

Steve H. Powell & Company

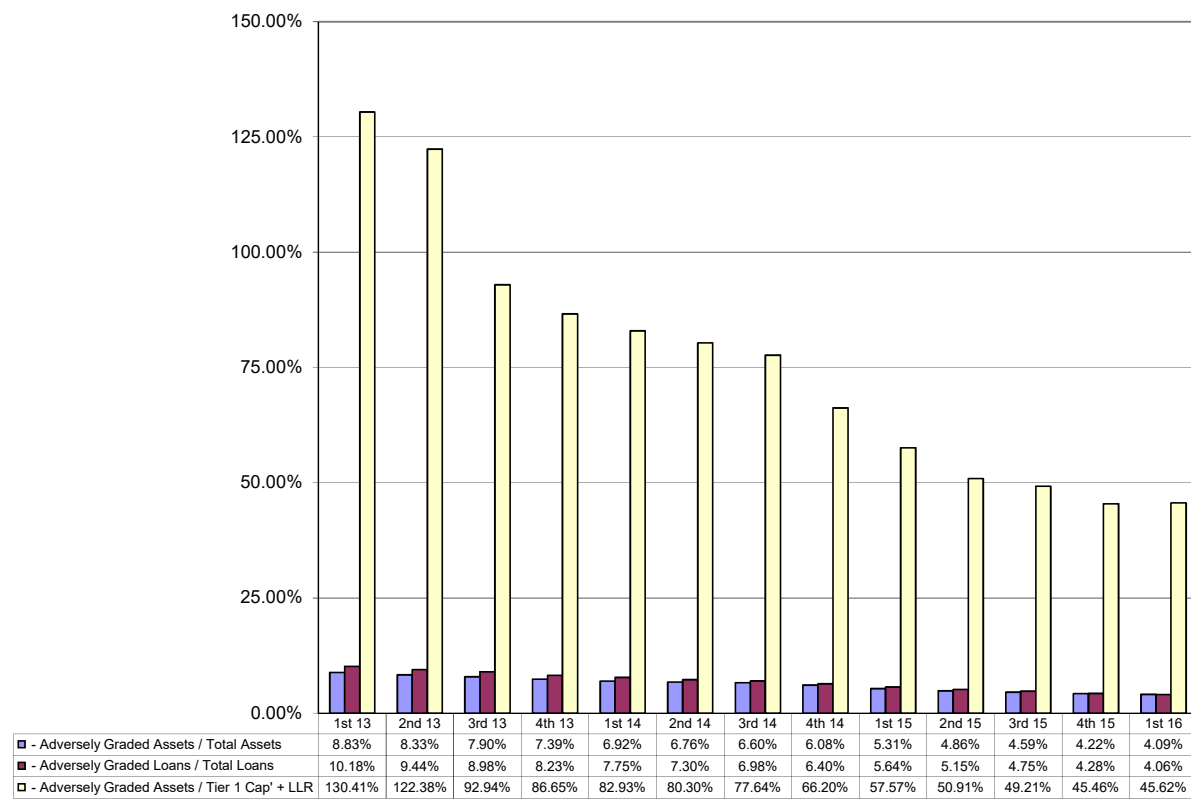
Quarterly Newsletter

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Q1 2016

Trends in Asset Quality

TRENDS IN ASSET QUALITY
AVERAGE LEVEL OF ADVERSELY GRADED ASSETS

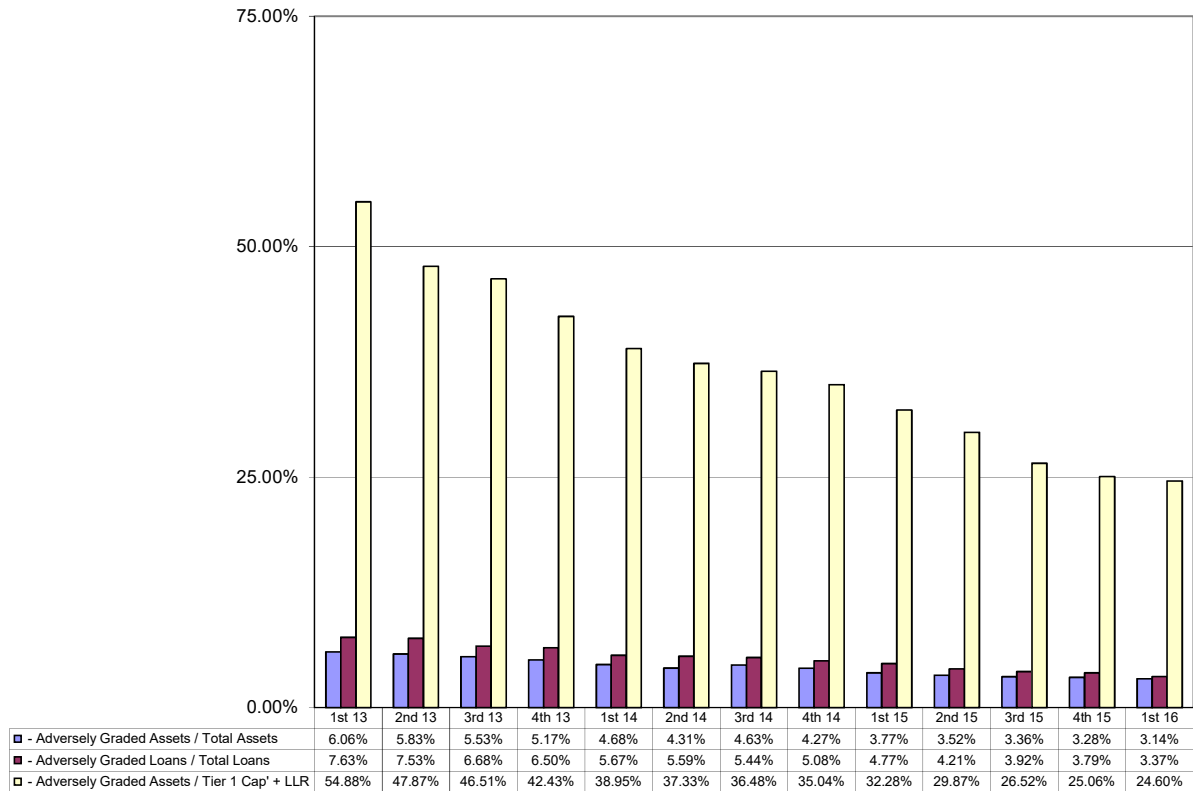


Based on Steve H. Powell & Company client data, during the First Quarter 2016, the average level of adversely graded assets decreased as a percentage of total assets and capital. Also, the average level of adversely graded loans decreased as a percentage of total loans. Problem assets averaged 4.09% of total assets and 45.62% of tier-one capital plus loan loss reserve as compared to 4.22% of total assets and 45.46% of tier-one capital plus loan loss reserve while problem loans averaged 4.06% of total loans as compared to 4.28% of total loans during the Fourth Quarter 2015.

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.

Median Level of Problem

TRENDS IN ASSET QUALITY
MEDIAN LEVEL OF ADVERSELY GRADED ASSETS



The median level of problem assets as of Q1 2016 decreased to 24.60% of tier-one capital plus loan loss reserve as compared to 25.06% during Q4 2015. Note the downward trend as overall asset quality continues to improve.

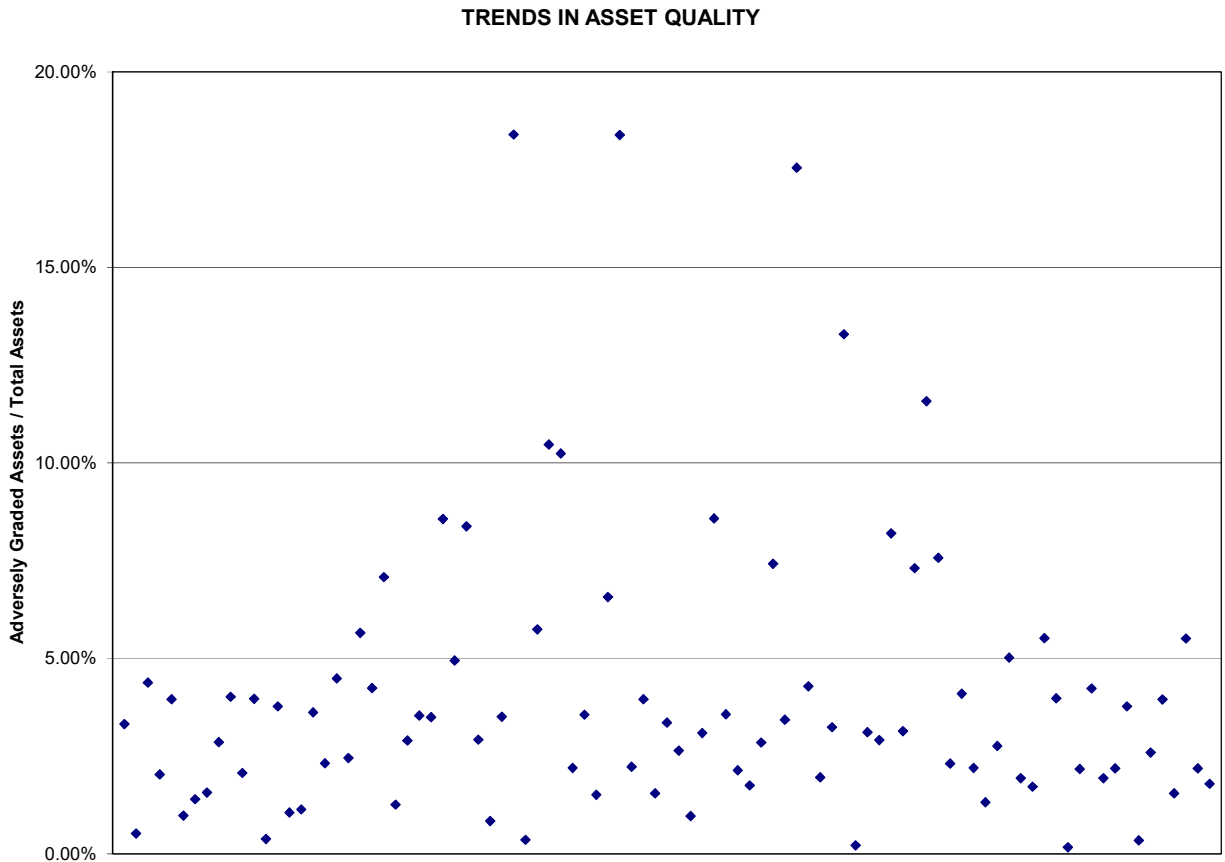
Historical Comparisons

During Q1 2016, increases in problem assets, as measured by adversely graded assets divided by tier-one capital plus loan loss reserve, were noted in approximately 23% of our clients. This quarter's increase compares to:

- 18% during the Fourth Quarter 2015
- 8% during the Third Quarter 2015
- 11% during the Second Quarter 2015
- 15% during the First Quarter 2015
- 12% during the Fourth Quarter 2014, and
- 15% during the Third Quarter 2014

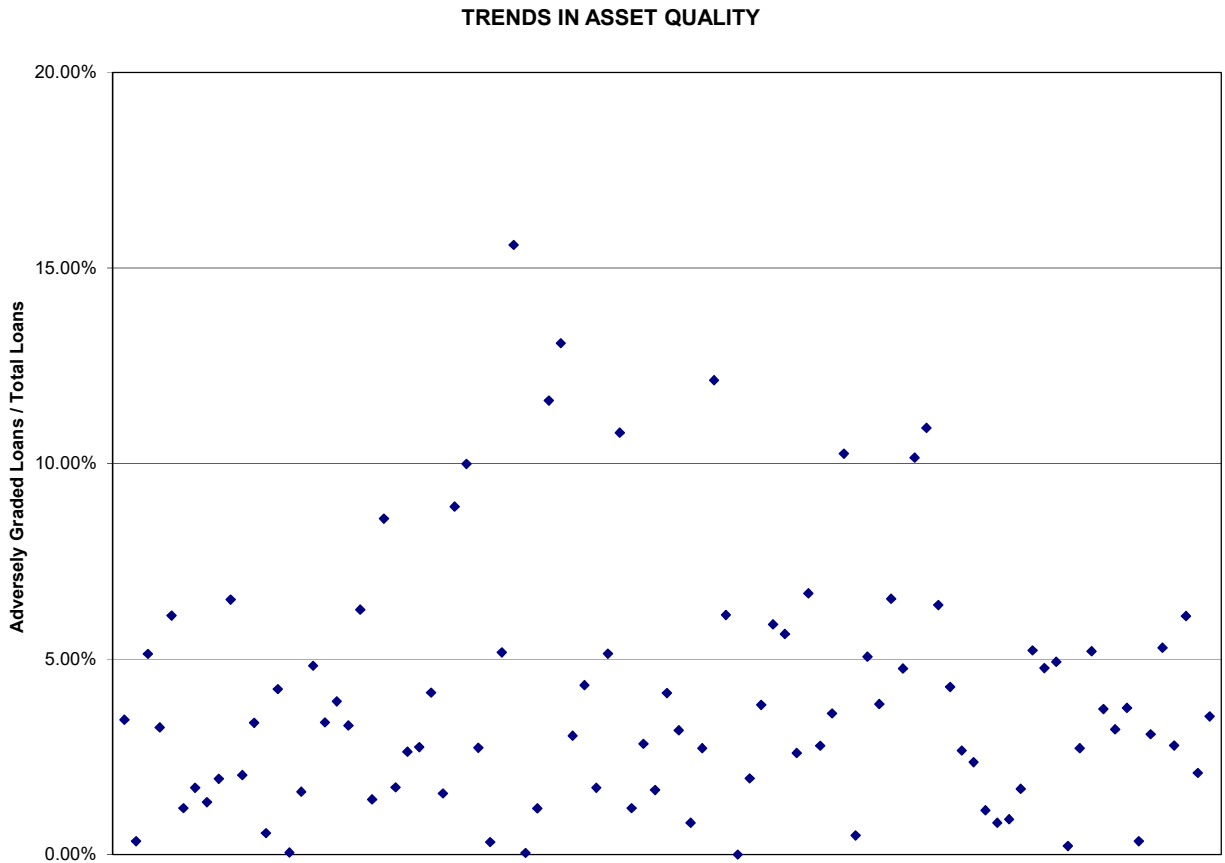
A higher level of volatility in the percentage of increases may be expected as overall asset quality stabilizes; however, increases may indicate a rise in portfolio risk.

Dispersion of Problem Assets as a Percentage of Total



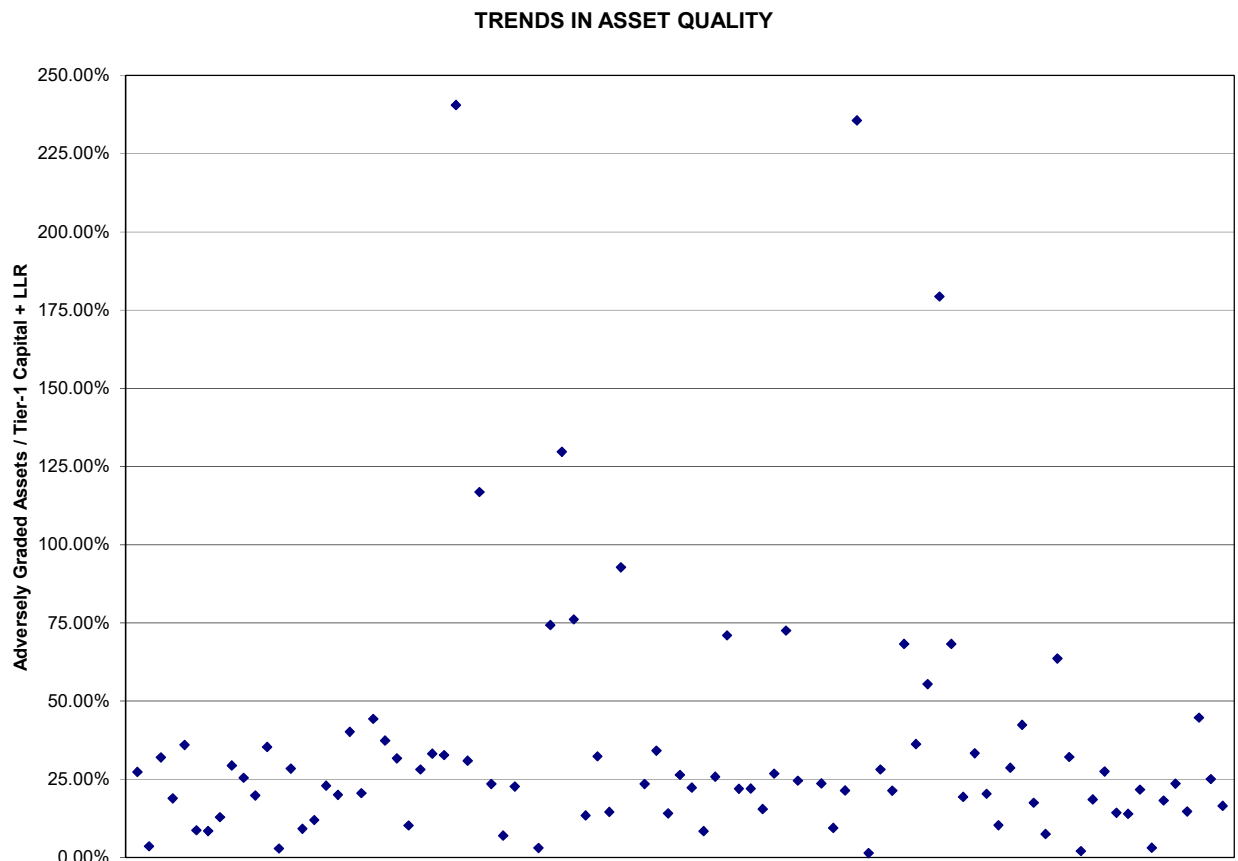
The above graph shows the dispersion of problem assets as a percentage of total assets. A traditional benchmark for significant asset quality concern is adversely graded assets that exceed 10% of total assets.

Dispersion of Problem Loans as a Percentage of Total



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

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



Please note that three data points have been excluded in order to prevent graph skewing.

Historical Comparisons

Our sample group includes sixteen (16) banks with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

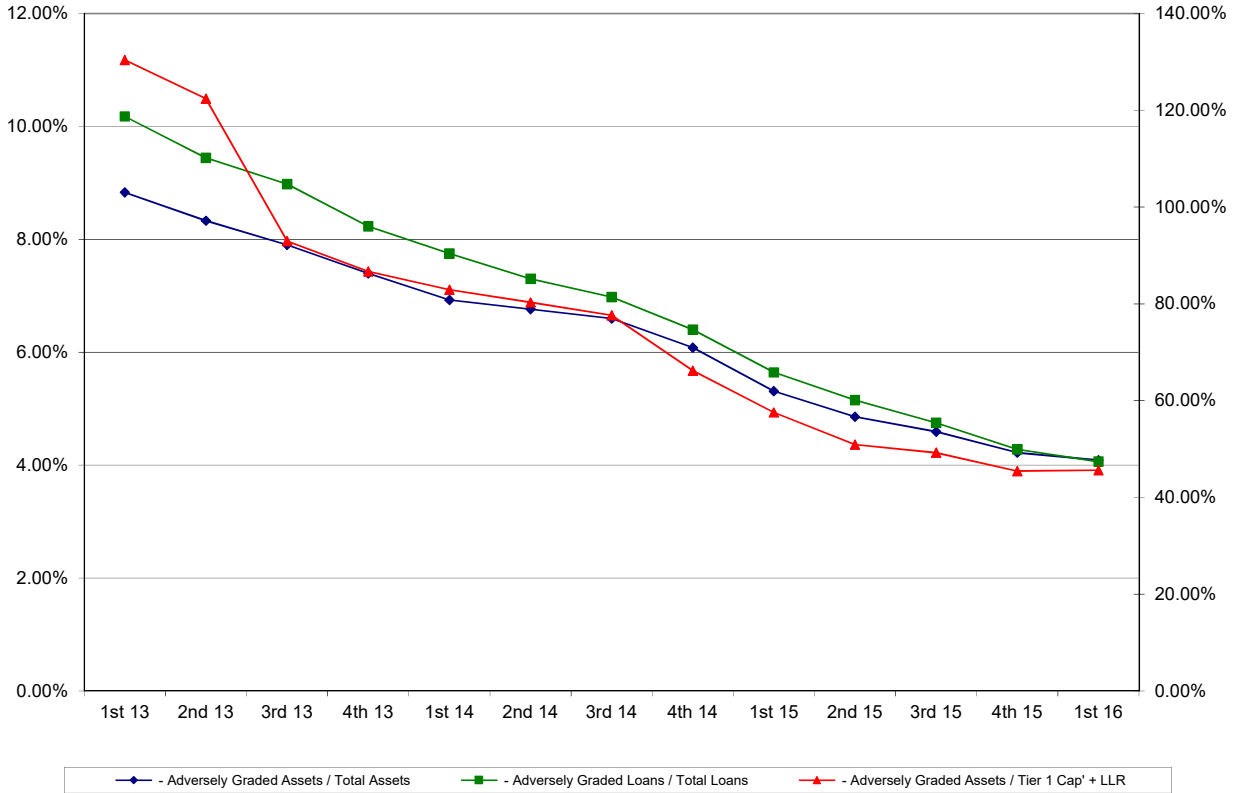
- Sixteen (16) during the Fourth Quarter 2015
- Fifteen (15) during the Third Quarter 2015
- Eighteen (18) during the Second Quarter 2015, and
- Twenty one (21) during the First Quarter 2015

Nine (9) 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 Fourth Quarter 2015
- Ten (10) during the Third Quarter 2015
- Twelve (12) during the Second Quarter 2015, and
- Fourteen (14) during the First Quarter 2015

Problem Asset Trend Analysis

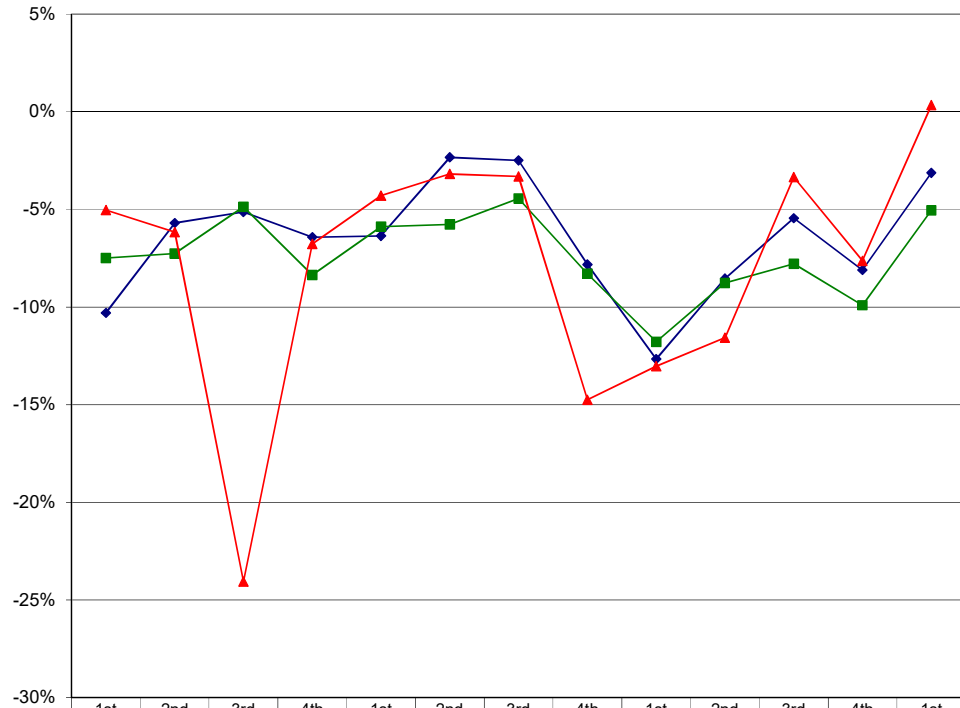
PROBLEM ASSET TREND ANALYSIS



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.

Comparative Percentage Change in Adversely Graded

COMPARATIVE % CHANGE IN ADVERSELY CLASSIFIED ASSETS
 Comparative to Assets, Loans and Tier One Capital + LLR



◆ % Change in ACA/TA	-10.29%	-5.69%	-5.12%	-6.42%	-6.35%	-2.33%	-2.48%	-7.82%	-12.66%	-8.53%	-5.44%	-8.10%	-3.13%
■ % Change in ACL/TL	-7.48%	-7.25%	-4.86%	-8.35%	-5.88%	-5.77%	-4.44%	-8.29%	-11.77%	-8.76%	-7.79%	-9.90%	-5.04%
▲ % Change in ACA/Tier 1 Cap + LLR	-5.03%	-6.16%	-24.06%	-6.76%	-4.29%	-3.17%	-3.31%	-14.74%	-13.03%	-11.57%	-3.33%	-7.63%	0.35%

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. Though the average level of adversely classified assets as compared to tier-one capital plus loan loss reserve increased, the median level continued a declining trend.

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 3.74% of total assets, 4.00% of total loans, and 36.55% of tier-one capital plus loan loss reserve. First Quarter 2016 modified data compares to the following Fourth Quarter 2015 modified average data set:

- 3.86% of total assets
- 4.21% of total loans, and
- 36.90% of tier-one capital plus loan loss reserve

Median asset quality ratios within the modified data set were 3.14% of total assets, 3.38% of total loans, and 24.60% of tier-one capital plus loan loss reserve. First Quarter 2016 modified data compares to the following Fourth Quarter 2015 modified median data set:

- 3.28% of total assets
 - 3.30% of total loans, and
 - 25.06% of tier-one capital plus loan loss reserve
-

Agriculture Carry Over Debt

Industry data and our findings during our reviews indicate downward creep in agriculture loan quality and a material increase in carry over debt. As per Regulatory definition, agriculture carry-over debt is:

The portion of an Ag operating line that the borrower cannot repay from operating production revenue (for example, from crop, livestock, or milk sales). It represents a substitute for investment capital and must be serviced through future cash flow, sale of unencumbered assets, or other sources.

Funding carry over debt is a part of lending in the agriculture industry and not inherently 'bad'. Agriculture debt, as with all other lending, will be viewed on overall underwriting, concentrations of credit and the segment's asset quality. Equity in hard collateral, dirt lending alone, is not sufficient to prevent regulatory criticism of agriculture carry over debt.

The presence of significant carryover debt may require restructuring the borrower's overall debt exposure. Depending on variables including the borrower's leverage position, projected cash flows, and balance sheet, it may be appropriate to restructure carryover debt into amortizing medium-term loans while continuing to finance current operations with short-term loans.

Of particular concern are borrowers with multiple years of carry over debts and loans that have been granted on extended amortization periods – in excess of five years. For some farmers, alternate means of repayment (outside of asset liquidation) would not appear to exist. Regulatory guidance is clear; the carry over loans are to be identified, collateralized, and properly structured.

A best practice is to segregate operating notes by crop year and not comingle operating proceeds between the different growing seasons. If loan proceeds are comingled for more than one crop year, management should be able to document the operating proceeds for each year to support management's risk ratings and repayment analysis. When collateral does not cover carryover debt and repayment capacity is not evidenced, the carryover balance should be classified and the examiner needs to determine whether a loss rating is appropriate.

Regulatory guidance indicates that carry over debt is not inherently 'bad', but how the debt is rated in an examination will depend on file documentation and underwriting. Collateral, or loan to value, alone will likely not be sufficient to prevent regulatory criticism. As with all loan relationships, the bank is expected to fully document and underwrite both borrower and global repayment ability.

SOURCE: <http://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/pub-ch-agricultural-lending.pdf>

Commercial Real Estate

Many recent regulatory communications have highlighted increasing concern regarding CRE lending and concentrations. Most of the regulatory issuances have stressed historical standards and publications.

The joint agency publication “Statement on Prudent Risk Management for Commercial Real Estate Lending” issued during December 2015 reiterated several items from historical publications. The joint issuance is clear on increased expectations for banks with higher CRE concentrations:

During 2016, supervisors from the banking agencies will continue to pay special attention to potential risks associated with CRE lending. When conducting examinations that include a review of CRE lending activities, the agencies will focus on financial institutions’ implementation of the prudent principles in the Concentration Guidance as well as other applicable guidance relative to identifying, measuring, monitoring, and managing concentration risk in CRE lending activities. In particular, the agencies will focus on those financial institutions that have recently experienced, or whose lending strategy plans for, substantial growth in CRE lending activity, or that operate in markets or loan segments with increasing growth or risk fundamentals. The agencies may ask financial institutions found to have inadequate risk management practices and capital strategies to develop a plan to identify, measure, monitor, and manage CRE concentrations, to reduce risk tolerances in their underwriting standards, or to raise additional capital to mitigate the risk associated with their CRE strategies or exposures.

SOURCE:

<https://fdic.gov/news/news/press/2015/pr15100a.pdf>

Real Estate Appraisals

We have fielded numerous calls regarding real estate appraisal and evaluation requirements – spurred by the FDIC’s March 2016 FIL-16-2016 addressing expectations of real estate evaluations.

According to the FIL:

Under the appraisal regulations, the following transaction types do not require an appraisal, but do require an evaluation:

- Transactions where the “transaction value” (generally the loan amount) is \$250,000 or less;
- Certain renewals, refinances, or other transactions involving existing extensions of credit; and
- Real estate-secured business loans with a transaction value of \$1,000,000 or less and when the sale of, or rental income derived from, real estate is not the primary source of repayment for the loan.

Regarding transactions that require evaluations, the December 2010 FIL “Interagency Appraisal and Evaluation Guidelines” states:

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:

- Involves an existing extension of credit at the lending institution, provided that:
 - o 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
 - o There is no advancement of new monies other than funds necessary to cover reasonable closing costs.

Real Estate Appraisals

In recent years, appraisals were nearly always required when new money was extended as the Great Recession created an obvious change in market conditions; however, when considering market conditions, a new appraisal may not always be necessary and an evaluation may suffice. Burden of proof that market conditions have not materially changed and the physical aspects of the property have not materially changed rest on the lending institution. The December 2010 FIL also notes:

To satisfy the condition for no obvious and material change in market conditions or the physical aspects of the property, the current or planned future use of the property should be consistent with the use identified in the existing appraisal or evaluation. For example, if a property has reportedly increased in value because of a planned change in use of the property resulting from rezoning, an appraisal should be performed unless another exemption applies.

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.

Uniform Standards of Professional Appraisal Practice (USPAP) is the guide for an appraiser, but should be considered minimum standards for regulatory expectations (generally referred to as FIRREA). During our field visits, we have noted a slight decline in some appraisal quality.

While fully vetted in the appraiser's scope, the omission of an approach to value could likely result in regulatory criticism. Field visits have found numerous instances in which the appraiser's substantiated scope would not appear to meet regulatory (FIRREA) requirements.

Examples include omission of the cost approach to value for construction projects. We have noted appraisals that utilize over two year old comparables that have been materially adjusted (>25% plus and minus). In addition, we have noted appraisals not utilizing a discounted cash flow method to value multiple lot subdivisions with an extended sell-out period. Each example could be deemed to be outside of FIRREA guidance.

As bankers, we should remember that the regulators:

Reserve the right to require an appraisal under this subpart whenever the agency believes it is necessary to address safety and soundness concerns.

SOURCE: <https://www.fdic.gov/news/news/financial/2016/fil16016.pdf>
<https://www.fdic.gov/news/news/financial/2010/fil10082.html>

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