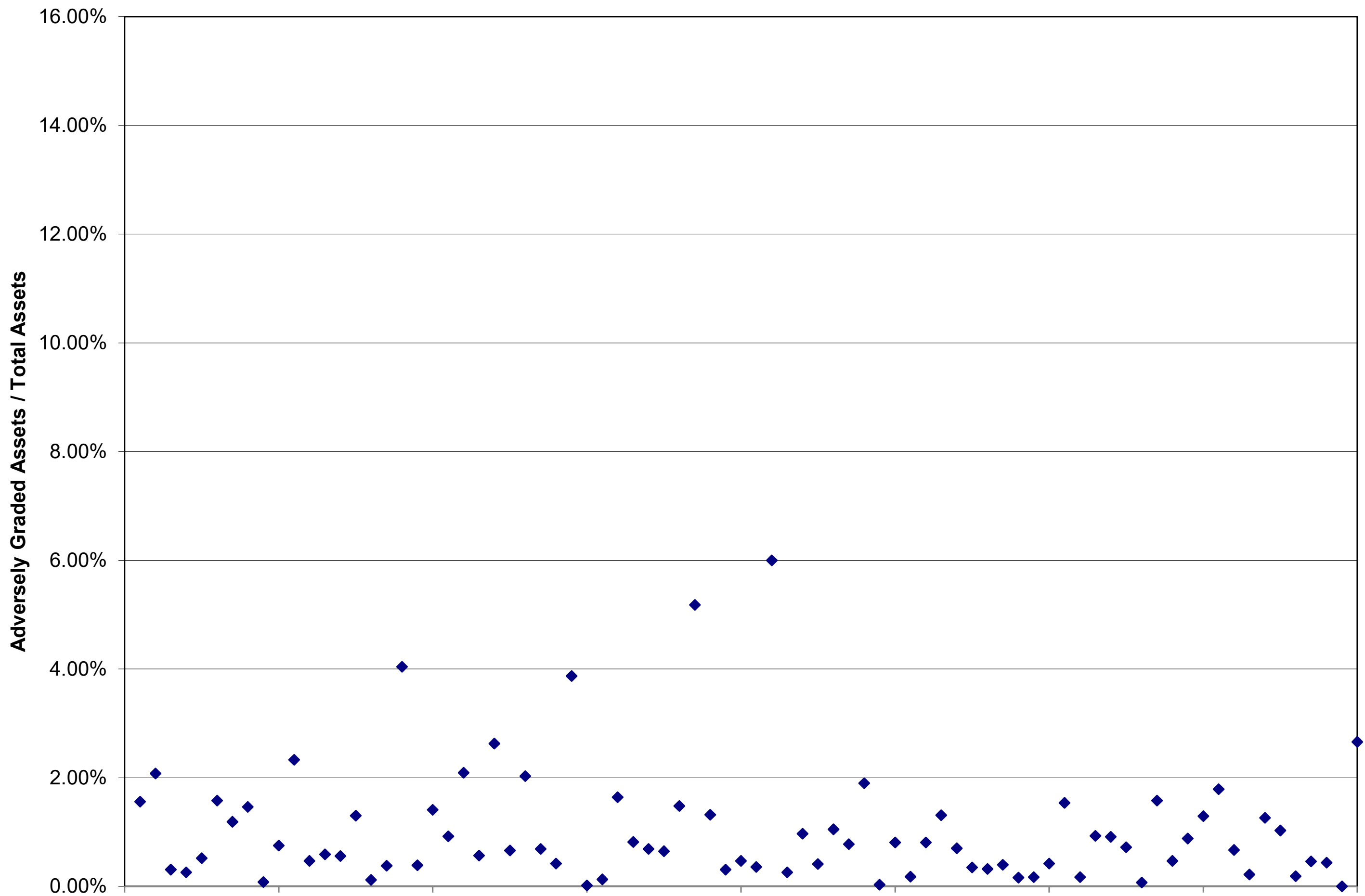
Historical Comparisons

During Q3 2021, increases in problem assets, as measured by adversely graded assets divided by tier-one capital plus loan loss reserve, were noted in approximately 6% of our clients. This quarter's increase compares to:

- 19% during the Second Quarter 2021
- 15% during the First Quarter 2021
- 9% during the Fourth Quarter 2020
- 10% during the Third Quarter 2020
- 21% during the Second Quarter 2020

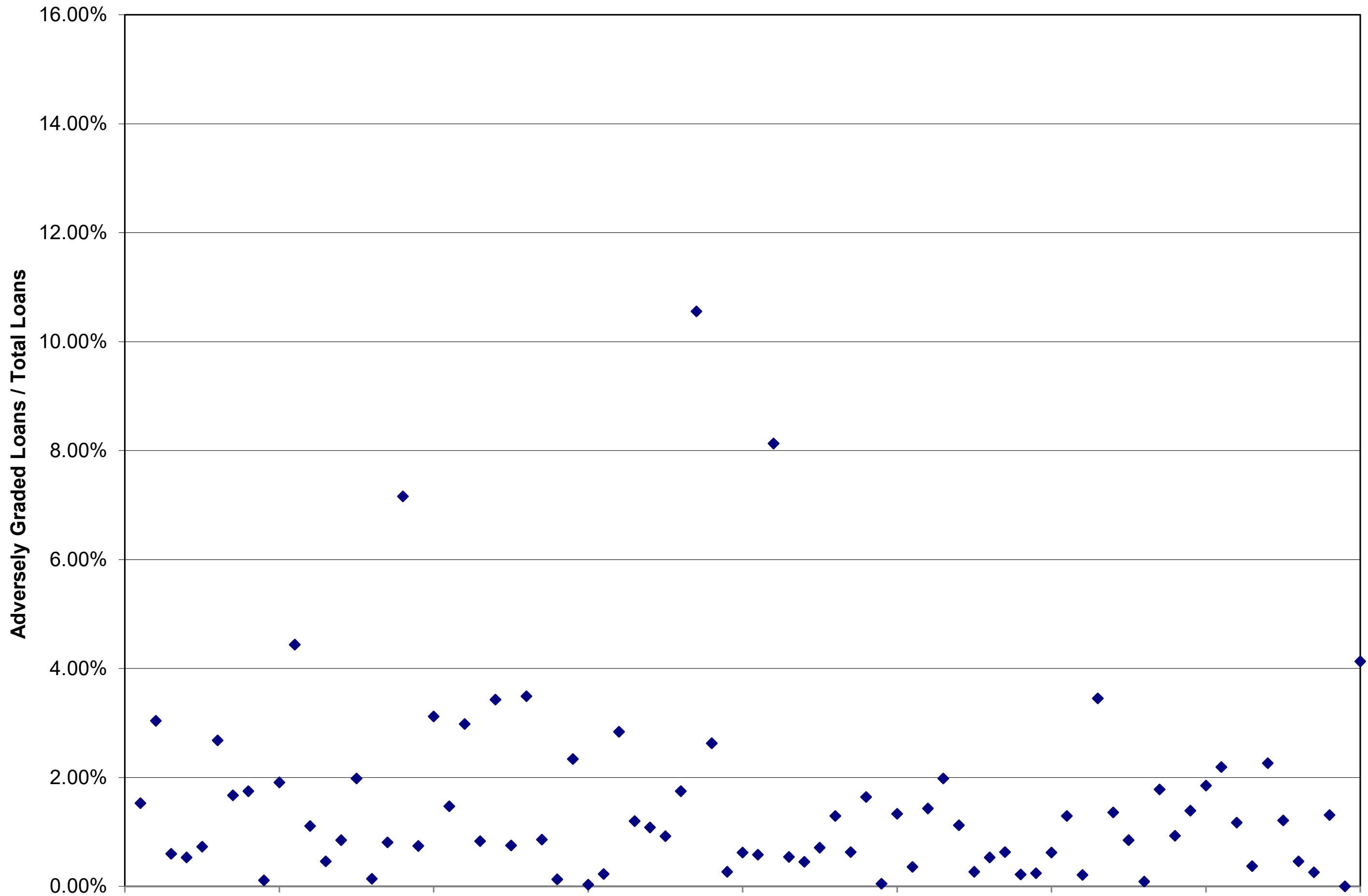
A higher level of volatility in the percentage of increases may be expected as overall asset quality stabilizes; however, increases may indicate a rise in portfolio risk.

Dispersion of Problem Assets – as a Percentage of Total Assets



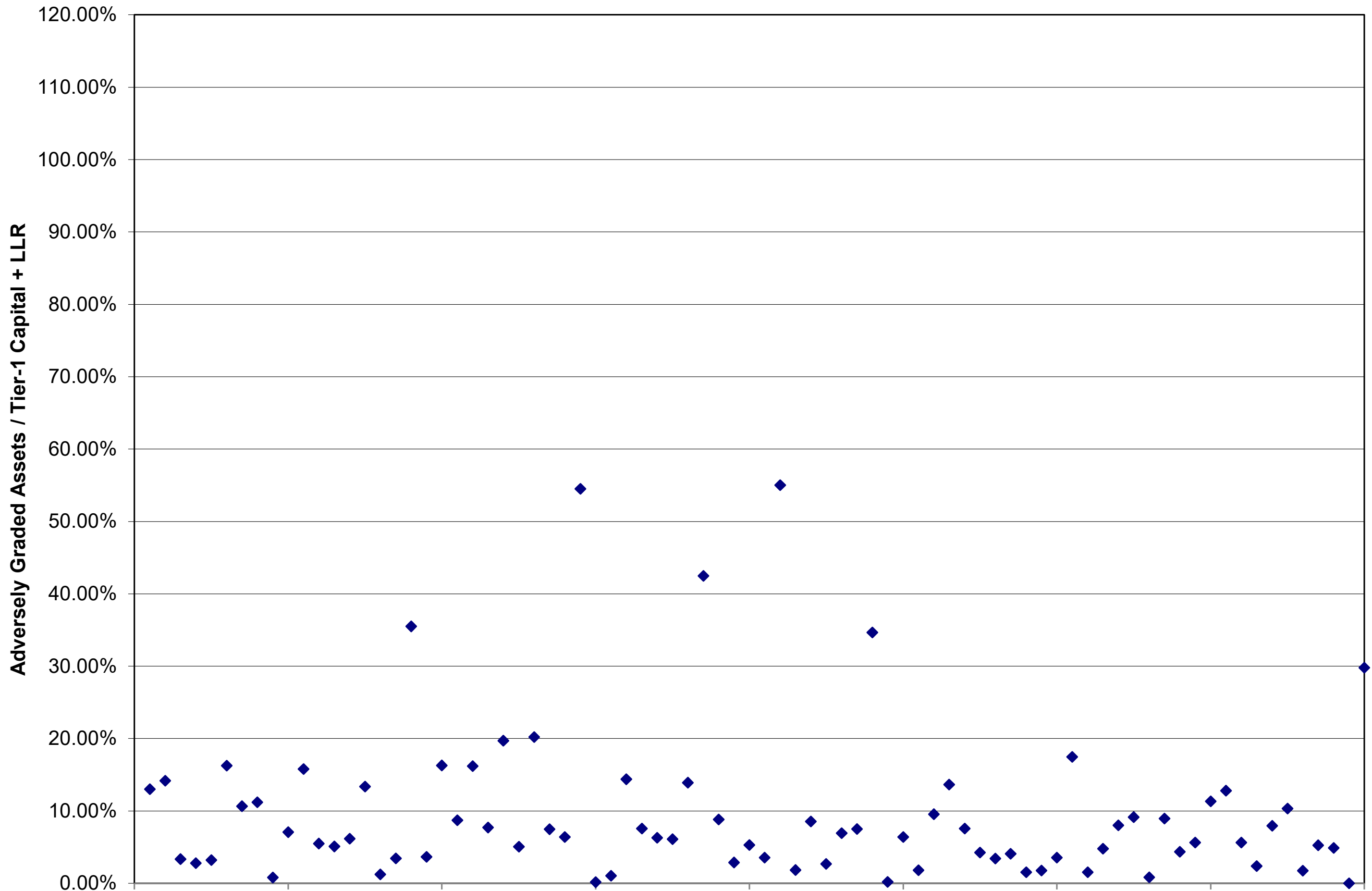
The above graph shows the dispersion of problem assets as a percentage of total assets. A traditional benchmark for significant asset quality concern is adversely graded assets that exceed 10% of total assets.

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

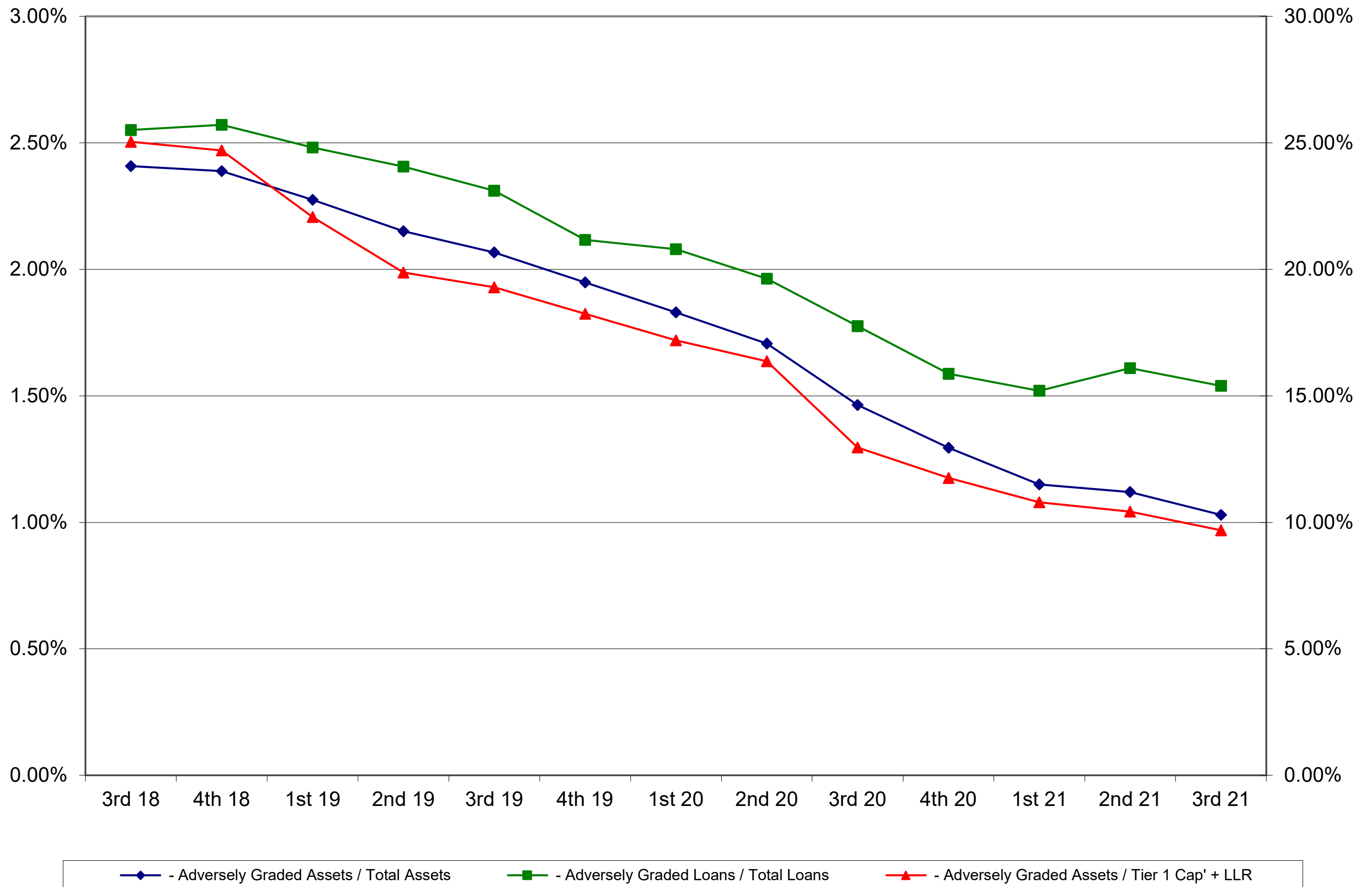
Our sample group includes no clients with problem assets that exceed 80% of tier-one capital plus loan loss reserve – a level normally associated with some form of formal regulatory action – as compared to:

- None (0) during the Second Quarter 2021
- One (1) during the First Quarter 2021
- One (1) during the Fourth Quarter 2020

Additionally, our sample includes no clients with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

- One (1) during the Second Quarter 2021
- Two (2) during the First Quarter 2021
- Two (2) during the Fourth 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.

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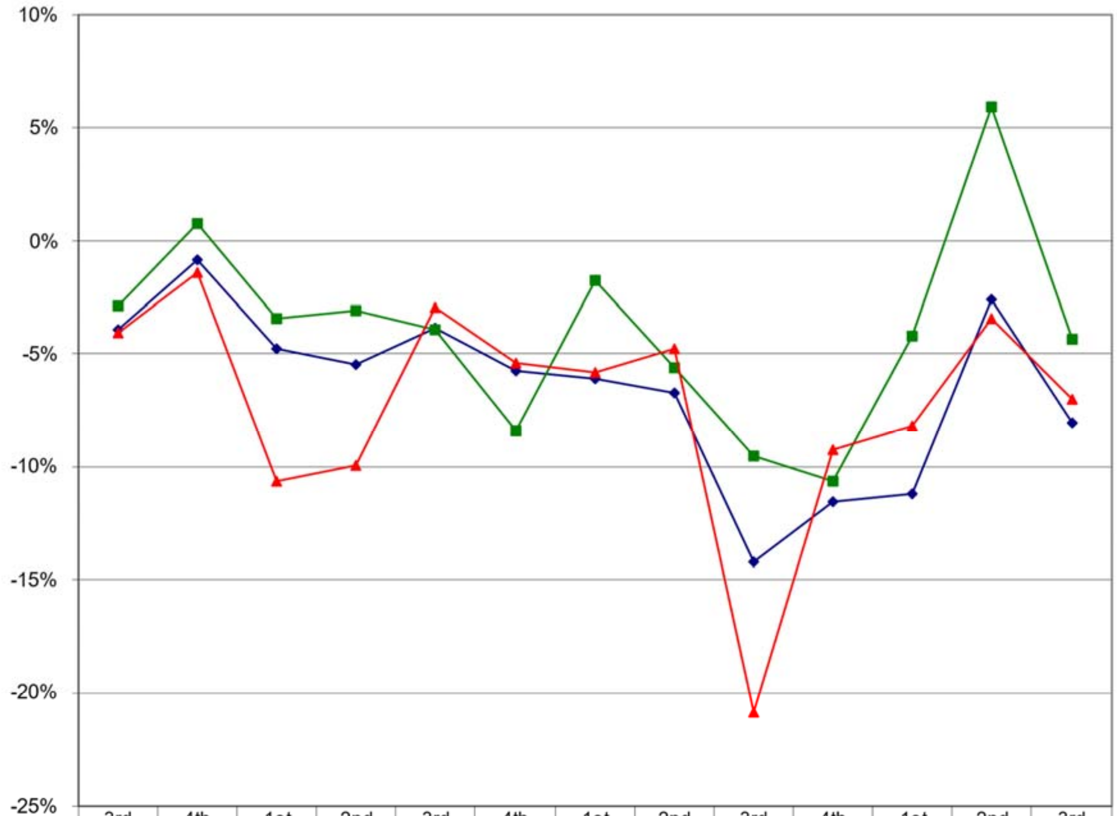
Problem Asset Comparative Change Analysis



	3rd 18	4th 18	1st 19	2nd 19	3rd 19	4th 19	1st 20	2nd 20	3rd 20	4th 20	1st 21	2nd 21	3rd 21
% Change in ACA/TA	-3.91%	-0.83%	-4.75%	-5.44%	-3.88%	-5.76%	-6.08%	-6.74%	-14.20%	-11.54%	-11.22%	-2.61%	-8.04%
% Change in ACL/TL	-2.91%	0.80%	-3.46%	-3.08%	-3.92%	-8.40%	-1.75%	-5.61%	-9.55%	-10.62%	-4.23%	5.92%	-4.35%
% Change in ACA/Tier 1 Cap' + LLR	-4.08%	-1.38%	-10.64%	-9.94%	-2.97%	-5.41%	-5.78%	-4.76%	-20.86%	-9.25%	-8.23%	-3.43%	-7.01%

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 0.91% of total assets, 1.38% of total loans, and 8.42% of tier-one capital plus loan loss reserve. Third Quarter 2021 modified data compares to the following Second Quarter 2021 modified average data set:

- 0.99% of total assets
- 1.44% of total loans, and
- 9.07% of tier-one capital plus loan loss reserve

Trouble Debt Restructuring / Non-Accrual Designation

During August 2021, the Office of the Comptroller of the Currency issued its Bank Accounting Advisory Series[1]. The 306 page document includes very detailed Q&A addressing Troubled Debt Restructures as well as Non-Accrual Loans. The TDR discussion includes forty six questions, and the Non-Accrual discussion encompasses thirty two questions. The document is a quality reference source of accounting treatment for the above 'hot topic' items.

For TDR, Question 45 addresses: Is it possible that a modification of a performing loan is a TDR?

> Yes. A borrower may be contractually current when the bank modifies the loan and the modification will be a TDR, if it meets the accounting definition… This may occur, for example, when the bank modifies a variable-rate loan after concluding that a borrower will be unable to meet higher payments when the rate resets to a higher interest rate. In this example, the modification is considered a TDR if the bank concludes that (a) the borrower is experiencing financial difficulties, and (b) the modification is a concession to the borrower that is granted for economic or legal reasons related to the borrower's financial difficulties….If the TDR designation has been removed (i.e., the conditions above were met) but the loan is subsequently determined to be impaired, then the impairment on the loan should be measured under ASC 310-10.

Question 46 addresses the following scenario: A bank properly accounted for a modified loan as a TDR. The bank subsequently restructures the loan at current market terms (i.e., no concession) and the borrower is no longer experiencing financial difficulties. Does the bank have to continue to account for the subsequently restructured loan as a TDR?

> It depends. The facts and circumstances of each subsequent restructuring of a TDR should be carefully evaluated to determine the appropriate accounting. The staff will not object to a bank no longer treating a loan as a TDR if:
>
> - At the time of the subsequent restructuring the borrower is not experiencing financial difficulties, and;
> - Under the terms of the subsequent restructuring agreement, no concession has been granted.

For Non-Accrual loans, Question 13 addresses: A bank takes a partial charge-off on a loan, because it believes that part of the obligation will be uncollectible ultimately. The loan is also placed on nonaccrual status. One year later, with two years remaining in the loan term, the borrower's financial condition improves dramatically. The loan is brought contractually current, and the bank now fully expects to collect the original contractual obligation, including the amount previously charged off. May the loan be returned to accrual status?

> Yes. If the doubt about full collectability, previously evidenced by the charge-off, has been removed, the loan meets the criteria in the call report for return to accrual status.

Non-Accrual loans Question 14: A loan with a borrower is past due in principal and interest. The bank takes a partial charge-off on the loan, because it believes that it will be unable to collect part of the obligation. The loan is also placed on nonaccrual status. One year later, the borrower's financial condition improves dramatically. The borrower has made regular monthly payments and is paying additional amounts to reduce the past due amount. Although the bank now fully expects to collect the original contractual obligation, including the amount previously charged off, the loan is not yet contractually current. May this loan be returned to accrual status?

> Yes. A loan, on which the borrower has resumed paying the full amount of the scheduled contractual obligation, may be returned to accrual status, even though it has not been brought fully current, if:
>
> - All principal and interest amounts contractually due are reasonably assured of repayment within a reasonable period of time, and;
> - There is a sustained period of repayment performance by the borrower.

[1] https://www.occ.treas.gov/publications-and-resources/publications/banker-education/files/pub-bank-accounting-advisory-series.pdf

Real Estate Lending Standards

During October 2021, the FDIC amended 12 CFR Part 365 to clarify the denominator in calculating the percent of loans that exceed Regulatory guidance as a percentage of bank capital[2]. The change will take effect 30 days after its publication in the Federal Register. Based on the FDIC's assessment, there are 2,210 smaller FDIC institutions in which total real estate loans exceed Tier 1 capital + allowance (or reserve benchmark).

The final rule allows a consistent approach for calculating the ratio of loans in excess of the supervisory loan-to-value limits (LTV Limits) at all FDIC-supervised institutions, using a methodology that approximates the historical methodology the FDIC has followed for calculating this measurement without requiring institutions to calculate tier 2 capital. The final rule also avoids any regulatory burden that could arise if an FDIC-supervised institution subsequently decides to switch between different capital frameworks. The change will allow:

> Banking organizations that have not adopted the current expected credit losses (CECL) methodology will use tier 1 capital plus the allowance for loan and lease losses (ALLL) as the denominator. Banking organizations that have adopted the CECL methodology will use tier 1 capital plus the portion of the allowance for credit losses (ACL) attributable to loans and leases.

The percentage of loans that exceed the Regulatory LTV limitations will remain unchanged. Total loans exceeding the Supervisory LTV limitation should not exceed 100% of total capital, and the 30% sub-limitation for all CRE, agricultural, multi-family & non-1-4 family residential remain unchanged.

Per the Regulation, "For the purposes of these Guidelines, for state non-member banks and state savings associations, "total capital" refers to the FDIC-supervised institution's tier 1 capital, as defined in § 324.2 of this chapter, plus the allowance for loan and leases losses or the allowance for credit losses attributable to loans and leases, as applicable. The allowance for credit losses attributable to loans and leases is applicable for institutions that have adopted the Current Expected Credit Losses methodology."

Appraisal Quality and Review Process

Within our community bank clients, numerous reviews have noted apparent appraisal weaknesses that have not been fully vetted within the appraisal review process. The apparent weaknesses involve omitted approach(s) to value. Of concern, not utilizing the cost approach to value within appraisals utilized to underwrite AD&C loans. Additionally, instances have been noted in which appraisals for CRE projects did not develop the market approach to value.

It would appear the cost approach is being omitted due to ongoing market volatility. However, omitting the cost approach to value within an appraisal used to underwrite an AD&C project would seem difficult to accept. At a minimum, the cost approach is needed as a feasibility check for the project.

As based on discussions within our client banks as well as limited correspondence with appraisers, omitted market approaches are likely attributable to the material increase in real estate prices, and current contracts & recent closings have yet to appear within public records. However, omitting a market approach to value may be difficult to support during an examination – particularity so for property types such as condominium units, apartment complexes, hotels, and so forth.

As appraisals are ordered, received, and reviewed, it would seem prudent to include any discussion / correspondence with the appraiser. Any apparent weaknesses should be fully vetted within the appraisal review process.

[2] https://www.fdic.gov/news/board-matters/2021/2021-10-21-notational-fr-b.pdf

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

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a. P.O. Box 2701, Statesboro, GA 30459 | p. 912.682.3029 | f. 912.489.5354

e. spowell@shpco.net | w. shpco.net

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