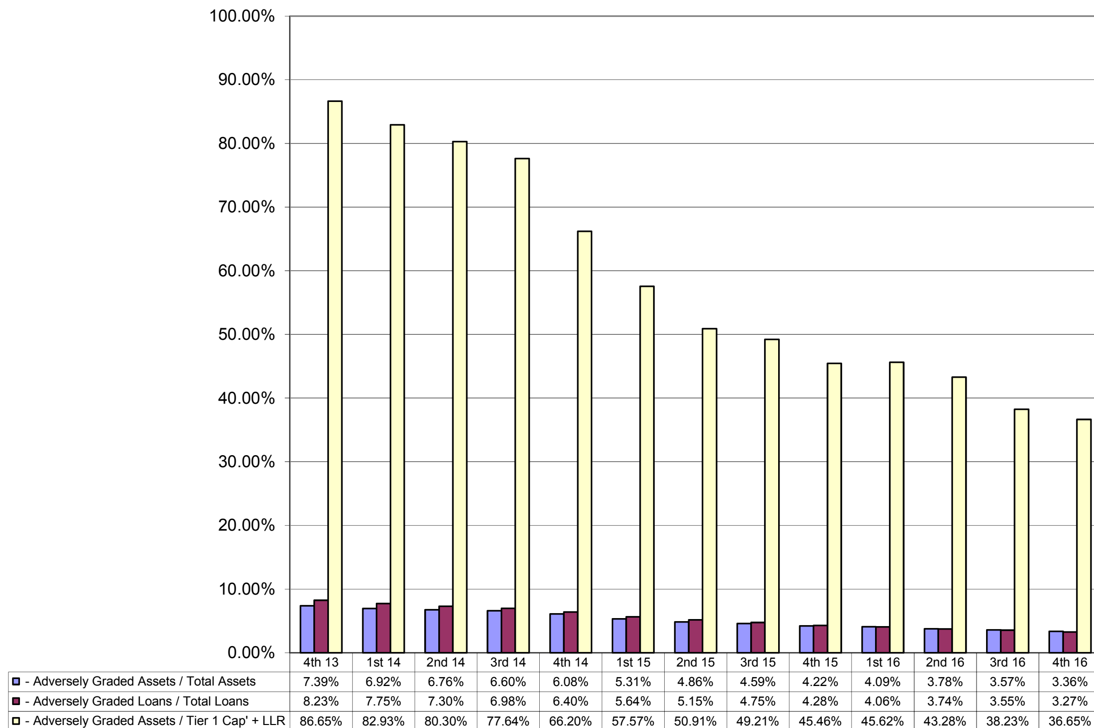
Steve H. Powell & Company

Asset Quality Update – Q4 2016 Edition

Trends in Asset Quality – Average Levels

Based on Steve H. Powell & Company client data, during the Fourth Quarter 2016, 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 3.36% of total assets and 36.65% of tier-one capital plus loan loss reserve as compared to 3.57% of total assets and 38.23% of tier-one capital plus loan loss reserve while problem loans averaged 3.27% of total loans as compared to 3.55% of total loans during the Third Quarter 2016.



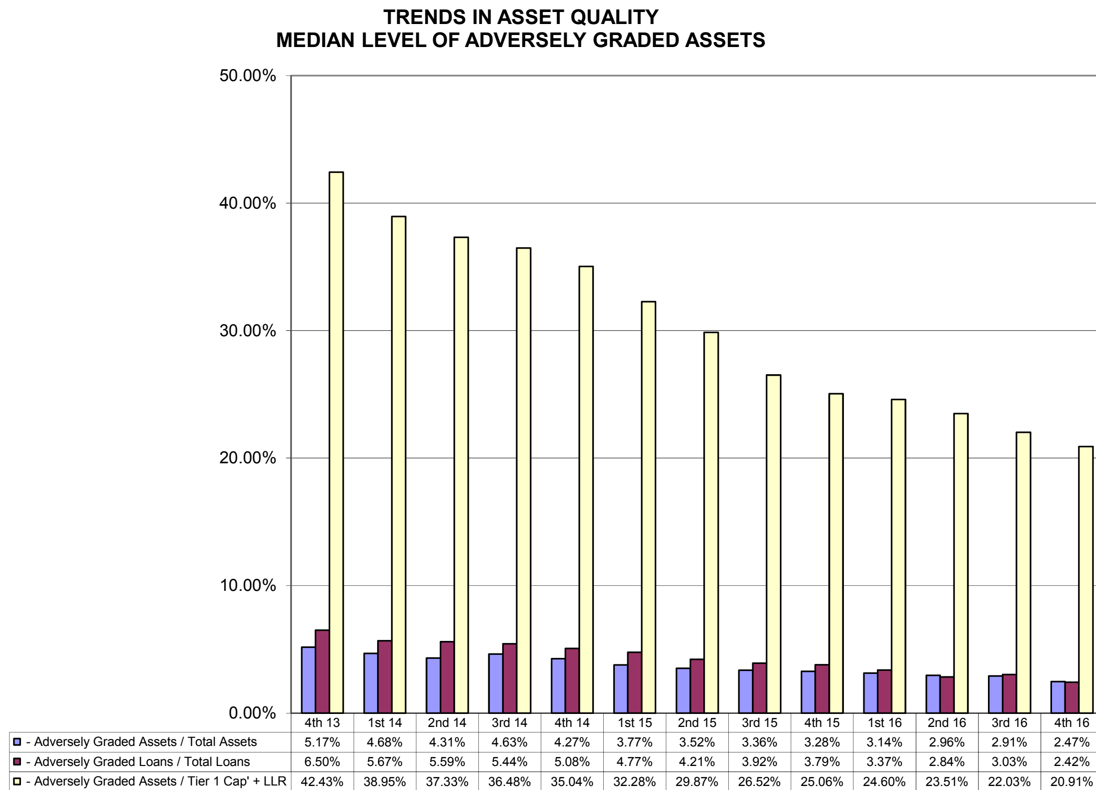
	4th 13	1st 14	2nd 14	3rd 14	4th 14	1st 15	2nd 15	3rd 15	4th 15	1st 16	2nd 16	3rd 16	4th 16
- Adversely Graded Assets / Total Assets	7.39%	6.92%	6.76%	6.60%	6.08%	5.31%	4.86%	4.59%	4.22%	4.09%	3.78%	3.57%	3.36%
- Adversely Graded Loans / Total Loans	8.23%	7.75%	7.30%	6.98%	6.40%	5.64%	5.15%	4.75%	4.28%	4.06%	3.74%	3.55%	3.27%
- Adversely Graded Assets / Tier 1 Cap' + LLR	86.65%	82.93%	80.30%	77.64%	66.20%	57.57%	50.91%	49.21%	45.46%	45.62%	43.28%	38.23%	36.65%

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.

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

Trends in Asset Quality – Median Levels

The median level of problem assets as of Q4 2016 decreased to 20.91% of tier-one capital plus loan loss reserve as compared to 22.03% during Q3 2016. Note the downward trend as overall asset quality continues to improve.



	4th 13	1st 14	2nd 14	3rd 14	4th 14	1st 15	2nd 15	3rd 15	4th 15	1st 16	2nd 16	3rd 16	4th 16
- Adversely Graded Assets / Total Assets	5.17%	4.68%	4.31%	4.63%	4.27%	3.77%	3.52%	3.36%	3.28%	3.14%	2.96%	2.91%	2.47%
- Adversely Graded Loans / Total Loans	6.50%	5.67%	5.59%	5.44%	5.08%	4.77%	4.21%	3.92%	3.79%	3.37%	2.84%	3.03%	2.42%
- Adversely Graded Assets / Tier 1 Cap' + LLR	42.43%	38.95%	37.33%	36.48%	35.04%	32.28%	29.87%	26.52%	25.06%	24.60%	23.51%	22.03%	20.91%

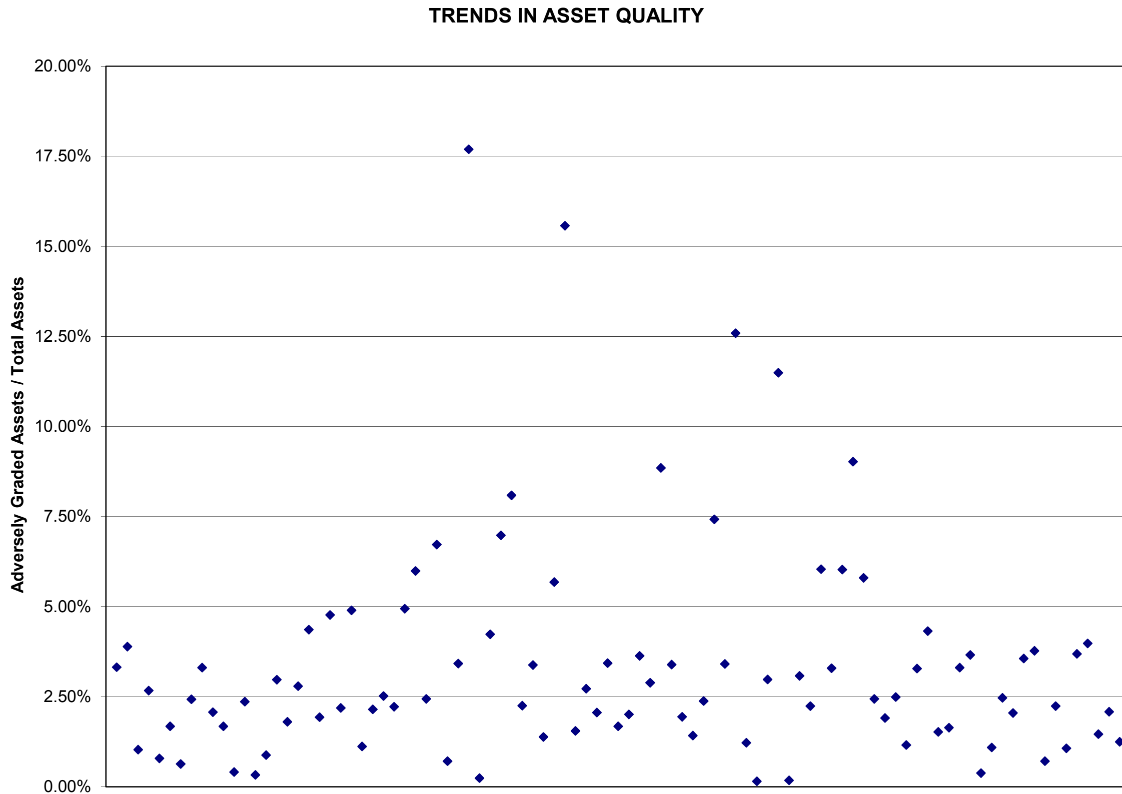
Historical Comparisons

During Q4 2016, increases in problem assets, as measured by adversely graded assets divided by tier-one capital plus loan loss reserve, were noted in approximately 18% of our clients. This quarter's increase compares to:

- 16% during the Third Quarter 2016
- 19% during the Second Quarter 2016
- 23% during the First Quarter 2016
- 18% during the Fourth Quarter 2015
- 8% during the Third Quarter 2015, and
- 11% during the Second Quarter 2015

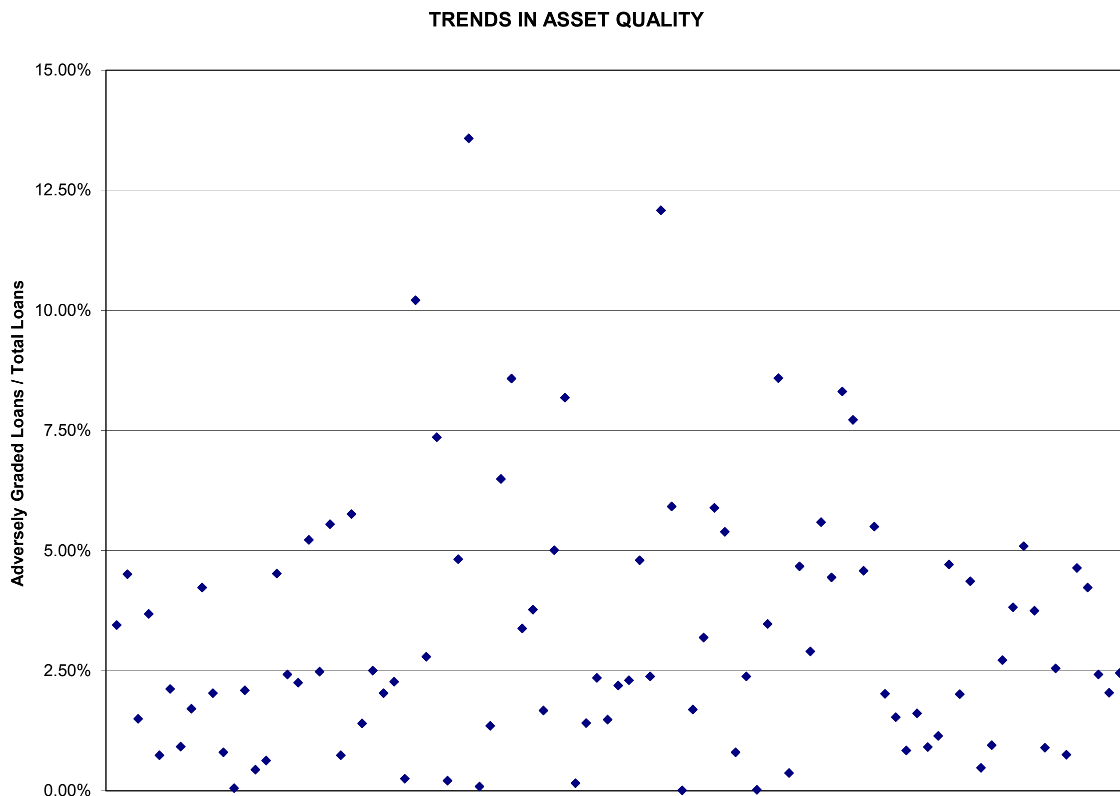
A higher level of volatility in the percentage of increases may be expected as overall asset quality stabilizes; however, increases may indicate a rise in portfolio risk.

Dispersion of Problem Assets – as a Percentage of Total Assets



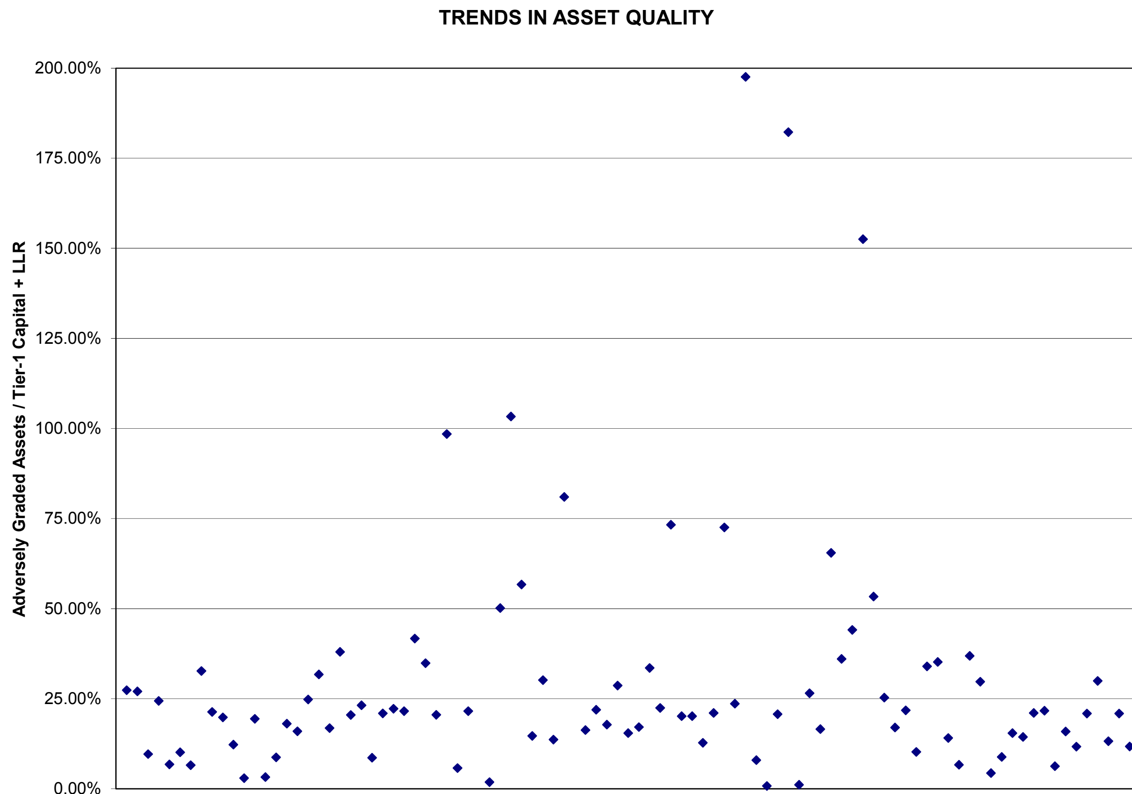
The above graph shows the dispersion of problem assets as a percentage of total assets. A traditional benchmark for significant asset quality concern is adversely graded assets that exceed 10% of total assets.

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.

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



Historical Comparisons

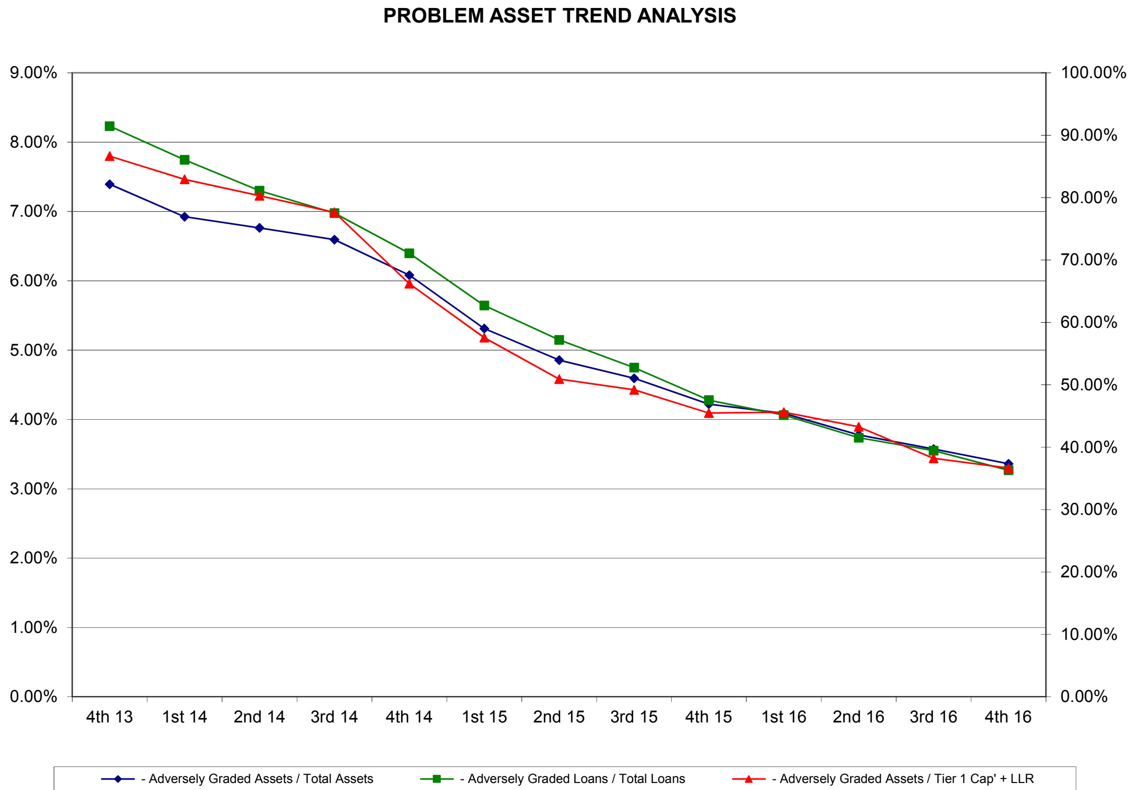
Our sample group includes eleven (11) banks with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

- Thirteen (13) during the Third Quarter 2016
- Fourteen (14) during the Second Quarter 2016
- Sixteen (16) during the First Quarter 2016, and
- Sixteen (16) during the Fourth Quarter 2015

Eight (8) 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:

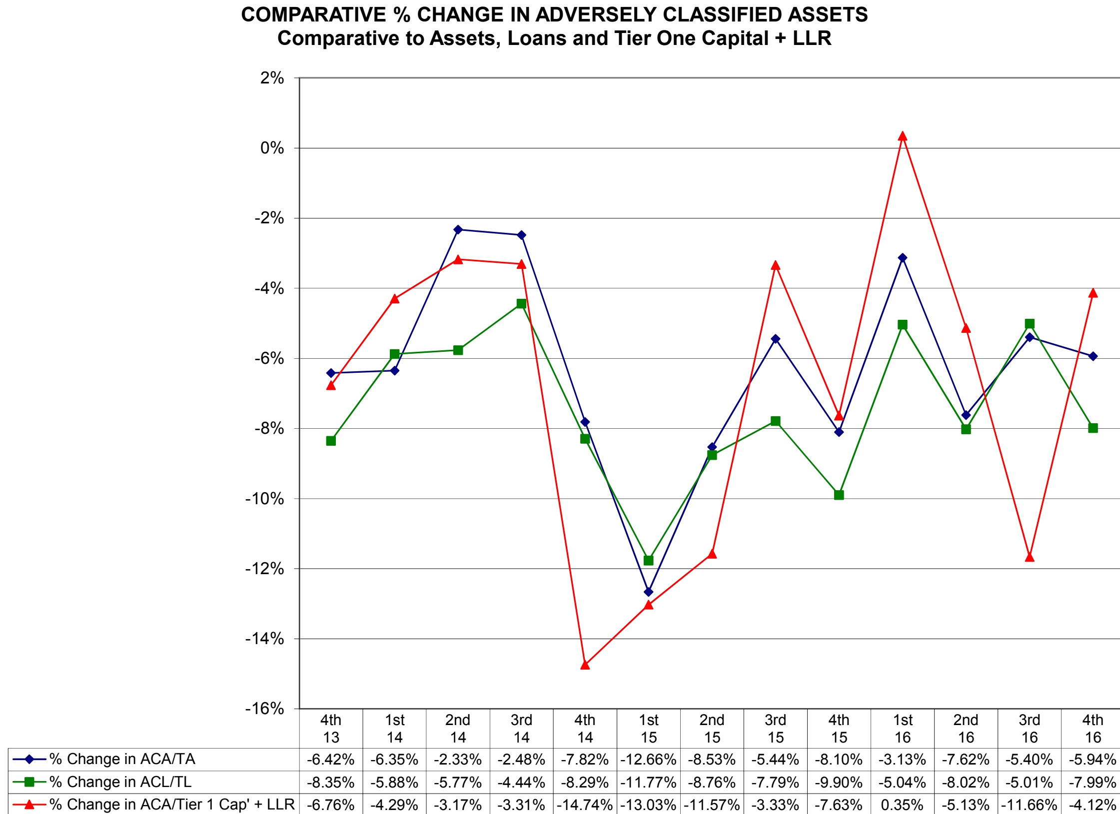
- Nine (9) during the Third Quarter 2016
- Ten (10) during the Second Quarter 2016
- Nine (9) during the First Quarter 2016, and
- Nine (9) during the Fourth Quarter 2015

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 13	1st 14	2nd 14	3rd 14	4th 14	1st 15	2nd 15	3rd 15	4th 15	1st 16	2nd 16	3rd 16	4th 16
% Change in ACA/TA	-6.42%	-6.35%	-2.33%	-2.48%	-7.82%	-12.66%	-8.53%	-5.44%	-8.10%	-3.13%	-7.62%	-5.40%	-5.94%
% Change in ACL/TL	-8.35%	-5.88%	-5.77%	-4.44%	-8.29%	-11.77%	-8.76%	-7.79%	-9.90%	-5.04%	-8.02%	-5.01%	-7.99%
% Change in ACA/Tier 1 Cap' + LLR	-6.76%	-4.29%	-3.17%	-3.31%	-14.74%	-13.03%	-11.57%	-3.33%	-7.63%	0.35%	-5.13%	-11.66%	-4.12%

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 3.07% of total assets, 3.23% of total loans, and 28.50% of tier-one capital plus loan loss reserve. Fourth Quarter 2016 modified data compares to the following Third Quarter 2016 modified average data set:

- 3.29% of total assets
- 3.53% of total loans, and
- 30.12% of tier-one capital plus loan loss reserve

Rising Interest Rates in Commercial Underwriting

By: Ken Bennett, CPA

In the previous twelve month period, the Federal Open Market Committee (FOMC) has increased short-term interest rate targets by 50 basis points:

- December 15, 2016 – 0.50-0.75%
- December 17, 2015 – 0.25-0.50%
- Prior Target – 0.00-0.25%

In addition to slower growth rates in, or even declining, commercial real estate values, future interest rate rises could have measurable effects on repayment ability. Borrowers with variable rate loans face increased debt service or, in the case of a fixed rate loan, the potential inability to refinance at the end of the loan term. Some substantial increases have historically happened in relatively short periods of time.

In a sample scenario, assume a $1 million loan, amortized over a 20 year period, secured by income-producing commercial real estate with non-escalating long-term leases and a 9% debt yield. A loan originated in November 2015 with an interest rate variable at WSJ Prime (3.25% at the time). An original debt service coverage ratio (DSCR) of 1.32x would now have decreased to 1.26x of January 2016 – assuming daily or monthly interest rate adjustments (Prime currently at 3.75%).

Loan	$ 1,000,000
NOI	$ 90,000
Debt Yield	9.00%
Amort (Yrs)	20

		Debt Service		
Scenario	Int. Rate	Monthly	Annual	DSCR
1	3.25%	$ 5,672	$ 68,063	1.32
2	3.50%	$ 5,800	$ 69,595	1.29
3	3.75%	$ 5,929	$ 71,147	1.26
4	4.00%	$ 6,060	$ 72,718	1.24
5	4.25%	$ 6,192	$ 74,308	1.21
6	4.50%	$ 6,326	$ 75,918	1.19
7	4.75%	$ 6,462	$ 77,547	1.16
8	5.00%	$ 6,600	$ 79,195	1.14
9	5.25%	$ 6,738	$ 80,861	1.11
10	5.50%	$ 6,879	$ 82,546	1.09
11	5.75%	$ 7,021	$ 84,250	1.07
12	6.00%	$ 7,164	$ 85,972	1.05
13	6.25%	$ 7,309	$ 87,711	1.03
14	6.50%	$ 7,456	$ 89,469	1.01
15	6.75%	$ 7,604	$ 91,244	0.99
16	7.00%	$ 7,753	$ 93,036	0.97
17	7.25%	$ 7,904	$ 94,845	0.95
18	7.50%	$ 8,056	$ 96,671	0.93

An increase of 350 basis points from the interest rate at origination results in a DSCR decrease to less than 1.00x.

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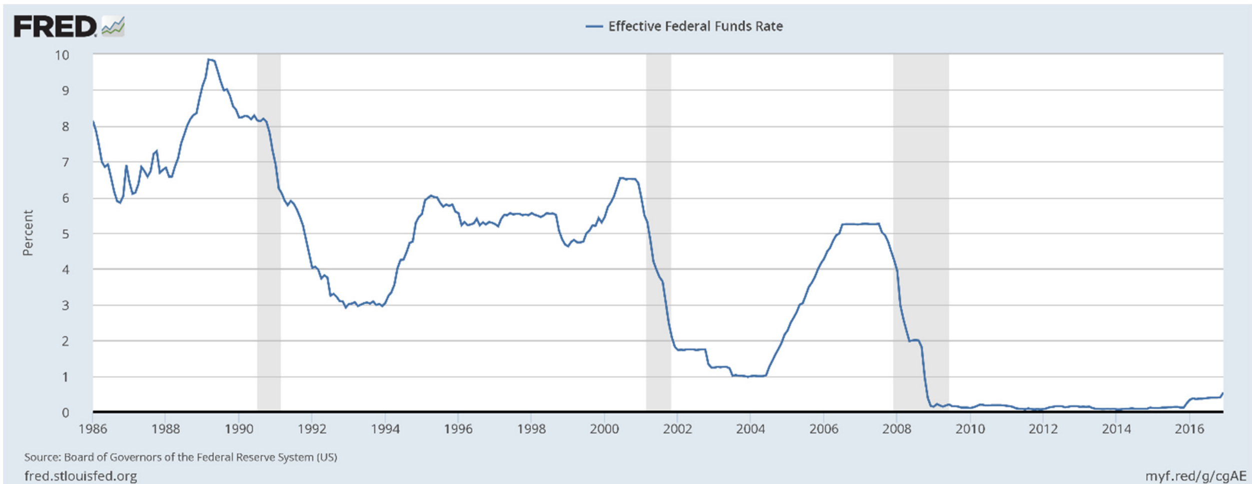
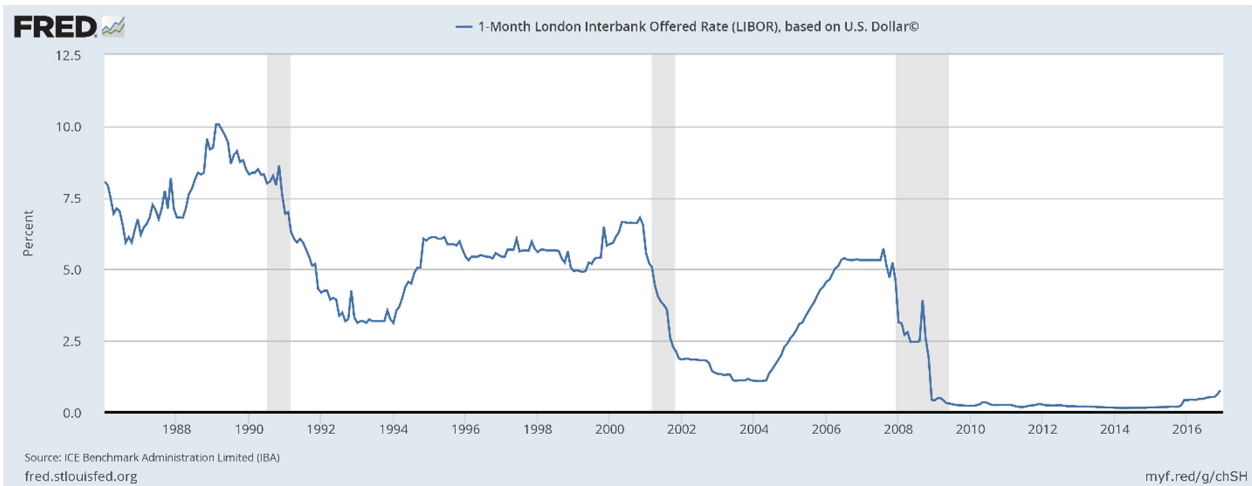
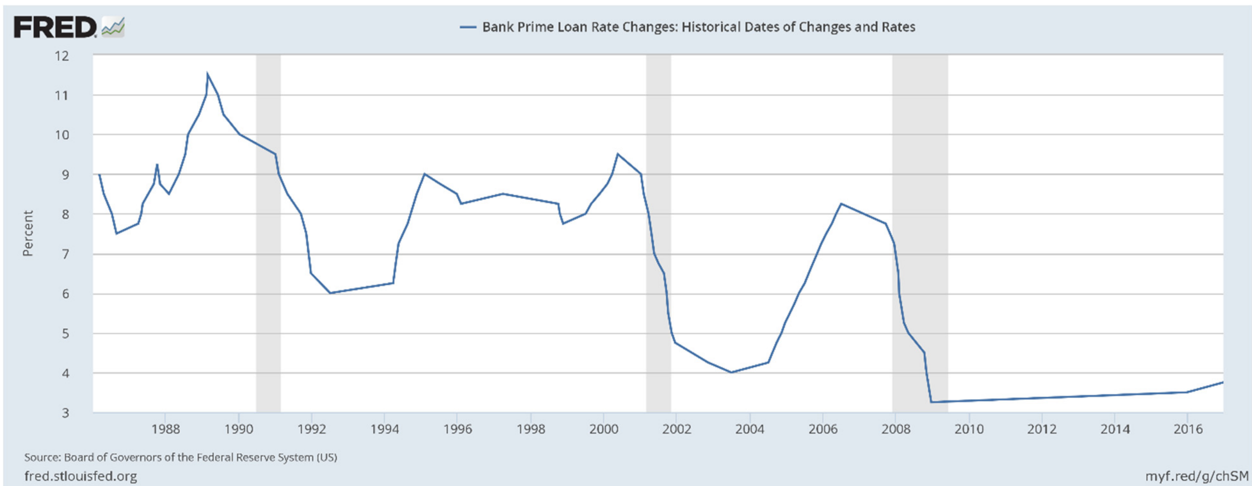
Considering recent history – the past decade or so – a 350 basis point rise in interest rates may seem extreme; however, consider historic rates and rate increases in the Federal Funds Rate – and in turn, the Prime and LIBO Rates:







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Over a fairly recent three year period preceding the great recession, target Federal Funds Rate rose approximately 425 basis points:

- 2004 – From 1.00% to 2.25%
- 2005 – From 2.25% to 4.25%
- 2006 – From 4.25% to 5.25%

Also note that in a single year (1994), interest rates rose approximately 250 basis points – from 3.00% to 5.50%.

Prudent and conservative underwriting should consider the effects of future interest rate changes on borrower repayment capacity. Income producing property with a strong long-term tenant and lease payments resulting in a 1.15x DSCR may need to be viewed with additional caution. Modern underwriting includes testing at various interest rate levels or "shocking" the interest rate at a very increased level to assess repayment capacity.

ALLL Methodology

An institution's allowance for loan and lease losses is of obvious importance and, as such, is subjected to increased focus of examiners and auditors alike. The calculation methodology can be complex and is qualitatively ever-changing. Our clients have noted increased ALLL scrutiny from regulatory agencies.

The Semiannual Risk Perspective includes that, for both Midsize & Community Bank Supervision and Large Bank Supervision, top priorities remain generally the same and include:

- **ALLL**: Assessing appropriateness of the ALLL, especially the documentation and support for the qualitative factors given the increased credit risk from growing concentrations, easing in underwriting standards, and increased risk layering. In addition, examiners will evaluate banks' plans to prepare for the implementation of the current expected credit loss standard.

At Steve H. Powell & Company, we offer affordable and thorough methodology reviews to allow an institution, as well as examiners and auditors, to have increased confidence in the methodology of the documentation and methodology for the ALLL calculation. Please contact us for more information.

ALLL Methodology

By: Ken Bennett, CPA

The Office of the Comptroller of the Currency (OCC) recently released two detailed publications regarding a Survey of Credit Underwriting Practices for 2016 and a Semiannual Risk Perspective from the National Risk Committee. The Federal Reserve also recently released a new edition of The Beige Book. These publications offer insight regarding the credit cycle, underwriting, regulatory compliance challenges, concentration management, interest rate risk, operational risks, cyber threats, and other topics. For Steve H. Powell & Company updates regarding regulatory compliance issues, please subscribe to our Compliance Pipeline.

Primary findings of the Survey of Credit Underwriting Practices note generally acceptable, but loosening, underwriting standards that are consistent with previous credit cycles:

- Banks continue to ease underwriting practices in response to competitive pressures, expanding credit risk appetites, and a desire for loan growth.
- While overall underwriting practices remain satisfactory, an increasing tolerance for looser underwriting has resulted in continued movement from more conservative underwriting practices to more moderate underwriting practices, a trend consistent with past credit cycles.
- Credit risk has increased since the 2015 survey in commercial and retail lending activities, and examiners expect the levels of credit risk in these areas to increase over the next 12 months. Primary areas of concern are aggressive growth rates, weaknesses in concentration risk management, deterioration in energy related portfolios, and the continued general easing of underwriting practices.

The Semiannual Risk Perspective (regarding the first half of 2016) noted increased revenue but decreased net income due to an increase in provision expenses. The publication also notes stronger return on equity (ROE) in banks with assets of less than $10 billion as compared to banks with assets of more than $10 billion. The report details:

- Strategic planning remains important as banks adopt innovative products, services, and processes in response to the evolving demands for financial services and the entrance of new competitors, such as out-of-market banks and financial technology firms (fintech firms).
- Continued incremental easing in underwriting standards is a concern as banks strive to achieve loan growth and to maintain or grow market share. Easing of underwriting standards in commercial, CRE, and auto lending presents increasing credit risk.
- Rapid CRE loan growth over the past year and recent underwriting reviews raise concern over the quality of CRE risk management, particularly managing concentrations.
- Operational risk remains a concern as banks deal with changing cybersecurity threats, increased reliance on third-party relationships, and address the need for sound governance over sales practices.
- Some banks continue to face challenges in complying with Bank Secrecy Act (BSA) requirements as money laundering and terrorism financing methods evolve.
- Change management processes are posing a challenge as banks allocate resources to implement processes and controls for multiple new or amended regulations including the integrated mortgage disclosures under the Truth in Lending Act (TILA) and Real Estate Settlement Procedures Act
- (RESPA) and the new requirements under the amended regulation implementing the Military Lending Act (MLA).

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Also, in additional detail, the publication discusses a mixed commercial real estate (CRE) outlook, potentially subdued GDP growth, expectations of farm income continuing to decline (in 2016 – per USDA projections), stable but historically low net income margins, segments leading commercial loan growth, and increasing loss severities in auto lending.

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

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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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