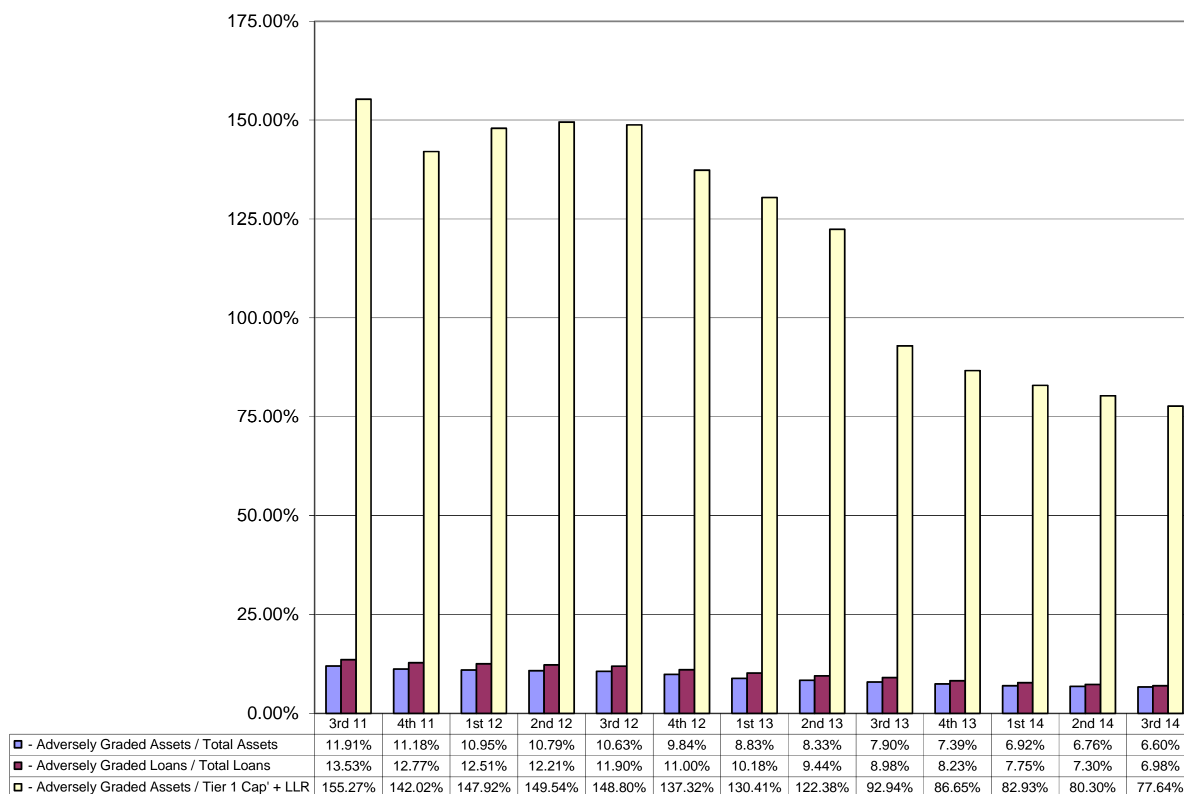
Steve H. Powell & Company

Quarterly Newsletter

P.O. Box 2701 | Statesboro, GA 30459 | Phone 912.682.3029 | Fax 912.489.5354 | spowell@shpco.net

Q3 2014

Trends in Asset Quality



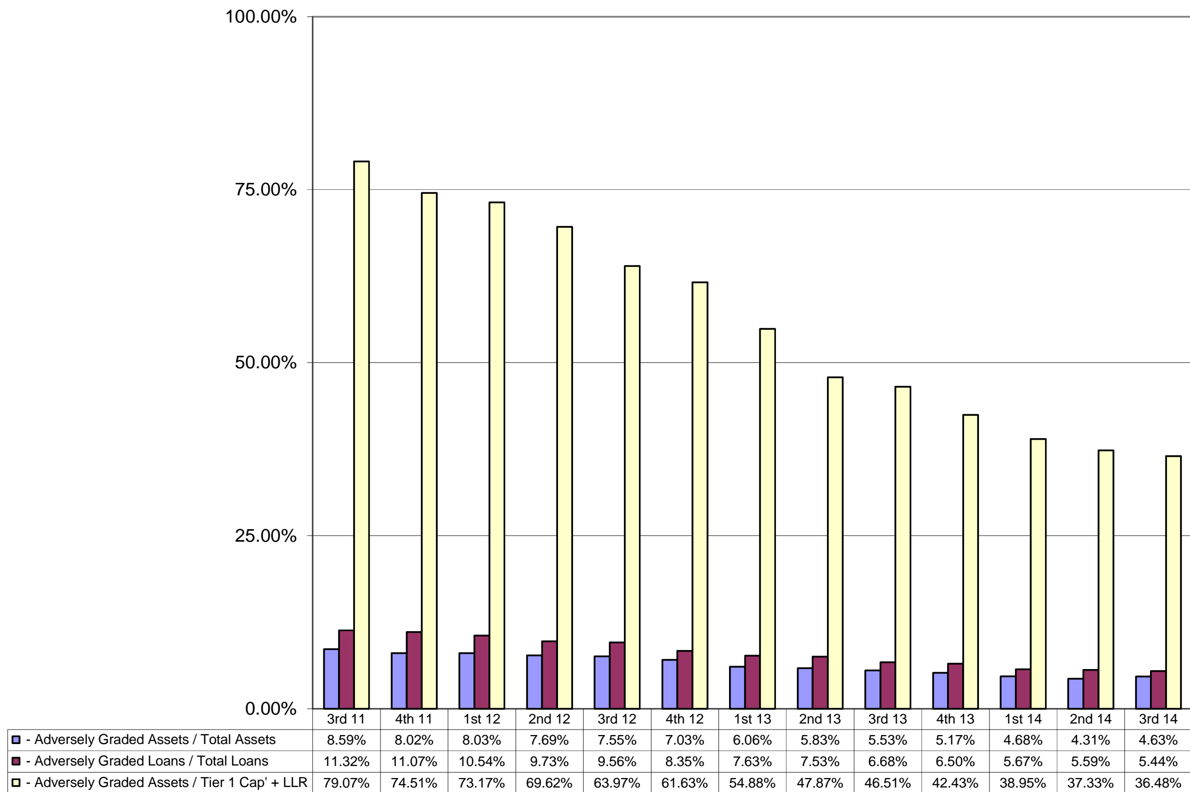
	3rd 11	4th 11	1st 12	2nd 12	3rd 12	4th 12	1st 13	2nd 13	3rd 13	4th 13	1st 14	2nd 14	3rd 14
- Adversely Graded Assets / Total Assets	11.91%	11.18%	10.95%	10.79%	10.63%	9.84%	8.83%	8.33%	7.90%	7.39%	6.92%	6.76%	6.60%
- Adversely Graded Loans / Total Loans	13.53%	12.77%	12.51%	12.21%	11.90%	11.00%	10.18%	9.44%	8.98%	8.23%	7.75%	7.30%	6.98%
- Adversely Graded Assets / Tier 1 Cap' + LLR	155.27%	142.02%	147.92%	149.54%	148.80%	137.32%	130.41%	122.38%	92.94%	86.65%	82.93%	80.30%	77.64%

Based on Steve H. Powell & Company client data, during the Third Quarter 2014, the average level of adversely graded assets decreased as a percentage of assets, loans, and capital. Problem assets averaged 6.60% of total assets, 6.98% of total loans, and 77.64% of tier-one capital plus loan loss reserve as compared to 6.76% of total assets, 7.30% of total loans, and 80.30% of tier-one capital plus loan loss reserve during the Second Quarter 2014.

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



	3rd 11	4th 11	1st 12	2nd 12	3rd 12	4th 12	1st 13	2nd 13	3rd 13	4th 13	1st 14	2nd 14	3rd 14
- Adversely Graded Assets / Total Assets	8.59%	8.02%	8.03%	7.69%	7.55%	7.03%	6.06%	5.83%	5.53%	5.17%	4.68%	4.31%	4.63%
- Adversely Graded Loans / Total Loans	11.32%	11.07%	10.54%	9.73%	9.56%	8.35%	7.63%	7.53%	6.68%	6.50%	5.67%	5.59%	5.44%
- Adversely Graded Assets / Tier 1 Cap' + LLR	79.07%	74.51%	73.17%	69.62%	63.97%	61.63%	54.88%	47.87%	46.51%	42.43%	38.95%	37.33%	36.48%

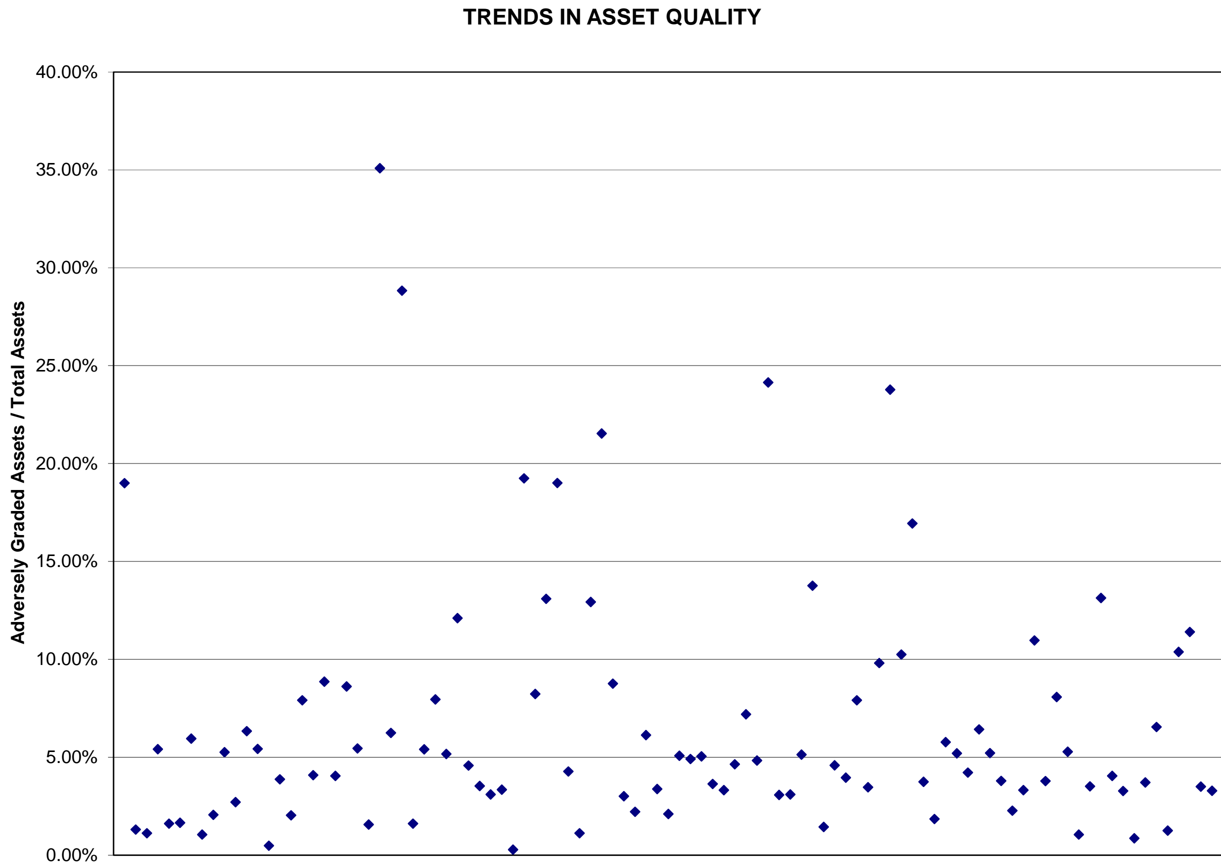
The median level of problem assets as of Q3 2014 decreased to 36.48% of tier-one capital plus loan loss reserve as compared to 37.33% during Q2 2014. Median classifications peaked at 92.05% in Q3 2010. Please note the continued downward trend from Q3 2011.

Historical Comparisons

During Q3 2014, increases in problem assets, as measured by adversely graded assets divided by tier-one capital plus loan loss reserve, were noted in approximately 15% of our clients. This quarter's increase compares to:

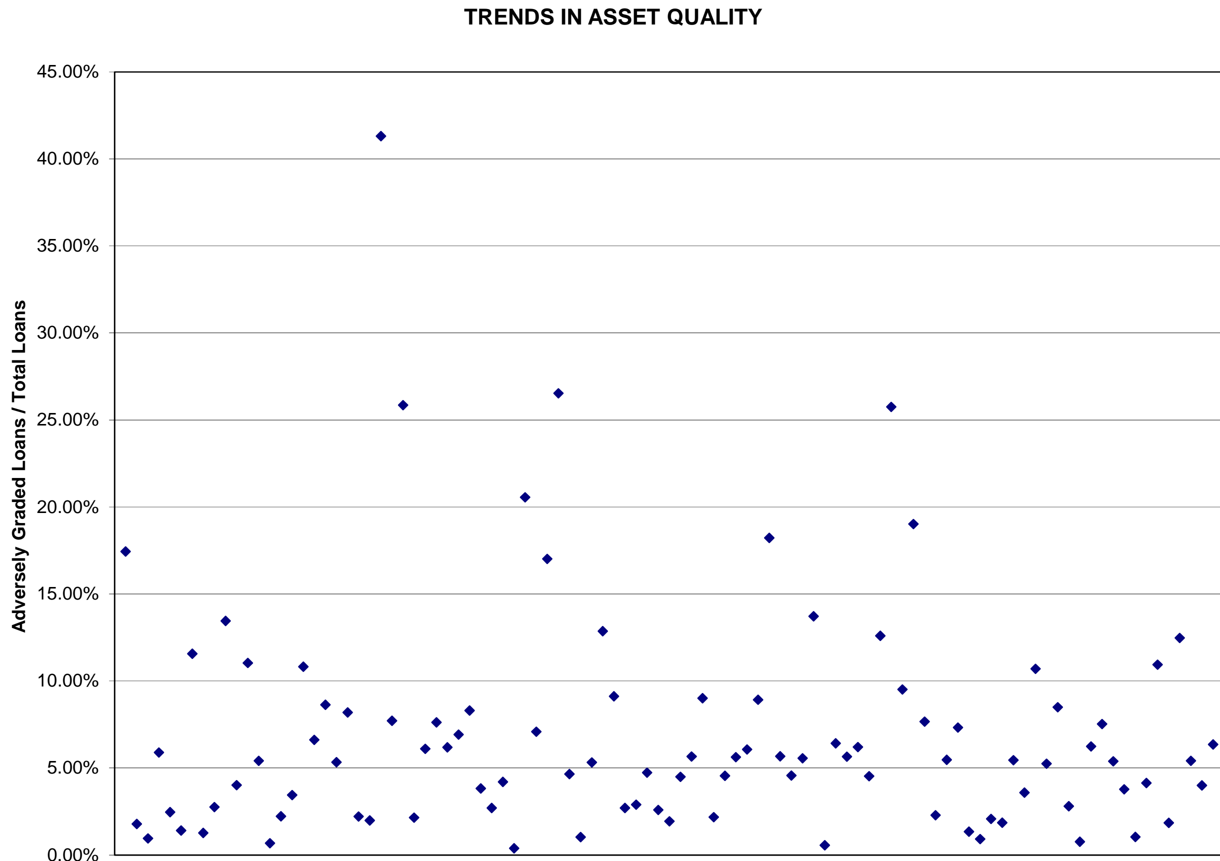
- 20% during the Second Quarter 2014
- 17% during the First Quarter 2014
- 14% during the Fourth Quarter 2013
- 23% during the Third Quarter 2013
- 15% during the Second Quarter 2013 and
- 25% during the First Quarter 2013

Dispersion of Problem Assets as % of Total Assets

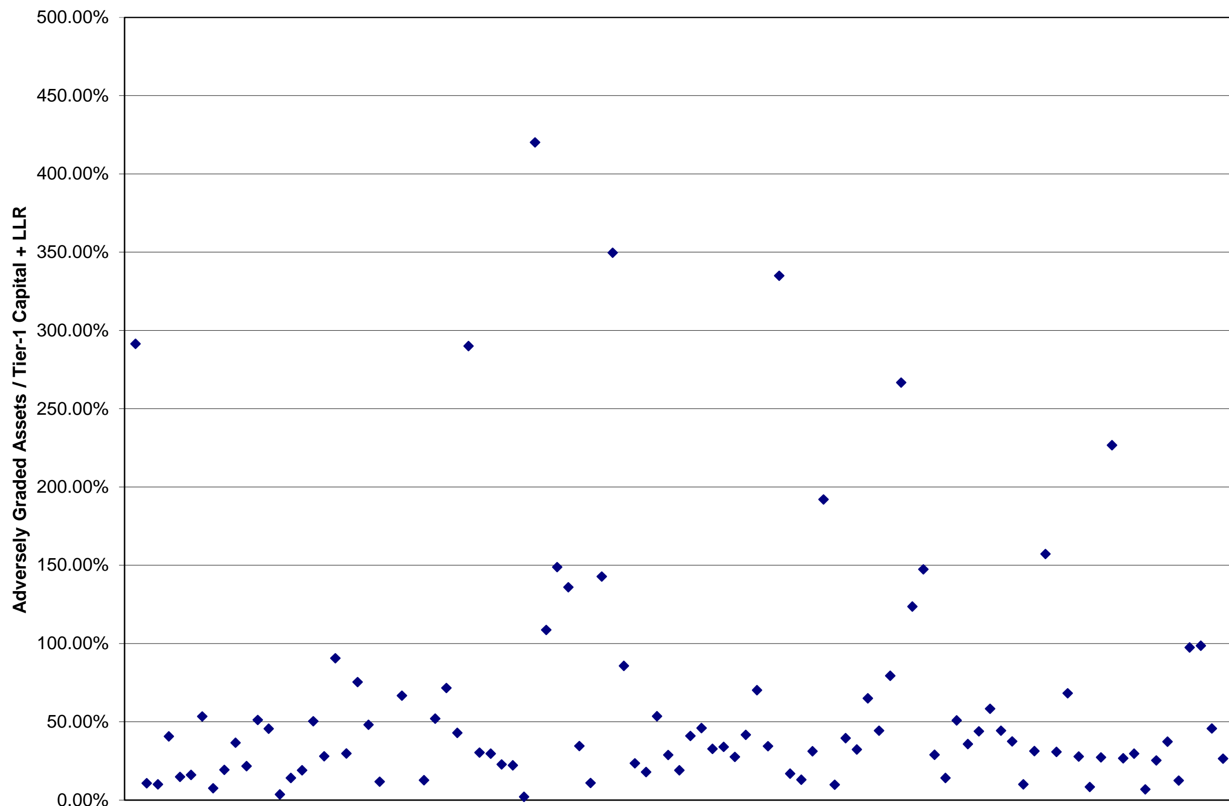


The above graph shows the dispersion of problem assets as a percentage of total assets. Please note the number of institutions with adversely graded assets that exceed 10% of total assets – a benchmark for significant asset quality concern.

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

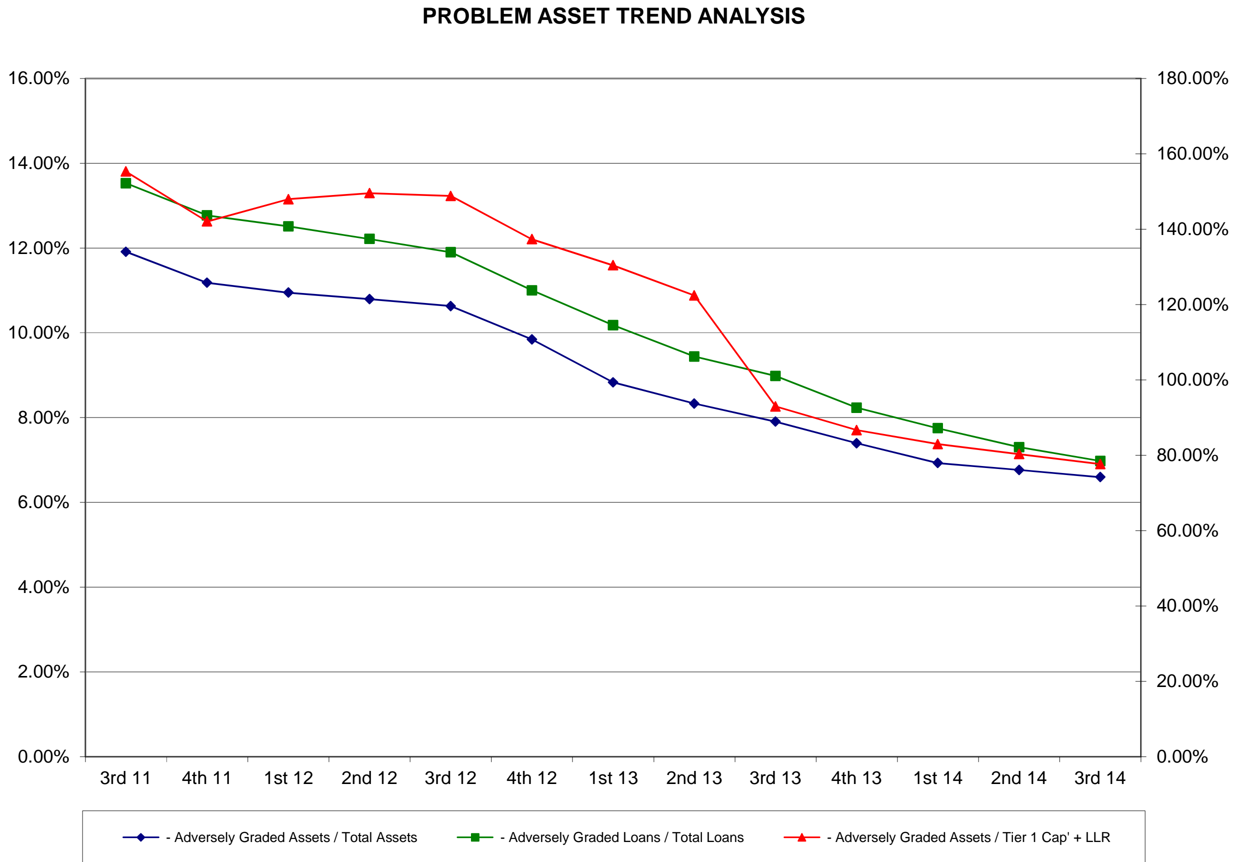
Our sample group includes twenty eight (28) banks with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

- Thirty one (31) during the Second Quarter 2014
- Thirty four (34) during the First Quarter 2014
- Thirty seven (37) during the Fourth Quarter 2013
- Forty three (43) during the Third Quarter 2013
- Forty four (44) during the Second Quarter 2013 and
- Forty six (46) during the First Quarter 2013

Twenty one (21) 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:

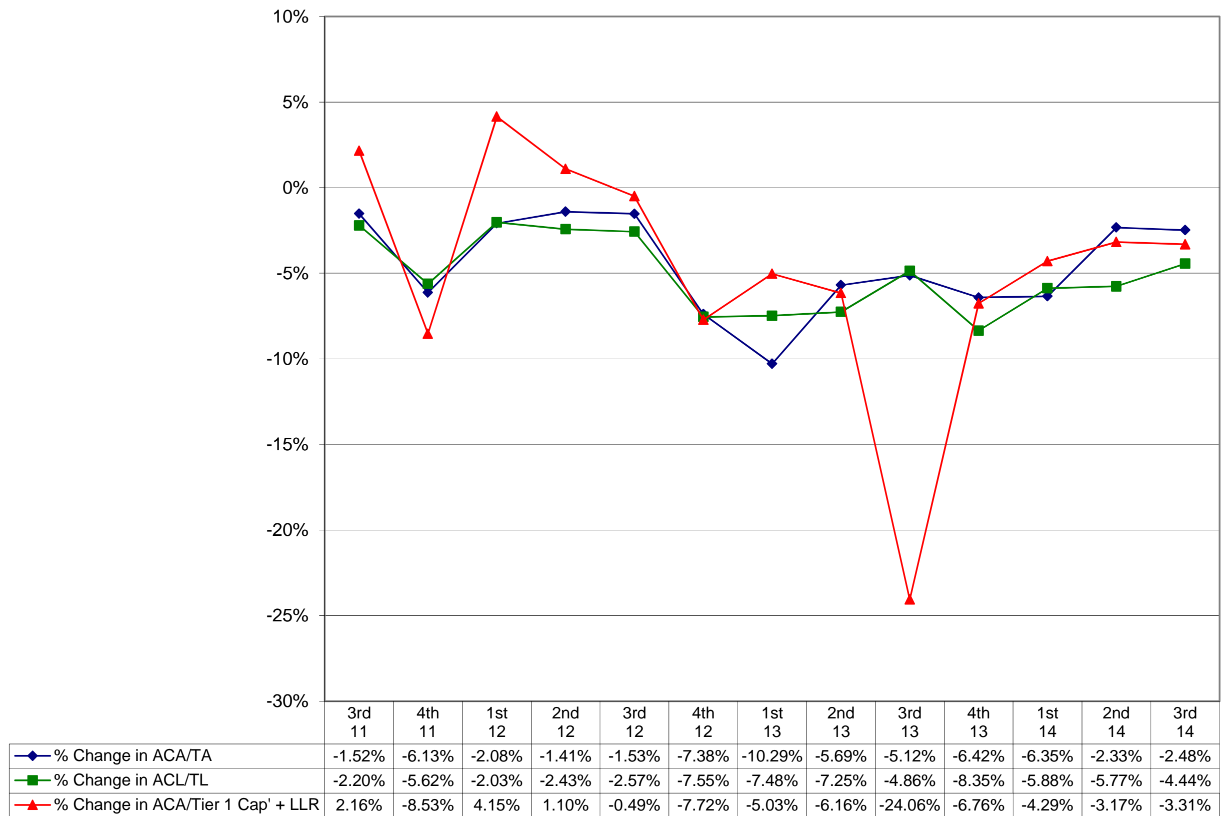
- Twenty four (24) during the Second Quarter 2014
- Twenty six (26) during the First Quarter 2014
- Twenty eight (28) during the Fourth Quarter 2013
- Twenty nine (29) during the Third Quarter 2013
- Thirty three (33) during the Second Quarter 2013 and
- Thirty seven (37) during the First Quarter 2013

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.

Comparative % Change in Adversely Graded Assets



	3rd 11	4th 11	1st 12	2nd 12	3rd 12	4th 12	1st 13	2nd 13	3rd 13	4th 13	1st 14	2nd 14	3rd 14
% Change in ACA/TA	-1.52%	-6.13%	-2.08%	-1.41%	-1.53%	-7.38%	-10.29%	-5.69%	-5.12%	-6.42%	-6.35%	-2.33%	-2.48%
% Change in ACL/TL	-2.20%	-5.62%	-2.03%	-2.43%	-2.57%	-7.55%	-7.48%	-7.25%	-4.86%	-8.35%	-5.88%	-5.77%	-4.44%
% Change in ACA/Tier 1 Cap' + LLR	2.16%	-8.53%	4.15%	1.10%	-0.49%	-7.72%	-5.03%	-6.16%	-24.06%	-6.76%	-4.29%	-3.17%	-3.31%

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

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 3.81%
- Tier Group 2 included banks between 3.82% and 6.91%
- Tier Group 3 included data points > 6.91%

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	2.54%	5.10%	12.15%
Adversely Graded Assets / Total Loans	2.00%	5.39%	13.54%
Adversely Graded Assets / Tier 1 Cap' + LLR	21.12%	48.80%	163.02%

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.

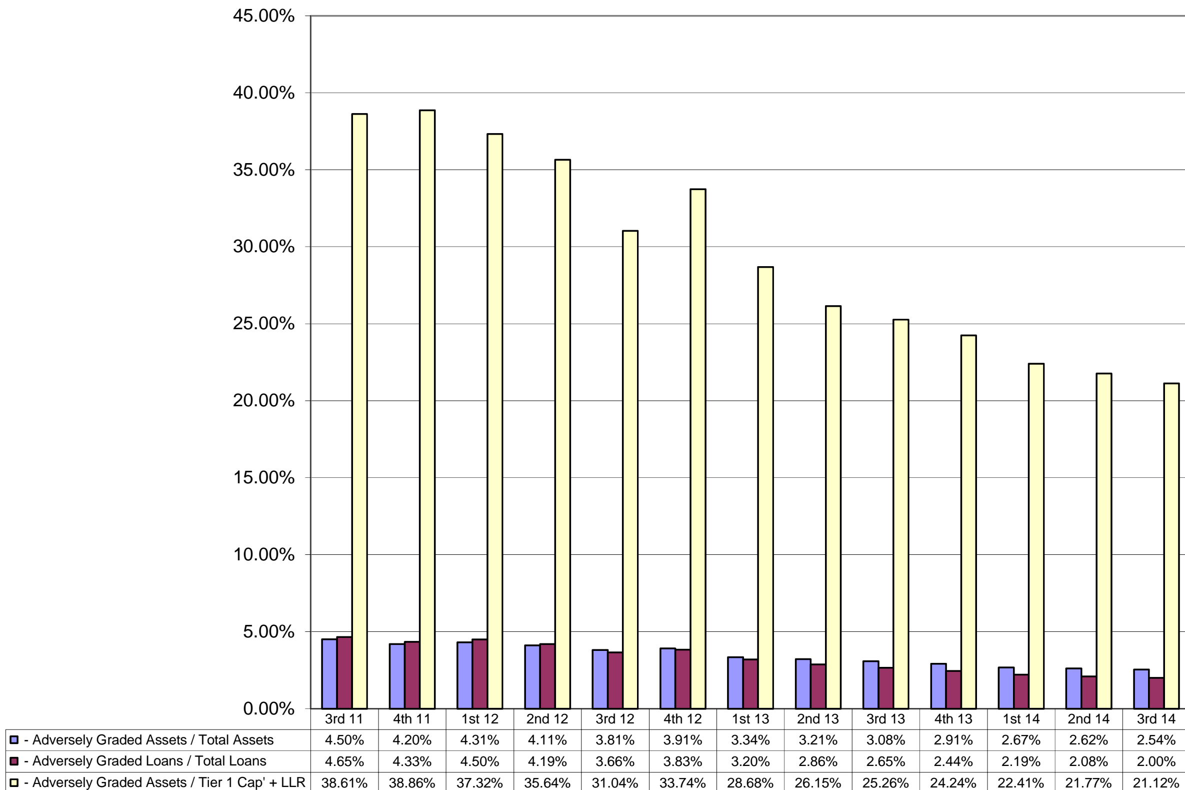
With the outlier data points excluded, problem assets averaged 6.11% of total assets, 6.40% of total loans, and 65.40% of tier-one capital plus loan loss reserve. Third Quarter 2014 modified data compares to the following Second Quarter 2014 modified average data set:

- 6.29% of total assets
- 6.80% of total loans, and
- 65.12% of tier-one capital plus loan loss reserve

Median asset quality ratios within the modified data set were 4.63% of total assets, 5.44% of total loans, and 36.48% of tier-one capital plus loan loss reserve. Third Quarter 2014 modified data compares to the following Second Quarter 2014 modified average data set:

- 4.31% of total assets,
- 5.59% of total loans, and
- 37.33% of tier-one capital plus loan loss reserve

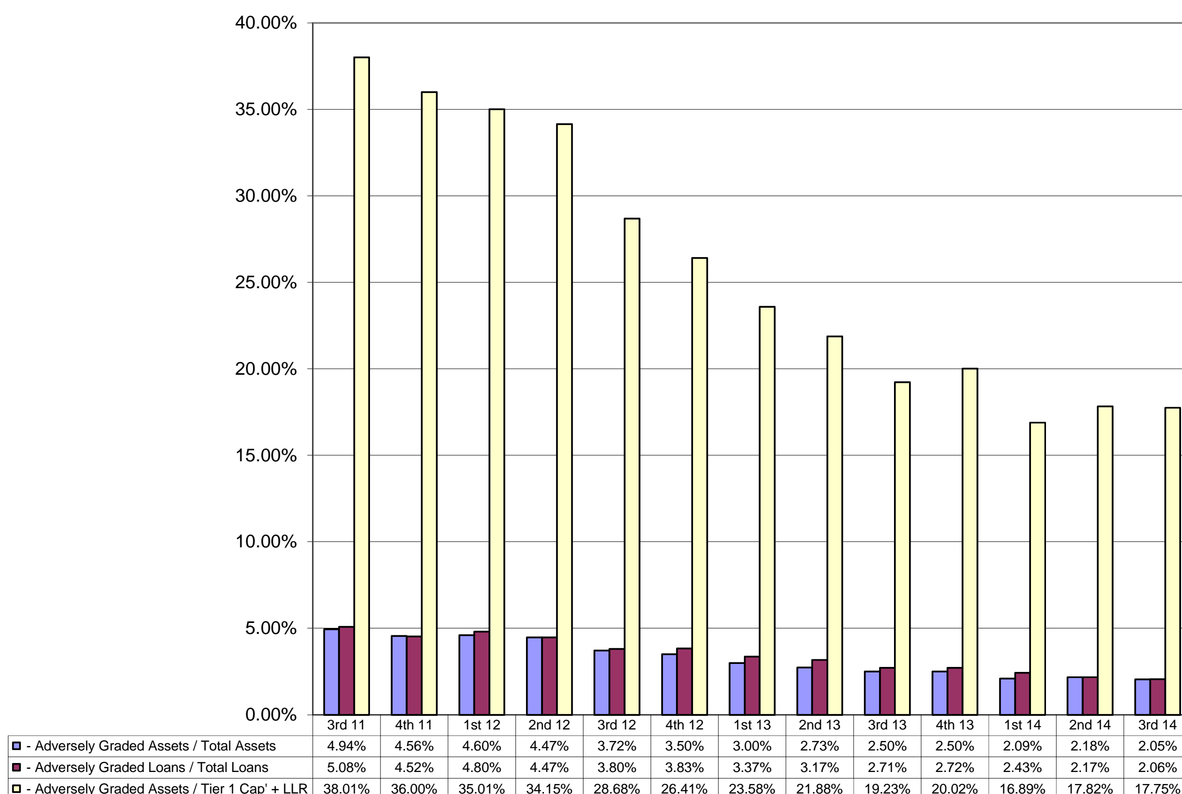
Tier Group 1



	3rd 11	4th 11	1st 12	2nd 12	3rd 12	4th 12	1st 13	2nd 13	3rd 13	4th 13	1st 14	2nd 14	3rd 14
- Adversely Graded Assets / Total Assets	4.50%	4.20%	4.31%	4.11%	3.81%	3.91%	3.34%	3.21%	3.08%	2.91%	2.67%	2.62%	2.54%
- Adversely Graded Loans / Total Loans	4.65%	4.33%	4.50%	4.19%	3.66%	3.83%	3.20%	2.86%	2.65%	2.44%	2.19%	2.08%	2.00%
- Adversely Graded Assets / Tier 1 Cap' + LLR	38.61%	38.86%	37.32%	35.64%	31.04%	33.74%	28.68%	26.15%	25.26%	24.24%	22.41%	21.77%	21.12%

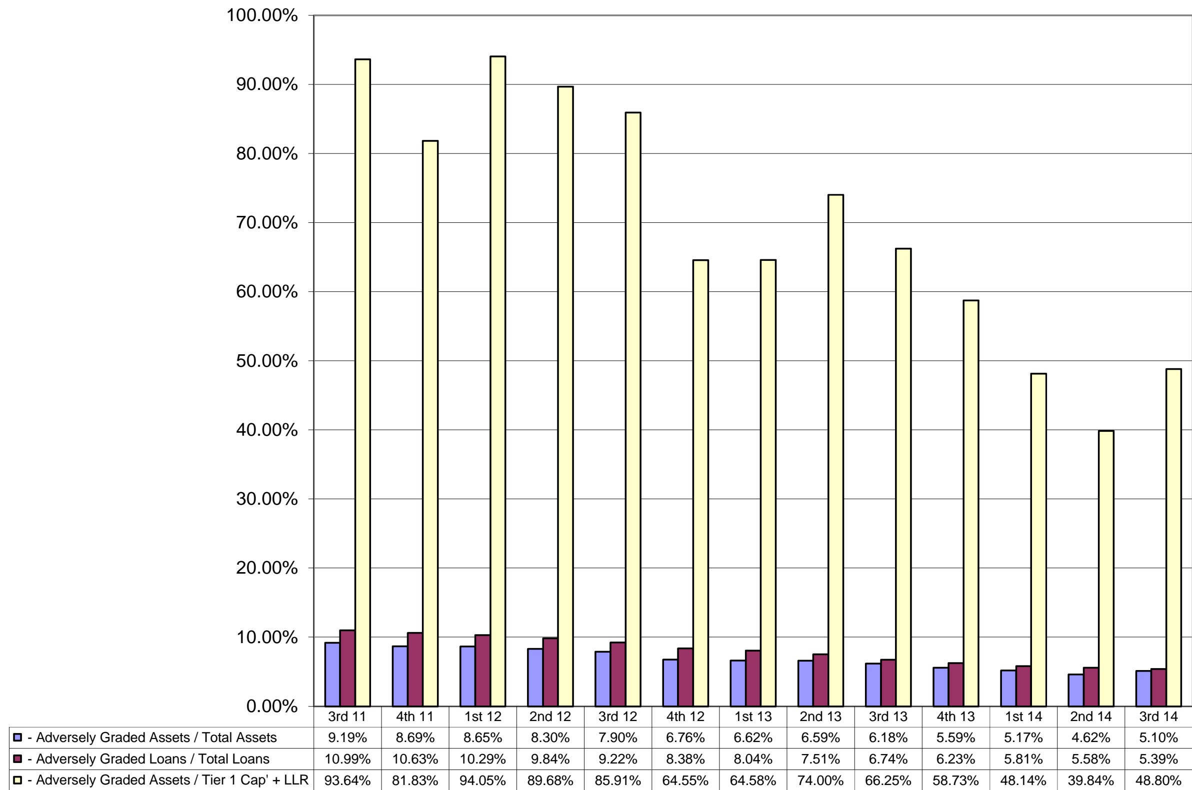
Tier Group 1 (continued)

Tier Group 1 banks' asset quality has stabilized at historically normal, or pre-2008 crash, levels. Tier Group 1 banks continue to benefit from positive earnings. Earnings momentum has contributed to expanding capital accounts. Decreases in adversely graded assets, in conjunction with expanding capital accounts, has driven the improvement in asset quality ratios.



	3rd 11	4th 11	1st 12	2nd 12	3rd 12	4th 12	1st 13	2nd 13	3rd 13	4th 13	1st 14	2nd 14	3rd 14
- Adversely Graded Assets / Total Assets	4.94%	4.56%	4.60%	4.47%	3.72%	3.50%	3.00%	2.73%	2.50%	2.50%	2.09%	2.18%	2.05%
- Adversely Graded Loans / Total Loans	5.08%	4.52%	4.80%	4.47%	3.80%	3.83%	3.37%	3.17%	2.71%	2.72%	2.43%	2.17%	2.06%
- Adversely Graded Assets / Tier 1 Cap' + LLR	38.01%	36.00%	35.01%	34.15%	28.68%	26.41%	23.58%	21.88%	19.23%	20.02%	16.89%	17.82%	17.75%

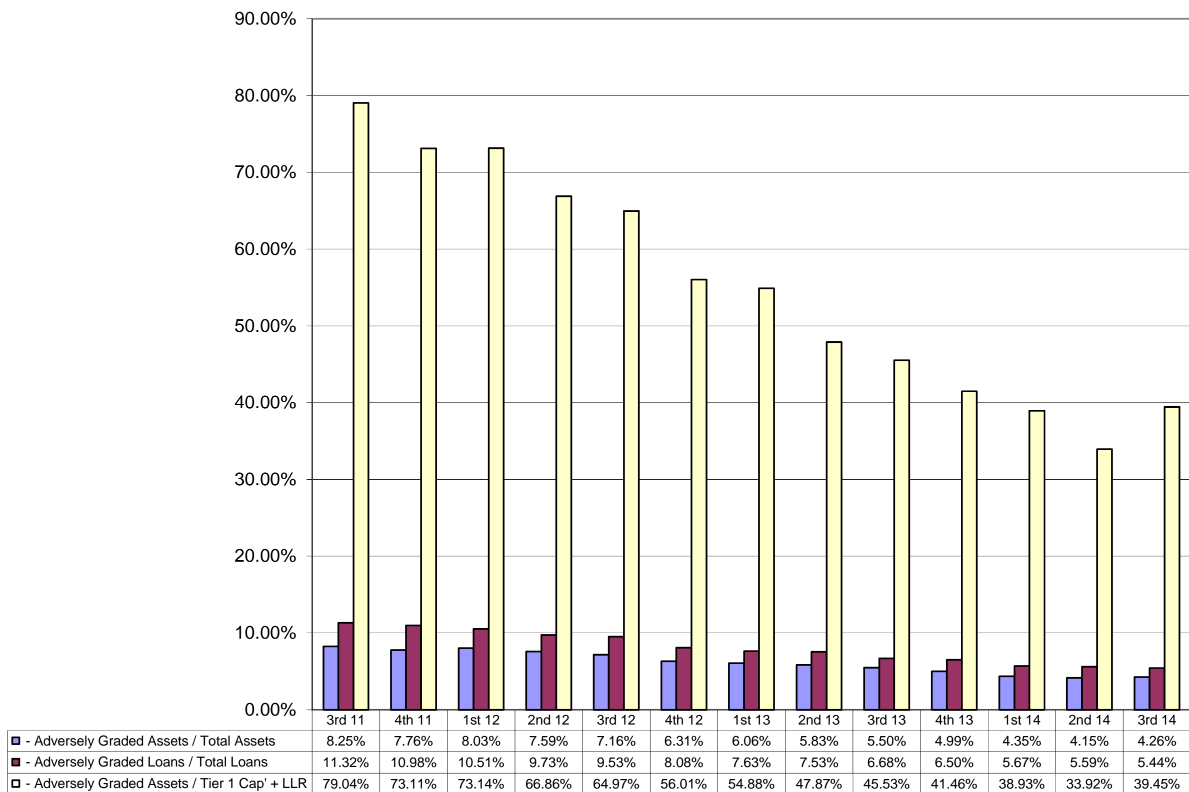
Tier Group 2



	3rd 11	4th 11	1st 12	2nd 12	3rd 12	4th 12	1st 13	2nd 13	3rd 13	4th 13	1st 14	2nd 14	3rd 14
- Adversely Graded Assets / Total Assets	9.19%	8.69%	8.65%	8.30%	7.90%	6.76%	6.62%	6.59%	6.18%	5.59%	5.17%	4.62%	5.10%
- Adversely Graded Loans / Total Loans	10.99%	10.63%	10.29%	9.84%	9.22%	8.38%	8.04%	7.51%	6.74%	6.23%	5.81%	5.58%	5.39%
- Adversely Graded Assets / Tier 1 Cap' + LLR	93.64%	81.83%	94.05%	89.68%	85.91%	64.55%	64.58%	74.00%	66.25%	58.73%	48.14%	39.84%	48.80%

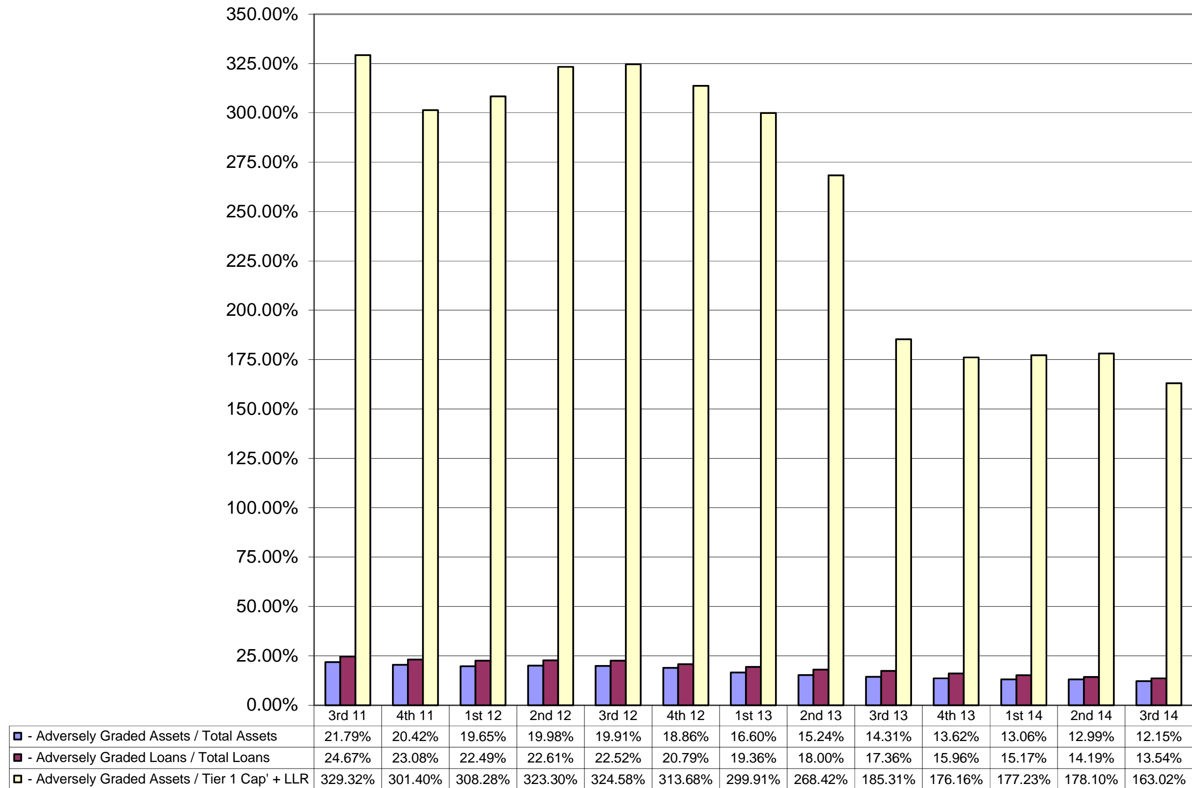
Tier Group 2 (continued)

Tier Group 2 banks continue to improve, but asset quality ratios do not appear to have reached the historically normal 20% - 40% of tier one capital + LLR. Tier 2 banks continue to work out of ORE holdings. Improvements in their loan customers' performance have enabled Tier 2 banks to return previously non-accrual loans to accrual status. Jettisoning other real estate and returning non-earning loans back to accrual status has led to expansion in capital accounts. As with Tier 1 banks, asset quality ratios continue to be driven by improvements in the various asset quality ratios' numerators and denominators.



	3rd 11	4th 11	1st 12	2nd 12	3rd 12	4th 12	1st 13	2nd 13	3rd 13	4th 13	1st 14	2nd 14	3rd 14
- Adversely Graded Assets / Total Assets	8.25%	7.76%	8.03%	7.59%	7.16%	6.31%	6.06%	5.83%	5.50%	4.99%	4.35%	4.15%	4.26%
- Adversely Graded Loans / Total Loans	11.32%	10.98%	10.51%	9.73%	9.53%	8.08%	7.63%	7.53%	6.68%	6.50%	5.67%	5.59%	5.44%
- Adversely Graded Assets / Tier 1 Cap' + LLR	79.04%	73.11%	73.14%	66.86%	64.97%	56.01%	54.88%	47.87%	45.53%	41.46%	38.93%	33.92%	39.45%

Tier Group 3

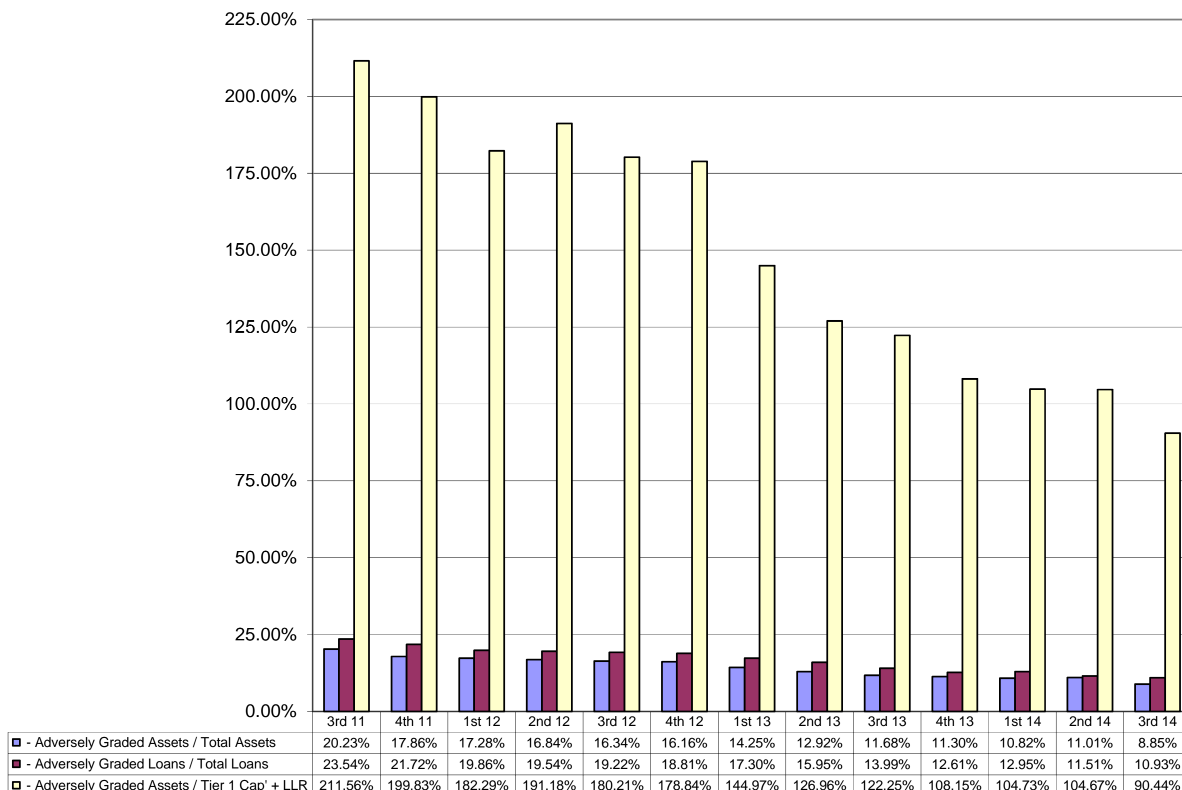


	3rd 11	4th 11	1st 12	2nd 12	3rd 12	4th 12	1st 13	2nd 13	3rd 13	4th 13	1st 14	2nd 14	3rd 14
- Adversely Graded Assets / Total Assets	21.79%	20.42%	19.65%	19.98%	19.91%	18.86%	16.60%	15.24%	14.31%	13.62%	13.06%	12.99%	12.15%
- Adversely Graded Loans / Total Loans	24.67%	23.08%	22.49%	22.61%	22.52%	20.79%	19.36%	18.00%	17.36%	15.96%	15.17%	14.19%	13.54%
- Adversely Graded Assets / Tier 1 Cap' + LLR	329.32%	301.40%	308.28%	323.30%	324.58%	313.68%	299.91%	268.42%	185.31%	176.16%	177.23%	178.10%	163.02%

Tier Group 3 (continued)

Tier 3 data still reflects excessive classification levels, but they continue general improvement. It would appear, as based on the historical trend line, the average level of classified assets, as measured by adversely graded assets divided by tier-1 capital + LLR, has decreased from approximately 178% to 163%. The increase is due to outliers as the median ratio was noted to remain stable.

Overall levels of classifications continue to slowly decline. Losses continue to wane, and capital accounts have generally stabilized, but tier one capital for many banks in the group is < 5%. As with Tier 2 banks, Tier 3 banks have begun to see positive earnings. The Tier 3 group's asset quality ratios are heavily influenced by several peer group banks whose classifications continue to exceed 150% of tier one capital + LLR.



	3rd 11	4th 11	1st 12	2nd 12	3rd 12	4th 12	1st 13	2nd 13	3rd 13	4th 13	1st 14	2nd 14	3rd 14
- Adversely Graded Assets / Total Assets	20.23%	17.86%	17.28%	16.84%	16.34%	16.16%	14.25%	12.92%	11.68%	11.30%	10.82%	11.01%	8.85%
- Adversely Graded Loans / Total Loans	23.54%	21.72%	19.86%	19.54%	19.22%	18.81%	17.30%	15.95%	13.99%	12.61%	12.95%	11.51%	10.93%
- Adversely Graded Assets / Tier 1 Cap' + LLR	211.56%	199.83%	182.29%	191.18%	180.21%	178.84%	144.97%	126.96%	122.25%	108.15%	104.73%	104.67%	90.44%

Current Banking Environment

SHP & Co. client banks' asset quality continues to improve. Improvements in asset quality ratios are driven by reductions in adversely graded assets, balance sheet expansion and upgrades of previously adversely graded loans. Improvements in SHP & Co. client banks generally mirror industry data reflected in the most recent Quarterly Banking Profile:

- The number of institutions on the FDIC's "Problem List" declined from 411 to 354. This is the smallest number of "problem" institutions since the end of first quarter 2009, and is 60 percent below the most recent peak level of 888 "problem" institutions at the end of first quarter 2011. Total assets of "problem" institutions declined from $126.1 billion to $110.2 billion.

Additionally the OCC's fact sheet reports "Eighty-nine percent of national banks and federal savings associations in the district are highly rated at 1 or 2 on the five-point CAMELS rating system".

Discussion with numerous client banks indicates continued heightened competition for new loans. Some banks indicate, due to competitive pressures, an inability to price for risk variances between AAA and AA type borrowers. The OCC indicates "Strategic risk and interest rate risk are significant concerns as a result of competitive pressure and the sustained low-rate environment".

In larger markets, for larger loans, the 'new normal' requires extended term fixed rate loans without personal recourse. General discussions in SHP & Co. client banks mirror industry data (as based on the QBP and the OCC's most recent Fact Sheet for its Southern District):

- The average net interest margin fell to 3.15 percent from 3.25 percent in second quarter 2013. This is the lowest quarterly margin for the industry since third quarter 1989.

- While credit quality indicators continue to improve, competition for good quality loans in most markets is affecting pricing and putting pressure on underwriting.

- Loan underwriting standards show signs of liberal concessions, including longer repayment terms, fewer and more liberal loan covenants, and releasing borrowers from personal liability on business and real estate development lending.

- Highly competitive marketplace with interest rate concessions possibly offered to achieve loan growth which could mean improper pricing for risk.

Current Banking Environment (continued)

In some banks, management has begun to expand bank lending into new products or markets. Many clients have begun to focus on loan portfolio expansion. As per the OCC's Fact Sheet "average loan growth rate doubled among community national banks and federal savings associations in the Southern District". The QBP indicates:

- The growth in loan balances was the largest quarterly increase since fourth quarter 2007 (excluding a change in accounting rules in first quarter 2010). Loan growth was led by commercial and industrial loans (up $49.9 billion, 3.1 percent).

Growth in unfunded commitments was led by a $44.5 billion (2.8 percent) increase in unfunded commercial and industrial loan commitments.

Interest in participations is beginning to grow. Larger and smaller SHP & Co. clients, as well as different charter types, have recently entered into the participation markets. Purchased loans have chiefly been centered in C&I credits.

A few clients indicate recent safety & soundness examinations were 'kinder-and-gentler'.

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.

For more information about Steve H. Powell & Company, please visit our website at www.shpco.net

P.O. Box 2701 l Statesboro, GA 30459 l Phone 912.682.3029 l Fax 912.489.5354 l spowell@shpco.net