Steve H. Powell & Company

Quarterly Newsletter

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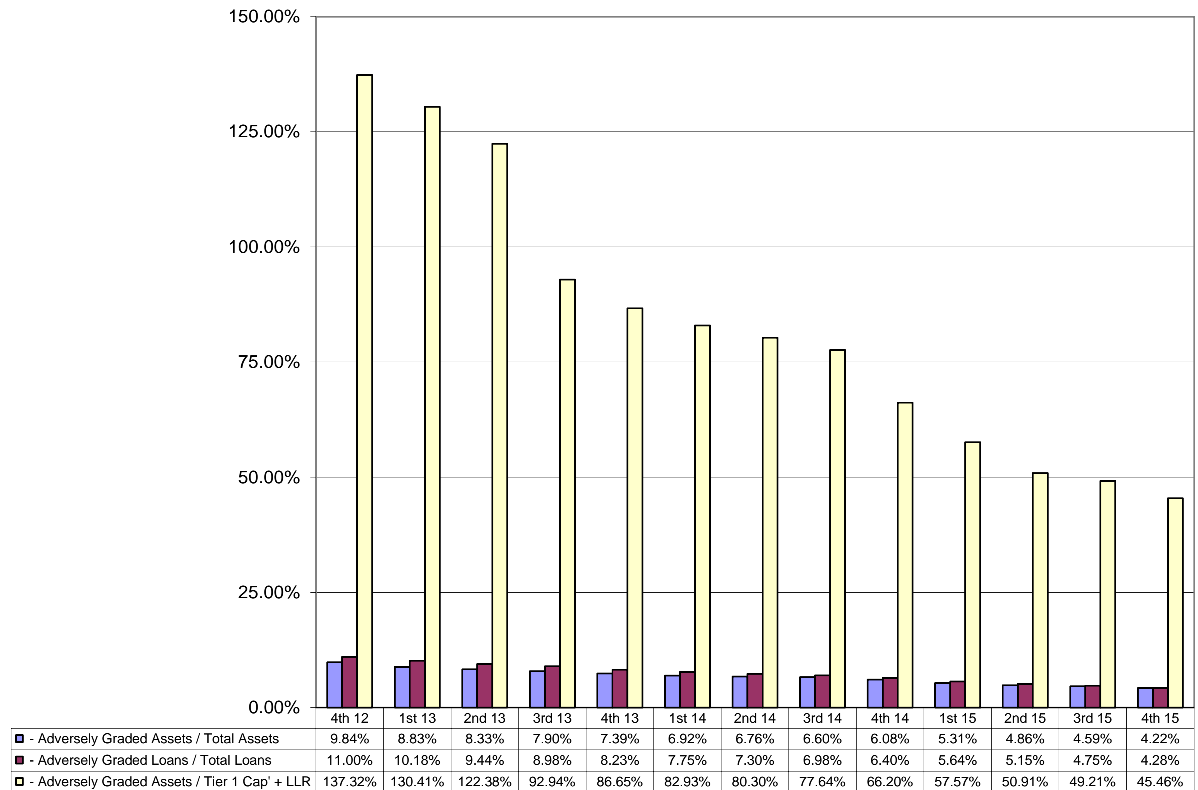
Q4 2015

Trends in Asset Quality

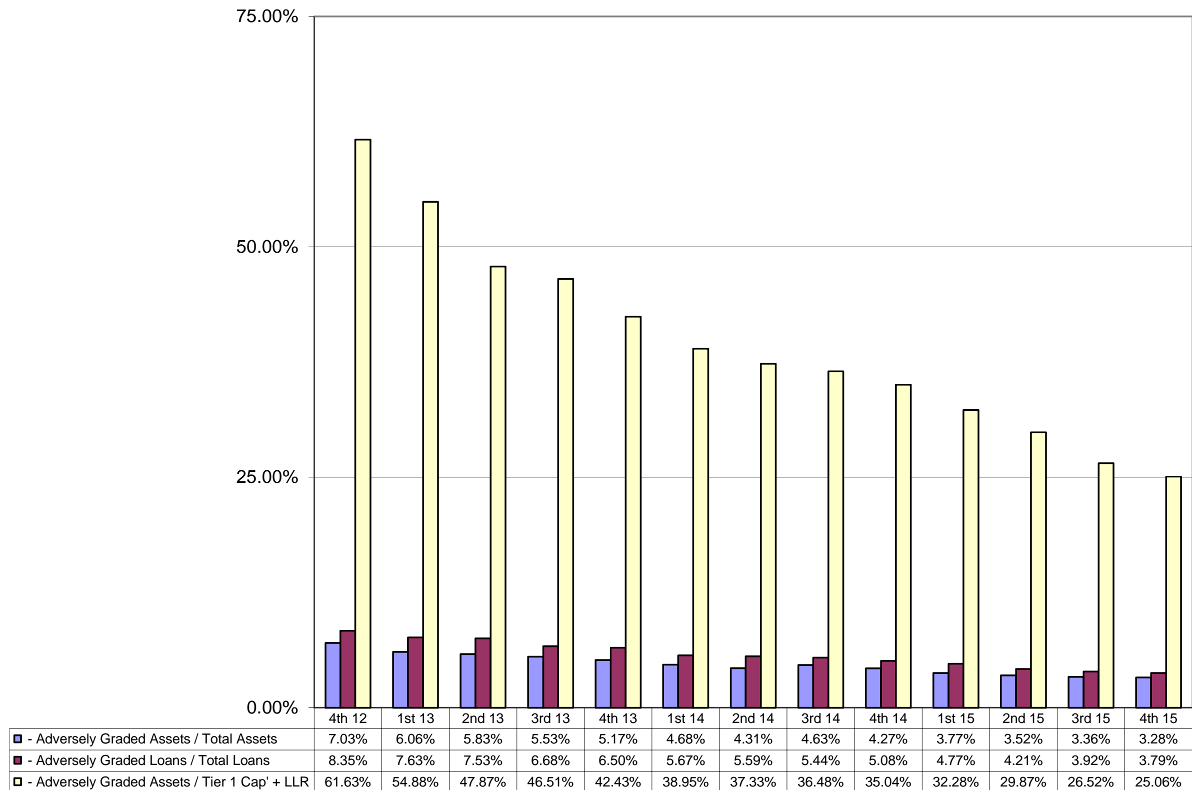


	4th 12	1st 13	2nd 13	3rd 13	4th 13	1st 14	2nd 14	3rd 14	4th 14	1st 15	2nd 15	3rd 15	4th 15
- Adversely Graded Assets / Total Assets	9.84%	8.83%	8.33%	7.90%	7.39%	6.92%	6.76%	6.60%	6.08%	5.31%	4.86%	4.59%	4.22%
- Adversely Graded Loans / Total Loans	11.00%	10.18%	9.44%	8.98%	8.23%	7.75%	7.30%	6.98%	6.40%	5.64%	5.15%	4.75%	4.28%
- Adversely Graded Assets / Tier 1 Cap' + LLR	137.32%	130.41%	122.38%	92.94%	86.65%	82.93%	80.30%	77.64%	66.20%	57.57%	50.91%	49.21%	45.46%

Based on Steve H. Powell & Company client data, during the Fourth Quarter 2015, 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 4.22% of total assets and 45.46% of tier-one capital plus loan loss reserve as compared to 4.60% of total assets and 49.24% of tier-one capital plus loan loss reserve while problem loans averaged 4.28% of total loans as compared to 4.75% of total loans during the Third 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 Assets



	4th 12	1st 13	2nd 13	3rd 13	4th 13	1st 14	2nd 14	3rd 14	4th 14	1st 15	2nd 15	3rd 15	4th 15
- Adversely Graded Assets / Total Assets	7.03%	6.06%	5.83%	5.53%	5.17%	4.68%	4.31%	4.63%	4.27%	3.77%	3.52%	3.36%	3.28%
- Adversely Graded Loans / Total Loans	8.35%	7.63%	7.53%	6.68%	6.50%	5.67%	5.59%	5.44%	5.08%	4.77%	4.21%	3.92%	3.79%
- Adversely Graded Assets / Tier 1 Cap' + LLR	61.63%	54.88%	47.87%	46.51%	42.43%	38.95%	37.33%	36.48%	35.04%	32.28%	29.87%	26.52%	25.06%

The median level of problem assets as of Q4 2015 decreased to 25.06% of tier-one capital plus loan loss reserve as compared to 26.52% during Q3 2015. Note the downward trend as overall asset quality continues to improve.

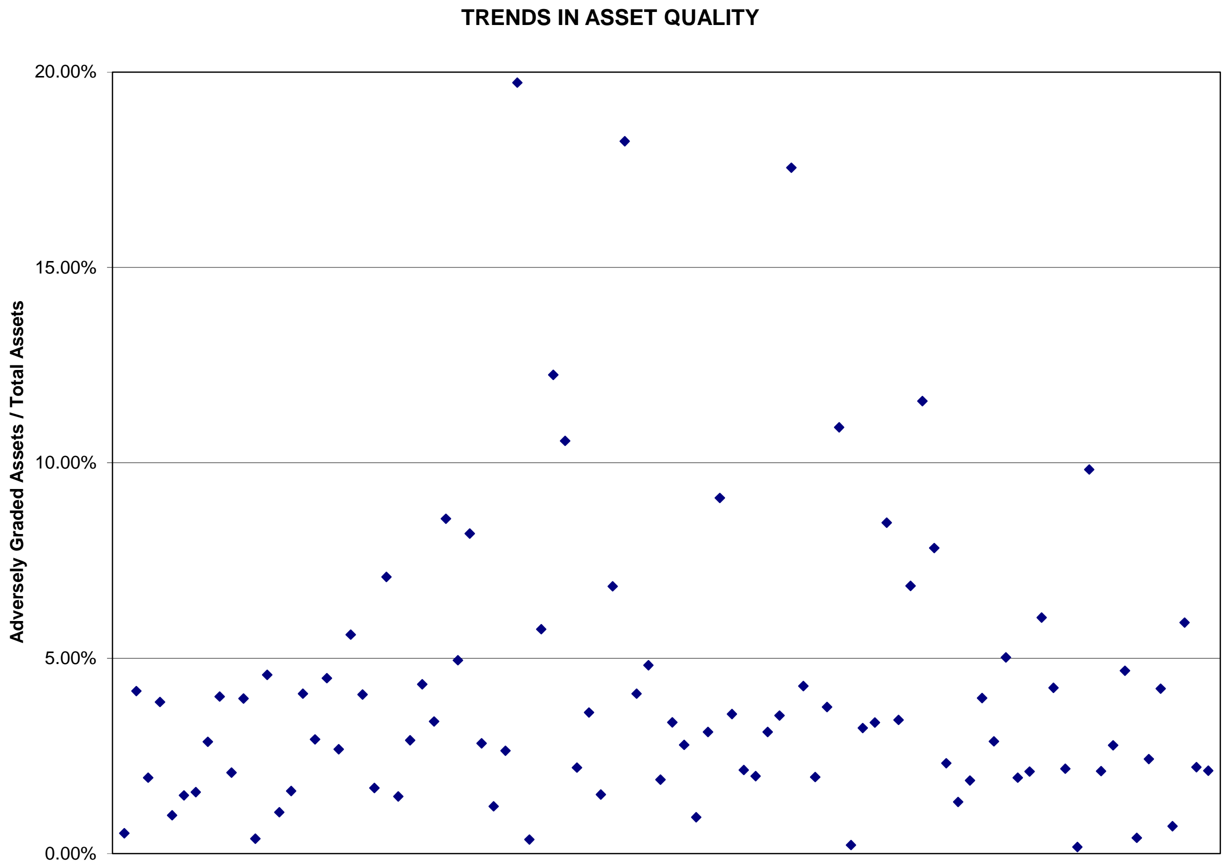
Historical Comparisons

During Q4 2015, 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:

- 8% during the Third Quarter 2015
- 11% during the Second Quarter 2015
- 15% during the First Quarter 2015
- 12% during the Fourth Quarter 2014
- 15% during the Third Quarter 2014, and
- 20% during the Second Quarter 2014

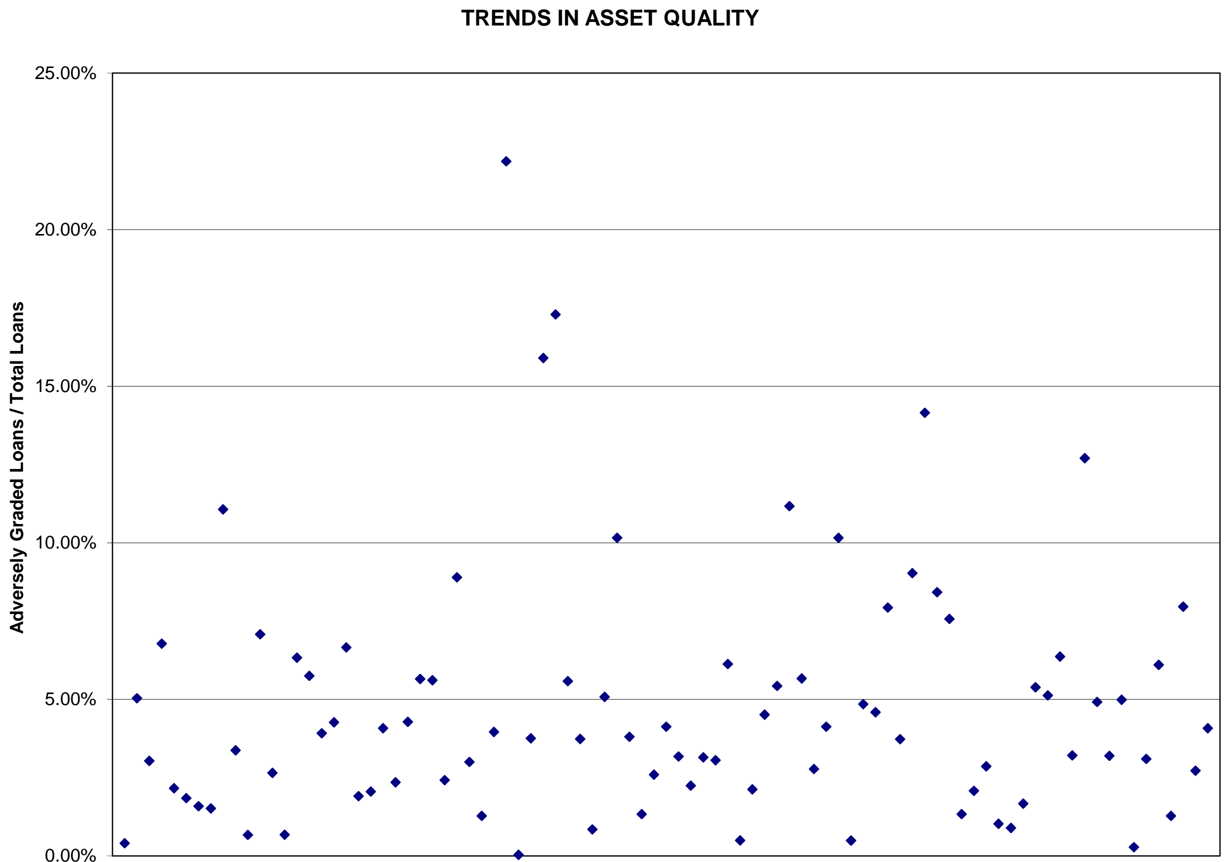
A higher level of volatility in the percentage of increases may be expected as overall asset quality stabilizes. A majority of the increases in Q4 2015 were nominal.

Dispersion of Problem Assets as a Percentage of Total Assets



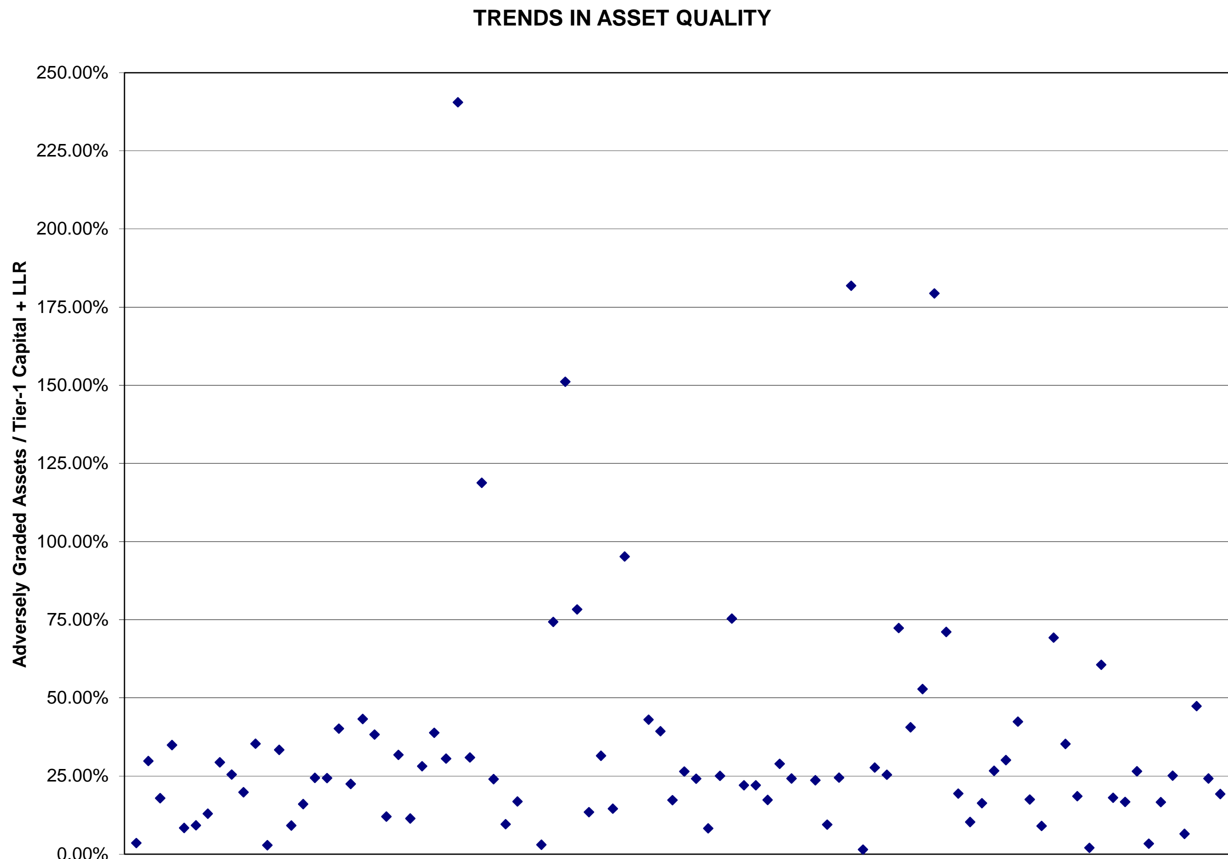
The above graph shows the dispersion of problem assets as a percentage of total assets. A traditional benchmark for significant asset quality concern is adversely graded assets that exceed 10% of total assets.

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

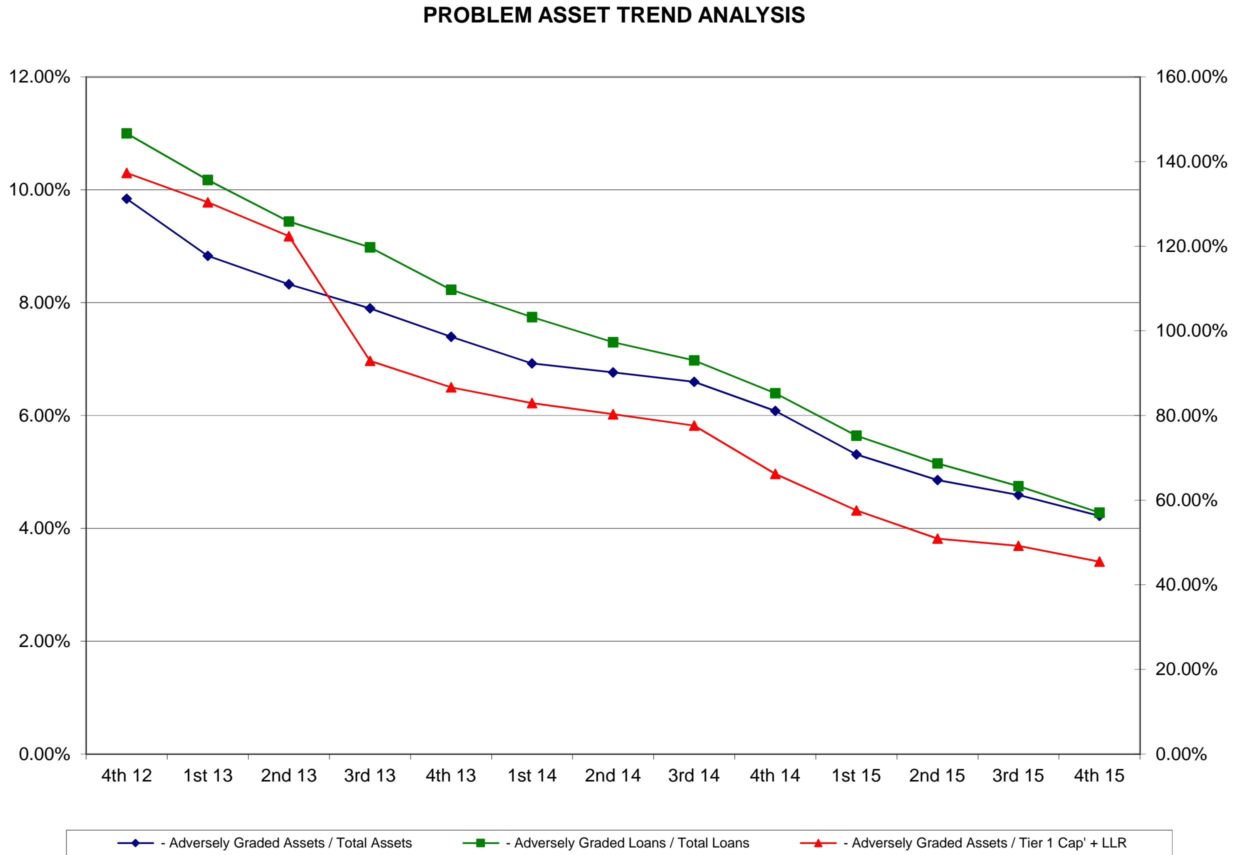
Our sample group includes sixteen (16) banks with problem assets exceeding 60% of tier-one capital plus loan loss reserve. This number compares to:

- Fifteen (15) during the Third Quarter 2015
- Eighteen (18) during the Second Quarter 2015
- Twenty one (21) during the First Quarter 2015, and
- Twenty four (24) during the Fourth Quarter 2014

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:

- Ten (10) during the Third Quarter 2015
- Twelve (12) during the Second Quarter 2015
- Fourteen (14) during the First Quarter 2015, and
- Seventeen (17) during the Fourth Quarter 2014

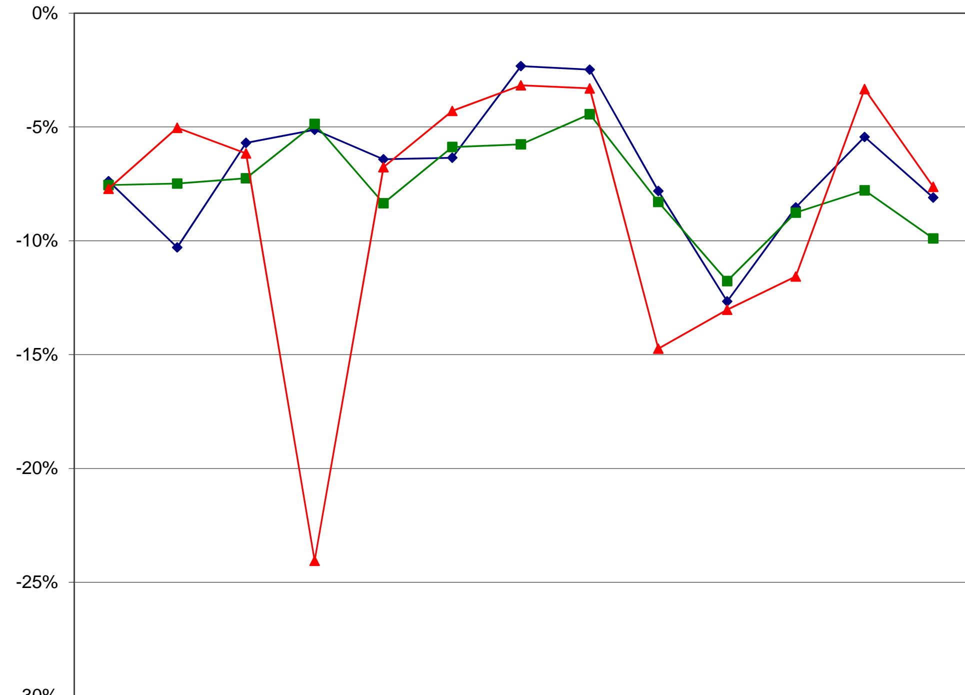
Problem Asset Trend Analysis



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



	4th 12	1st 13	2nd 13	3rd 13	4th 13	1st 14	2nd 14	3rd 14	4th 14	1st 15	2nd 15	3rd 15	4th 15
% Change in ACA/TA	-7.38%	-10.29%	-5.69%	-5.12%	-6.42%	-6.35%	-2.33%	-2.48%	-7.82%	-12.66%	-8.53%	-5.44%	-8.10%
% Change in ACL/TL	-7.55%	-7.48%	-7.25%	-4.86%	-8.35%	-5.88%	-5.77%	-4.44%	-8.29%	-11.77%	-8.76%	-7.79%	-9.90%
% Change in ACA/Tier 1 Cap' + LLR	-7.72%	-5.03%	-6.16%	-24.06%	-6.76%	-4.29%	-3.17%	-3.31%	-14.74%	-13.03%	-11.57%	-3.33%	-7.63%

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 3.86% of total assets, 4.21% of total loans, and 36.90% of tier-one capital plus loan loss reserve. Fourth Quarter 2015 modified data compares to the following Third Quarter 2015 modified average data set:

- 4.13% of total assets
- 4.56% of total loans, and
- 38.53% of tier-one capital plus loan loss reserve

Median asset quality ratios within the modified data set were 3.28% of total assets, 3.80% of total loans, and 25.06% of tier-one capital plus loan loss reserve. Fourth Quarter 2015 modified data compares to the following Third Quarter 2015 modified median data set:

- 3.36% of total assets
- 3.92% of total loans, and
- 26.52% of tier-one capital plus loan loss reserve

Underwriting Standards

On a semi-annual basis, the Office of the Comptroller of the Currency publishes a Risk Perspective. The most recent is *Semiannual Risk Perspective, Fall 2015*.

As noted in historical new letters, the twice-yearly report's findings are useful information for all OCC regulated banks and should prove helpful for all banks in helping to identify possible industry trends and proving discussion points for internal underwriting standards.

The findings included:

- Underwriting standards eased at a significant number of banks for the three-year period from 2013 through 2015….trends similar to those experienced from 2005 through 2007
- The level of credit risk increased, with a significant percentage of commercial and retail loan products reflecting increased risk from 2014. Examiners expect the level of credit risk to increase in both portfolios over the next 12 months.
- Supervisory strategies continue to include evaluating new loan originations, new product portfolios, and portfolios with increasing loan volumes.

The FDIC's Supervisory Insights, Winter 2015 *Credit Survey Results* also highlighted various underwriting trends. The Winter 2015 SI included:

- The observations reported by examiners in the Credit Survey reflect continuing improvement in the financial condition and overall risk profile of the banking industry. At the same time, Credit Survey results suggest that just as loan growth is returning, so to some extent are riskier lending practices.

Within many community banks, very common issues are continued weak loan demand and very aggressive competition for quality loans. In rural as well as urban markets, SHP & Co. client banks indicate competitive pressures that could result in heightened interest rate risks (long term fixed rate pricing) in conjunction with credit risks (lower debt coverage ratios and lower equity requirements). Competitive pressures should not be the driving factor in lessened underwriting standards.

Shared National Credits & Participation Lending

Throughout our client base, we are frequently asked about Shared National Credit (SNC) loans. For many small banks, SNCs offer an avenue to increase their loan portfolios. As with any loan, SNCs involve risk. Purchased loans, as highlighted in historical newsletter articles, should be carefully underwritten internally.

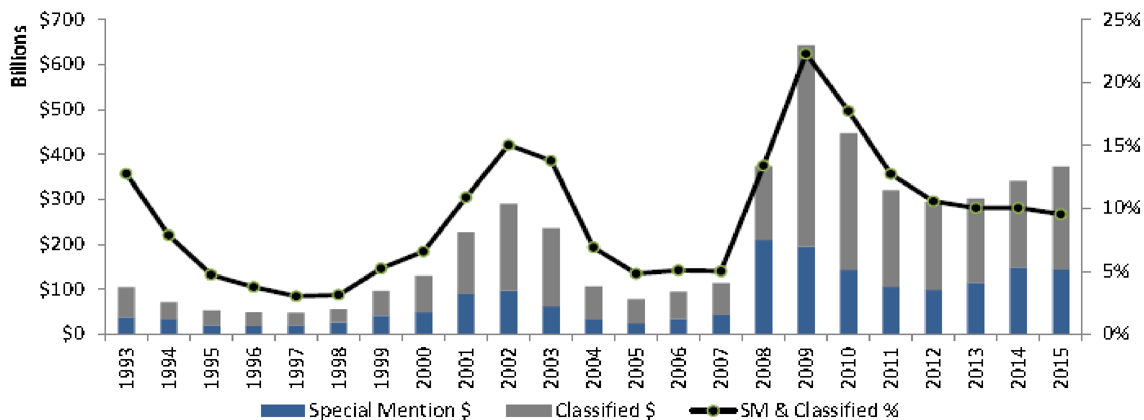
Please compare the level of classified SNCs to the average & median classification levels in the SHP & Co. bank peer group.

- SHP & Co. average classified loans to total loans 4.28%
- SHP & Co. median classified loans to total loans 3.79%
- Classified SNCs to the total portfolio 5.8%

Also of note, oil and gas related credits represent 15% of total SNC classified loans. Assuming a 15% reduction in total SNC classification, roughly 4.9% of the portfolio would still be adversely classified.

While a very rough 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.

Highlights from the Shared National Credits Program 2015 Review included:



- Classified commitments increased from $191.3 billion to $228.4 billion, representing 5.8 percent of the portfolio, compared with 5.6 percent in 2014. Classified dollar volume increased 19.4 percent from 2014
- Credits rated special mention, which exhibit potential weakness and could result in further deterioration if uncorrected, decreased slightly from $149.2 billion to $144.2 billion, representing 3.7 percent of the portfolio, compared with 4.4 percent in 2014. Special mention credits decreased 3.5 percent from 2014
- Credits classified doubtful and loss rose by $5.6 billion. In addition, adjusted for losses, nonaccrual loans increased from $43.3 billion to $49.9 billion, a 15.1 percent increase

The interagency Shared National Credits (SNC) Review for 2015 indicates credit risk in the portfolio remains high, despite a relatively favorable economic environment. The agencies noted a significant increase in leveraged lending volumes and continued loose underwriting…

The SNC examination noted weaknesses in underwriting standards in 28 percent of the loan transactions sampled which was higher than experienced in recent years…. The most frequently cited underwriting deficiencies identified during the 2015 SNC review were minimal or no loan covenants, liberal repayment terms, repayment dependent on refinancing, and inadequate collateral valuations. The weak underwriting structures were in part attributable to aggressive competition and market liquidity.

Slowing revenue growth and rising interest rates will adversely affect these borrowers' ability to meet cash flow projections especially considering the limited financial performance present in many of the current pass credits.

The FDIC issued FIL-49-2015 FDIC *Advisory on Effective Risk Management Practices for Purchased Loans and Purchased Loan Participations* during November 2015.

Within the FIL, the FDIC indicated:

> An increasing number of financial institutions are purchasing loans from nonbank third parties and are relying on third-party arrangements to facilitate the purchase of loans, including unsecured loans or loans underwritten using proprietary models that limit the purchasing institution's ability to assess underwriting quality, credit quality, and adequacy of loan pricing. In some situations, it is evident that financial institutions have not thoroughly analyzed the potential risks arising from third-party arrangements.

We encourage banks to look to diversify risk within their portfolios. Participation loans, from other banks or from third parties, and SNCs could prove a profitable venture and serve to improve a bank's overall risk profile. However, a purchasing institution should fully vet a purchased loan as they would any other loan. Please refer to the Q1 2015 SHP & Co. newsletter for additional discussion of participation lending.

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