# Steve H. Powell & Company

## Quarterly Newsletter

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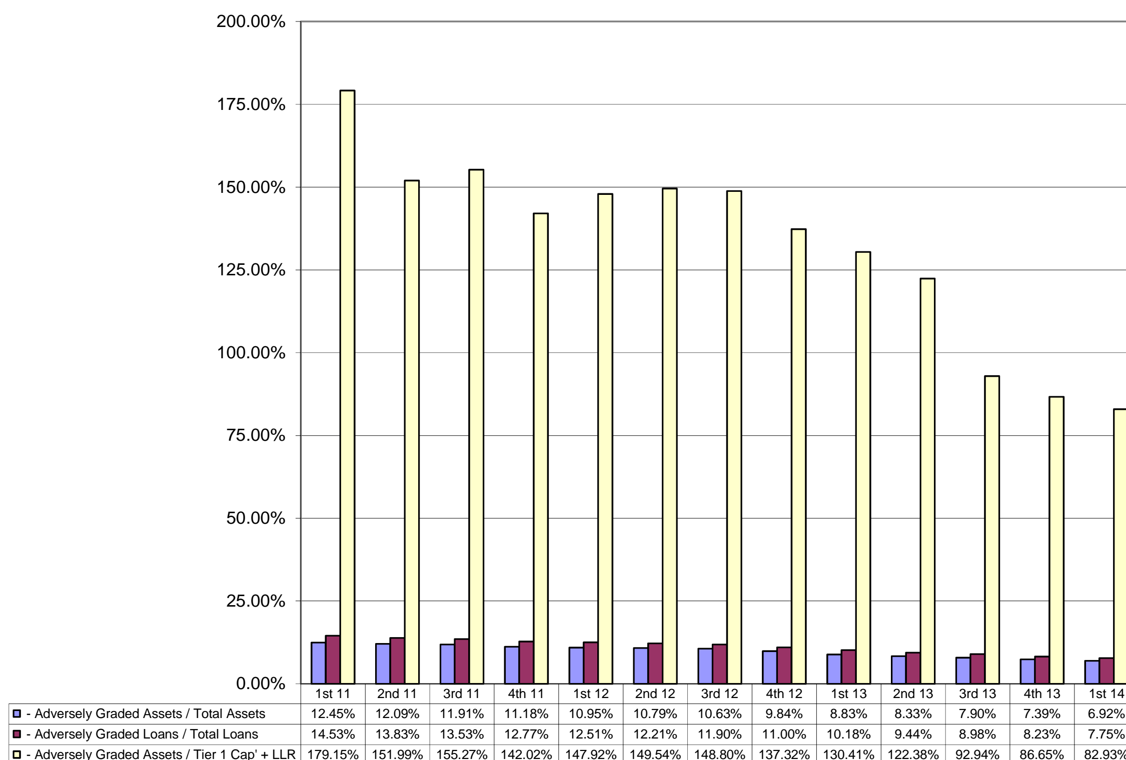
Q1 2014

## Trends in Asset Quality

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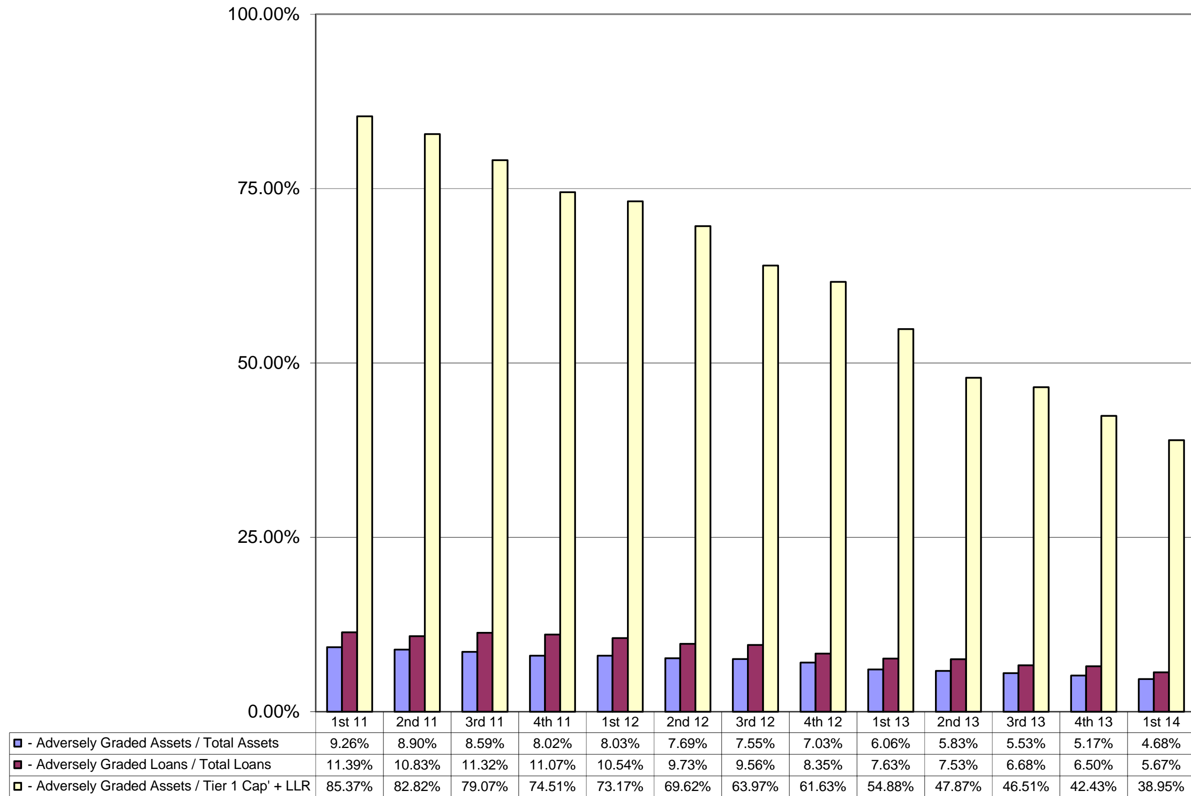
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| - Adversely Graded Assets / Total Assets | 12.45% | 12.09% | 11.91% | 11.18% | 10.95% | 10.79% | 10.63% | 9.84% | 8.83% | 8.33% | 7.90% | 7.39% | 6.92% |
| - Adversely Graded Loans / Total Loans | 14.53% | 13.83% | 13.53% | 12.77% | 12.51% | 12.21% | 11.90% | 11.00% | 10.18% | 9.44% | 8.98% | 8.23% | 7.75% |
| - Adversely Graded Assets / Tier 1 Cap' + LLR | 179.15% | 151.99% | 155.27% | 142.02% | 147.92% | 149.54% | 148.80% | 137.32% | 130.41% | 122.38% | 92.94% | 86.65% | 82.93% |

Based on Steve H. Powell & Company client data, during the First Quarter 2014, the average level of adversely graded assets decreased as a percentage of capital, loans and assets. Problem assets averaged 6.92% of total assets, 7.75% of total loans, and 82.93% of tier-one capital plus loan loss reserve as compared to 7.39% of total assets, 8.23% of total loans, and 86.65% of tier-one capital plus loan loss reserve during the Fourth Quarter 2013.

*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 to now exceed 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 backgrounds.*

# Median Level of Problem Assets

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|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| - Adversely Graded Assets / Total Assets | 9.26% | 8.90% | 8.59% | 8.02% | 8.03% | 7.69% | 7.55% | 7.03% | 6.06% | 5.83% | 5.53% | 5.17% | 4.68% |
| - Adversely Graded Loans / Total Loans | 11.39% | 10.83% | 11.32% | 11.07% | 10.54% | 9.73% | 9.56% | 8.35% | 7.63% | 7.53% | 6.68% | 6.50% | 5.67% |
| - Adversely Graded Assets / Tier 1 Cap' + LLR | 85.37% | 82.82% | 79.07% | 74.51% | 73.17% | 69.62% | 63.97% | 61.63% | 54.88% | 47.87% | 46.51% | 42.43% | 38.95% |

The median level of problem assets as of Q1 2014 decreased to 38.95% of tier-one capital plus loan loss reserve as compared to 42.43% during Q4 2013. Median classifications peaked at 92.05% in Q3 2010. Please note the continued downward trend from Q1 2011.

## Historical Comparisons

During Q1 2014, increases in problem assets, as measured by adversely graded assets divided by tier-one capital plus loan loss reserve were noted in approximately 17% of our clients. This quarter's increase compares to:

- 14% during the Fourth Quarter 2013
- 23% during the Third Quarter 2013
- 15% during the Second Quarter 2013
- 25% during the First Quarter 2013
- 23% during Fourth Quarter 2012 and
- 27% during Third Quarter 2012

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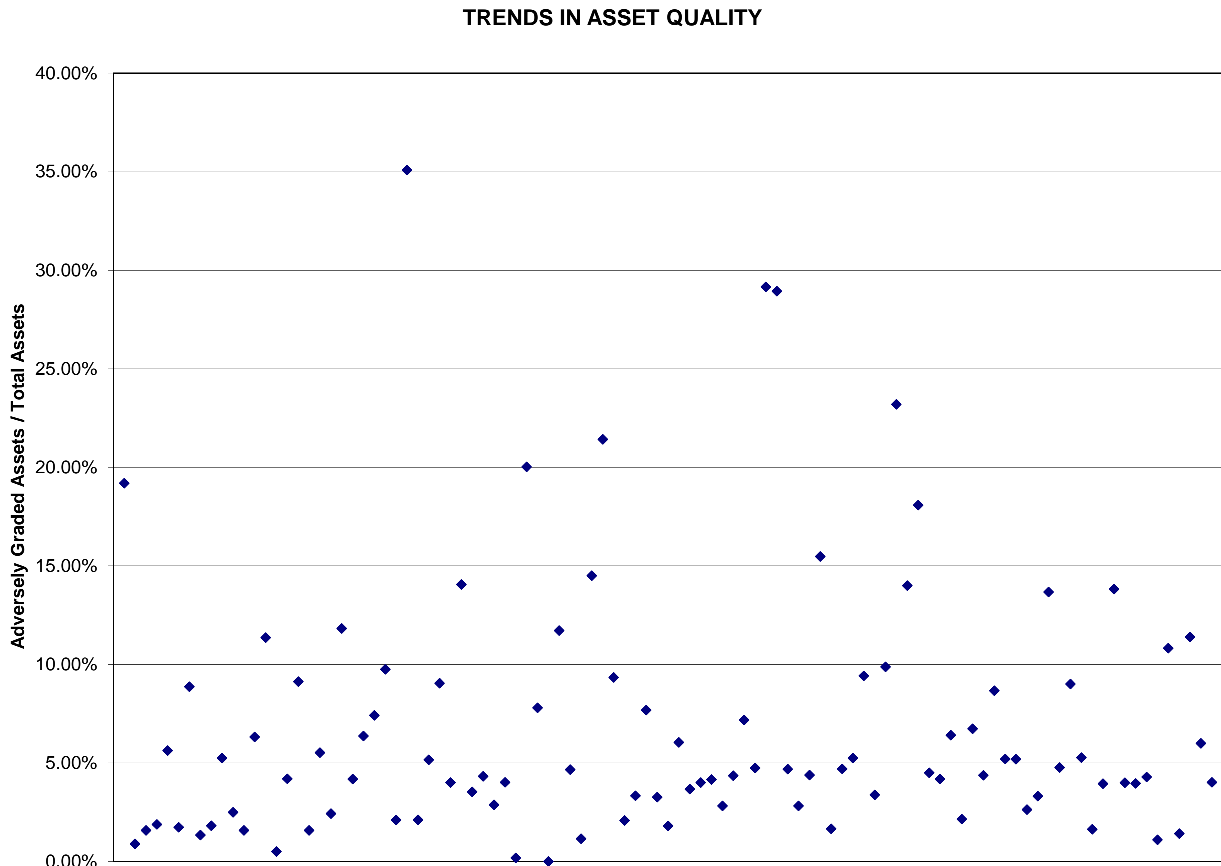
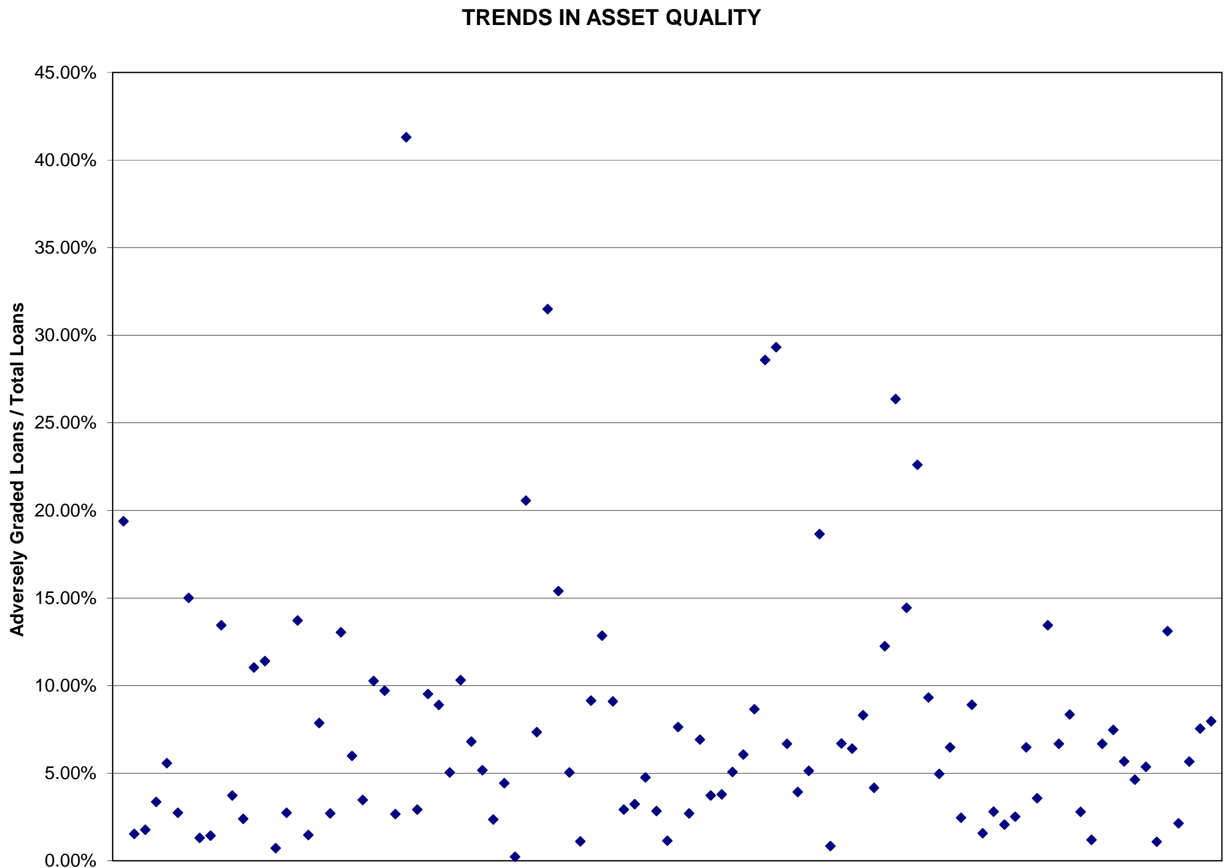
## Dispersion of Problem Assets as % of Total Assets

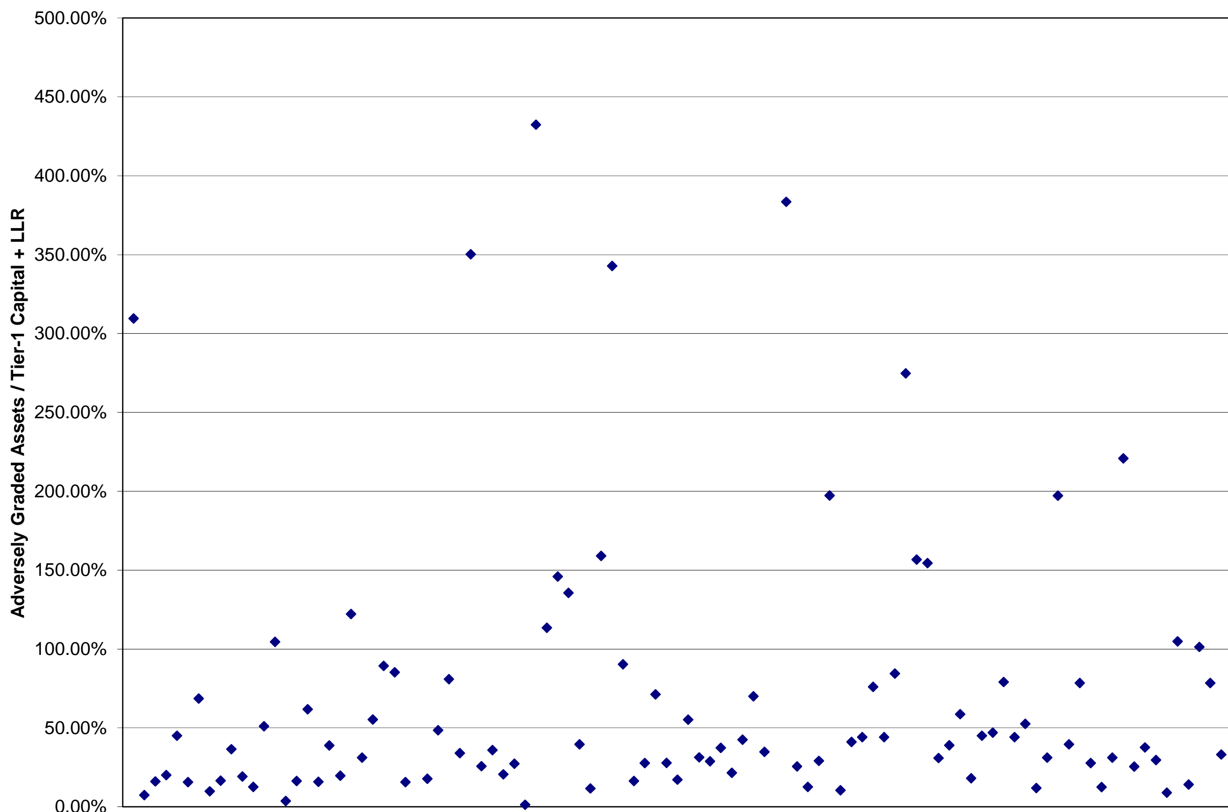



The above graph shows the dispersion of problem assets as a percentage of total assets. Please note the number of institutions with adversely graded assets that exceed 10% of total assets – a benchmark for significant asset quality concern.

## Dispersion of Problem Loans as % of Total Loans




Please note the number of institutions with adversely graded loans that exceed 10% of total loans - a benchmark for significant loan quality concern.




## Historical Comparisons

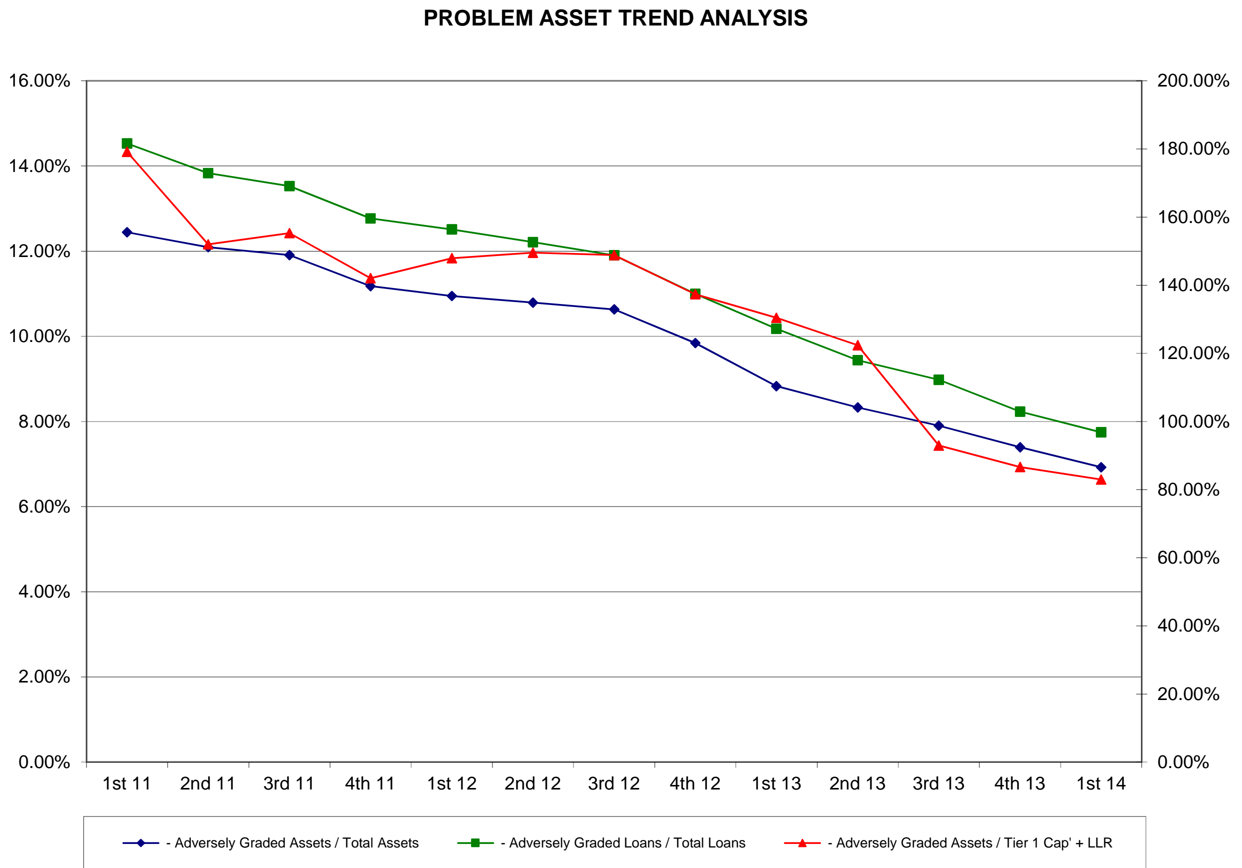
Our sample group includes thirty four (34) banks with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

- Thirty seven (37) during the Fourth Quarter 2013
- Forty three (43) during the Third Quarter 2013
- Forty four (44) during the Second Quarter 2013
- Forty six (46) during the First Quarter 2013
- Fifty six (56) during the Fourth Quarter 2012 and
- Fifty seven (57) during the Third Quarter 2012

Twenty six (26) 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:

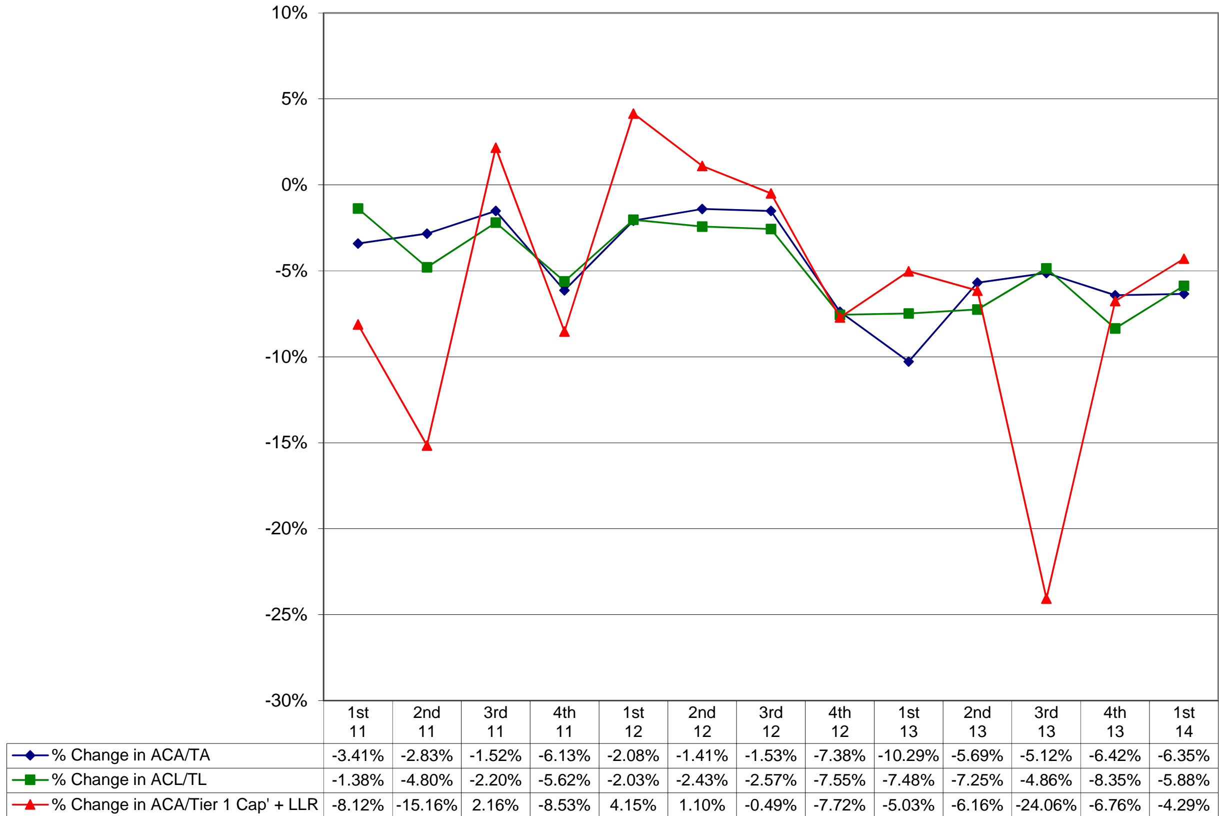
- Twenty eight (28) during the Fourth Quarter 2013
- Twenty nine (29) during the Third Quarter 2013
- Thirty three (33) during the Second Quarter 2013
- Thirty seven (37) during the First Quarter 2013
- Forty three (43) during the Fourth Quarter 2012 and
- Forty three (43) during the Third Quarter 2012

# Problem Asset Trend Analysis




The above graph reflects the trend in asset quality 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. The average level of adversely graded assets as a percentage of total assets and adversely graded loans as a percentage of total loans continued a downward trend that began during Q3 & Q4 2010. Note the decline of approximately 10,000 basis points in average adversely graded assets divided by tier-one capital plus loan loss reserve from Q1 2011 to Q1 2014.

# Comparative % Change in Adversely Graded Assets

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|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| % Change in ACA/TA | -3.41% | -2.83% | -1.52% | -6.13% | -2.08% | -1.41% | -1.53% | -7.38% | -10.29% | -5.69% | -5.12% | -6.42% | -6.35% |
| % Change in ACL/TL | -1.38% | -4.80% | -2.20% | -5.62% | -2.03% | -2.43% | -2.57% | -7.55% | -7.48% | -7.25% | -4.86% | -8.35% | -5.88% |
| % Change in ACA/Tier 1 Cap' + LLR | -8.12% | -15.16% | 2.16% | -8.53% | 4.15% | 1.10% | -0.49% | -7.72% | -5.03% | -6.16% | -24.06% | -6.76% | -4.29% |

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 assets and loans. Please note any data points below 0% indicate improvement in asset quality.

## Modified Peer Data Analysis

Prior newsletters have included a discussion of a cross-peer comparison. The comparison was performed again this quarter. The data set was divided into three modified peer group segments – SHP & Co. peer group data was divided into thirds. The segmentation was based on adversely graded loans as a percentage of total loans:

- Tier Group 1 included banks ranging from 0% to 3.72%
- Tier Group 2 included banks between 3.72% and 7.9%
- Tier Group 3 included data points > 7.9%

Average classification ratios in the three tier groups are reflected in the following table:

| Modified Peer Comparison | *Tier Group 1* | *Tier Group 2* | *Tier Group 3* |
|---|---|---|---|
| **Adversely Graded Assets / Total Assets** | 2.67% | 5.17% | 13.06% |
| **Adversely Graded Assets / Total Loans** | 2.19% | 5.81% | 15.17% |
| **Adversely Graded Assets / Tier 1 Cap' + LLR** | 22.41% | 48.14% | 177.23% |

*Additional Modified Data Set*

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.

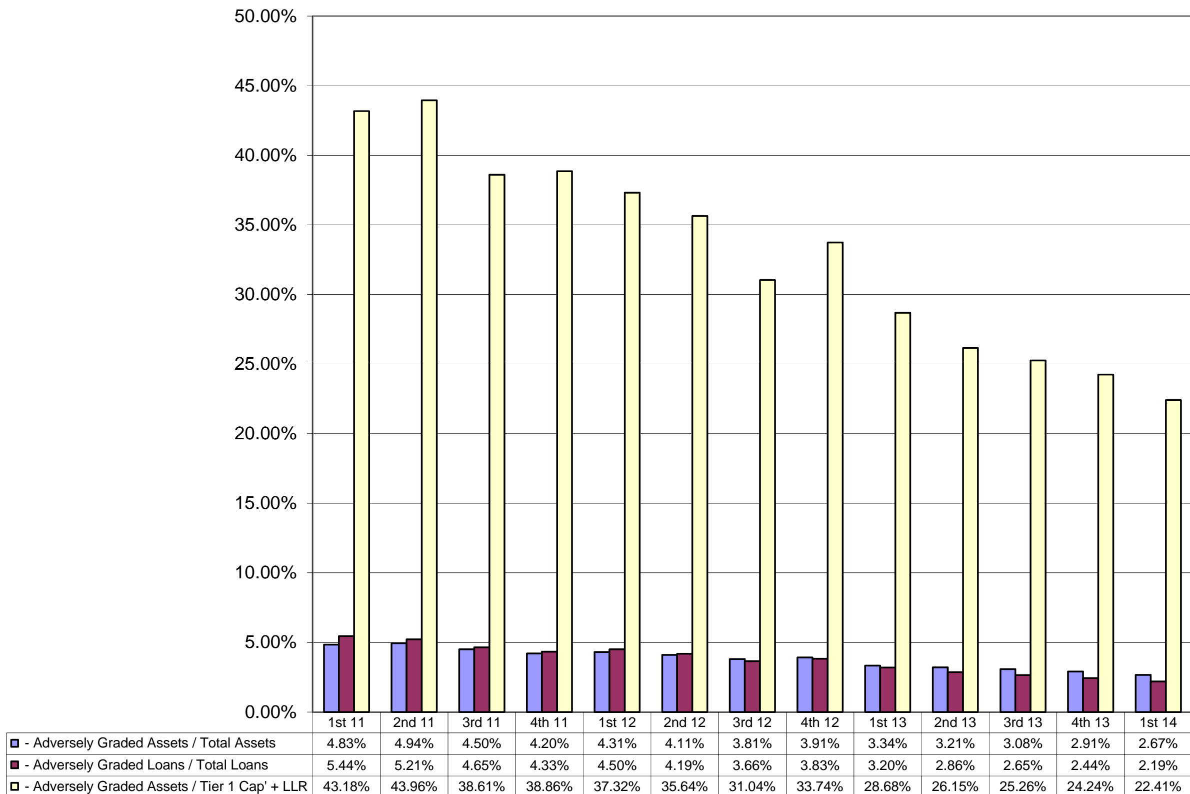
With the outlier data points excluded, problem assets averaged 6.45% of total assets, 7.26% of total loans, and 68.13% of tier-one capital plus loan loss reserve. First Quarter 2014 modified data compares to the following Fourth Quarter 2013 modified average data set:

- 6.96% of total assets
- 7.79% of total loans, and
- 72.27% of tier-one capital plus loan loss reserve

Median asset quality ratios within the modified data set were 4.68% of total assets, 5.67% of total loans, and 38.95% of tier-one capital plus loan loss reserve. First Quarter 2014 modified data compares to the following Fourth Quarter 2013 modified average data set:

- 5.17% of total assets,
- 6.50% of total loans, and
- 42.43% of tier-one capital plus loan loss reserve

# Tier Group 1

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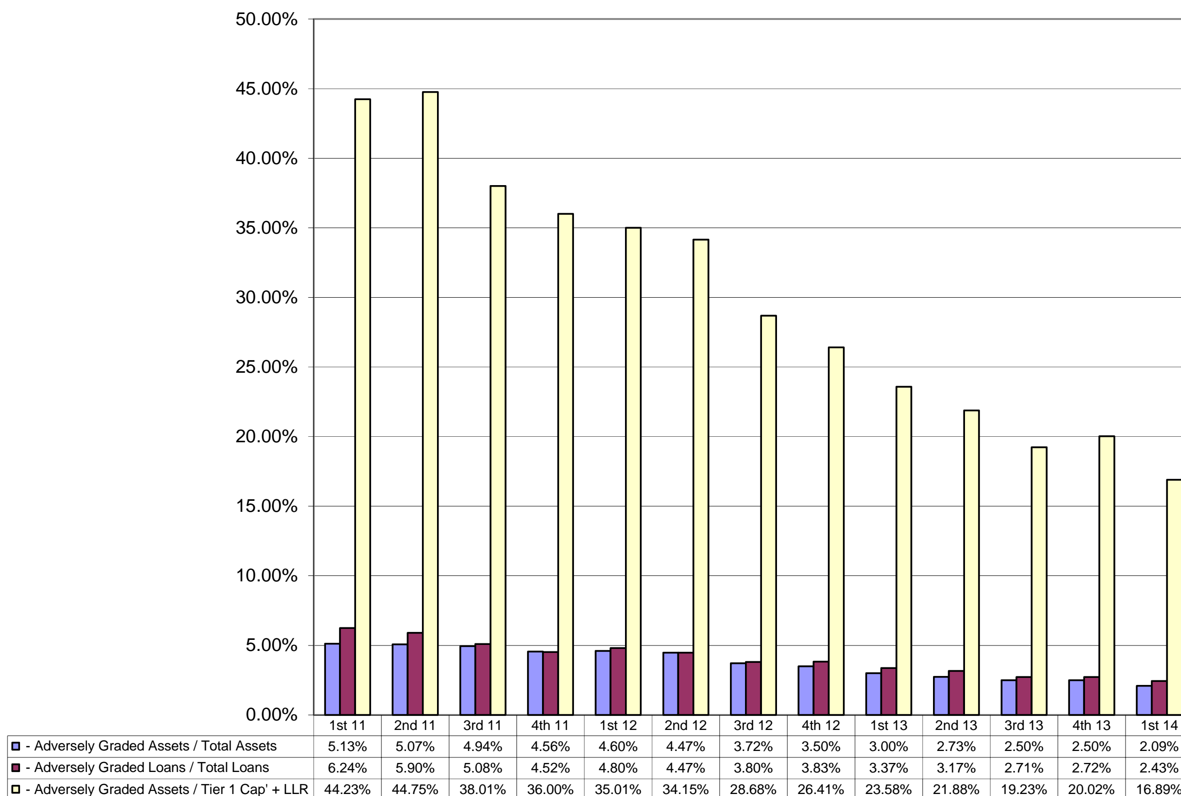
| - Adversely Graded Assets / Total Assets | 4.83% | 4.94% | 4.50% | 4.20% | 4.31% | 4.11% | 3.81% | 3.91% | 3.34% | 3.21% | 3.08% | 2.91% | 2.67% |
| - Adversely Graded Loans / Total Loans | 5.44% | 5.21% | 4.65% | 4.33% | 4.50% | 4.19% | 3.66% | 3.83% | 3.20% | 2.86% | 2.65% | 2.44% | 2.19% |
| - Adversely Graded Assets / Tier 1 Cap' + LLR | 43.18% | 43.96% | 38.61% | 38.86% | 37.32% | 35.64% | 31.04% | 33.74% | 28.68% | 26.15% | 25.26% | 24.24% | 22.41% |

# Tier Group 1 (continued)

Tier Group 1 banks' asset quality continues to improve. Classifications, as measured by the coverage ratio, are returning to historically more 'normal' levels. Banks in Tier Group 1 have seen increasing momentum in earnings. Additionally, clients in the Tier Group 1 have been able to liquidate other real estate and work-out of troubled loans at a quickening pace, and several clients have indicated increased activity for raw land held in other real estate.

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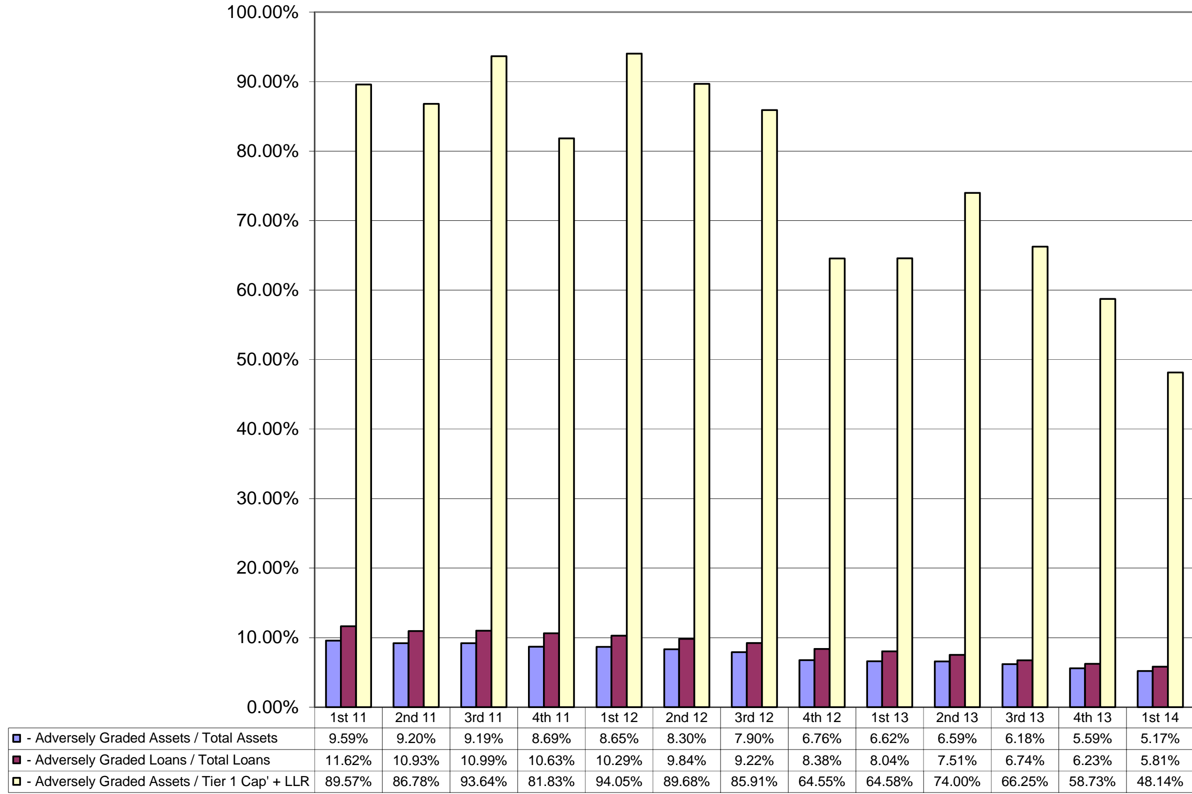
| - Adversely Graded Assets / Total Assets | 5.13% | 5.07% | 4.94% | 4.56% | 4.60% | 4.47% | 3.72% | 3.50% | 3.00% | 2.73% | 2.50% | 2.50% | 2.09% |
| - Adversely Graded Loans / Total Loans | 6.24% | 5.90% | 5.08% | 4.52% | 4.80% | 4.47% | 3.80% | 3.83% | 3.37% | 3.17% | 2.71% | 2.72% | 2.43% |
| - Adversely Graded Assets / Tier 1 Cap' + LLR | 44.23% | 44.75% | 38.01% | 36.00% | 35.01% | 34.15% | 28.68% | 26.41% | 23.58% | 21.88% | 19.23% | 20.02% | 16.89% |

# Tier Group 2

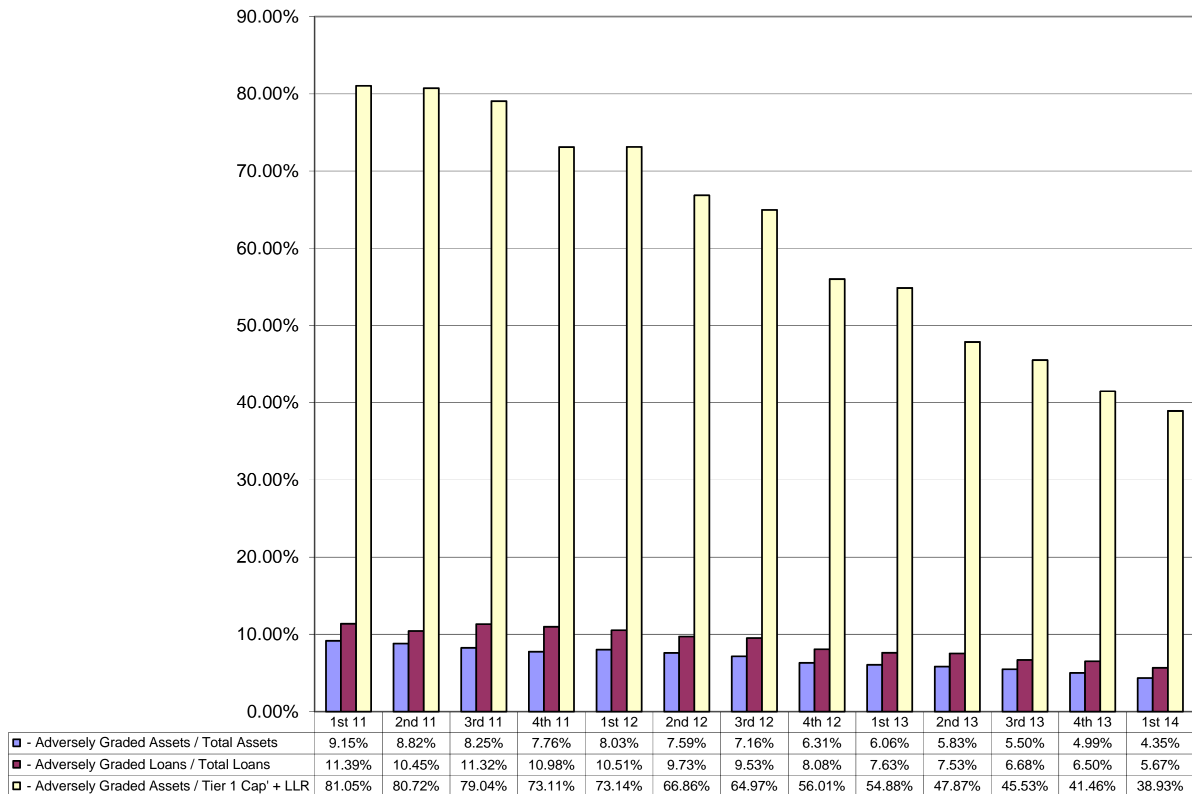



| | 1st 11 | 2nd 11 | 3rd 11 | 4th 11 | 1st 12 | 2nd 12 | 3rd 12 | 4th 12 | 1st 13 | 2nd 13 | 3rd 13 | 4th 13 | 1st 14 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| - Adversely Graded Assets / Total Assets | 9.59% | 9.20% | 9.19% | 8.69% | 8.65% | 8.30% | 7.90% | 6.76% | 6.62% | 6.59% | 6.18% | 5.59% | 5.17% |
| - Adversely Graded Loans / Total Loans | 11.62% | 10.93% | 10.99% | 10.63% | 10.29% | 9.84% | 9.22% | 8.38% | 8.04% | 7.51% | 6.74% | 6.23% | 5.81% |
| - Adversely Graded Assets / Tier 1 Cap' + LLR | 89.57% | 86.78% | 93.64% | 81.83% | 94.05% | 89.68% | 85.91% | 64.55% | 64.58% | 74.00% | 66.25% | 58.73% | 48.14% |

# Tier Group 2 (continued)

Please note the decline in both average and median classifications within Tier Group 2 banks. Both average and median classifications at Q1 2014 are materially improved when compared to classification levels during Q1 2011.

Please note the positive, continual, improvement trend in median classification, which began during Q4 2010. With improvements in asset quality, asset quality within Tier Group 2 banks varies between 2 to 4 rating on the CAMELS scale.

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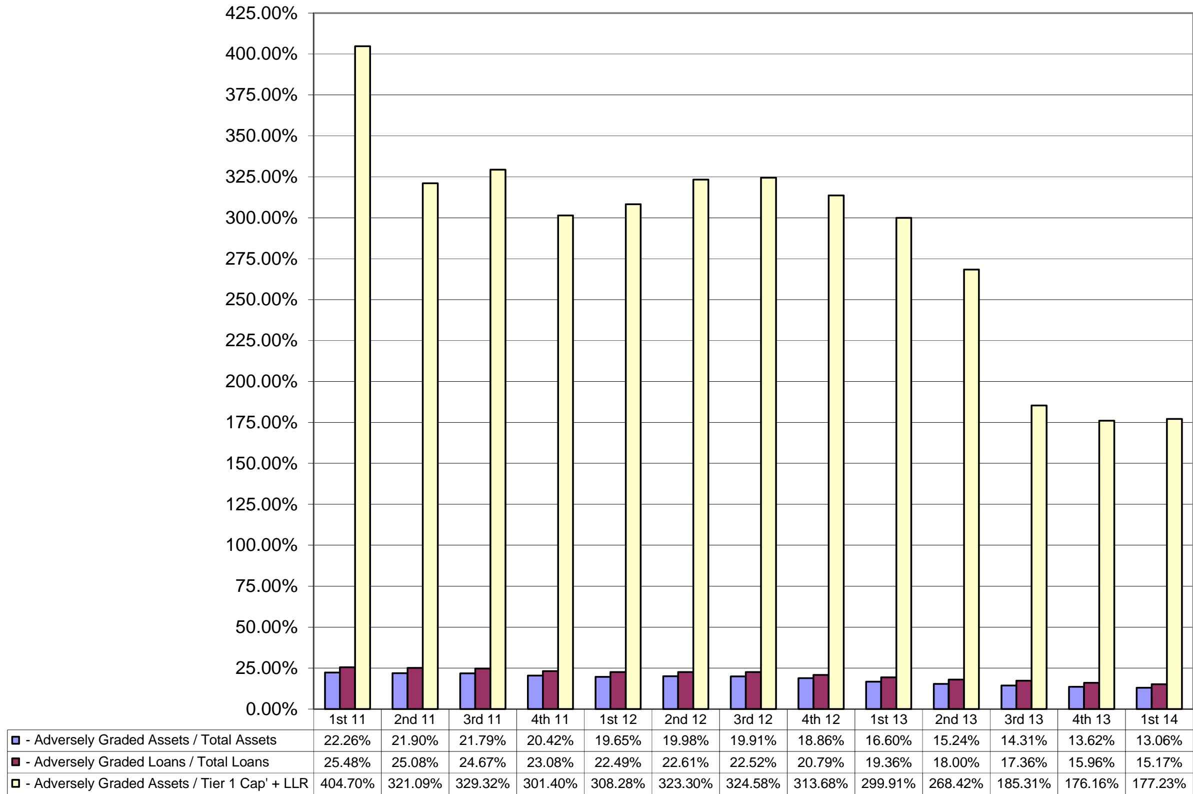
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| - Adversely Graded Assets / Total Assets | 9.15% | 8.82% | 8.25% | 7.76% | 8.03% | 7.59% | 7.16% | 6.31% | 6.06% | 5.83% | 5.50% | 4.99% | 4.35% |
| - Adversely Graded Loans / Total Loans | 11.39% | 10.45% | 11.32% | 10.98% | 10.51% | 9.73% | 9.53% | 8.08% | 7.63% | 7.53% | 6.68% | 6.50% | 5.67% |
| - Adversely Graded Assets / Tier 1 Cap' + LLR | 81.05% | 80.72% | 79.04% | 73.11% | 73.14% | 66.86% | 64.97% | 56.01% | 54.88% | 47.87% | 45.53% | 41.46% | 38.93% |

# Tier Group 3

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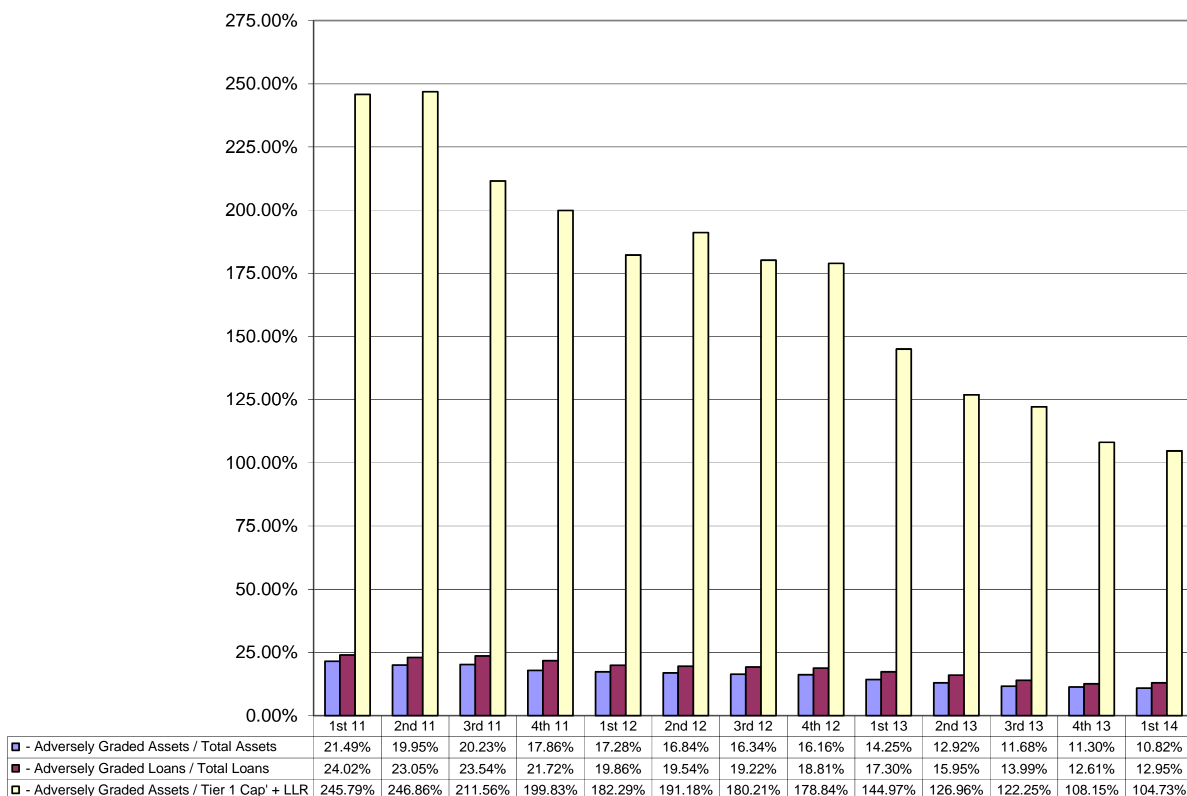
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| - Adversely Graded Assets / Total Assets | 22.26% | 21.90% | 21.79% | 20.42% | 19.65% | 19.98% | 19.91% | 18.86% | 16.60% | 15.24% | 14.31% | 13.62% | 13.06% |
| - Adversely Graded Loans / Total Loans | 25.48% | 25.08% | 24.67% | 23.08% | 22.49% | 22.61% | 22.52% | 20.79% | 19.36% | 18.00% | 17.36% | 15.96% | 15.17% |
| - Adversely Graded Assets / Tier 1 Cap' + LLR | 404.70% | 321.09% | 329.32% | 301.40% | 308.28% | 323.30% | 324.58% | 313.68% | 299.91% | 268.42% | 185.31% | 176.16% | 177.23% |

## Tier Group 3 (continued)

Tier Group 3 data, while still reflecting excessive levels of classifications, continues to reflect general improvement. Note that, if current trends hold true, the median level of adversely graded assets in Tier Group 3 will drop below 100% in 2014.

As based on average classifications, Tier Group 3 banks' average asset quality, as measured by the adversely graded assets divided by tier-1 capital + LLR, has slightly increased from approximately 176% to 177%. The increase is due to outliers as an improvement in the median radio was noted.

Asset quality within Tier Group 3 banks remains a 5 rating on the CAMELS scale.

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|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| - Adversely Graded Assets / Total Assets | 21.49% | 19.95% | 20.23% | 17.86% | 17.28% | 16.84% | 16.34% | 16.16% | 14.25% | 12.92% | 11.68% | 11.30% | 10.82% |
| - Adversely Graded Loans / Total Loans | 24.02% | 23.05% | 23.54% | 21.72% | 19.86% | 19.54% | 19.22% | 18.81% | 17.30% | 15.95% | 13.99% | 12.61% | 12.95% |
| - Adversely Graded Assets / Tier 1 Cap' + LLR | 245.79% | 246.86% | 211.56% | 199.83% | 182.29% | 191.18% | 180.21% | 178.84% | 144.97% | 126.96% | 122.25% | 108.15% | 104.73% |

## Current Banking Environment

*OCC Fact Sheets: Southern District, April 22, 2014*

The following was taken from the most recent OCC Fact Sheet form its Southern District. The OCC's Southern District includes banks in Alabama, Arkansas, Florida, Georgia, Louisiana, Mississippi, Oklahoma, Tennessee, and Texas. Banks within the nine state area doubled loan growth from 2012 to 2013.

District average return on average assets increased slightly to 0.75 percent in the fourth quarter of 2013, up from 0.72 percent a year ago.

- This increase is primarily attributable to a continued reduction in provision for loan loss expenses going from 0.21 percent to 0.11 percent of average assets. However, reductions in provision levels have declined to about as low as they can go, and there should be little additional future earnings improvement from this source.
- Other factors improving earnings were a modest decline in noninterest expenses and an increasing reliance on one-time gains on investment securities. The availability of future security gains are also a limited source and will provide limited future earnings support.

Generating sustainable earnings growth remains difficult.

- Seventy-three percent of Southern District banks saw their net interest margin decline by at least 20 basis points.
- Only 17 percent of district institutions reflected a significant increase of 10 basis points or more to their net interest margin.
- Competitive pressures and the continuing low interest rate environment make it difficult to obtain yields to cover overhead costs without assuming significant interest rate or credit risk.

## Current Banking Environment

*OCC Fact Sheets: Southern District, April 22, 2014 – Continued*

As also noted in SHPCO client data, the OCC found:

- Traditional credit metrics reflect improving asset quality and fewer problem assets. Assets classified as substandard, doubtful, and loss, have declined in each quarter since peaking in the first quarter 2011.

- Asset quality has improved. At the end of 2013, classified assets represented 25% of capital compared with 34% at the end of 2012.

Note that adversely classified assets, including other real estate owned, among SHPCO clients peaked in the third quarter of 2010.

Of particular importance for national bankers, the OCC sees five top risks facing banks in its Southern District:

- Strategic risk
- Sensitivity to market or interest rate risk
- Credit risk
- Compliance risk and
- Operational risk

- Competitive pressures and the sustained low-rate environment have resulted in many institutions assuming significant interest rate or credit risk.

- Loan growth is uneven and the strong competition or good quality loans in most markets is affecting pricing and putting pressure on underwriting.

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*Information obtained from the OCC Fact Sheet for the Southern District – issued April 22, 2014.*

*The original OCC publication can be found here:*

http://www.occ.gov/news-issuances/news-releases/2014/nr-occ-2014-61a.pdf

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*Information on the following page obtained from the Federal Reserve Board's publication of the Senior Loan Officer Opinion Survey on Bank Lending Practices.*

*The original FRB publication can be found here:*

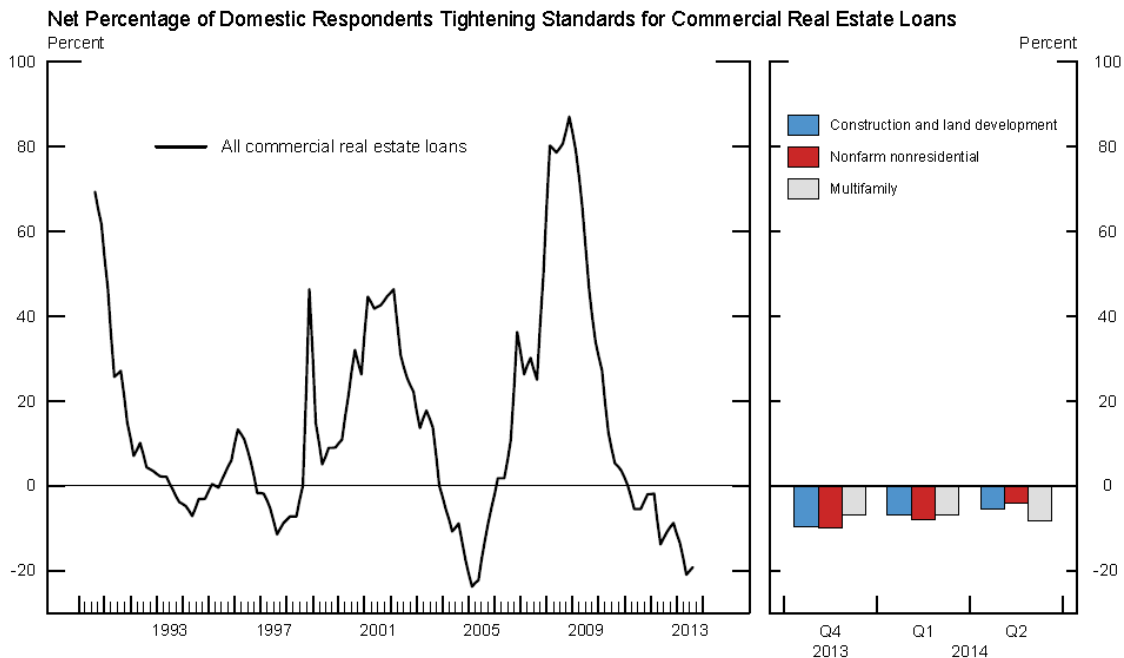
*http://www.federalreserve.gov/boarddocs/snloansurvey/201405/fullreport.pdf*
*http://www.federalreserve.gov/econresdata/statisticsdata.htm*

## Current Banking Environment

*Senior Loan Officer Opinion Survey on Bank Lending Practices – Federal Reserve Board*

According to the April 2014 Senior Loan Officer Opinion Survey on Bank Lending Practices:

- Regarding loans to businesses, banks eased their lending policies for commercial and industrial (C&I) and commercial real estate (CRE) loans.
- On net, banks eased standards on consumer credit card and auto loans and tightened standards on nontraditional closed-end mortgage loans.




National statistics, as well as observations noted during SHPCO quarterly loan reviews, show an ease in the strictness of lending standards for both C&I and CRE loans.

The ease in policy and underwriting standards again appears to be attributable to competitive pressure and desire for loan growth. FRB information on this page and the following page corroborate OCC data regarding an increase in credit and interest rate risk.

## Current Banking Environment

As well as an ease in the strictness of lending policies, answers to the FRB survey note a sizeable reduction in the spread over cost of funds for both C&I and CRE loans.

- In regard to CRE lending:

c. Spread of loan rates over your bank's cost of funds (wider spreads=tightened; narrower spreads=eased)

| | All Respondents | | Large Banks | | Other Banks | |
|---|---|---|---|---|---|---|
| | **Banks** | **Percent** | **Banks** | **Percent** | **Banks** | **Percent** |
| Tightened considerably | 1 | 1.4 | 1 | 2.6 | 0 | 0.0 |
| Tightened somewhat | 3 | 4.1 | 1 | 2.6 | 2 | 5.9 |
| Remained basically unchanged | 35 | 47.9 | 14 | 35.9 | 21 | 61.8 |
| Eased somewhat | 32 | 43.8 | 21 | 53.8 | 11 | 32.4 |
| Eased considerably | 2 | 2.7 | 2 | 5.1 | 0 | 0.0 |
| **Total** | 73 | 100.0 | 39 | 100.0 | 34 | 100.0 |

- In regard to C&I lending (for firms with annual sales of < $50 million):

d. Spreads of loan rates over your bank's cost of funds (wider spreads=tightened, narrower spreads=eased)

| | All Respondents | | Large Banks | | Other Banks | |
|---|---|---|---|---|---|---|
| | **Banks** | **Percent** | **Banks** | **Percent** | **Banks** | **Percent** |
| Tightened considerably | 0 | 0.0 | 0 | 0.0 | 0 | 0.0 |
| Tightened somewhat | 2 | 2.8 | 0 | 0.0 | 2 | 5.7 |
| Remained basically unchanged | 30 | 42.3 | 16 | 44.4 | 14 | 40.0 |
| Eased somewhat | 38 | 53.5 | 19 | 52.8 | 19 | 54.3 |
| Eased considerably | 1 | 1.4 | 1 | 2.8 | 0 | 0.0 |
| **Total** | 71 | 100.0 | 36 | 100.0 | 35 | 100.0 |

*Information on the following page obtained from publications of the FDIC's Division of Research and Statistics.*

*The original FDIC publications can be found here:*

*http://www.fdic.gov/bank/historical/history/3_85.pdf*
*http://www.fdic.gov/bank/historical/history/vol2/panel3.pdf*

## Current Banking Environment

The recent banking crisis and recession prompts self-reflection within the banking industry. Where did we go wrong and what have we learned?

In the same manner, in 1997 the FDIC's Division of Research and Statistics examined the banking crisis of the 1980's and early 1990's, during which more than 1600 FDIC-insured banks failed. Common themes were found present in the four major recessions associated with bank failures during that period:

1. Each followed a period of rapid expansion; in most cases, cyclical forces were accentuated by external factors.

2. In all four recessions, speculative activity was evident. "Expert" opinion often gave support to overly optimistic expectations.

3. In all four cases there were wide swings in real estate activity, and these contributed to the severity of the regional recessions.

4. Commercial real estate markets in particular deserve attention because boom and bust activity in these markets was one of the main causes of losses at both failed and surviving banks.

A quick glance will see that all of these characteristics were present in the recent recession as well. A corresponding symposium offered retrospect on regulatory actions as well as the following observation:

- The biggest danger for financial institutions is lending based on excessive optimism generated about certain kinds of lending that are the fashion of the day.

In summary, OCC and SHPCO data indicate steady asset quality improvement in the southeast. Recent OCC publications warn against loosening underwriting standards and historic FDIC publications warn against trendy lending – both brought on by hunger for overall growth and growth above or comparable to an institution's peer group. To further the indicated improvement, institutions are encouraged to maintain core underwriting standards, continue monitoring credit concentrations, and lend only in areas that are well understood by bank lenders and management.

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