Steve H. Powell & Company

Asset Quality Update – Q4 2017 Edition

Trends in Asset Quality – Average Levels

Based on Steve H. Powell & Company client data, during the Fourth 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 2.77% of total assets and 29.26% of tier-one capital plus loan loss reserve as compared to 2.90% of total assets and 30.45% of tier-one capital plus loan loss reserve while problem loans averaged 2.90% of total loans as compared to 3.09% of total loans during the Third Quarter 2017.

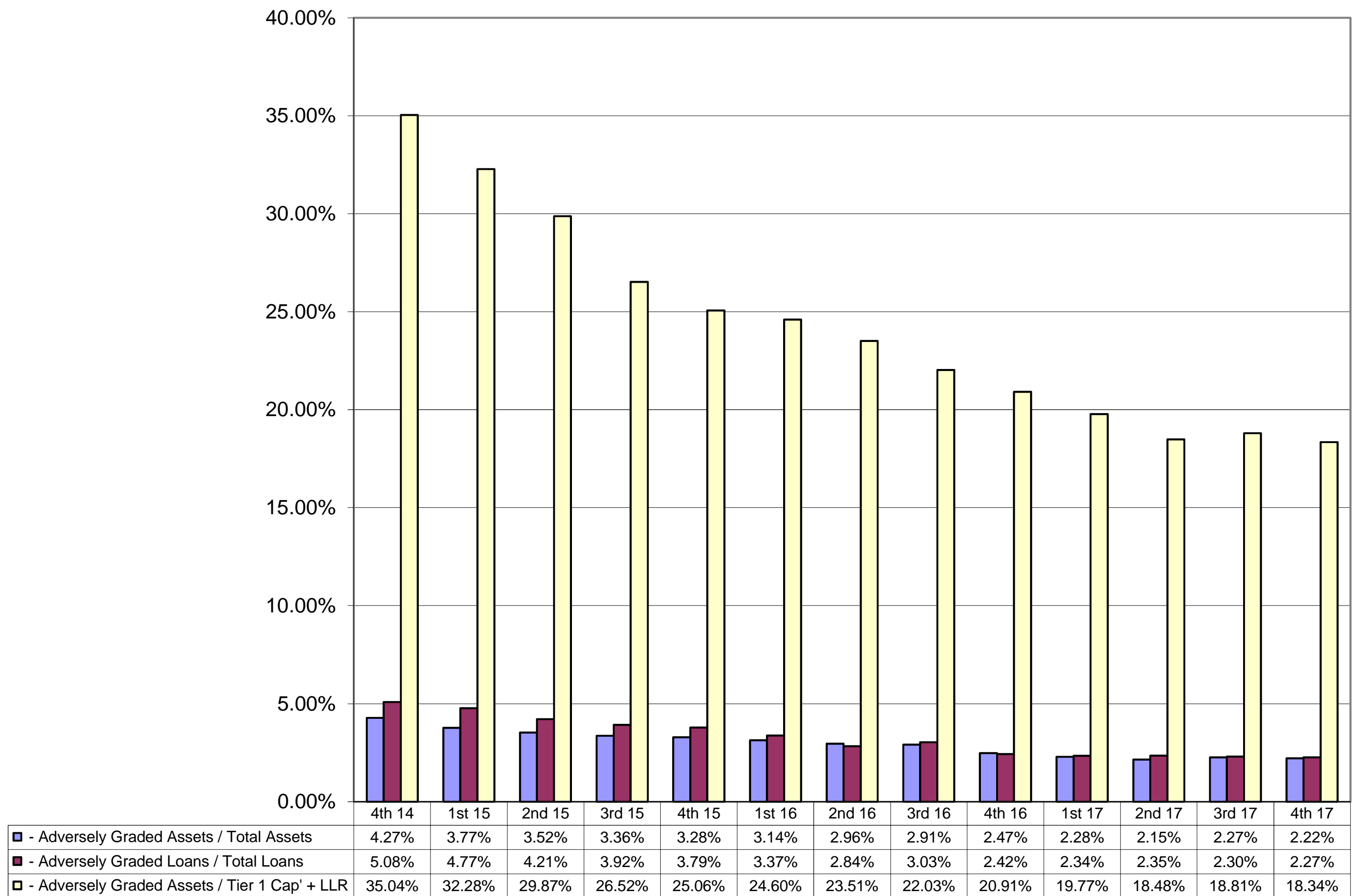
TRENDS IN ASSET QUALITY
AVERAGE LEVEL OF ADVERSELY GRADED ASSETS

	4th 14	1st 15	2nd 15	3rd 15	4th 15	1st 16	2nd 16	3rd 16	4th 16	1st 17	2nd 17	3rd 17	4th 17
- Adversely Graded Assets / Total Assets	6.08%	5.31%	4.86%	4.59%	4.22%	4.09%	3.78%	3.57%	3.36%	3.12%	2.97%	2.90%	2.77%
- Adversely Graded Loans / Total Loans	6.40%	5.64%	5.15%	4.75%	4.28%	4.06%	3.74%	3.55%	3.27%	3.23%	3.10%	3.09%	2.90%
- Adversely Graded Assets / Tier 1 Cap' + LLR	66.20%	57.57%	50.91%	49.21%	45.46%	45.62%	43.28%	38.23%	36.65%	33.39%	31.99%	30.45%	29.26%

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 2017 decreased to 18.34% of tier-one capital plus loan loss reserve as compared to 18.81% during Q3 2017. Note the downward trend as overall asset quality continues to improve.



	4th 14	1st 15	2nd 15	3rd 15	4th 15	1st 16	2nd 16	3rd 16	4th 16	1st 17	2nd 17	3rd 17	4th 17
- Adversely Graded Assets / Total Assets	4.27%	3.77%	3.52%	3.36%	3.28%	3.14%	2.96%	2.91%	2.47%	2.28%	2.15%	2.27%	2.22%
- Adversely Graded Loans / Total Loans	5.08%	4.77%	4.21%	3.92%	3.79%	3.37%	2.84%	3.03%	2.42%	2.34%	2.35%	2.30%	2.27%
- Adversely Graded Assets / Tier 1 Cap' + LLR	35.04%	32.28%	29.87%	26.52%	25.06%	24.60%	23.51%	22.03%	20.91%	19.77%	18.48%	18.81%	18.34%

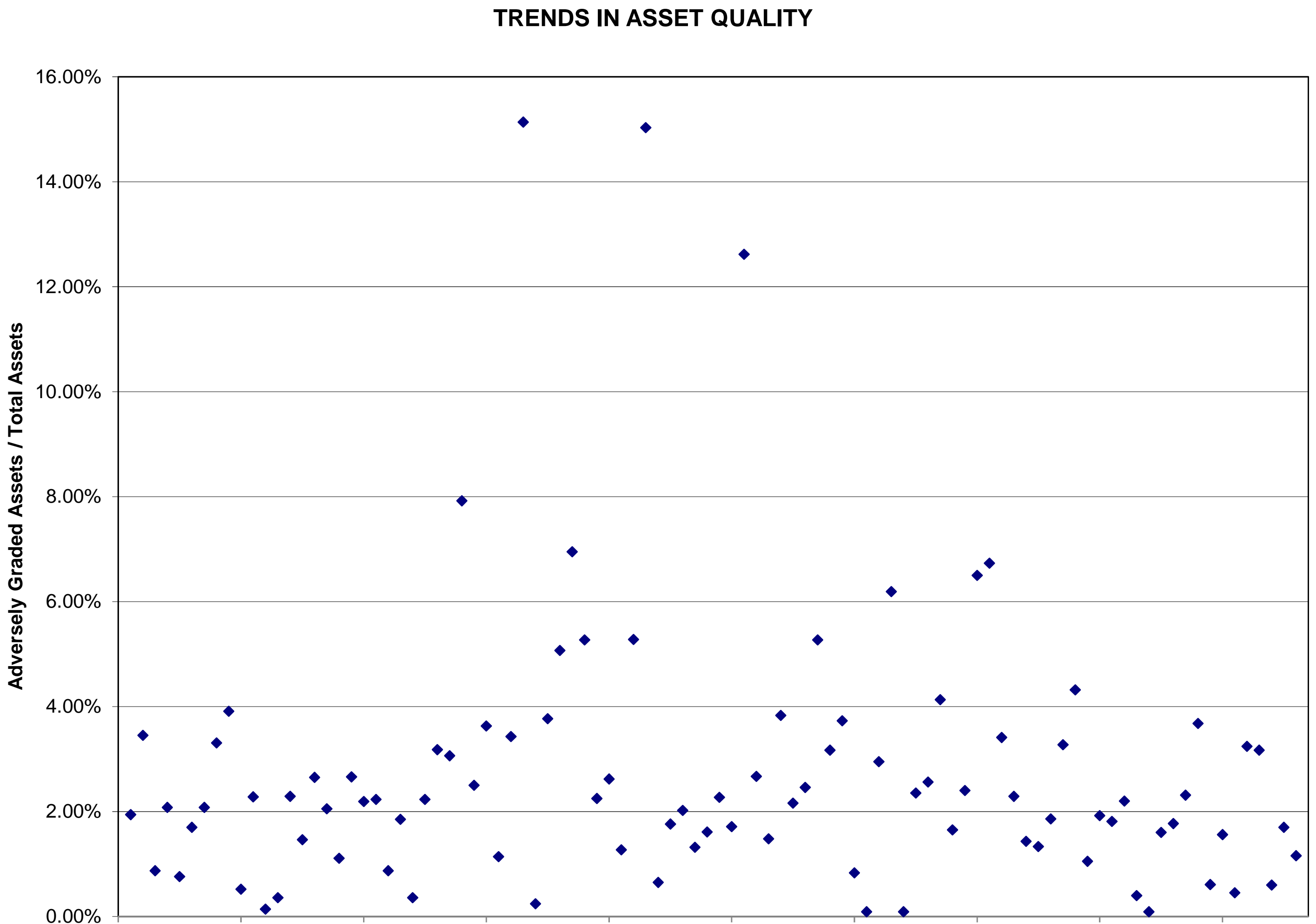
Historical Comparisons

During Q4 2017, increases in problem assets, as measured by adversely graded assets divided by tier-one capital plus loan loss reserve, were noted in approximately 13% of our clients. This quarter's increase compares to:

- 21% during the Third Quarter 2017
- 14% during the Second Quarter 2017
- 18% during the First Quarter 2017
- 18% during the Fourth Quarter 2016
- 16% during the Third Quarter 2016
- 19% during the Second Quarter 2016

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.

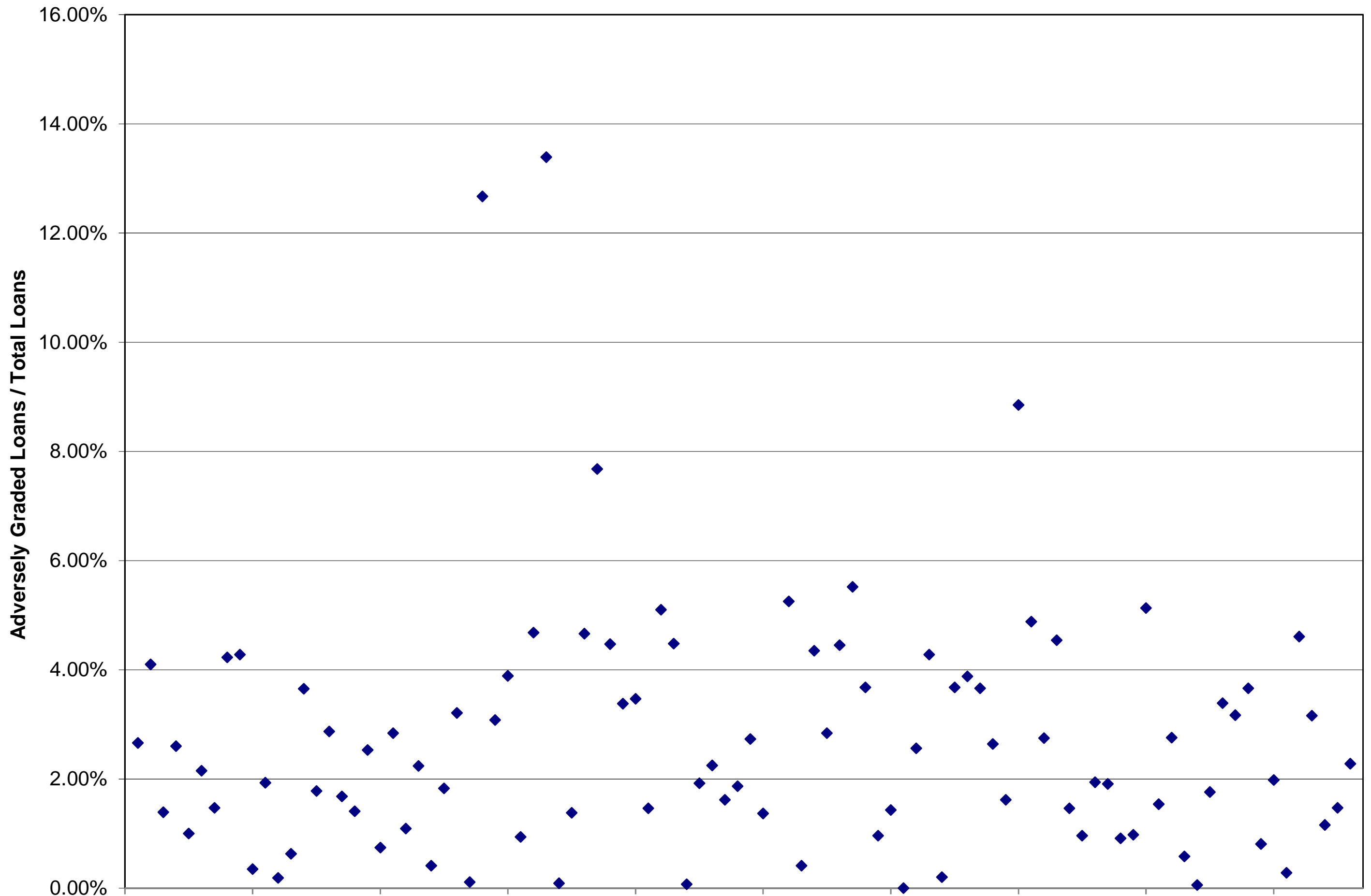
Dispersion of Problem Assets – as a Percentage of Total Assets



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.

P&Co.
Est. 1993

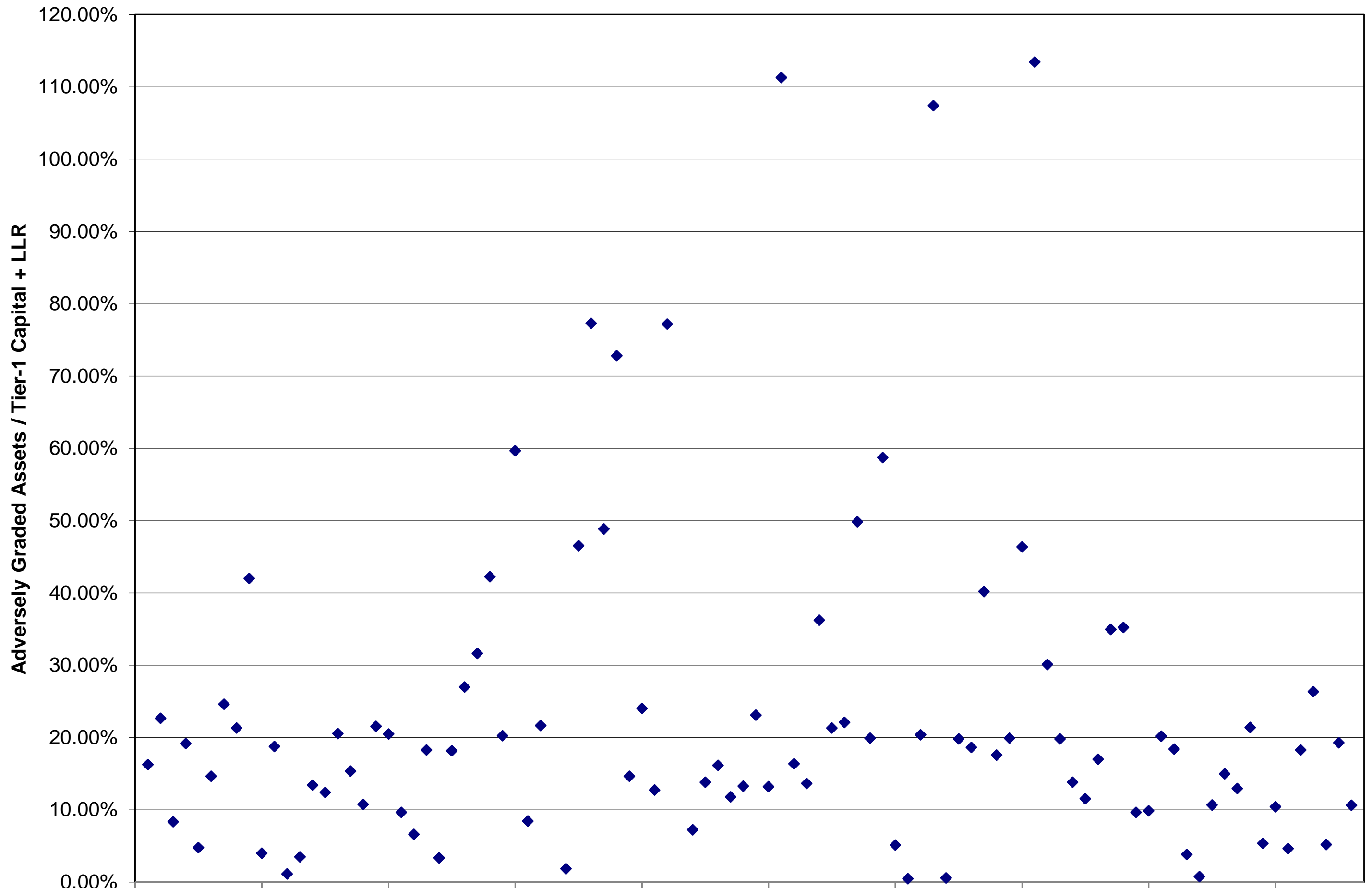
Dispersion of Problem Assets – as a Percentage of Total Loans



A traditional benchmark for significant asset quality concern is adversely graded loans that exceed 10% of total loans.

P&Co.
Est. 1993

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

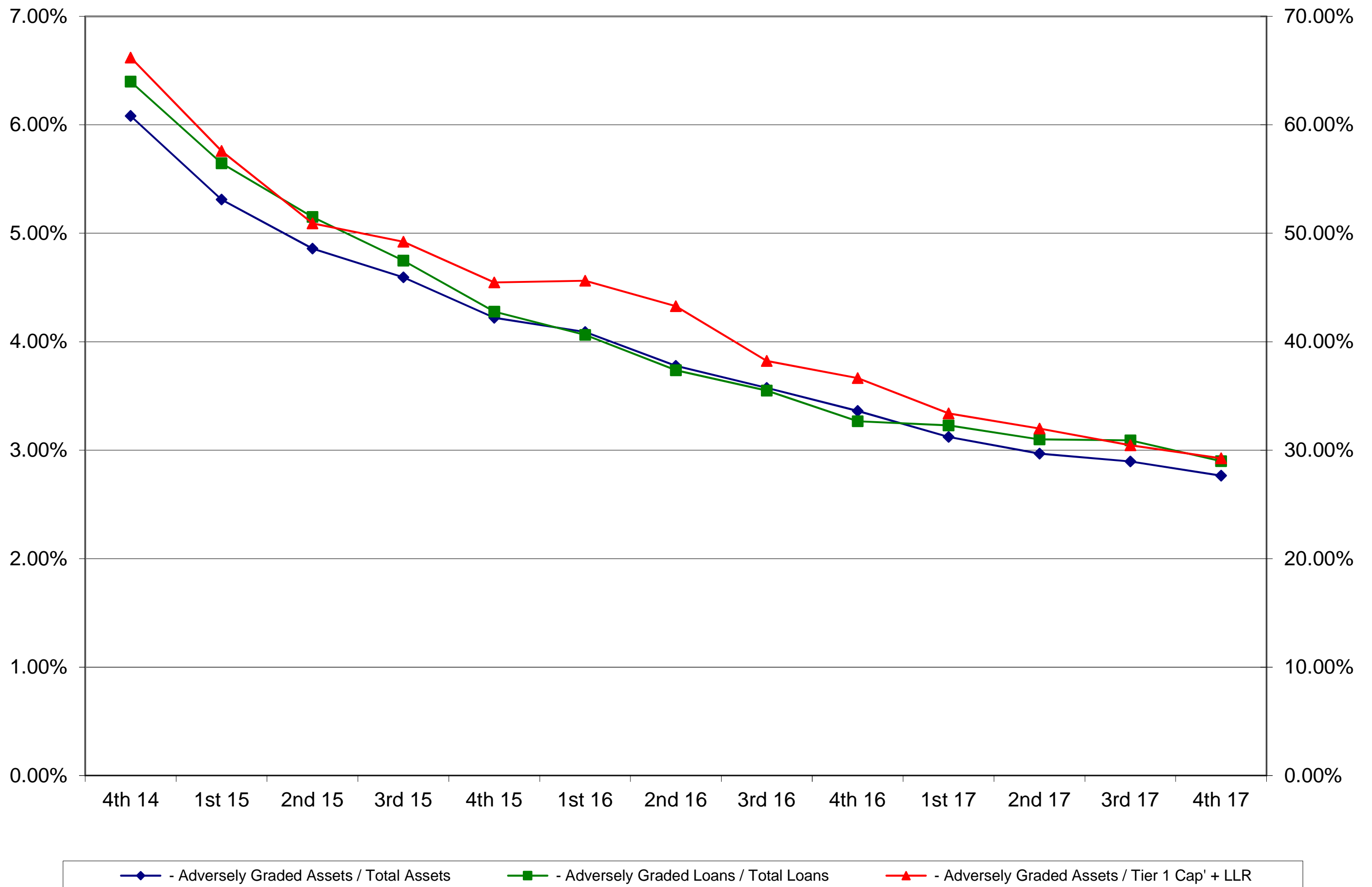
Our sample group includes eight (8) banks with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

- Ten (10) during the Third Quarter 2017
- Eleven (11) during the Second Quarter 2017
- Eleven (11) during the First Quarter 2017

Five (5) 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:

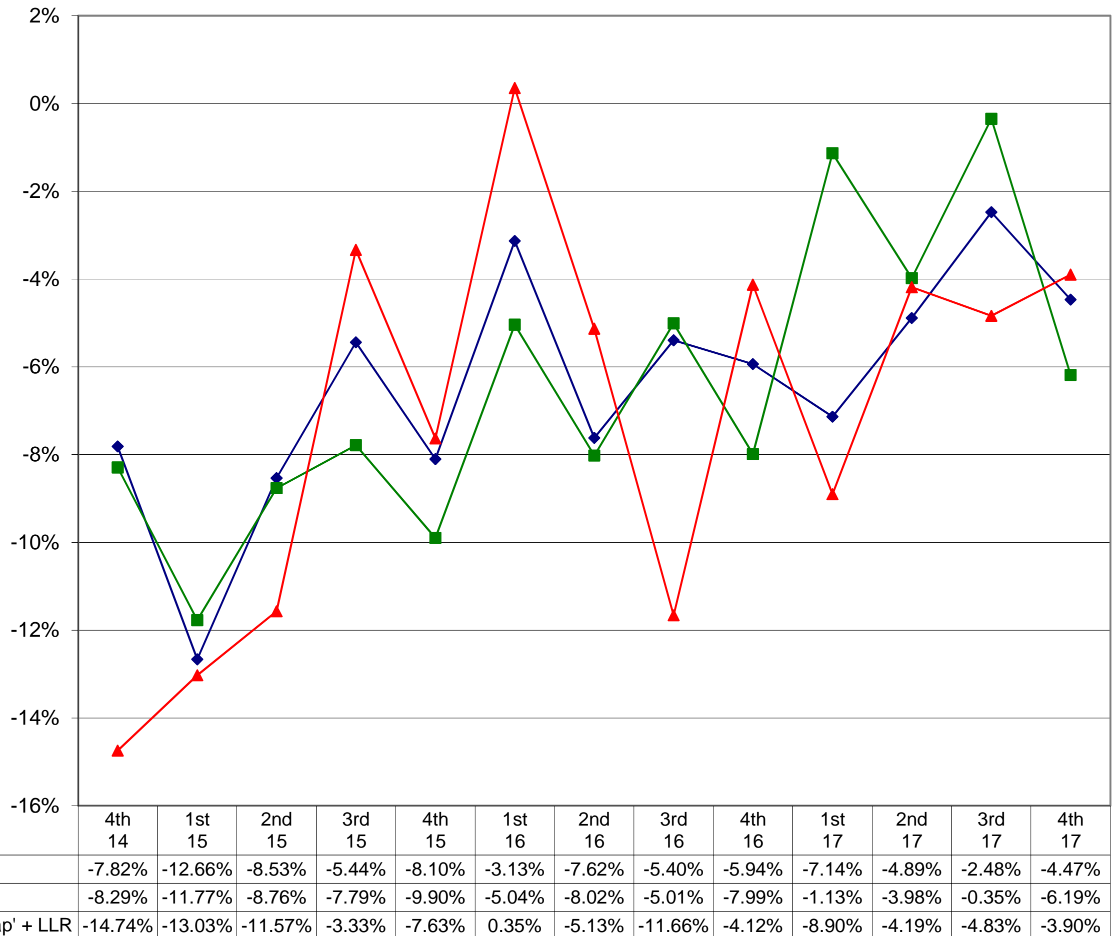
- Five (5) during the Third Quarter 2017
- Seven (7) during the Second Quarter 2017
- Eight (8) during the First Quarter 2017

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 14	1st 15	2nd 15	3rd 15	4th 15	1st 16	2nd 16	3rd 16	4th 16	1st 17	2nd 17	3rd 17	4th 17
% Change in ACA/TA	-7.82%	-12.66%	-8.53%	-5.44%	-8.10%	-3.13%	-7.62%	-5.40%	-5.94%	-7.14%	-4.89%	-2.48%	-4.47%
% Change in ACL/TL	-8.29%	-11.77%	-8.76%	-7.79%	-9.90%	-5.04%	-8.02%	-5.01%	-7.99%	-1.13%	-3.98%	-0.35%	-6.19%
% Change in ACA/Tier 1 Cap' + LLR	-14.74%	-13.03%	-11.57%	-3.33%	-7.63%	0.35%	-5.13%	-11.66%	-4.12%	-8.90%	-4.19%	-4.83%	-3.90%

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 2.54% of total assets, 2.84% of total loans, and 23.19% of tier-one capital plus loan loss reserve. Fourth Quarter 2017 modified data compares to the following Third Quarter 2017 modified average data set:

- 2.59% of total assets
- 2.87% of total loans, and
- 25.30% of tier-one capital plus loan loss reserve

Credit Management Information

Several recent regulatory publications indicate increasing risks in the banking sector. Within the SHP & Co. peer banks, discussion of recent exams indicates a somewhat increased regulatory focus on loan concentrations and interest rate risk.

In its Winter 2017 issue of Supervisory Insights, the FDIC published Credit Management Information, Systems: A Forward-Looking Approach. The article drew information from 24 large state nonmember banks and indicated "forward-looking metrics are showing signs of increasing risk at some institutions". The article stressed the need for proactive MIS. The following matrix reflects various report types and suggested credit metrics.

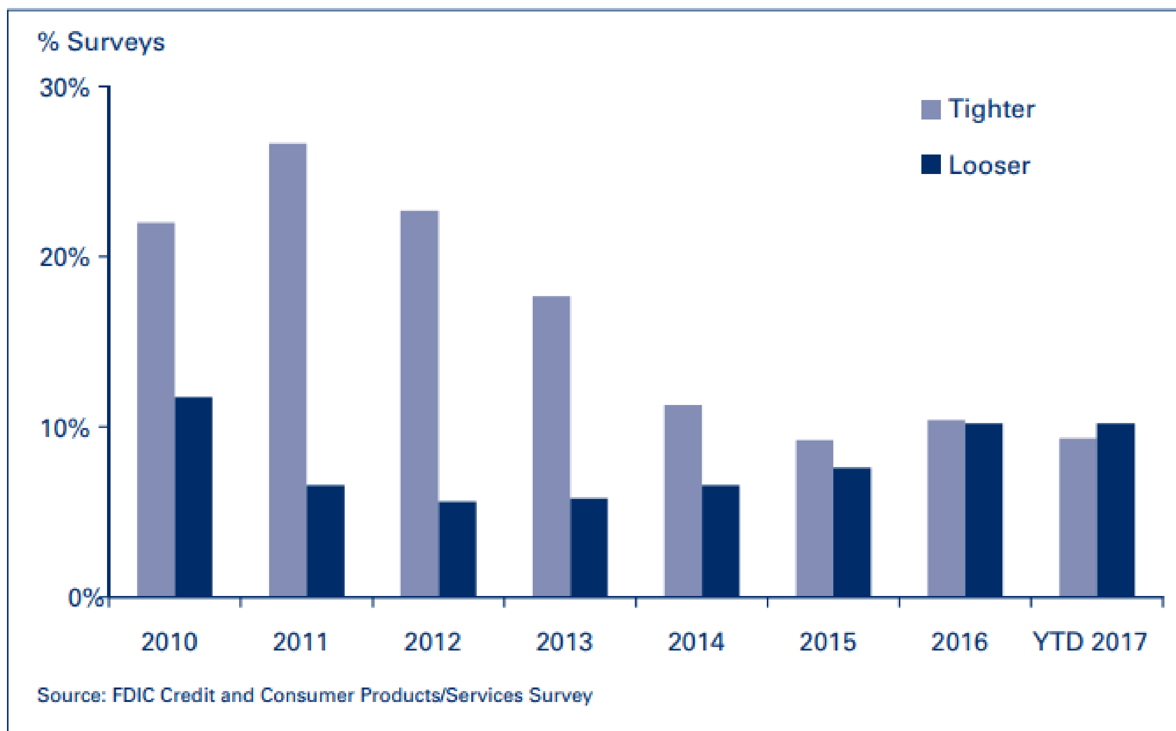
	FORWARD-LOOKING CREDIT METRICS			
Report Type	**Purpose**	**Wholesale Metrics**	**Retail Metrics**	**Effective Practices**
Loan Policy Exceptions	Monitor compliance with board approved policies. Evaluate changes to policies and/or practices based on results.	• LTV • DSCR • Amortization requirements • Maximum maturity • Guarantor requirements • Interest reserves[5] • Hard equity • Financial statements • Loan Extensions	• Credit Bureau scores • Debt-to-Income ratios • Advance rates and down payments • LTV • Co-signer requirements • Maximum maturity • Amortization • Payment Extensions / Deferrals	• Exceptions are tracked based on number and dollar amount.[6] • Exceptions are segmented by loan type as well as type of exception. • Formal exception limits are established and monitored. • Reports are provided on volume of loans that were approved with exceptions.
Underwriting Trends	Track trends in key underwriting metrics to help assess level and direction of portfolio credit risk.	• LTV • DSCR • Amortization • Cap rates by property type	• LTV • Debt-to-Income Ratios • Amortization • Credit Bureau scores	• Use of risk layering (combining metrics to further segment risks) is implemented. For example, reporting focuses on the distribution of loans by LTV and certain DSCRs.
Loan Grading	Analyze distribution of loan grades and migrations over time.	• Includes Pass, Watch List, Special Mention, and Adversely Classified risk grades.	• As retail loans are not typically subject to loan grading, refreshed credit bureau scores are frequently used as a proxy.	• Shows loan grade distributions for new originations vs. the portfolio. • Shows migrations in and out of individual loan grades over time (particularly Watch, Special Mention, and Adversely classified grades). • "Roll rate" reports[7] on past-due loans are useful for the retail portfolio.

Credit Management Information - continued

Per the SI issue, the following were the most common issues contributing to increased risk:

- Out-of-area lending (including whole loan purchases, loan participations, and shared national credits);
- Growth in loans, ADC or CRE concentrations, assets, or deposits; and
- Higher risk practices in lending or underwriting, often in response to increased competition

Historical SHP & Co. newsletters have discussed competition as a contributing factor to changes in client bank & industry underwriting. We have noted a slight up-tick in loan policy exceptions within internal underwriting at some clients. Of note, our findings would appear to mirror those found in the SI. See the graph below.



Potential Changes in LLR Methodology

We have fielded several questions regarding pending LLR methodology changes. The Regulatory bodies will be hosting a webinar on February 27, 2018 beginning a 1:00 pm - Community Bank Webinar: Implementation Examples for the Current Expected Credit Losses Methodology (CECL). For access to the webcast:
https://www.webcaster4.com/Webcast/Page/583/24368

Additional references for reserve methodology changes are available at:
https://www.fdic.gov/news/news/financial/2017/fil17041a.pdf

https://www.fdic.gov/news/news/financial/2018/fil18008.pdf

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

The materials included in this newsletter are provided for informational purposes only and do not constitute legal advice. You should not act or rely on any information contained in this publication without first seeking the advice of an attorney. The content of the this Asset Quality Update is intended solely for internal use by our clients and may not be reproduced or quoted without written consent from Steve H. Powell & Company.

---

a. P.O. Box 2701, Statesboro, GA 30459 | p. 912.682.3029 | f. 912.489.5354 | e. spowell@shpco.net | w. shpco.net