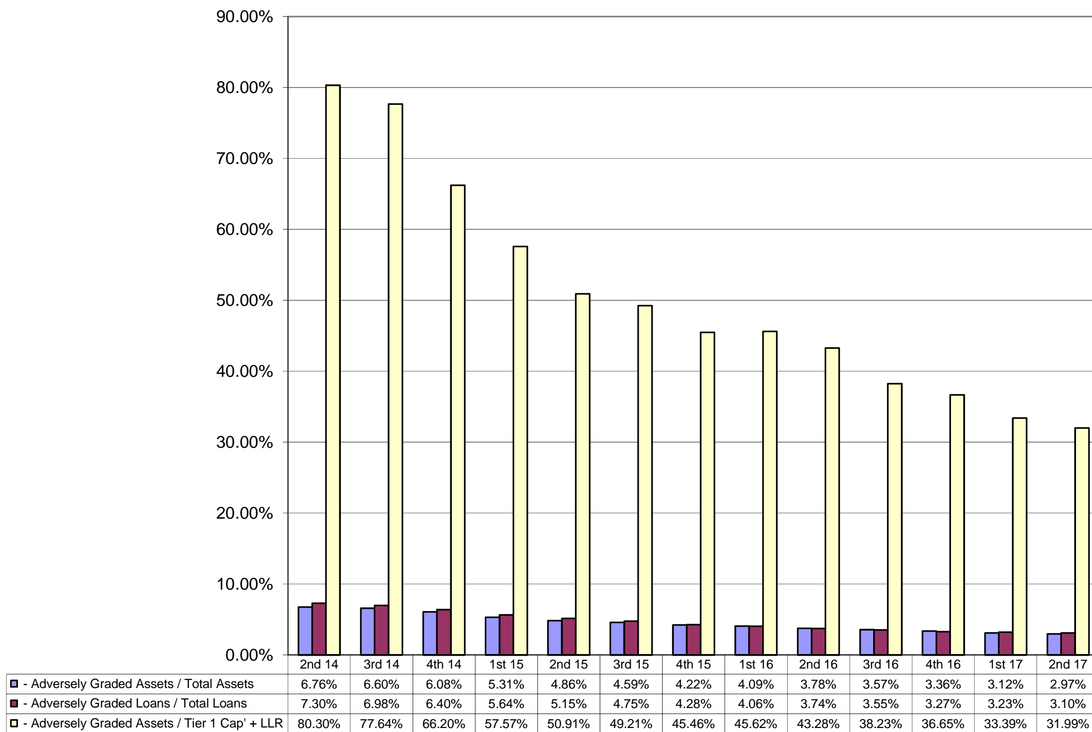
Steve H.
Powell & Company

Asset Quality Update – Q2 2017 Edition

Trends in Asset Quality – Average Levels

Based on Steve H. Powell & Company client data, during the Second Quarter 2017, the average level of adversely graded assets decreased as a percentage of total assets and capital. Also, the average level of adversely graded loans decreased as a percentage of total loans. Problem assets averaged 2.97% of total assets and 31.99% of tier-one capital plus loan loss reserve as compared to 3.12% of total assets and 33.39% of tier-one capital plus loan loss reserve while problem loans averaged 3.10% of total loans as compared to 3.23% of total loans during the First Quarter 2017.



	2nd 14	3rd 14	4th 14	1st 15	2nd 15	3rd 15	4th 15	1st 16	2nd 16	3rd 16	4th 16	1st 17	2nd 17
- Adversely Graded Assets / Total Assets	6.76%	6.60%	6.08%	5.31%	4.86%	4.59%	4.22%	4.09%	3.78%	3.57%	3.36%	3.12%	2.97%
- Adversely Graded Loans / Total Loans	7.30%	6.98%	6.40%	5.64%	5.15%	4.75%	4.28%	4.06%	3.74%	3.55%	3.27%	3.23%	3.10%
- Adversely Graded Assets / Tier 1 Cap' + LLR	80.30%	77.64%	66.20%	57.57%	50.91%	49.21%	45.46%	45.62%	43.28%	38.23%	36.65%	33.39%	31.99%

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.

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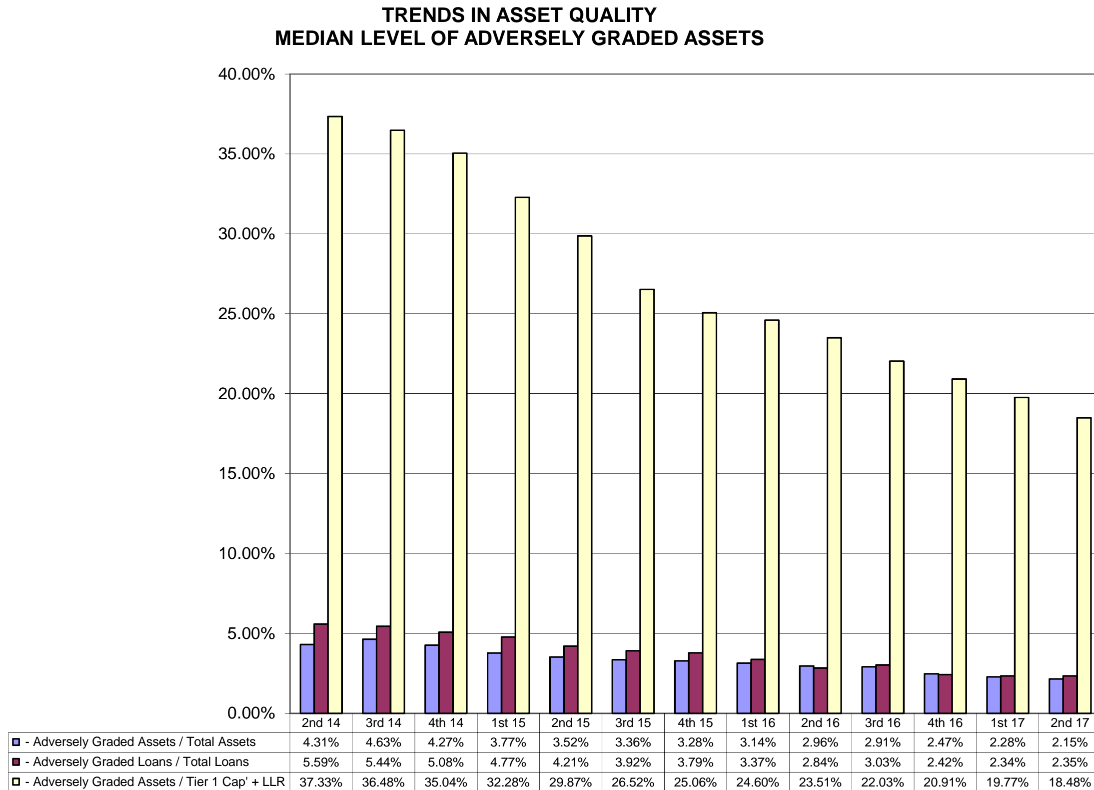
Trends in Asset Quality – Median Levels

The median level of problem assets as of Q2 2017 decreased to 18.48% of tier-one capital plus loan loss reserve as compared to 19.98% during Q1 2017. Note the downward trend as overall asset quality continues to improve.



	2nd 14	3rd 14	4th 14	1st 15	2nd 15	3rd 15	4th 15	1st 16	2nd 16	3rd 16	4th 16	1st 17	2nd 17
- Adversely Graded Assets / Total Assets	4.31%	4.63%	4.27%	3.77%	3.52%	3.36%	3.28%	3.14%	2.96%	2.91%	2.47%	2.28%	2.15%
- Adversely Graded Loans / Total Loans	5.59%	5.44%	5.08%	4.77%	4.21%	3.92%	3.79%	3.37%	2.84%	3.03%	2.42%	2.34%	2.35%
- Adversely Graded Assets / Tier 1 Cap' + LLR	37.33%	36.48%	35.04%	32.28%	29.87%	26.52%	25.06%	24.60%	23.51%	22.03%	20.91%	19.77%	18.48%

Historical Comparisons

During Q2 2017, increases in problem assets, as measured by adversely graded assets divided by tier-one capital plus loan loss reserve, were noted in approximately 14% of our clients. This quarter's increase compares to:

- 18% during the First Quarter 2017
- 18% during the Fourth Quarter 2016
- 16% during the Third Quarter 2016
- 19% during the Second Quarter 2016
- 23% during the First Quarter 2016, and
- 18% during the Fourth Quarter 2015

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.

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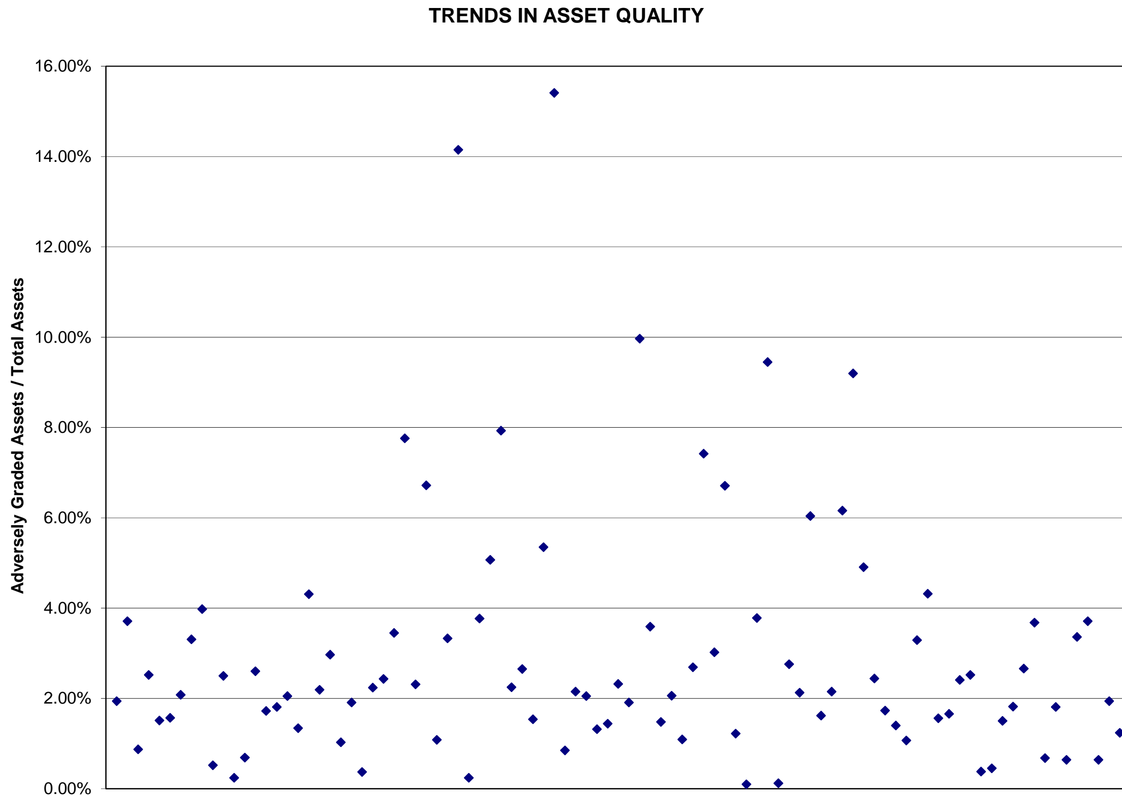
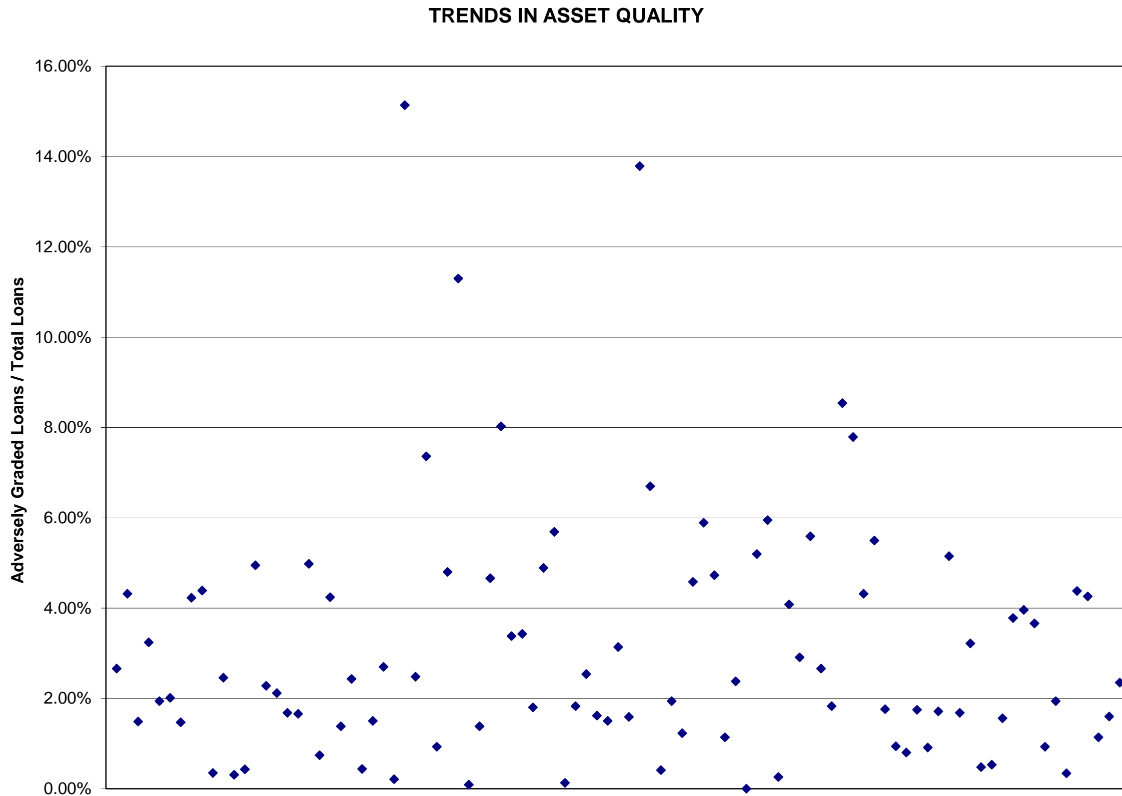
Dispersion of Problem Assets – as a Percentage of Total Assets



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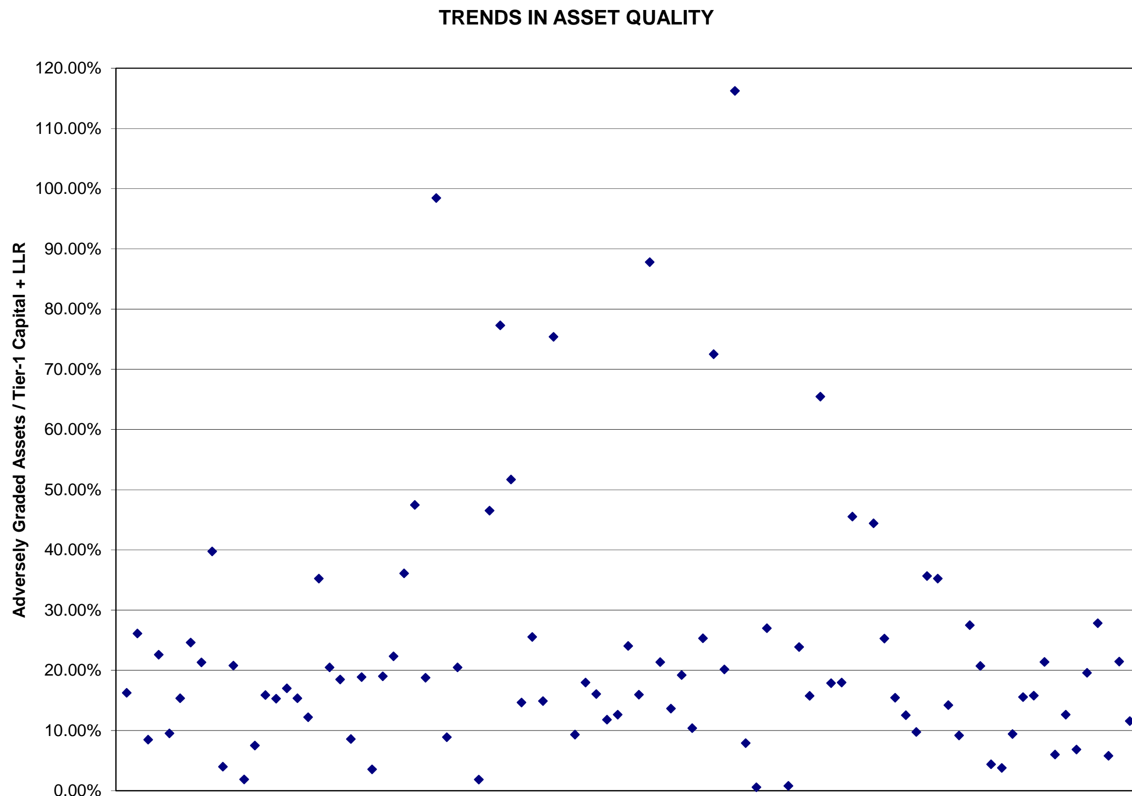
Dispersion of Problem Assets – as a Percentage of Tier-One Capital & Reserves



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

Historical Comparisons

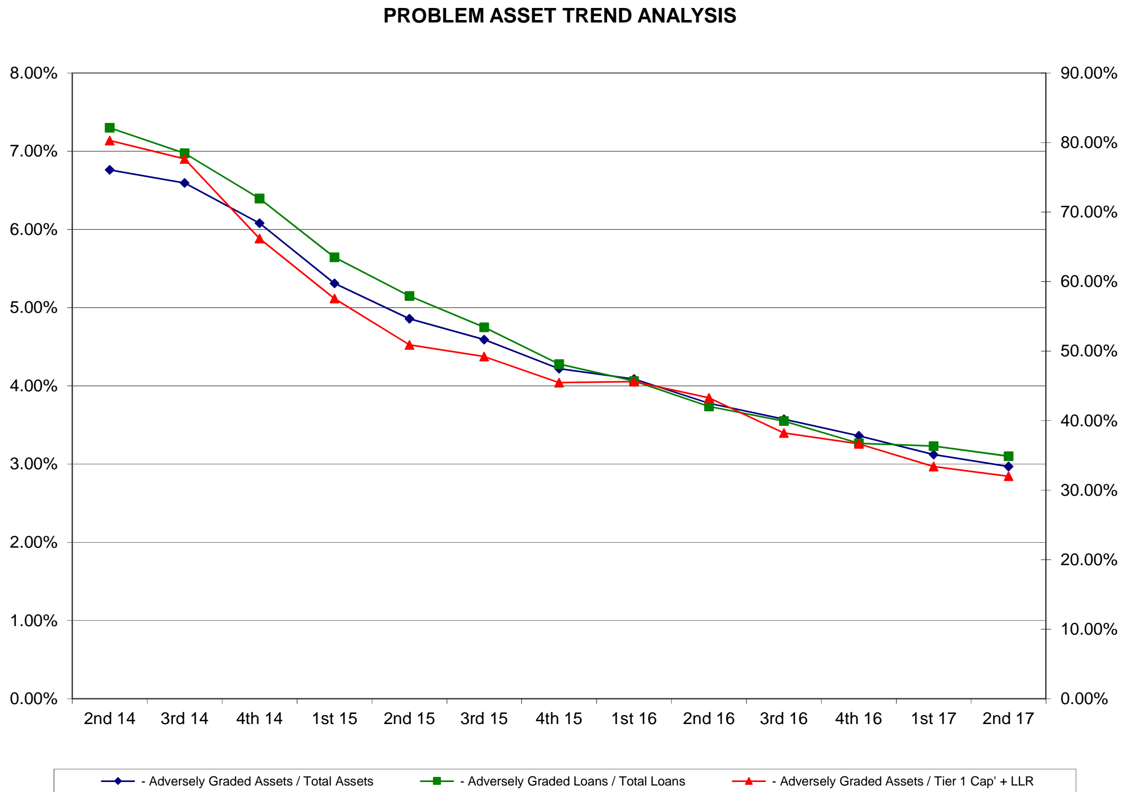
Our sample group includes eleven (11) banks with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

- Eleven (11) during the First Quarter 2017
- Eleven (11) during the Fourth Quarter 2016, and
- Thirteen (13) during the Third Quarter 2016

Seven (7) 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:

- Eight (8) during the First Quarter 2017
- Eight (8) during the Fourth Quarter 2016, and
- Nine (9) during the Third Quarter 2016

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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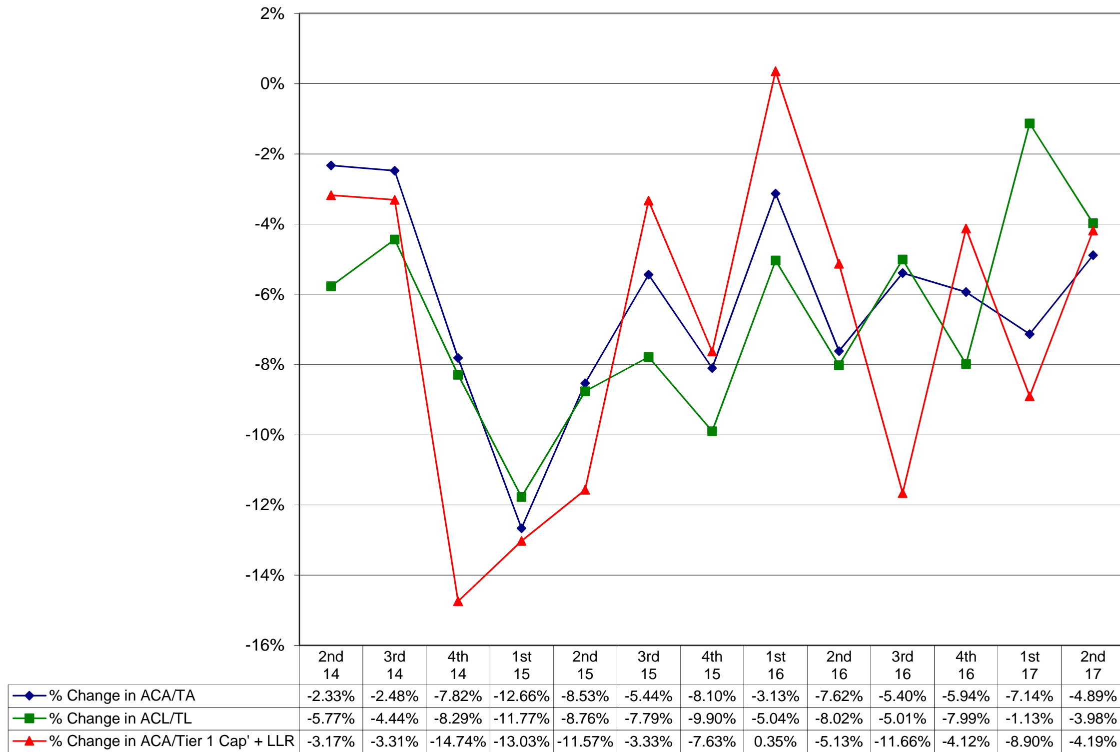
Problem Asset Comparative Change Analysis



	2nd 14	3rd 14	4th 14	1st 15	2nd 15	3rd 15	4th 15	1st 16	2nd 16	3rd 16	4th 16	1st 17	2nd 17
% Change in ACA/TA	-2.33%	-2.48%	-7.82%	-12.66%	-8.53%	-5.44%	-8.10%	-3.13%	-7.62%	-5.40%	-5.94%	-7.14%	-4.89%
% Change in ACL/TL	-5.77%	-4.44%	-8.29%	-11.77%	-8.76%	-7.79%	-9.90%	-5.04%	-8.02%	-5.01%	-7.99%	-1.13%	-3.98%
% Change in ACA/Tier 1 Cap' + LLR	-3.17%	-3.31%	-14.74%	-13.03%	-11.57%	-3.33%	-7.63%	0.35%	-5.13%	-11.66%	-4.12%	-8.90%	-4.19%

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 a total of six outlier 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 outlier data points excluded, problem assets (or loans when compared to total loans) averaged 2.73% of total assets, 3.03% of total loans, and 25.55% of tier-one capital plus loan loss reserve. Second Quarter 2017 modified data compares to the following First Quarter 2017 modified average data set:

- 2.91% of total assets
- 3.10% of total loans, and
- 27.21% of tier-one capital plus loan loss reserve

Georgia Legal Lending Limit Changes

By: Ken Bennett

In 2017 (effective – July 1, 2017), Georgia revised legal lending limit rules under Chapter 1 of Title 7 of the Official Code of Georgia Annotated ("OCGA"). Excerpts from the new OCGA 7-1-285 is shown below:

(a.1) A bank shall not at any time:

(1) Make loans to any one person or corporation;
(2) Have obligations owing to it from any one person or corporation as a result of purchasing or discounting evidences of indebtedness or agreements for the payment of money; or
(3) Have credit exposure as a counterparty in derivative transactions with any one person or corporation, where the aggregate of such loans, obligations, and credit exposure together exceeds 15 percent of the statutory capital base of the bank at the time of issuance of a binding commitment unless each loan, discount, purchase, or derivative transaction in excess of such 15 percent limit is approved in advance by the board of directors or a committee authorized to act for it subject to the provisions set forth in subsections (b) and (c) of this Code section. Approval by the board of directors or authorized committee shall be recorded in the formal minutes of the actions of the board or its committee by name of borrower, amount of loan, maturity of loan, general type of collateral, and such other information as required pursuant to the rules and regulations of the department. Any action required by this subsection may be taken pursuant to Code Section 7-1-483, provided that the minutes of the proceedings of the board or of the committee reflect such action and each director taking such action signs the minutes reflecting such action by no later than the next regular meeting of the board or committee attended by such director.

(b) Except as provided in subsection (c) of this Code section, a bank shall not directly or indirectly make loans, have obligations, or have credit exposure as a counterparty in derivative transactions to any one person or corporation which in aggregate exceed 15 percent of the statutory capital base of the bank at the time of issuance of a binding commitment unless the entire amount of such loans, obligations, and credit exposure in derivative transactions is secured by good collateral or other ample security and does not exceed 25 percent of the statutory capital base at the time of issuance of a binding commitment. Except as otherwise indicated in subsection (c) of this Code section, the purchase or discount of agreements for the payment of money or evidences of indebtedness shall be regarded as indirect loans to the person or corporation receiving the proceeds of such transactions. In estimating the legal lending limit for any one person or corporation, loans to related corporations, partnerships, and other entities shall be combined subject to regulations established by the department.

In summary, unsecured credit extensions (loans, committed loan balances, overdrafts, etc.) are limited to 15% of the bank's Statutory Capital Base ("SCB" – defined below). For extensions of credit exceeding 15% of the bank's SCB, the extension must be approved in advance by the board of directors or a committee authorized to act for it (as a potential example: the directors loan committee), all debts must then be fully secured, and the total exposure should not exceed 25% of the bank's SCB. Note that the July 2017 update added further clarification for how approval should be documented under section (a.1)(3).

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The largest change is the revision of the definition (OCGA 7-1-4) of (35) 'Statutory Capital Base' ("SCB").

Old definition:

> (35) 'Statutory capital base' means the sum of the capital stock, paid-in capital, appropriated retained earnings, and capital debt of a bank or trust company less any amount of good will, core deposit intangibles, or other intangible assets related to the purchase, acquisition, or merger of a bank charter or accumulated deficit (negative retained earnings).

New definition:

> (35) 'Statutory capital base' means the sum of the common equity tier 1 capital, as defined by applicable federal law, and the allowance of loan and lease losses, as defined by applicable federal law, as reported in the bank's most recent Consolidated Report of Condition and Income; provided, however, that the department may enact regulations to phase in the revision to this definition for those banks that will have a decreased statutory capital base as of July 1, 2017. If significant capital changes occur after the filing of the Consolidated Report of Condition and Income which causes the common equity tier 1 capital to increase or decrease by 5 percent or more, then the statutory capital base will be immediately recalculated at the time of the capital change and it will be effective until the filing of the next Consolidated Report of Condition and Income.
>
> > Per the FDIC (Risk Management Manual of Examination Policies, Part II, 2.1 Capital) regarding Tier 1 Common Equity, "It includes qualifying common stock and related surplus net of treasury stock; retained earnings; certain accumulated other comprehensive income (AOCI) elements if the institution does not make an AOCI opt-out election (refer to opt-out election discussion in next paragraph), plus or minus regulatory deductions or adjustments as appropriate; and qualifying common equity tier 1 minority interests."

For most DBF and FDIC-regulated banks in Georgia, the definition change increases the institution's legal lending limit by effectively allowing inclusion of non-appropriated (and positive) retained earnings and the ALLL in the SCB. For comparative purposes, federal regulations (12 CFR 32) allow extensions of credit of up to 15% of the institution's capital and surplus (tier 1 and tier 2 capital). Extensions of up to 25% are allowed, but the excess (over 15%) must be secured by readily marketable collateral.

> (v) Readily marketable collateral means financial instruments and bullion that are salable under ordinary market conditions with reasonable promptness at a fair market value determined by quotations based upon actual transactions on an auction or similarly available daily bid and ask price market.

In general, this results in higher credit exposure allowed (if readily marketable collateral is not pledged) under the Georgia rules than under national rules. Georgia banks should consider:

- Participations previously sold that are subsequently repurchased (under normal circumstances) should be prior approved by the board (or committee to act for it) if it exceeds 15% of the bank's SCB as it is likely an increase in exposure over what was previously approved.

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- It may be a prudent time for bank management and directors to institute an in-house limit if one is not already in place. An in-house limit (less than the legal lending limit) is typically a trigger for additional caution and underwriting/due diligence scrutiny.

Note that capital debt was included in the old SCB definition:

> (9) "Capital debt" means the sum of the face value of the subordinated securities of a financial institution issued pursuant to Code Section 7-1-419.

Some institutions with subordinated securities that constitute capital debt could see a decrease in their legal lending limits under OCGA 7-1-285 and should assess the portfolio accordingly.

The reader is reminded that the exceptions above are not comprehensive and exclude other information in the regulations / codes (notably OCGA 7-1-285). The full text should be consulted for legal lending limit decisions.

Proposed Appraisal Regulations

By: Ken Bennett

After an Economic Growth and Regulatory Paperwork Reduction Act review, the agencies (OCC, FRB, FDIC) have proposed to raise the regulatory threshold requiring appraisals from $250,000 to $400,000. The Agencies are inviting comments on the proposed change:

https://www.fdic.gov/news/board/2017/2017-07-18-notice-dis-a-fr.pdf
https://www.occ.gov/news-issuances/news-releases/2017/nr-ia-2017-81.html
https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170719a.htm

The most detailed clarification of the current appraisal regulations can be found here.

Per the December 2010 Interagency Appraisal Guidelines (FIL 82-2010):

VII. Transactions That Require Appraisals

Although the Agencies' appraisal regulations exempt certain real estate-related financial transactions from the appraisal requirement, most real estate-related financial transactions over the appraisal threshold are considered federally related transactions and, thus, require appraisals. The Agencies also reserve the right to require an appraisal under their appraisal regulations to address safety and soundness concerns in a transaction.

XI. Transactions That Require Evaluations

The Agencies' appraisal regulations permit an institution to obtain an appropriate evaluation of real property collateral in lieu of an appraisal for transactions that qualify for certain exemptions. These exemptions include a transaction that:

- Has a transaction value equal to or less than the appraisal threshold of $250,000.
- Is a business loan with a transaction value equal to or less than the business loan threshold of $1 million, and is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment.
- Involves an existing extension of credit at the lending institution, provided that:
    - There has been no obvious and material change in market conditions or physical aspects of the property that threaten the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or
    - There is no advancement of new monies other than funds necessary to cover reasonable closing costs.

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Appendix A (Appraisal Exemptions) goes on to note:

1. Appraisal Threshold

For transactions with a transaction value equal to or less than $250,000, the Agencies' appraisal regulations, at a minimum, require an evaluation consistent with safe and sound banking practices. If an institution enters into a transaction that is secured by several individual properties that are not part of a tract development, the estimate of value of each individual property should determine whether an appraisal or evaluation would be required for that property. For example, an institution makes a loan secured by seven commercial properties in different markets with two properties valued in excess of the appraisal threshold and five properties valued less than the appraisal threshold. An institution would need to obtain an appraisal on the two properties valued in excess of the appraisal threshold and evaluations on the five properties below the appraisal threshold, even though the aggregate loan commitment exceeds the appraisal threshold.

7. Renewals, Refinancings, and Other Subsequent Transactions

Under certain circumstances, renewals, refinancings, and other subsequent transactions may be supported by evaluations rather than appraisals. The Agencies' appraisal regulations permit an evaluation for a renewal or refinancing of an existing extension of credit at the institution when either:

(i) There has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or
(ii) There is no advancement of new monies, other than funds necessary to cover reasonable closing costs.

… If an evaluation is permitted under this exemption, an institution may use an existing appraisal or evaluation as long as the institution verifies and documents that the appraisal or evaluation continues to be valid. (See the discussion in the Validity of Appraisals and Evaluations section of these Guidelines.) Even if a subsequent transaction qualifies for this exemption, an institution should consider the risk posed by the transaction and may wish to consider obtaining a new appraisal.

As the real estate market has generally stabilized or improved over recent years, SHP & Co. recommends performing a brief, updated assessment of the real estate market when relying upon an older appraisal or evaluation at loan renewal or modification. In a simple example, if a residential rental home loan is renewed with an older appraisal, the institution could analyze a few comparable sales to determine how sales price per square foot in the market compare to the appraisal.

Readers are reminded that this is a proposed rule and the current threshold of $250,000 is still in place. Also note that the Interagency Appraisal Guidelines provides much more detailed information regarding appraisal expectations than is excerpted above.

Shared National Credit Comparison

By: Stephen Rountree

Annually, we discuss and compare the asset quality in the SNC portfolio to that within the SHP & Co. client group. With the 3rd Quarter 2017 SNC review, we have updated our annual comparison using SHP & Co. Q2 2017 client data.

For reference: the SNC portfolio included ~11,300 credits totaling $4.3 trillion in commitments and $2.1 trillion in outstandings. Classified assets totaled $285.9 billion with special mention loans totaling $131.7 billion. Included in the adverse ratings are $245.1 billion in substandard, $24.2 billion doubtful and $16.6 billion in loss.

- SHP & Co. average classified loans to total loans 3.10%
- SHP & Co. median classified loans to total loans 2.35%
- Classified SNCs to the total portfolio 6.6%
    - Special mention represented 3.1% of the total portfolio

Also of note, oil and gas related credits represent 26.5% of total SNC classified loans. Assuming a 27% reduction in total SNC classification, roughly 4.8% of the portfolio would still be adversely classified.

While a crude comparison, it would appear as based on average and median volume of classified loans, the 'average community bank' loan portfolio within the Powell & Co. client base contains a lower volume of classified loans as compared to the SNC portfolio.

The August 2017 SNC review highlights included:

	2016 Commitments ($ Billion)	2017 Commitments ($ Billion)	2017 vs. 2016 ($ Billion)	2017 vs. 2016 (%)
SNC Portfolio Commitments	$4,102.3	$4,303.7	$201.4	4.9%
SNC Portfolio Outstanding	$1,986.5	$2,149.4	$162.9	8.2%
SNC Portfolio Borrowers	6,676	6,902	226	3.4%
SM and Classified Commitments	$421.4	$417.6	($3.9)	-0.9%
SM Commitments	$136.4	$131.7	($4.7)	-3.5%
Classified Commitments	$285.1	$285.9	$0.8	0.3%
Non-Accrual Commitments	$72.6	$58.0	($14.6)	-20.2%

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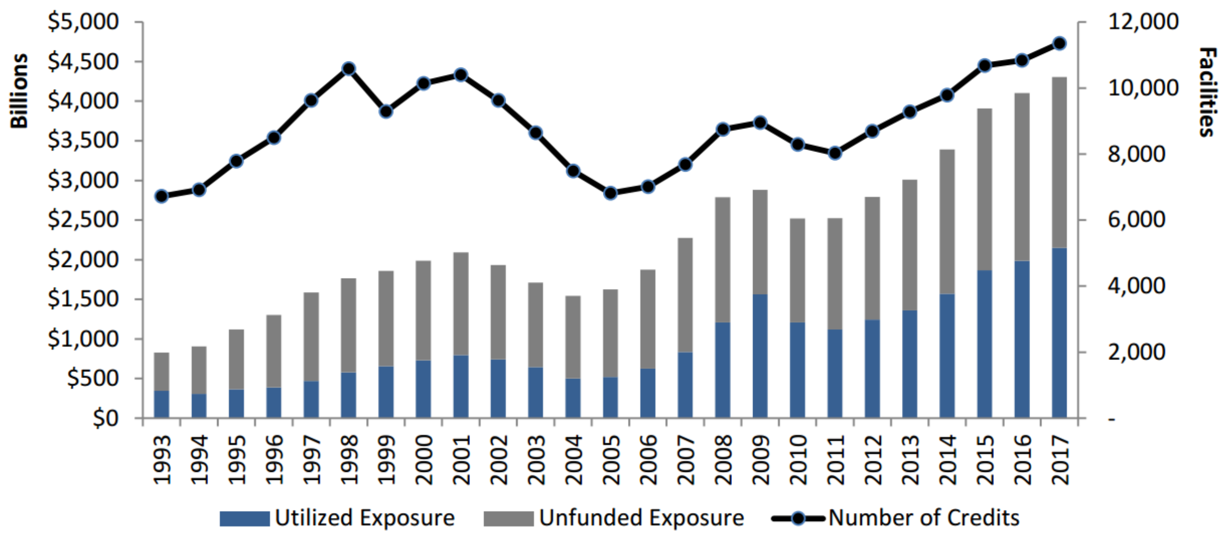

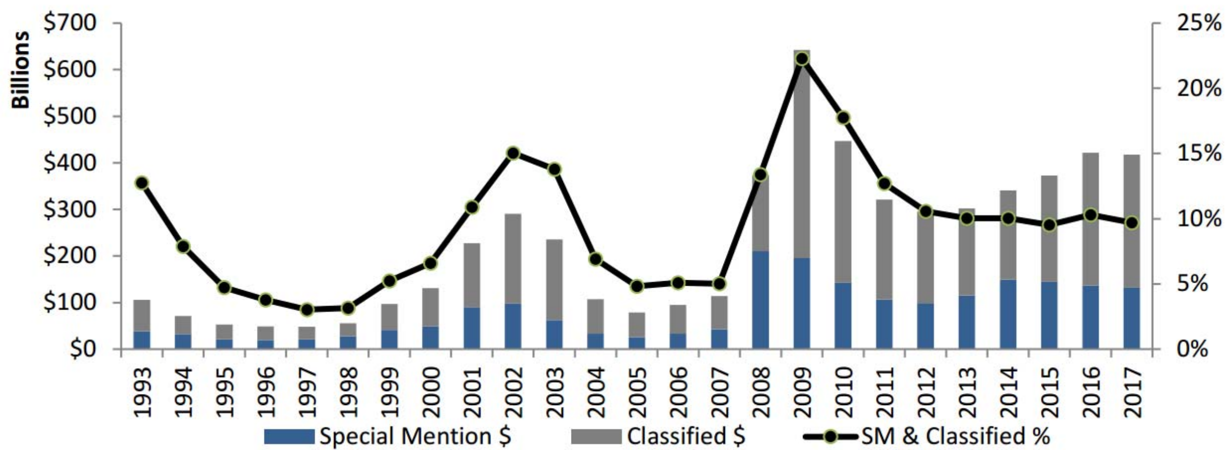

All Industries (Total)											
Commitment	2,275.4	2,789.2	2,881.2	2,518.5	2,524.2	2,792.0	3,011.1	3,390.5	3,908.8	4,102.3	4,303.7
Classified	71.7	163.1	446.8	304.5	214.6	195.8	187.0	191.3	228.4	285.1	285.9
Special Mention	42.4	210.4	195.3	142.7	106.4	99.3	115.0	149.4	144.2	136.4	131.7
% Classified	3.2%	5.8%	15.5%	12.1%	8.5%	7.0%	6.2%	5.6%	5.8%	6.9%	6.6%
% Special Mention	1.9%	7.5%	6.8%	5.7%	4.2%	3.6%	3.8%	4.4%	3.7%	3.3%	3.1%

https://www.occ.gov/news-issuances/news-releases/2017/nr-ia-2017-90a.pdf

Cross Default Language

By: Stephen Rountree

In several client banks, we have noted a relatively recent change in various platform generated loan documents, particularly notes and security agreements, that appears to limit cross collateralization:

The cross-collateralization clause on any existing or future loan, but not including this Loan, is void and ineffective as to this Loan, including any extension or refinancing…

It appears the language is a result of various consumer compliance regulations. However, it would appear the language is appearing in both consumer and commercial loan documentation. We are encouraging banks to review their loan documentation. If the platform system has defaulted to the apparently limiting language, the bank should seek legal & compliance staff counsel before making changes. It would, however, appear the language is not needed (and is potentially detrimental) for commercial loans.

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

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