Steve H. Powell & Company

Quarterly Newsletter

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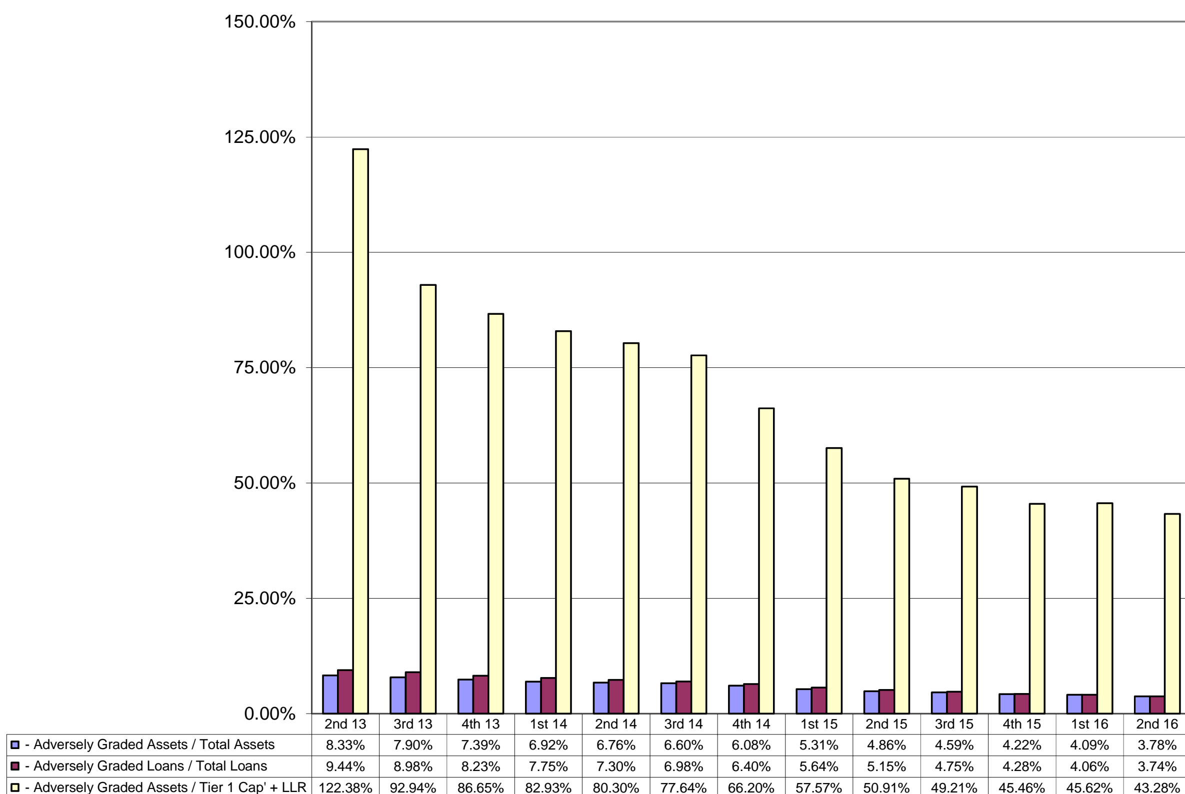
Q2 2016

Trends in Asset Quality

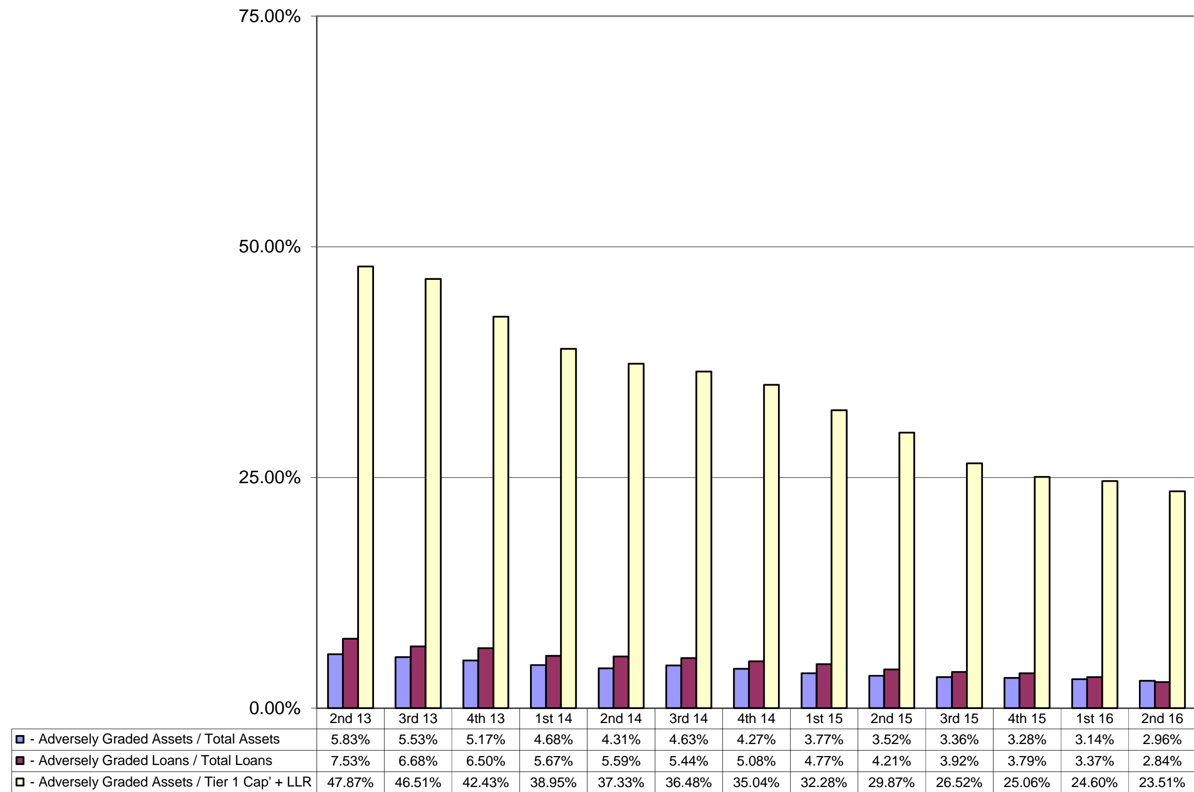


	2nd 13	3rd 13	4th 13	1st 14	2nd 14	3rd 14	4th 14	1st 15	2nd 15	3rd 15	4th 15	1st 16	2nd 16
- Adversely Graded Assets / Total Assets	8.33%	7.90%	7.39%	6.92%	6.76%	6.60%	6.08%	5.31%	4.86%	4.59%	4.22%	4.09%	3.78%
- Adversely Graded Loans / Total Loans	9.44%	8.98%	8.23%	7.75%	7.30%	6.98%	6.40%	5.64%	5.15%	4.75%	4.28%	4.06%	3.74%
- Adversely Graded Assets / Tier 1 Cap' + LLR	122.38%	92.94%	86.65%	82.93%	80.30%	77.64%	66.20%	57.57%	50.91%	49.21%	45.46%	45.62%	43.28%

Based on Steve H. Powell & Company client data, during the Second 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 3.78% of total assets and 43.28% of tier-one capital plus loan loss reserve as compared to 4.09% of total assets and 45.62% of tier-one capital plus loan loss reserve while problem loans averaged 3.74% of total loans as compared to 4.06% of total loans during the First Quarter 2016.

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 Assets



	2nd 13	3rd 13	4th 13	1st 14	2nd 14	3rd 14	4th 14	1st 15	2nd 15	3rd 15	4th 15	1st 16	2nd 16
- Adversely Graded Assets / Total Assets	5.83%	5.53%	5.17%	4.68%	4.31%	4.63%	4.27%	3.77%	3.52%	3.36%	3.28%	3.14%	2.96%
- Adversely Graded Loans / Total Loans	7.53%	6.68%	6.50%	5.67%	5.59%	5.44%	5.08%	4.77%	4.21%	3.92%	3.79%	3.37%	2.84%
- Adversely Graded Assets / Tier 1 Cap' + LLR	47.87%	46.51%	42.43%	38.95%	37.33%	36.48%	35.04%	32.28%	29.87%	26.52%	25.06%	24.60%	23.51%

The median level of problem assets as of Q2 2016 decreased to 23.51% of tier-one capital plus loan loss reserve as compared to 24.60% during Q1 2016. Note the downward trend as overall asset quality continues to improve.

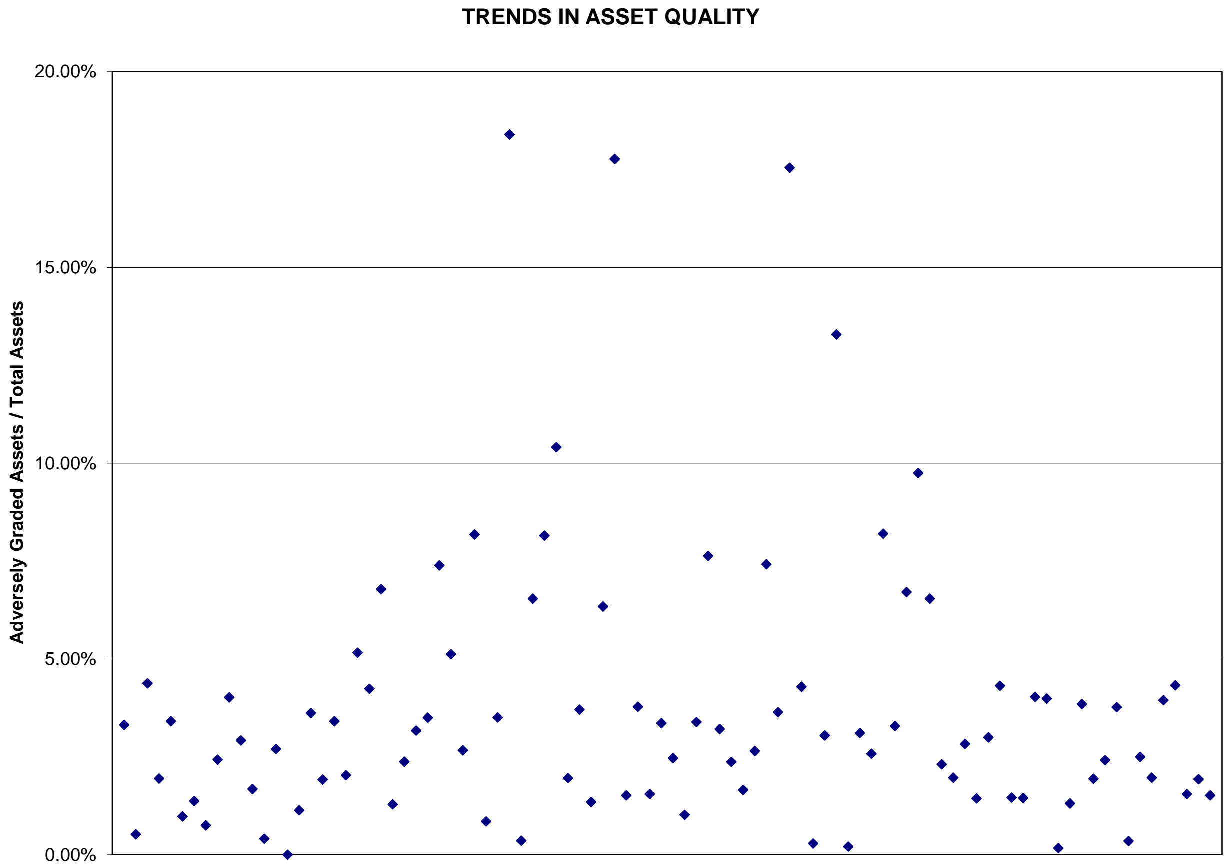
Historical Comparisons

During Q2 2016, increases in problem assets, as measured by adversely graded assets divided by tier-one capital plus loan loss reserve, were noted in approximately 19% of our clients. This quarter's increase compares to:

- 23% during the First Quarter 2016
- 18% during the Fourth Quarter 2015
- 8% during the Third Quarter 2015
- 11% during the Second Quarter 2015
- 15% during the First Quarter 2015, and
- 12% during the Fourth Quarter 2014

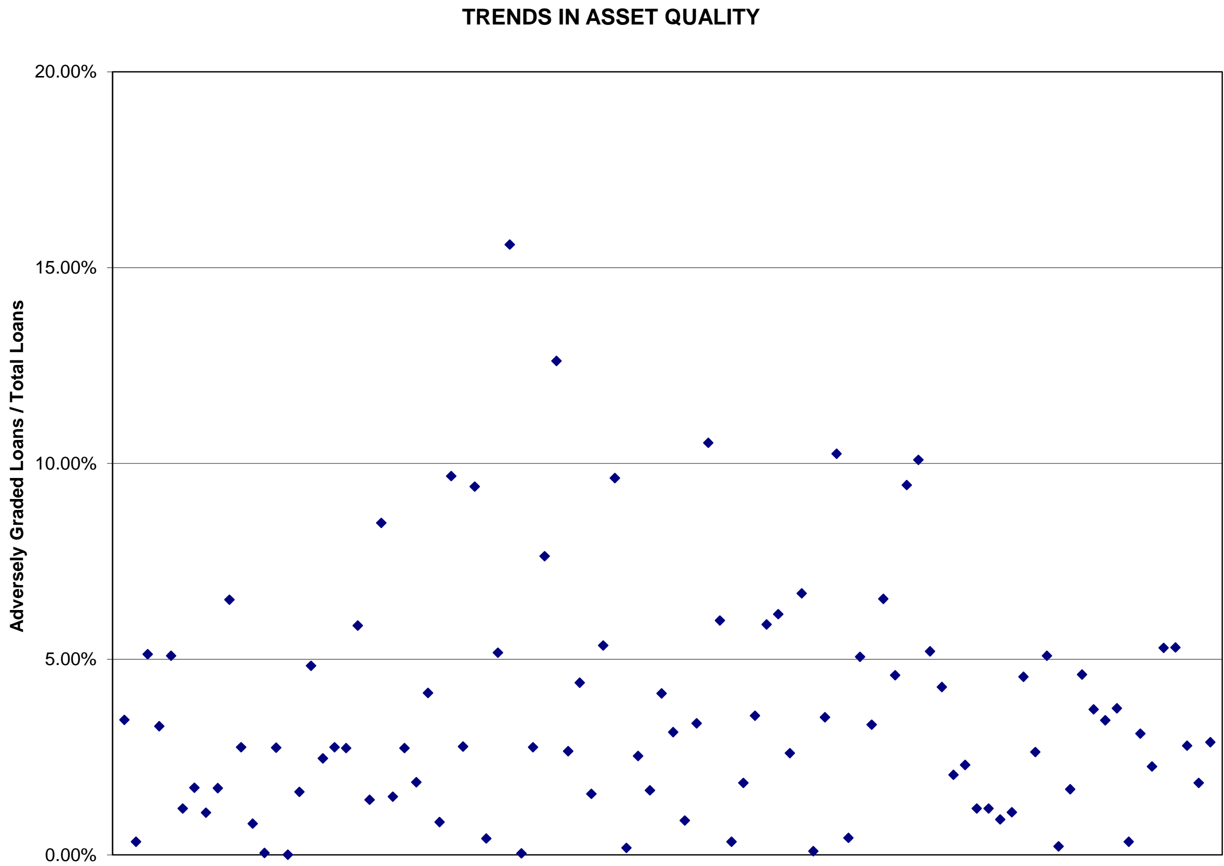
A higher level of volatility in the percentage of increases may be expected as overall asset quality stabilizes; however, increases may indicate a rise in portfolio risk.

Dispersion of Problem Assets as a Percentage of Total Assets



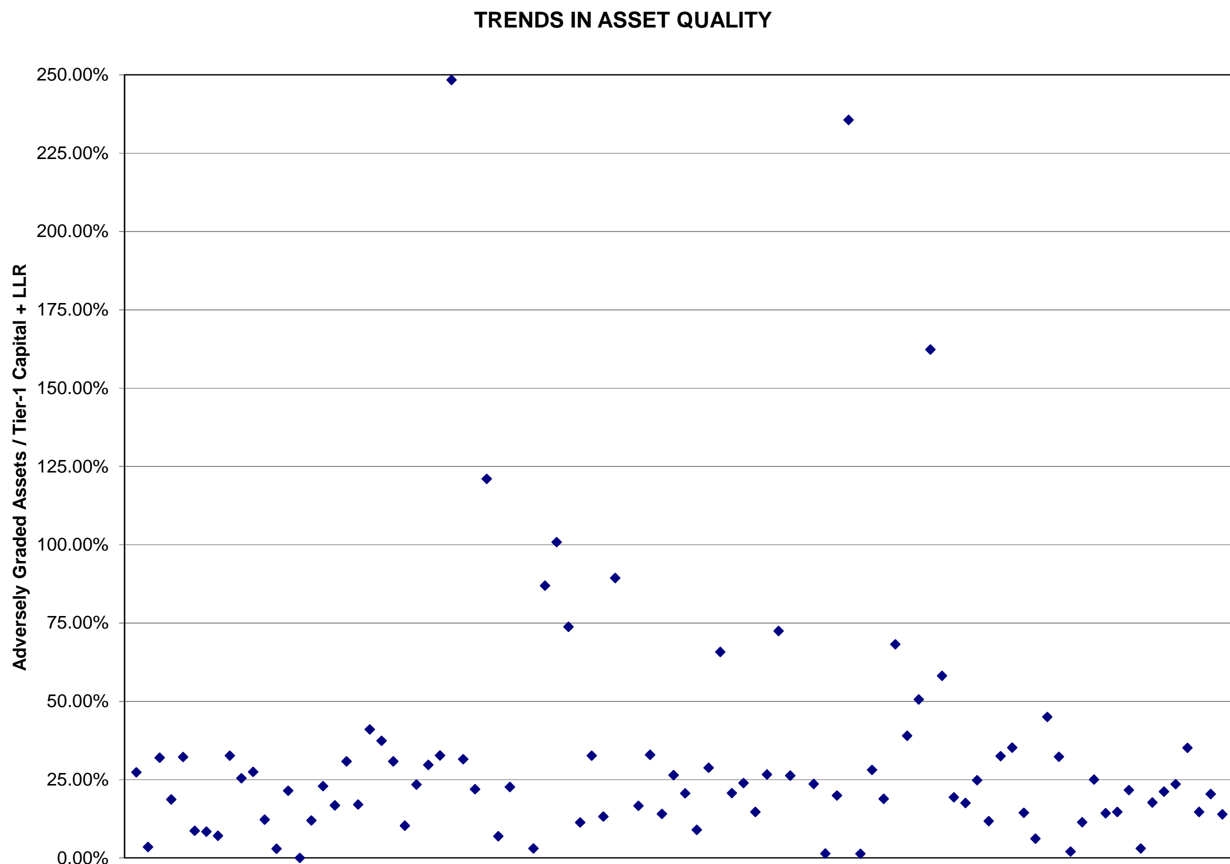
The above graph shows the dispersion of problem assets as a percentage of total assets. A traditional benchmark for significant asset quality concern is adversely graded assets that exceed 10% of total assets.

Dispersion of Problem Loans as a Percentage of Total Loans



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



Historical Comparisons

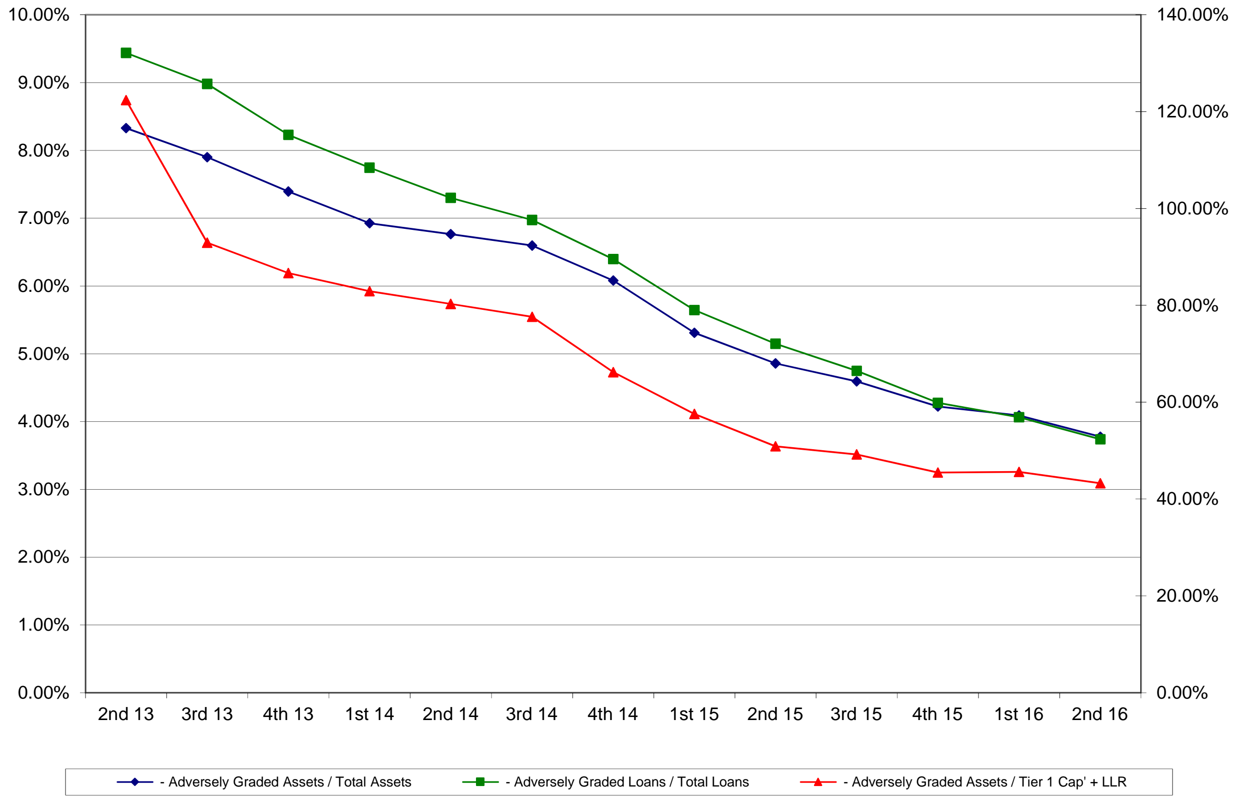
Our sample group includes sixteen (14) banks with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

- Sixteen (16) during the First Quarter 2016
- Sixteen (16) during the Fourth Quarter 2015
- Fifteen (15) during the Third Quarter 2015, and
- Eighteen (18) during the Second Quarter 2015

Ten (10) 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 First Quarter 2016
- Nine (9) during the Fourth Quarter 2015
- Ten (10) during the Third Quarter 2015, and
- Twelve (12) during the Second Quarter 2015

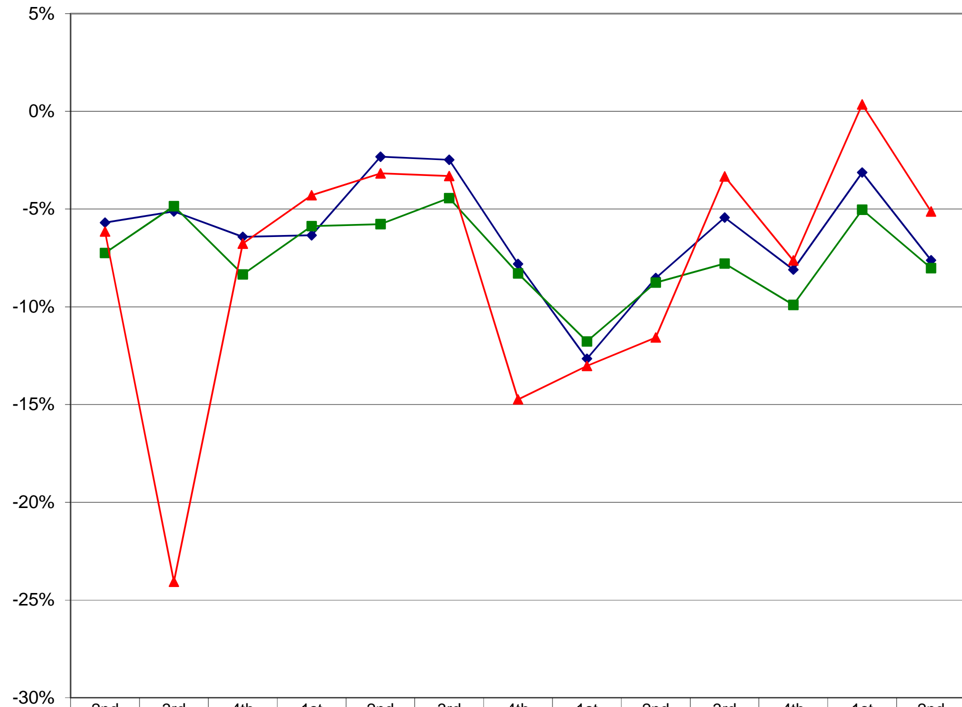
Problem Asset Trend Analysis



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.

Comparative Percentage Change in Adversely Graded Assets

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



	2nd 13	3rd 13	4th 13	1st 14	2nd 14	3rd 14	4th 14	1st 15	2nd 15	3rd 15	4th 15	1st 16	2nd 16
% Change in ACA/TA	-5.69%	-5.12%	-6.42%	-6.35%	-2.33%	-2.48%	-7.82%	-12.66%	-8.53%	-5.44%	-8.10%	-3.13%	-7.62%
% Change in ACL/TL	-7.25%	-4.86%	-8.35%	-5.88%	-5.77%	-4.44%	-8.29%	-11.77%	-8.76%	-7.79%	-9.90%	-5.04%	-8.02%
% Change in ACA/Tier 1 Cap' + LLR	-6.16%	-24.06%	-6.76%	-4.29%	-3.17%	-3.31%	-14.74%	-13.03%	-11.57%	-3.33%	-7.63%	0.35%	-5.13%

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 3.42% of total assets, 3.67% of total loans, and 34.22% of tier-one capital plus loan loss reserve. Second Quarter 2016 modified data compares to the following First Quarter 2016 modified average data set:

- 3.74% of total assets
- 4.00% of total loans, and
- 36.55% of tier-one capital plus loan loss reserve

Median asset quality ratios within the modified data set were 2.96% of total assets, 2.99% of total loans, and 23.51% of tier-one capital plus loan loss reserve. Second Quarter 2016 modified data compares to the following First Quarter 2016 modified median data set:

- 3.14% of total assets
- 3.38% of total loans, and
- 24.60% of tier-one capital plus loan loss reserve

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Concentrations of Credit

As commercial real estate concentrations industry-wide continue to grow, we have fielded numerous client questions regarding concentrations of credit. Various historical SHP & Co. newsletters have addressed concentrations of credit.

Historical Regulatory guidance can be reviewed in *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (December 12, 2006)*. If concentrations in CRE reach 100% in AD&C, total CRE exceeds 300%, or the bank's CRE portfolio has expanded by 50% over the previous three years, heightened exam scrutiny can reasonably be anticipated.

During July 2016, the FDIC issued guidance for banks with concentrations of credit in oil & gas industry. The FIL contains specific guidance for O&G concentrations, but the guidance could be used to monitor any concentrations – including CRE.

In addition to monitoring direct lending concentrations, institutions should attempt to quantify and monitor the following, as applicable, when analyzing the impact of expanding or contracting economic cycles on borrowers who are heavily reliant on a single industry.

- Loans to businesses that would be immediately impacted by a growing or contracting local economy
- Other borrowers who may also be impacted by a growing or contracting local economy, but not necessarily immediately
- Potential compounding effects of other concentrations in the bank's loan portfolio

FIL-49-2016

https://www.fdic.gov/news/news/financial/2016/fil16049a.pdf

https://www.federalreserve.gov/boarddocs/srletters/2007/SR0701a2.pdf

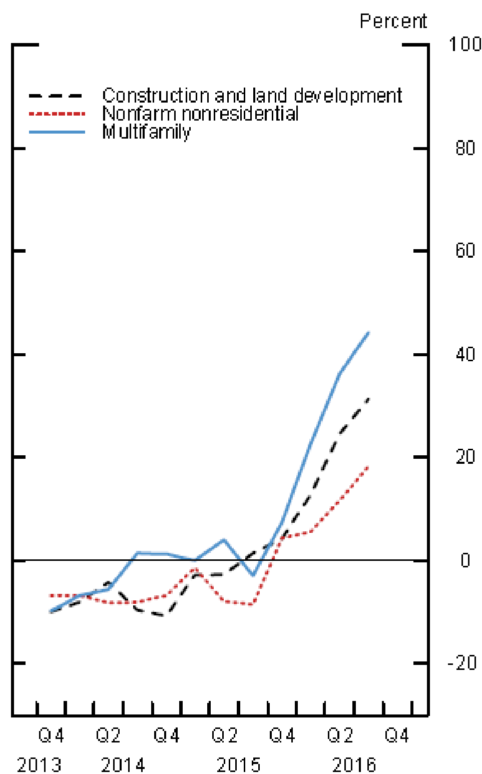
Lending Practices Survey

During July 2016, The Federal Reserve issued its *Senior Loan Officer Opinion Survey on Bank Lending Practices.* The survey included seventy one domestic banks and twenty three U.S. branches and agencies of foreign banks. As part of a community bank's portfolio and risk monitoring, the results of the Survey should be considered. Please note continued competitive pressures and changes in CRE underwriting.

- Lending standards for all categories of C&I loans are currently easier than the midpoints of the ranges that have prevailed since 2005
- Domestic banks that reported having eased either their standards or terms on C&I loans pointed to more aggressive competition from other banks or nonbank lenders as an important reason for doing so
- Standards on all types of CRE loans are currently tighter than the midpoints of their respective ranges

Domestic survey respondents generally indicated that their lending standards for CRE loans of all types tightened during the second quarter. In particular, a moderate net fraction of banks reported tightening standards for loans secured by nonfarm nonresidential properties, whereas significant net fractions of banks reported tightening standards for construction and land development loans and loans secured by multifamily residential properties.

Net Percentage of Domestic Respondents Tightening Standards for CRE Loans



https://www.federalreserve.gov/boarddocs/snloansurvey/201608/fullreport.pdf

Shared National Credits

We last discussed SNCs during the fourth quarter 2015. With the updated SNC review, published during July 2016, we performed the same comparison as in the Q4 2015.

For reference: the SNC portfolio included ~10,800 credits and totaled $4.1 trillion.

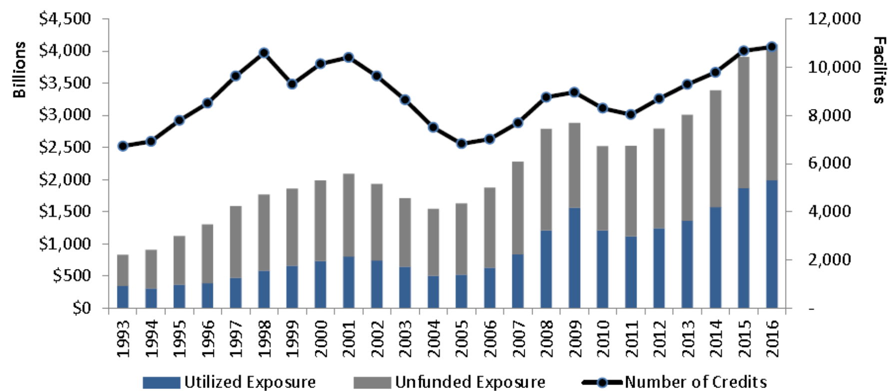
- SHP & Co. average classified loans to total loans 3.74%
- SHP & Co. median classified loans to total loans 2.84%
- Classified SNCs to the total portfolio 6.9%

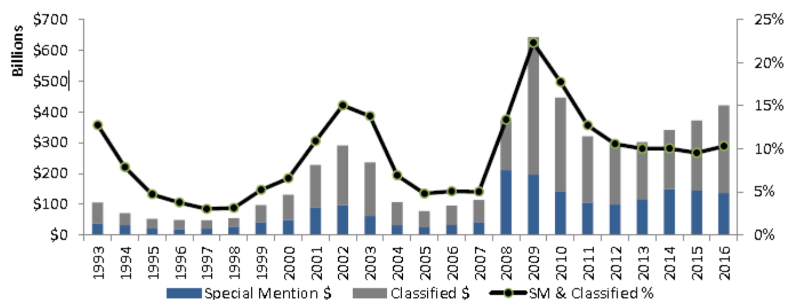
Also of note, oil and gas related credits represent 27% of total SNC classified loans. Assuming a 27% reduction in total SNC classification, roughly 5.0% of the portfolio would still be adversely classified.

Again, 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 July 2016 SNC review highlights included:

- Examiners again raised concerns about borrowers' capacity to repay certain new originations—both underwritten and refinanced loans—if economic conditions deteriorated, or if interest rates rose to historical norms
- Examiners observed structures with ineffective or no covenants, liberal repayment terms…





Shared National Credits

Committed and Outstanding Balances (Dollars in Billions)								
Year	Special Mention	Sub-Standard	Doubtful	Loss	Total Classified	Total SM and Classified	Total Committed	Total Outstanding
2013	115.0	164.5	14.5	8.0	187.0	302.0	3,011	1,362
2014	149.2	171.0	11.8	7.8	191.3	340.6	3,389	1,568
2015	144.2	203.2	20.6	4.6	228.4	372.6	3,909	1,867
2016	136.4	250.7	25.7	8.6	285.1	421.4	4,102	1,986

Industry	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
All Industries (Total)											
Commitment	1,873.9	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
Classified	61.8	71.7	163.1	446.8	304.5	214.6	195.8	187.0	191.3	228.4	285.1
Special Mention	33.4	42.4	210.4	195.3	142.7	106.4	99.3	115.0	149.4	144.2	136.4
% Classified	3.3%	3.2%	5.8%	15.5%	12.1%	8.5%	7.0%	6.2%	5.6%	5.8%	6.9%
% Special Mention	1.8%	1.9%	7.5%	6.8%	5.7%	4.2%	3.6%	3.8%	4.4%	3.7%	3.3%

	2015 Commitments ($ Billion)	1Q16 Commitments ($ Billion)	1Q16 vs. 2015 ($ Billion)	1Q16 vs. 2015 (%)
SNC Portfolio Commitments	$3,908.8	$4,102.3	$193.5	5.0%
SNC Portfolio Outstanding	$1,867.1	$1,986.5	$119.4	6.4%
SNC Portfolio Borrowers	6,571	6,676	105	1.6%
SM and Classified Commitments	$372.6	$421.4	$48.8	13.0%
SM Commitments	$144.2	$136.4	($7.8)	-5.4%
Classified Commitments	$228.4	$285.1	$56.7	24.8%
Nonaccrual Commitments	$51.3	$72.6	$21.4	41.7%

Note: Nonaccrual amounts are net of loss dispositions.

Lender Type	1Q16 Special Mention and Classified ($ billion)	1Q16 Special Mention and Classified (% Share Held by Lender Type)	1Q16 Special Mention and Classified (% Share of Total Commitments)
U.S. Banks	$93.8	22.3%	2.3%
FBOs	$71.5	17.0%	1.7%
Non-Banks	$256.2	60.8%	6.2%
Total	$421.4	100.0%	10.3%

Note: Non-banks also owned $41.8 billion or 57.5 percent of all nonaccrual loans.

FOR REFERENCE: The percentages of non-pass and classified commitments increased to 10.3 percent and 6.9 percent compared with 9.5 percent and 5.8 percent in 2015, respectively. SNC examination data showed classified O&G borrowers totaled $77.0 billion or 27.0 percent of total classified commitments in first quarter 2016, compared with $38.2 billion or 16.7 percent in 2015.

http://www.occ.treas.gov/news-issuances/news-releases/2016/nr-ia-2016-87a.pdf

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