CECL is Here, Now What?

Arkansas Bankers Association MEGA Conference

September 27, 2023

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Today's Speakers

Shawn O'Brien
President
QwickRate

- Leads the strategy for the premier non-brokered CD marketplace and accompanying products
- Serves on the Board of Directors - National Bank of St. Anne
- Former Owner & President of QR Lending
- Co-founder of QwickAnalytics

shawn.obrien@qwickrate.com

Let's look at what is happening now

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Current Credit/Banking Concerns (General)

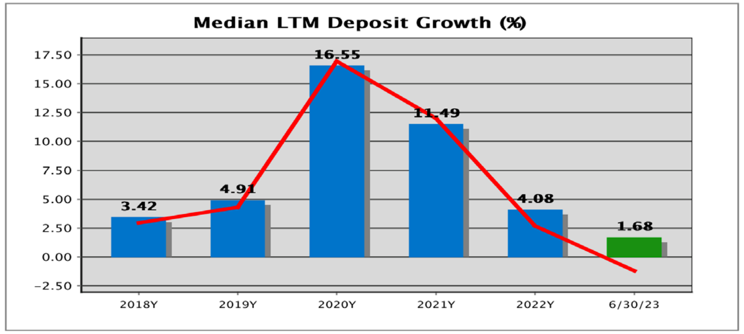
Liquidity & deposit drains fuel fears of loan funding / credit crunch.

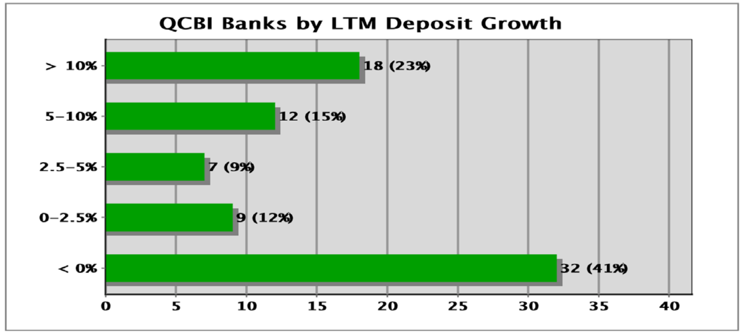
Deposit Growth Trends: Banks <$10B

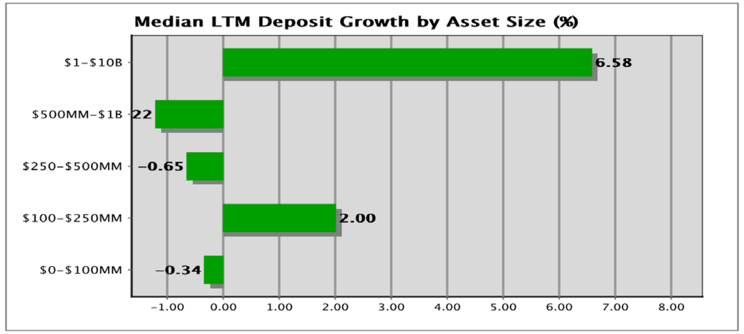
QwickAnalytics State Performance Trends

Deposit Growth Trends

Arkansas
Banks
June 30, 2023







National Trend

* *LTM = Last 12-months (or "trailing" 12-months)*

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Q2 '23 Call Report Data

Along with concentrations, a key factor in fueling your customers' fear is the possibility of a **credit crunch ahead!**

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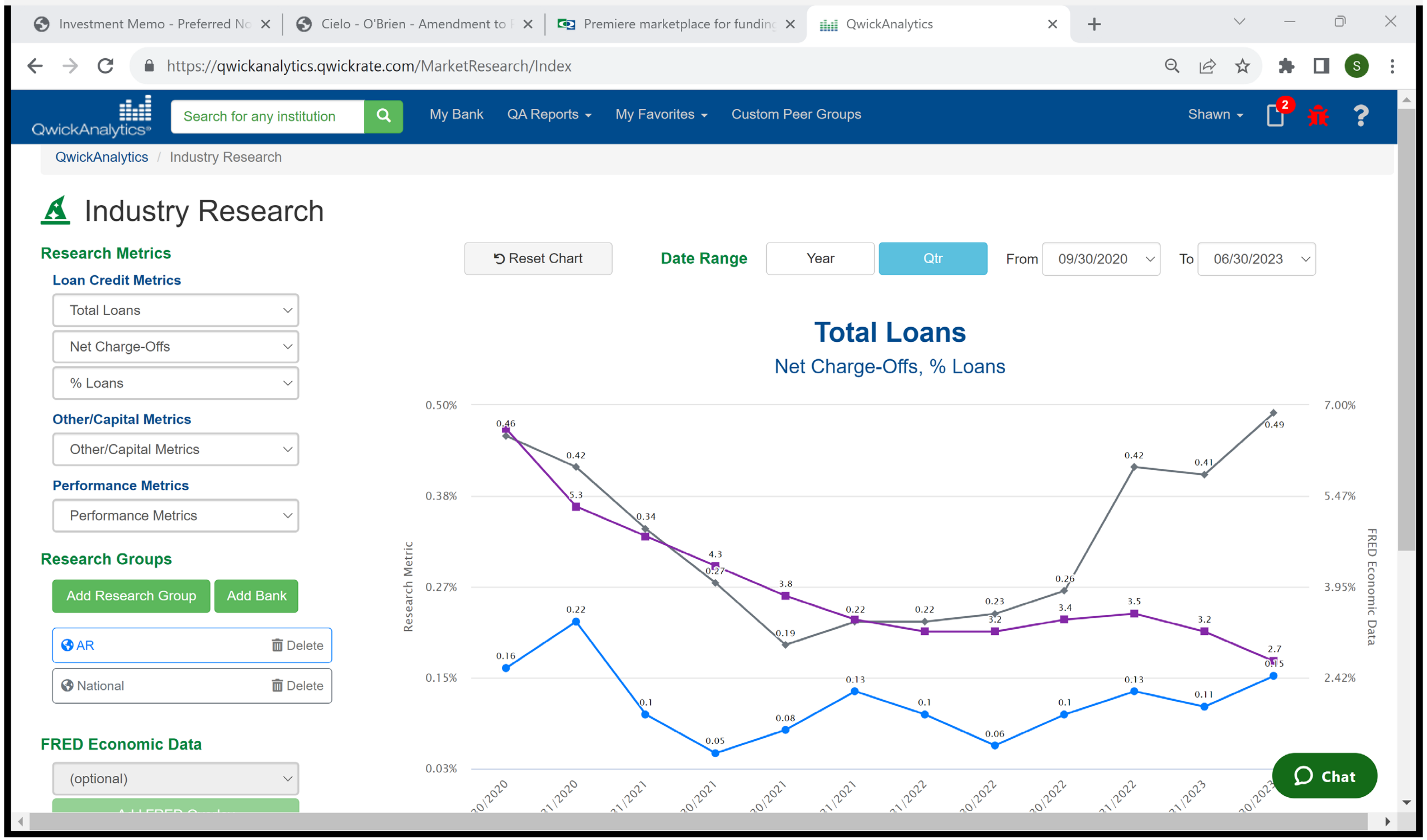
Current Credit/Banking Concerns (General)

Liquidity & deposit drains fuel fears of loan funding / credit crunch.

Reserves at smaller banks have declined–not so at larger banks or in Arkansas

Arkansas median Net Chargeoffs are better than the National median



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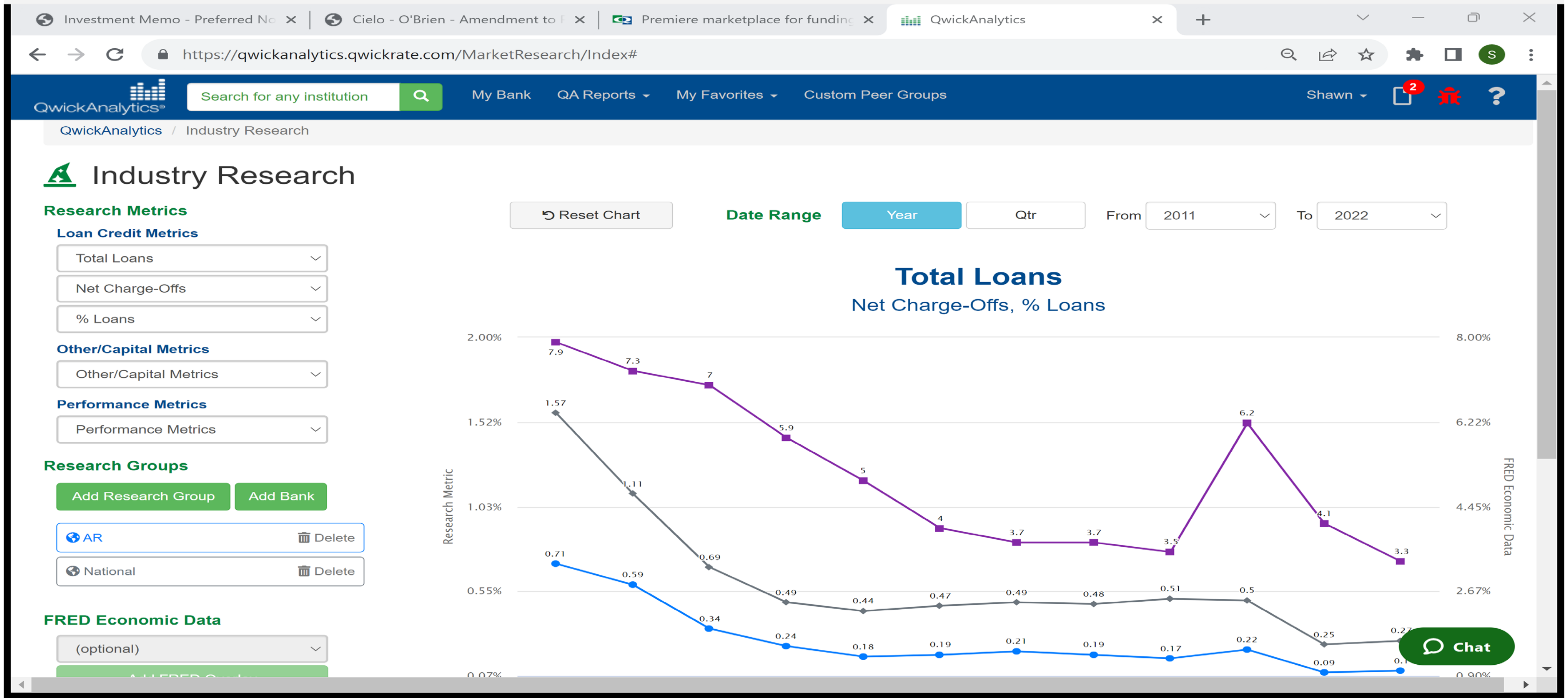
Longer term the trend is true too!



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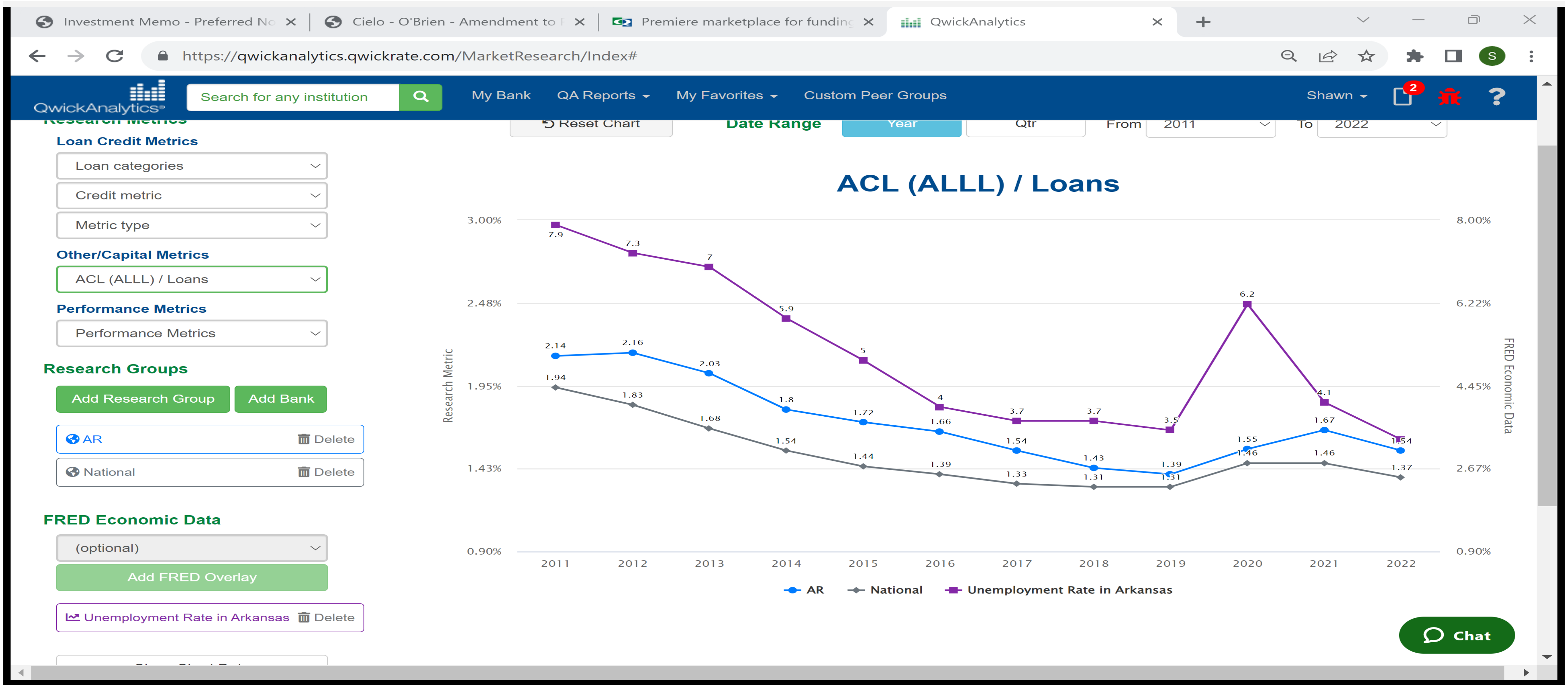
Fewer charge-offs, higher reserves.



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Current Credit/Banking Concerns **(Industry General)**

Community banks' earnings declined Q2 '23.

Liquidity & deposit drains fuel fears of loan funding / credit crunch.

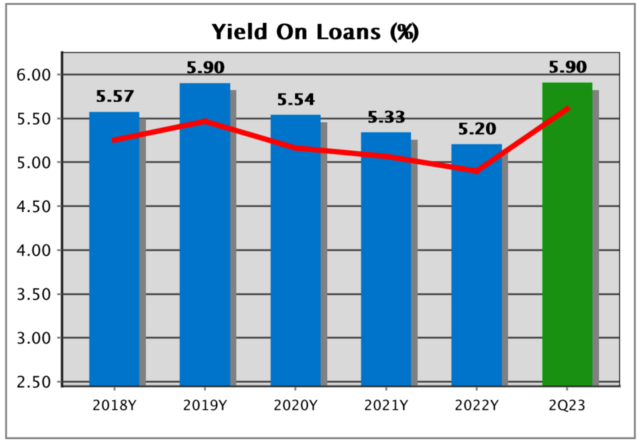
Reserves at smaller banks have declined—not so at larger banks.

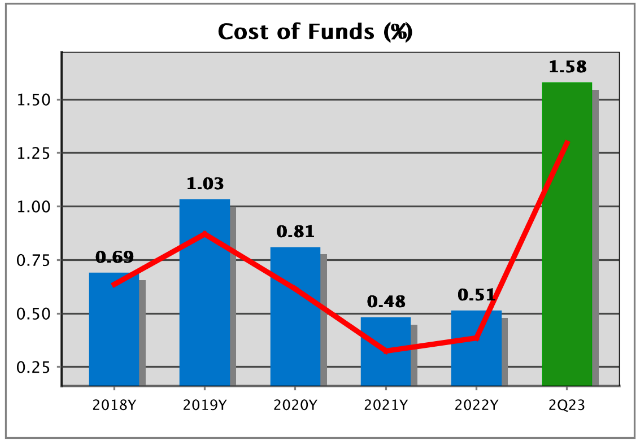
Continuing negative pressures on NIM's and efficiency ratios.

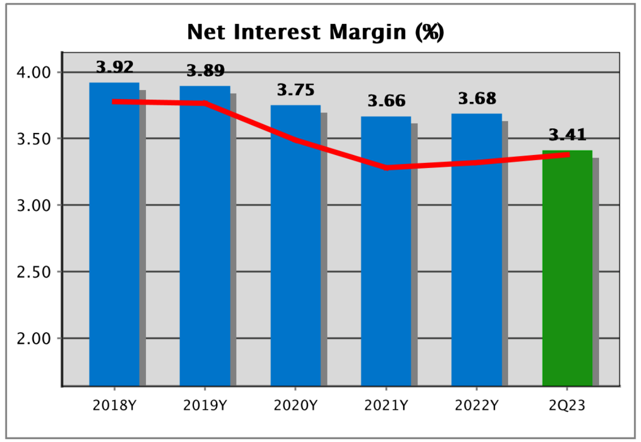
Performance Trends

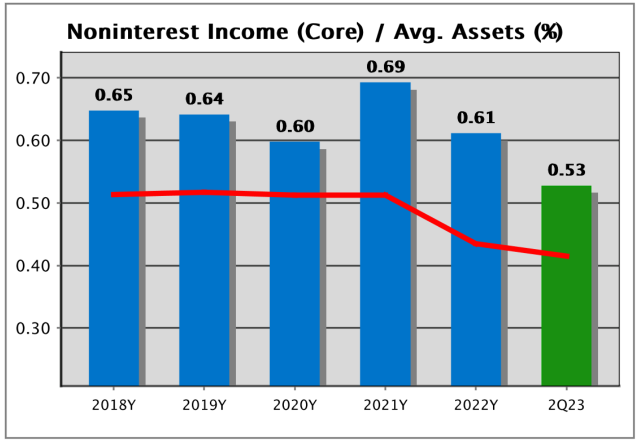
Arkansas Banks

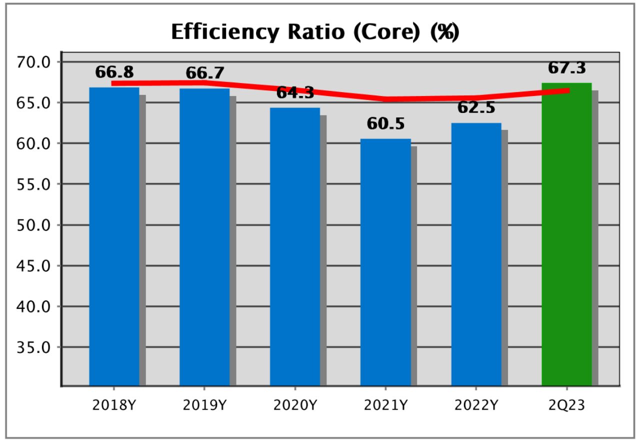
June 30, 2023









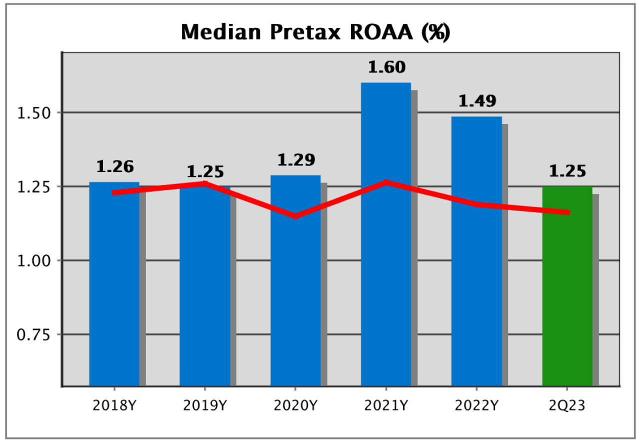


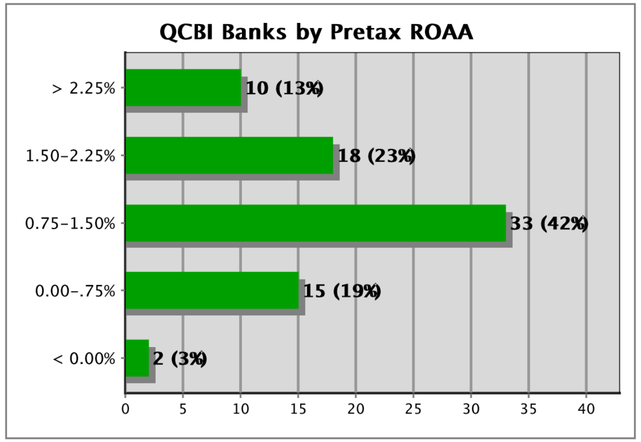
National Trend

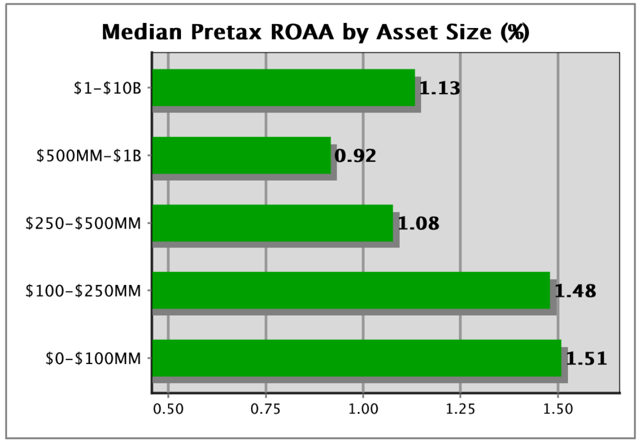
Note: All data points represent median values;
current period data (green bars) are for the most recent quarter (MRQ); Core items exclude nonrecurring gains/losses

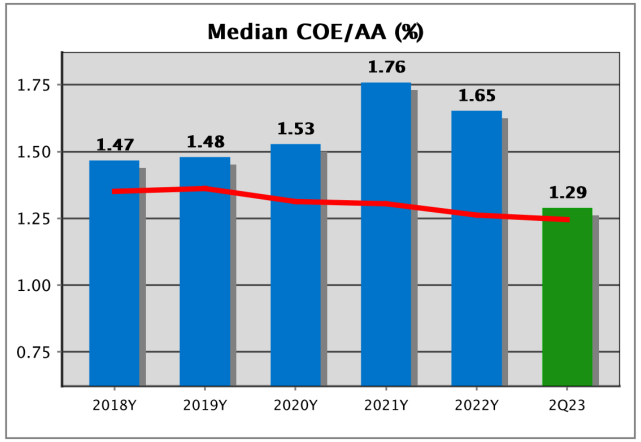
QwickAnalytics State Performance Trends
Profitability Trends

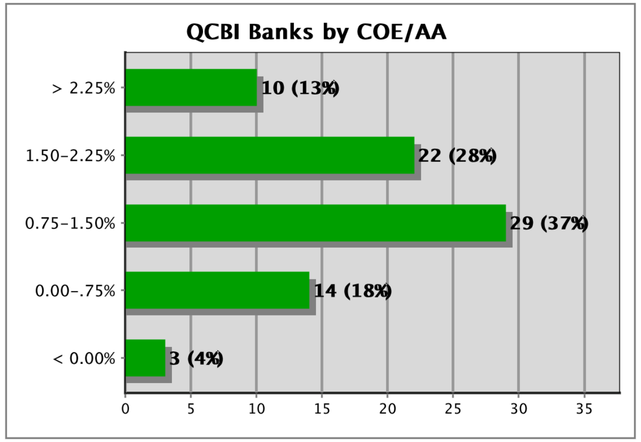
Arkansas Banks
June 30, 2023

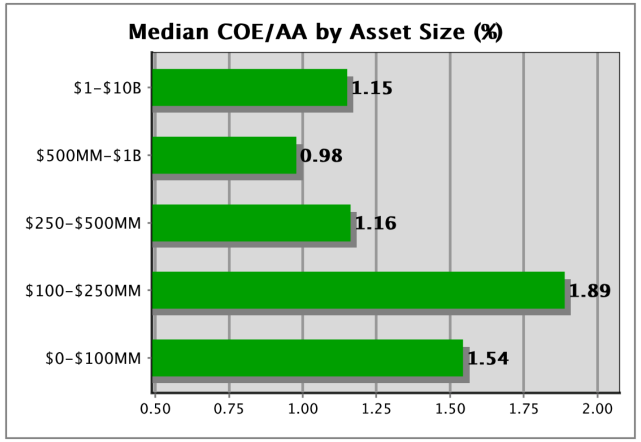












National Trend

** Core Operating Earnings excludes credit-related & nonrecurring items (loan loss provision, nonrecurring gain/(loss) on the sale of assets (other than loans), impairment losses, etc.)*
current period data (green bars) are for the most recent quarter (MRQ)

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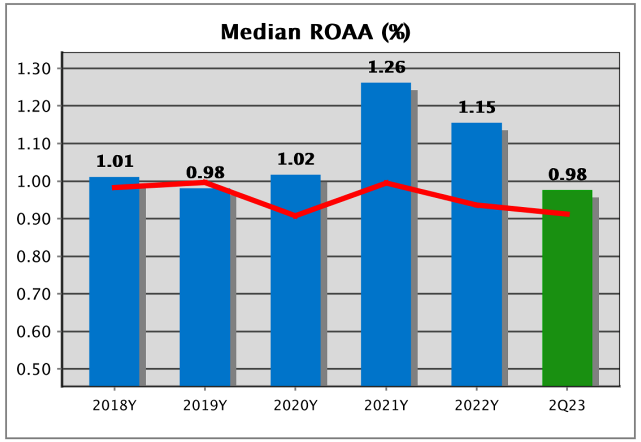
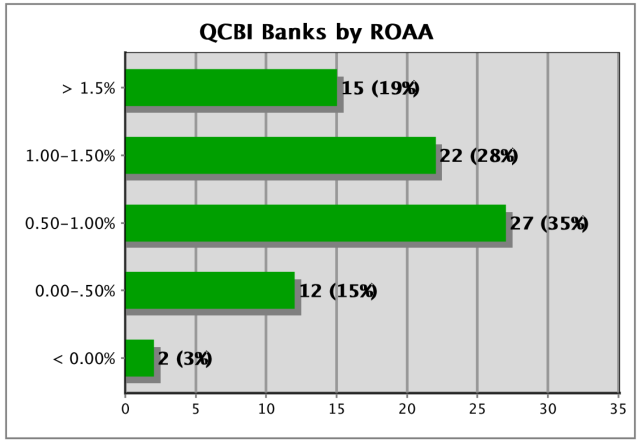
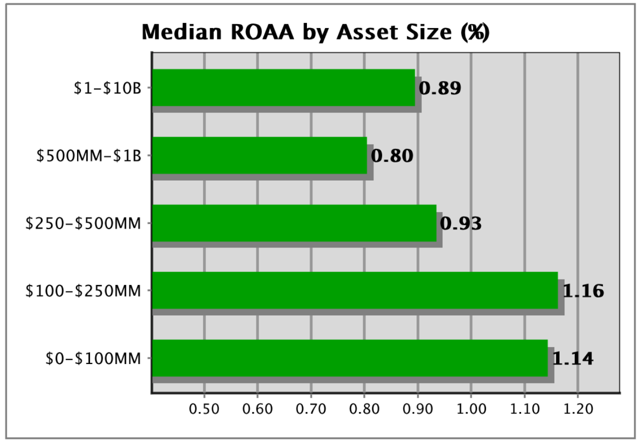
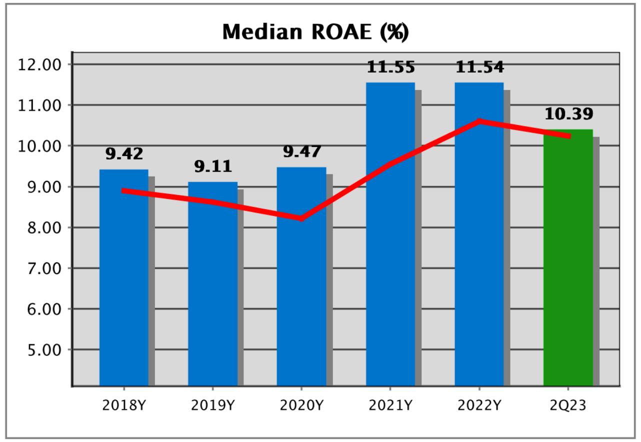
QwickAnalytics State Performance Trends
Profitability Trends

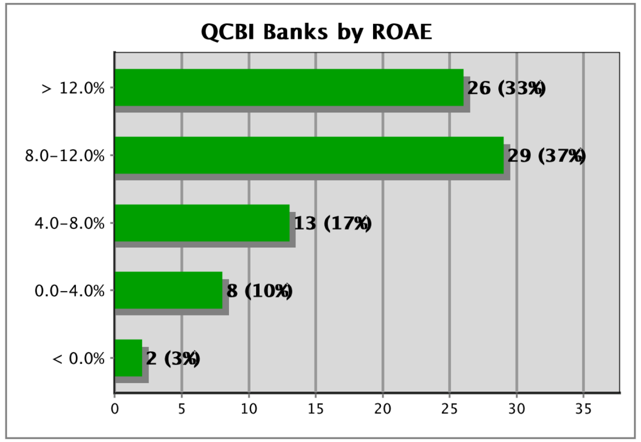
Arkansas Banks
June 30, 2023

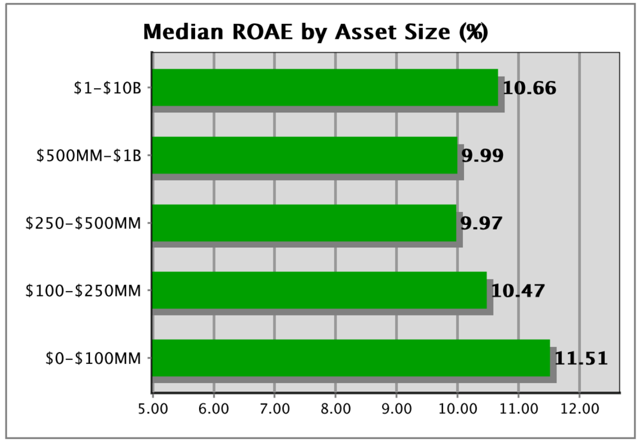












National Trend

** ROAA & ROAE have been tax-affected for all S-Corp status institutions at an assumed tax rate of 21% (35% prior to 3/31/18); current period data (green bars) are for the most recent quarter (MRQ)*

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Current Credit/Banking Concerns (Industry General)

Community banks' earnings declined Q2 '23.

Liquidity & deposit drains fuel fears of loan funding / credit crunch.

Reserves at smaller banks have declined–not so at larger banks.

Continuing negative pressures on NIM's and efficiency ratios.

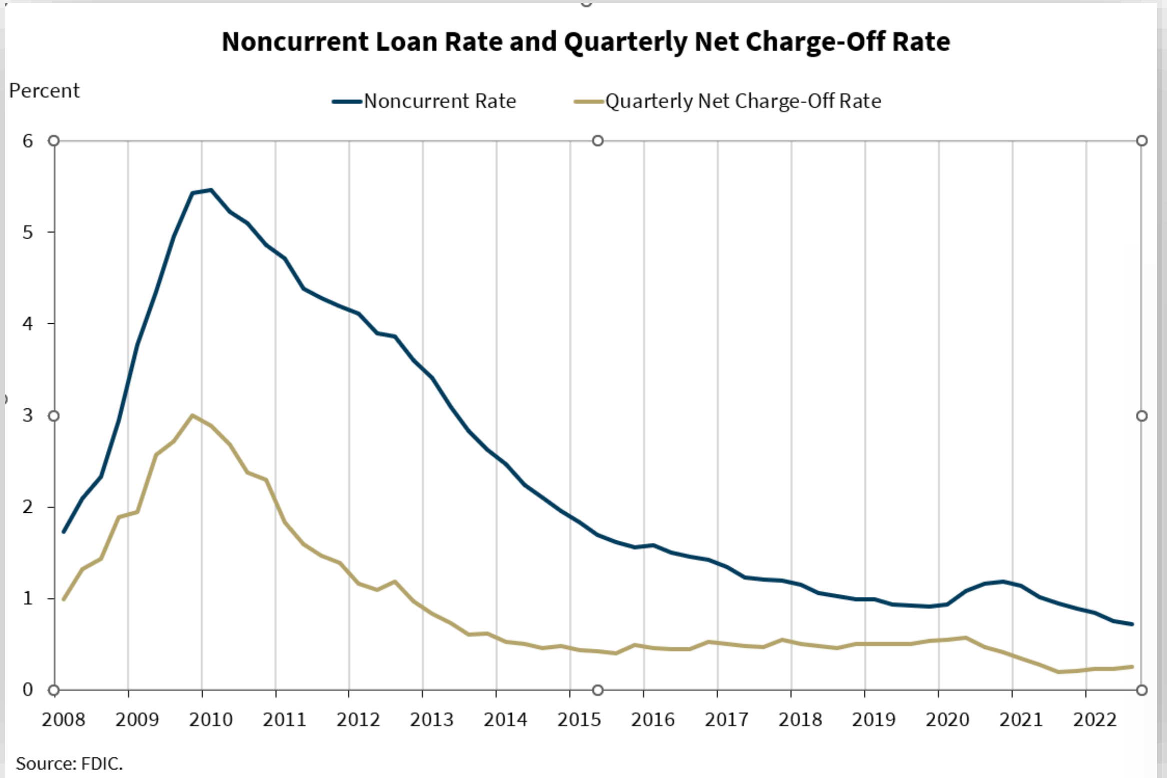
Community banker economic sentiment "worse than dismal". (CSBS Chief Economist)

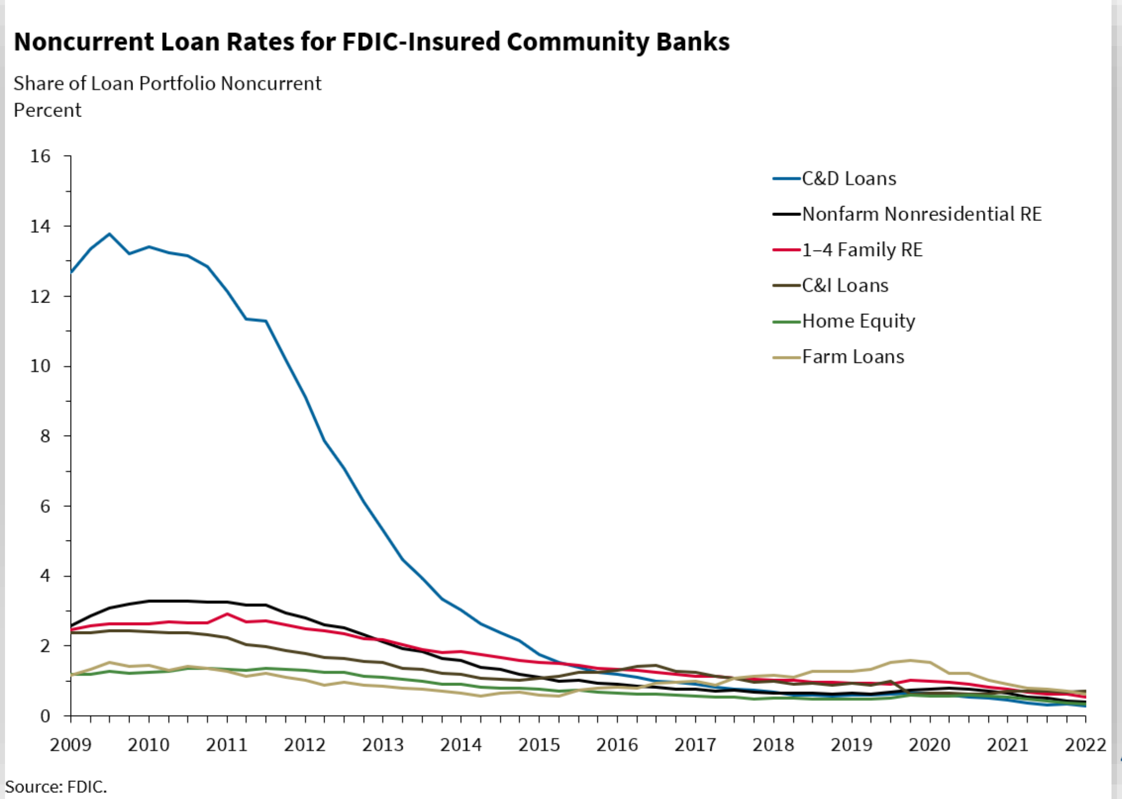
Be prepared for overreaction (investor & regulatory) over first signs of stress.

Current Credit Concerns (General)

Credit *performance* metrics still good, but future clouded by several factors.

Source Of The Complacency





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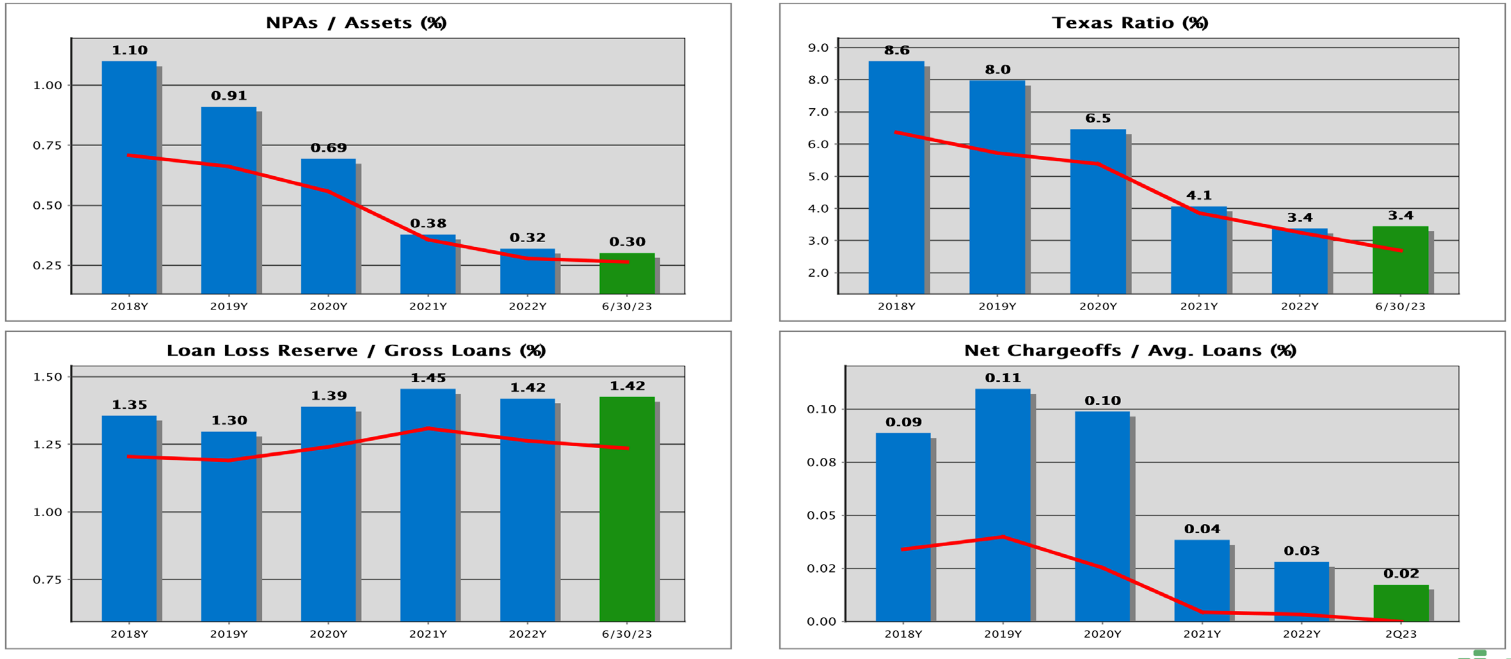
NPAs down, reserves are strong in Arkansas

QwickAnalytics State Performance Trends

Asset Quality Trends

Arkansas
Banks
June 30, 2023



National Trend

* All data points represent median values; NPAs = loans 90+ days P.D. + nonaccrual loans + restructured loans + OREO; Texas Ratio = NPAs as a percentage of tangible equity + loan loss reserve

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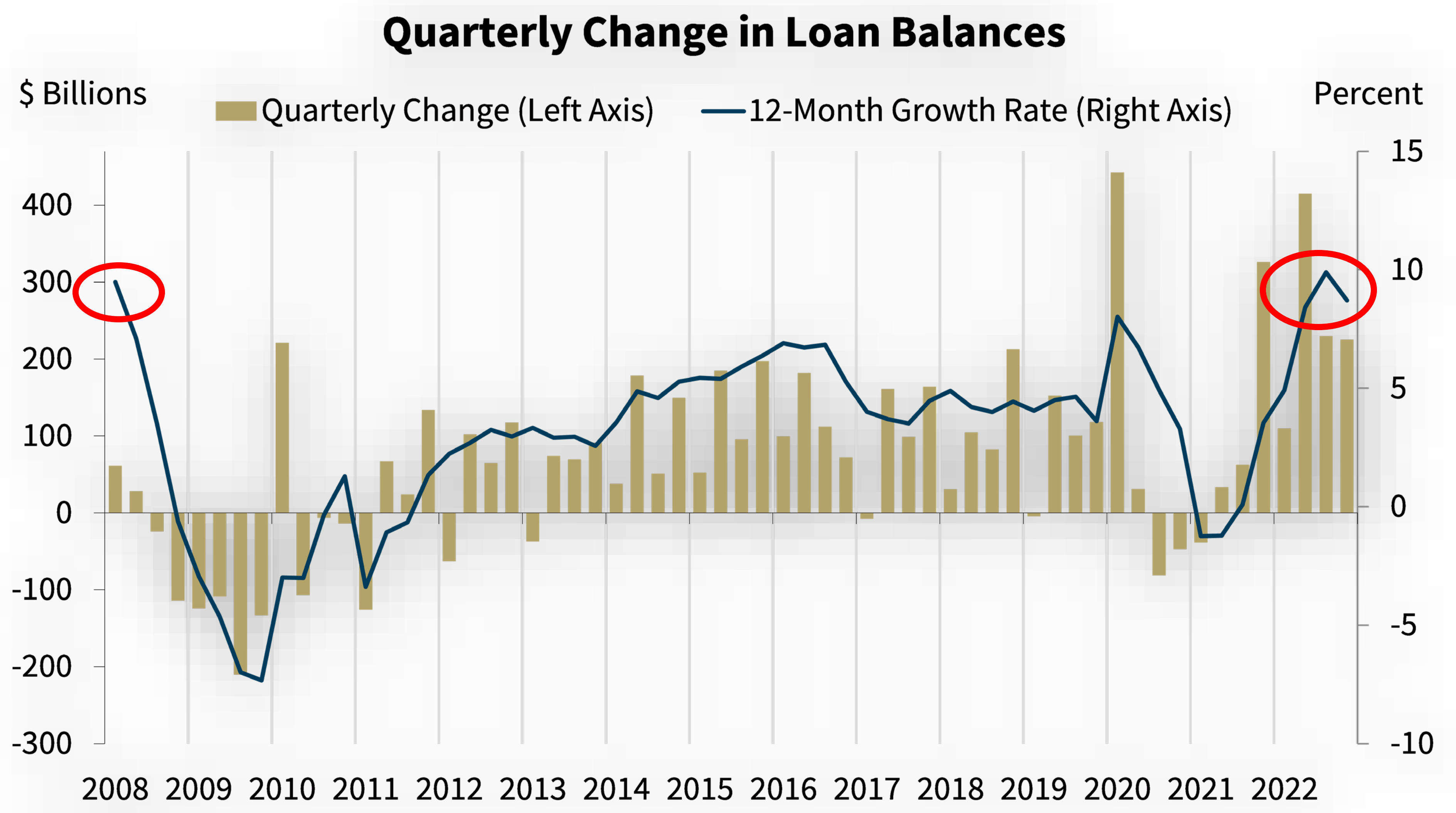
IF and WHEN this curve turns upward,
remember the smaller banks' conundrum:

- Reluctance to move against known borrowers
- Disproportionate capital/reputational impact of losses
- High dependence on real estate (the most illiquid of problem assets

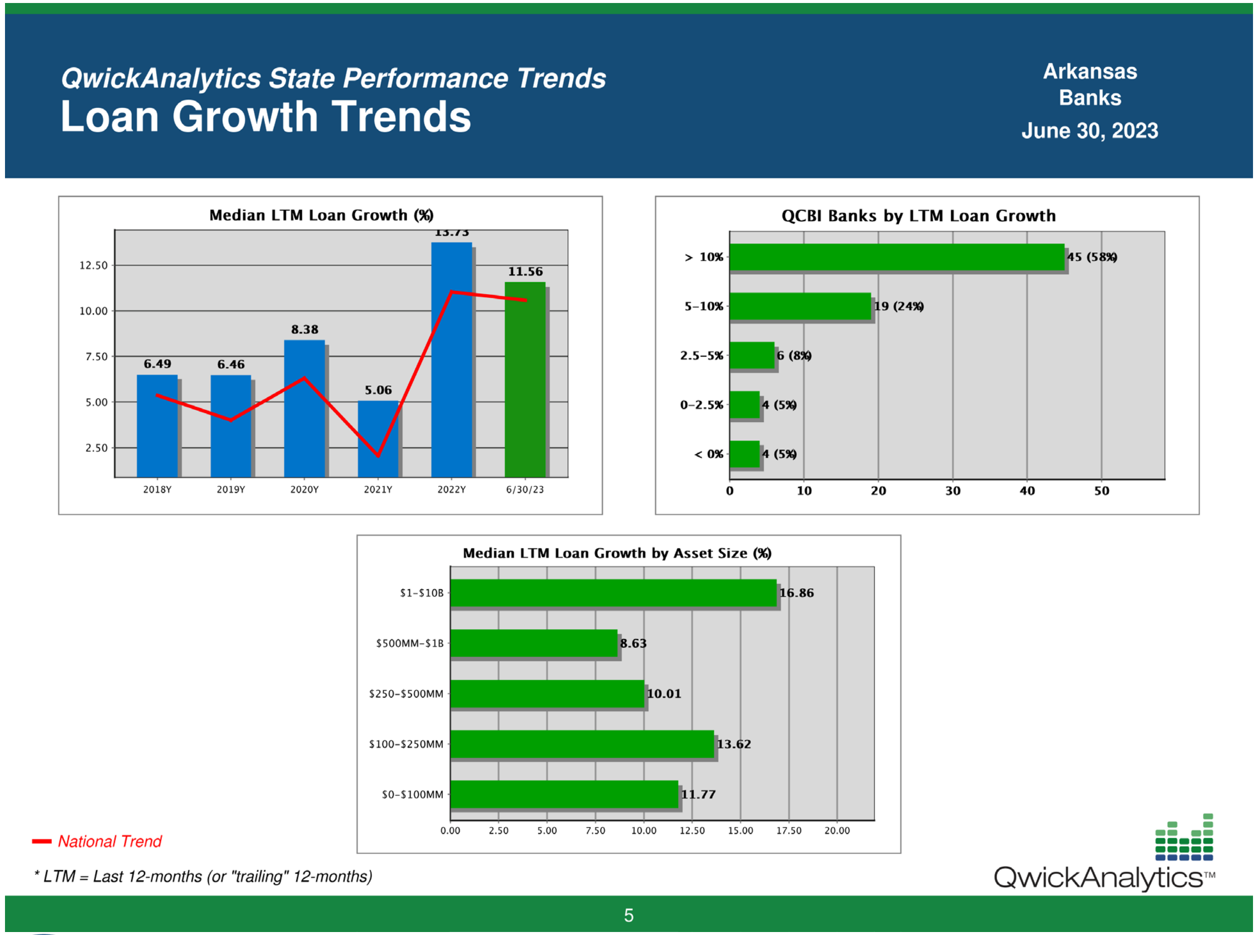
National Loan Growth Trends: All Banks



Source: FDIC.

AR Loan Growth Trends: Banks <$10B

Q2 '23 Call Report Data



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Vintages matter:
A weakened economy will disproportionately penalize credit quality from the most recent bursts of growth!

Lending headwinds:
~57% of CRE/C&I now funded by non-banks–

Piper Sandler AOBA Conference 1/31/2023

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Current Credit Concerns (General)

Credit *performance* metrics still good, but future clouded by several factors.

Loan demand moderating, but vintages require monitoring.

Credit servicing continues to struggle.

Rising consumer debt and delinquencies are now real.

Current Credit* Concerns (By Industry)

Highest Risk: CRE Office & Retail / Consumer* / Small Business

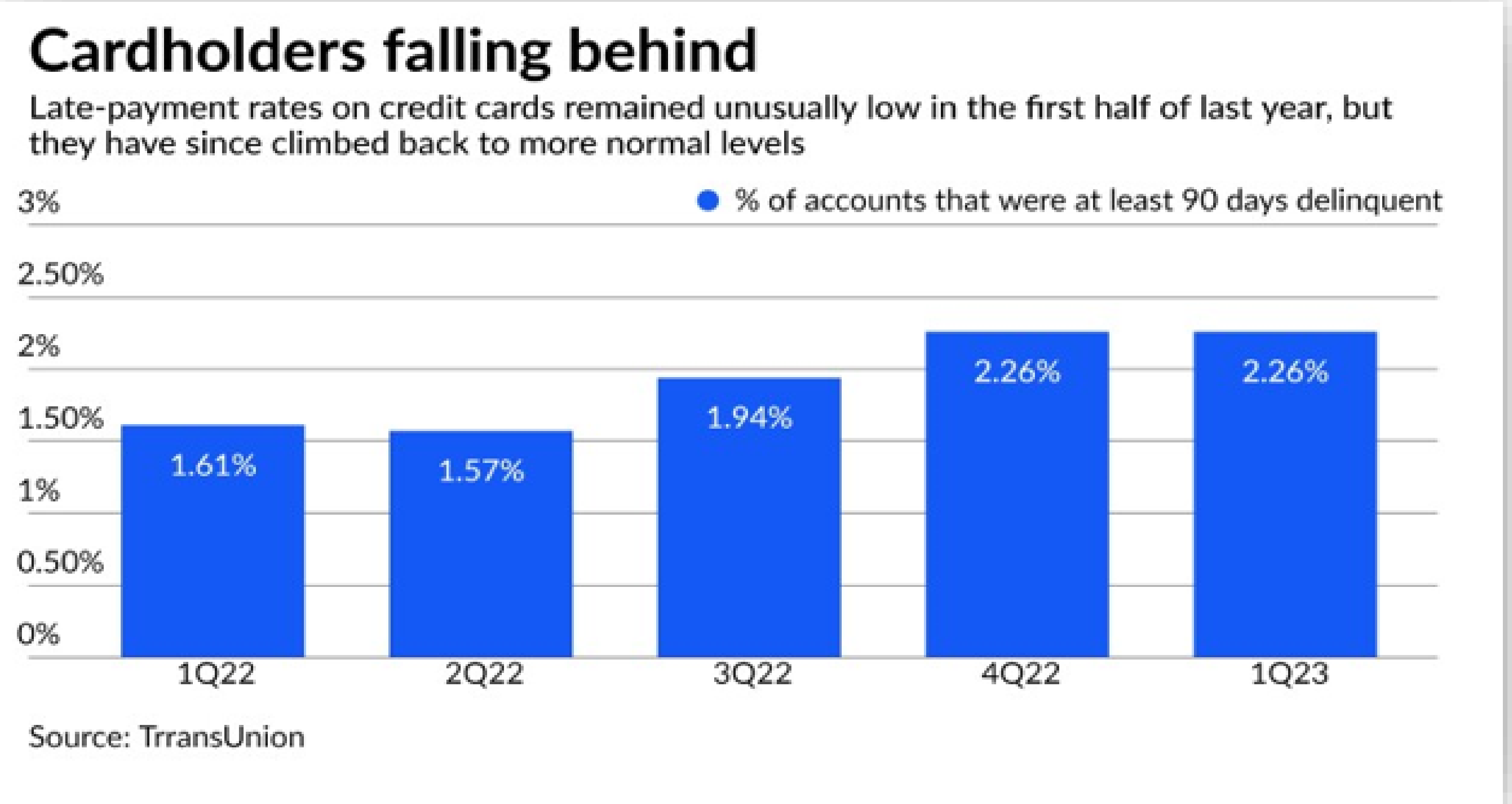
Moderate Risk: CRE Hospitality / Specialty Lending

Lowest Risk: Agriculture

*Based on recent regulatory commentary / our DD & LR findings

**Susceptible Consumer*

Early Signs Of Stress . . . Mainly Consumer



- The increase was driven by subprime borrowers, who have been more vulnerable to inflation and interest rate hikes than borrowers with higher credit scores.
- U.S. credit card balances: $917B in the Q1 '24 from $769B in Q1 '23.
- Mortgage repayment performances remain strong.
- Truly a tale of two consumer segments!

--American Banker May, '23

Consumer debt passes $17 trillion for the first time despite slide in mortgage demand

PUBLISHED MON, MAY 15 2023-11:00 AM EDT

--CNBC May, '23

Current Credit Concerns (General)

Credit *performance* metrics still good, but future clouded by several factors.

Loan demand moderating, but vintages require monitoring.

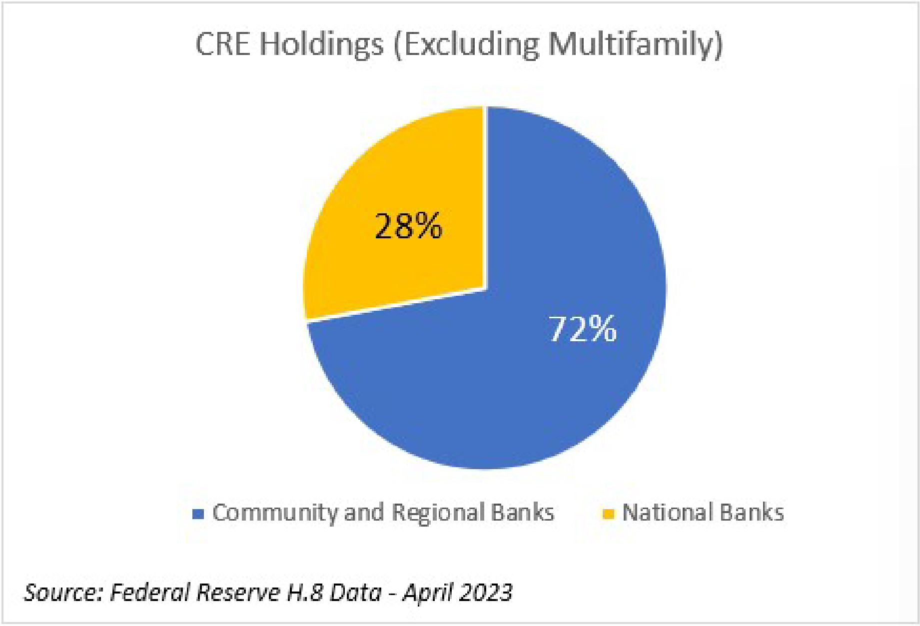
Credit servicing continues to struggle.

Rising consumer debt and delinquencies are now real.

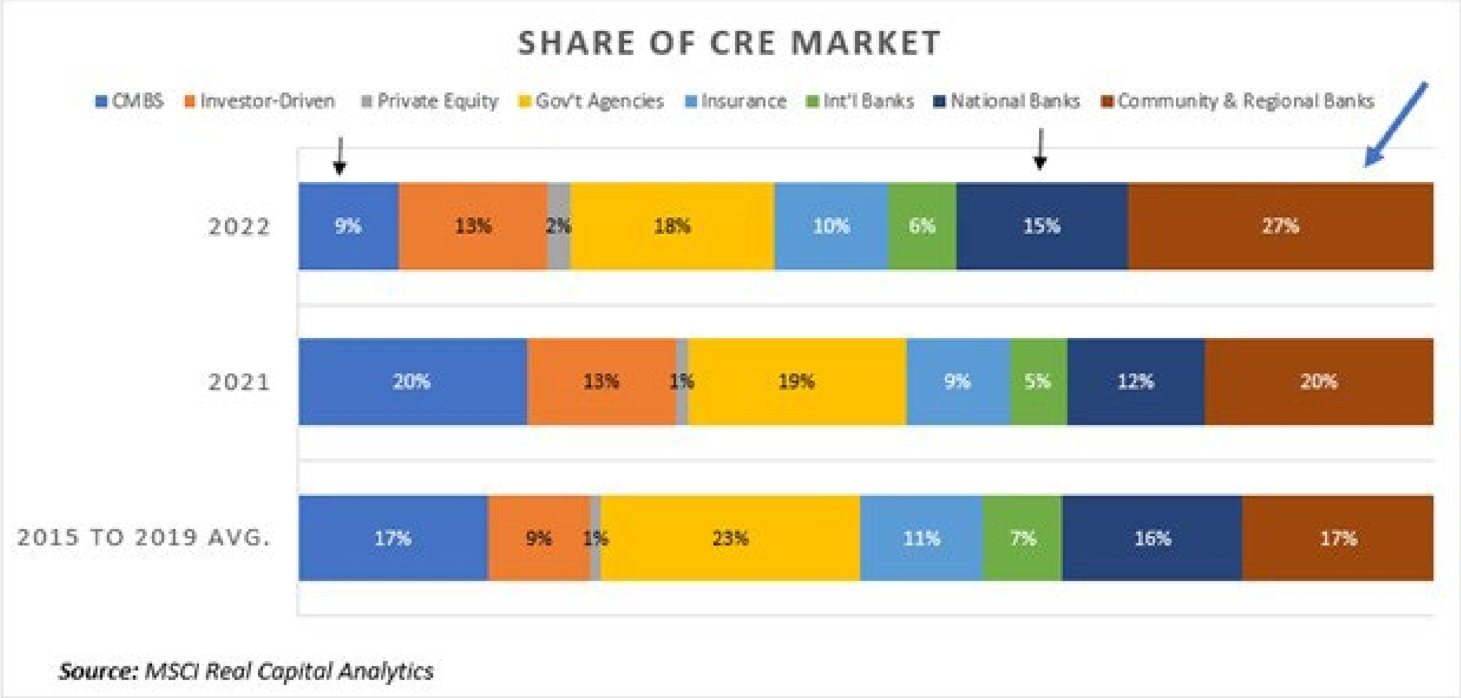
But, for commercial bankers, most concern should be about CRE loans!

Community And Regional Banks:
CRE Has Exploded In Exposure *Just Since The Pandemic!*

Commercial Banking Exposure



All CRE Exposure



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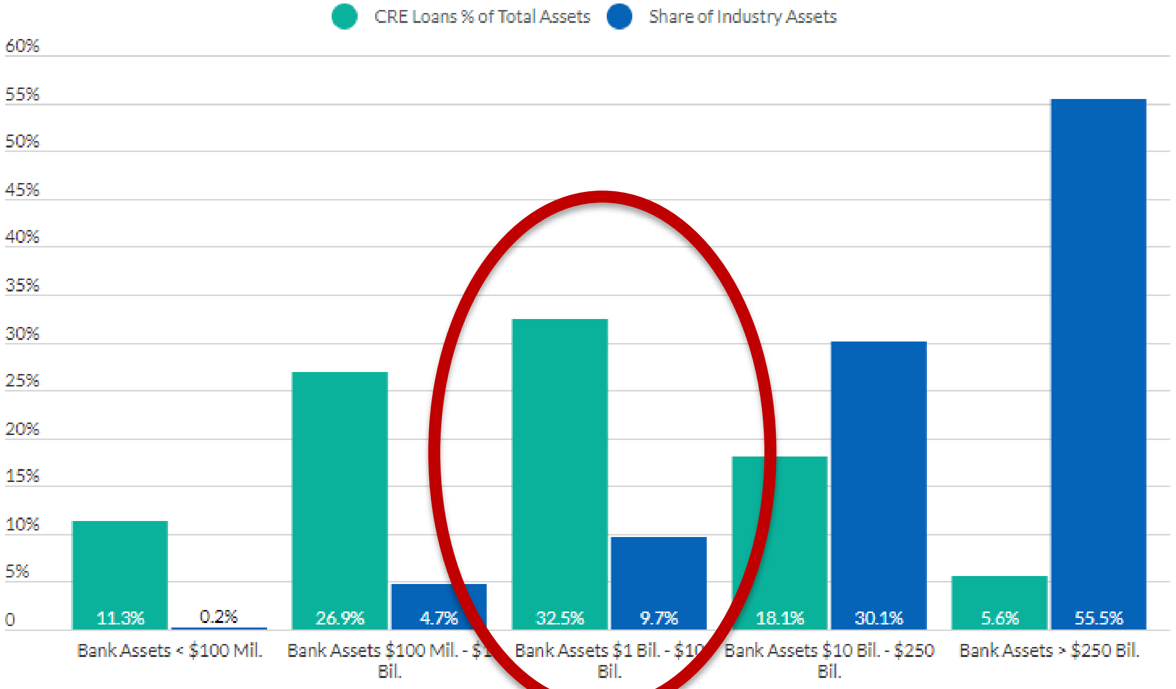
CRE Lending (% Of Assets):
Smaller Banks' CRE Exposure Dwarfs Larger Banks

Smaller Banks Exposure to CRE Significantly Higher than Larger Banks

Higher CRE Exposures and Elevated Loan Growth Have Historically Been Correlated to Small Bank Failures

Percentage of Total Capital | Share of Assets



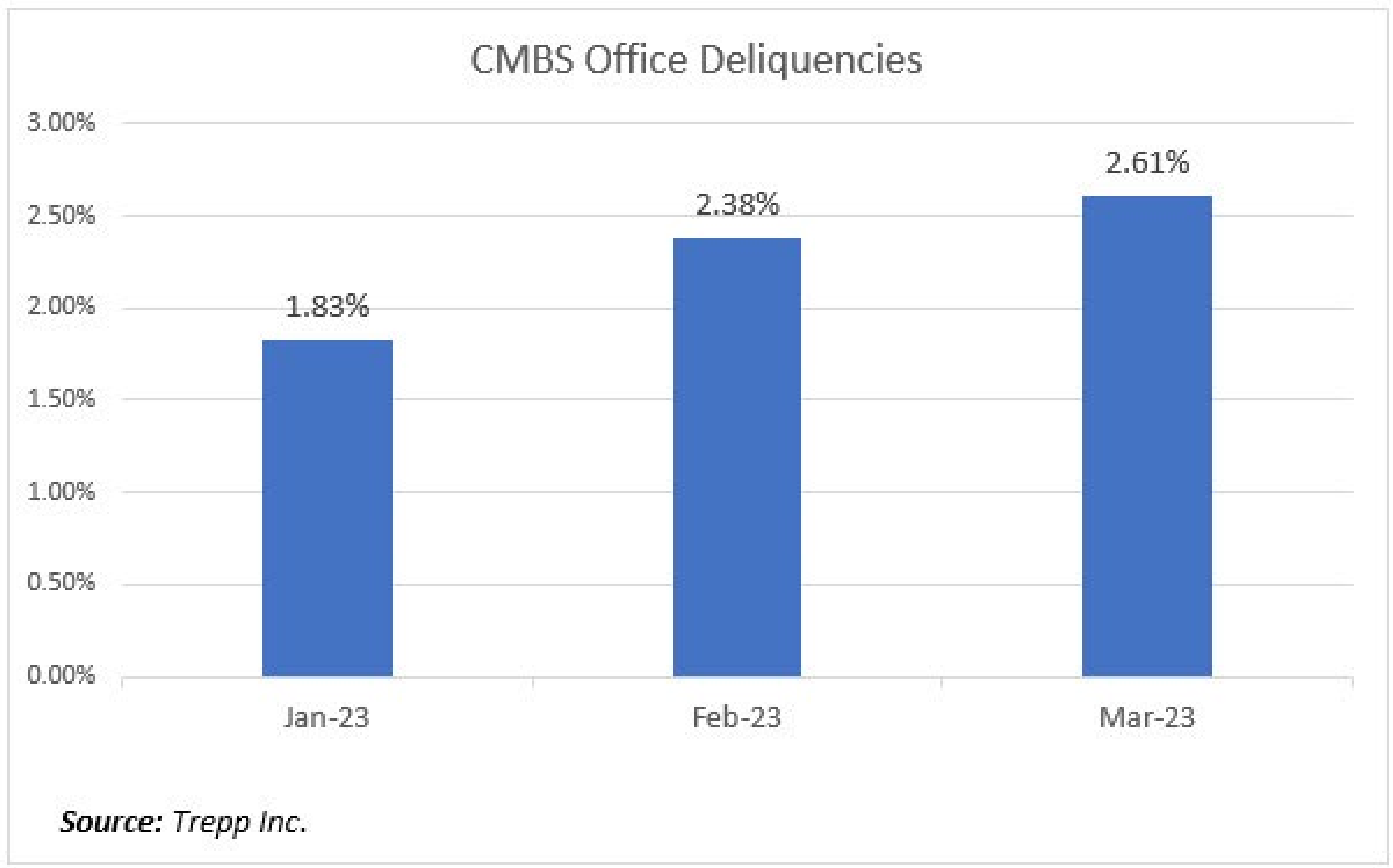
Note: CRE includes all owner occupied and construction CRE loans. Total capital includes all Tier 1 and Tier 2 capital per definitions under U.S. regulations.

Source: Fitch Ratings, FedFis.

FitchRatings

Share

Delinquencies – Especially Office Space – Rising!



- June CMBS delinquencies ↑20 bps / ↑16% in last six months
- Morgan Stanley estimates $1.4T in office space lending will be up for rate adjustments in next 24 months

All Four National Regulators Send Red Flag On CRE

PRESS RELEASE / June 29, 2023

Inter-Agency Guidance Policy Statement on Commercial Real Estate Loan Accommodations and Workouts

IF within basic safety & soundness protocols, examiners will not:

- criticize financial institutions adopting CRE workout plans and short-term accommodations; and
- automatically downgrade loans to "Substandard or worse" solely due to declining RE values, and borrower objectively is not deemed to be beyond ultimate repayment capacity.

All Four National Regulators Send Red Flag On CRE

PRESS RELEASE / June 29, 2023

Inter-Agency Guidance Policy Statement on Commercial Real Estate Loan Accommodations and Workouts

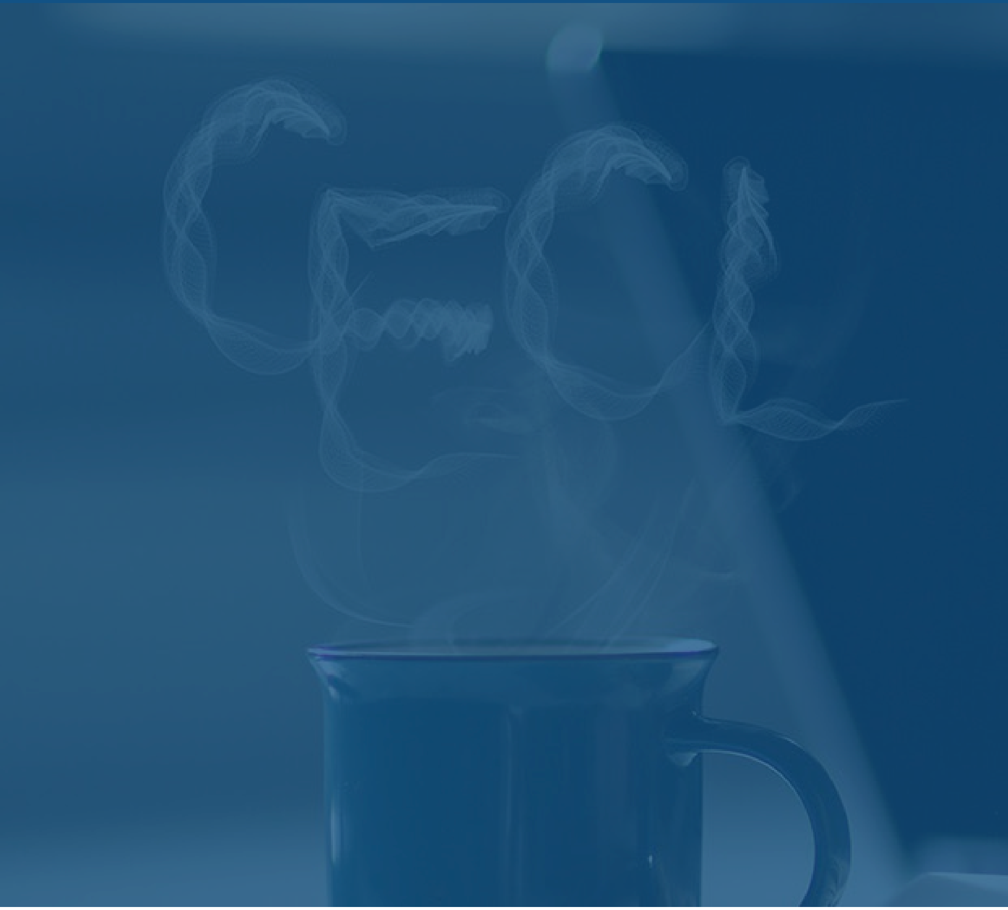
Other Highlights include guidance on:

- Short-term accommodations
- Loan workout programs
- Long-term workout arrangements
- Classification of loans, relative to:
  - Loan Performance
  - Renewals/restructurings
  - CRE dependent on sale of collateral
  - Classifications & treatment of accrual status

The guidance makes no changes in regulatory reporting and accounting protocols.

Higher for Longer might increase refinancing risk

- **Will a WALL OF MATURITIES bring stress/distress?**
- **$1.5 trillion of CRE debt is expiring by the end of 2025**
- **$117 billion of office loans are expiring in 2024**
- **Higher interest rates**
- **Unstable rent rolls**
- **High-cost basis**
- **Limited to no debt options**
- **Office loan defaults increasing**



Questions arising from CECL

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Do I Need A New ALLL Policy?

- In general, many institutions have a brief policy on the ALLL calculation and process. CECL is sufficiently different to warrant you reviewing your existing policy and probably updating the policy. *Policy should be completed by 3/31/23.*
- **Policy Components to Consider:**
  - **Not Needed**: you do not have to repeat all the accounting language to describe what CECL is, or have your policy serve as a training or educational tool. Brief intro paragraph noting you have adopted the CECL guidance, the approach used, model and vendor.
  - **Responsibility:** name the individuals in the Bank who will access and run the model and who have oversight.
  - **Frequency:** the policy should specify how often the model will be run, the required reporting process to the Board/Board committees.
  - **Key Assumptions:** consider listing the key assumptions, the way average life and look back period will be determined, that CECL will apply to certain HTM securities, how unfunded commitments will be evaluated. Specify that key assumptions will be reviewed and approved by the Board/Board committee, and the frequency.

Early Questions – Reporting on Call Report

Is it better to have one provision account or three separate accounts?

Three separate accounts.

Top Questions – Reporting on Call Report

Do you have any information/recommendations about GL accounts and accounting entries so we can set them up appropriately on our books?

The Loan Loss reserve should be created in the same manner as you did for your ALLL reserve.

The HTM Securities reserve should be established as a contra-account in your securities section of the general ledger.

The Unfunded Commitments reserve should be set up as an "other liability" in the liabilities section of your general ledger.

Top Questions – WARMs

How often should we map our WARMs?

Initially, every quarter.

Top Questions – Prepayments and Unfunded Commitments

Which prepayment suggestion should I use?

Whichever one you feel comfortable with. The standard calls for a "reasonable and supportable" forecast. You can use our suggested assumption or modify based on your expectations or internal analysis.

Top Questions – Q Factors

What Q Factors can I use?

Any you feel will impact your loss rates in the future. Q factors are designed to adjust for risks not already reflected in your historical charge-off activity. This allows you best assess the reserve you believe is appropriate for your institution going forward.

Remember, the E in CECL stands for expected. Regulators are "expecting" to see increases to reserves prior to actual losses.

Top Questions – HTMs

How you would even calculate a reserve on an HTM?

Your securities dealer who sold you the security should have data for this. Absent that, you will have to perform an internal analysis. Again, there is not a requirement to have a reserve, but simply that the securities were evaluated to determine if a reserve is necessary.

Suggestion: Again, there is no requirement to have a reserve—but to evaluate securities to determine if a reserve is necessary.

Additional Observations

- Banks benefitted from parallel runs
- Q factors are still important – Your expectations
- Data warehousing/data quality is important and for some banks will become increasingly important
- Documentation remains important
- While now required, most banks do not have HTM Securities requiring analysis
- Unfunded commitments evaluations are necessary, but for most banks not terribly material
- Unfunded commitments will likely receive more attention in the future

Q Factors Are Still Relevant Under CECL

- Your historical numbers may not fully reflect your expectation of future losses
- Accounting for these differences from your historical experience are your Q factors

Q Factors Remain Central To Banks Reserve Calculations

- Qualitative Factors utilized in the ALLL and found in the FFIEC Guidance remain central for community banks
- What impacts your portfolio?
- Document your process

Don’t Drown In Economic Data/Forecasting

What should I do?

- Be directionally accurate
- Monitor some macroeconomic data
  - Most banks review < 5 variables
- Be sensitive to what impacts your area economically
- Monitor larger banks in your area and nationally – Trend/Directional accuracy

National Bureau of Economic Research

- **Typically confirmed with the benefit of hindsight**
- **What do they review to determine whether or not we are in recession?**
  - Non-Farm payrolls
  - Real Consumption
  - Employment
  - Industrial Production
  - Real Personal Income (excluding transfer payments)
  - Real Manufacturing and Trade sales

Understand Validation Expectations

- Understand limitations/weaknesses
- Ask for SOC 1/validation
- Validation expectations in line with scope of model/tool
- Timing
  - Non-public banks later this year or next year's audit
  - The above subject to an earlier request from your auditor/regulator

Improve Your Q Factor Process In The Future

- Track internal portfolio metrics to better identify changes over time
- Track how your Risk Ratings are moving?
- Drill down into your portfolio to identify specific portfolios and characteristics
- Your portfolio data should ultimately dictate your Q factors!
  - You need to warehouse your data
    - Start with Interagency Loan Data Request file (ILDR file)
  - You need to analyze your portfolio

You Have The Data – Use It

CREDIT OVERVIEW + Tables & Charts Recent 12/31/2022 Prior 10/31/2022 Tags Entire portfolio Borrower, Note Number, Relationship

STANDARD REPORTS
- Credit Overview
- Loan Quality Indicators
- Concentration Report
- Top Borrowers & Concentrations
- Risk Grade Distribution
- Past Due Distribution
- Non Pass Loans
- Delinquent Loans
- Pricing for Risk
- Vintages

CUSTOM REPORTS
- Report Builder
- Custom Query
- Pivot Table

ADMIN
- Custom Groupbys

PERIOD TO PERIOD CHANGES PAST DUE TRENDS RISK GRADE TRENDS

Period to Period Changes

Show ACL Groups

General	Recent Period 12/31/2022	Change	Prior Period 10/31/2022
Loan Count	1,243	14	1,229
Total Balance	$88,676,509	$3,157,341	$85,519,168
Average Loan Size	$71,341	$1,756	$69,584
WAVG Interest Rate	5.11%	0.21%	4.91%
WAVG Risk Grade	3.16	-0.01	3.16
Special Mention / Classified			
Special Mention	$268,004	($2,262)	$270,266
% of Total	*0.30%*		*0.32%*
Classified	$47,933	($680)	$48,613
% of Total	*0.05%*		*0.06%*
Non-Accrual	$47,933	($680)	$48,613
% of Total	*0.05%*		*0.06%*

Balance Changes by Allowance for Credit Loss (ACL) Groups

Construction	Commercial RE	Residential RE	Commercial	Consumer	Other
$427,549	$1,254,739	$324,806	$15,573	$63,699	$1,070,974

Balance Changes - Special Mention/Classified Loans

	Construction	Commercial RE	Residential RE	Commercial	Consumer	Other
Special Mention	--	($1,378)	($884)	--	--	--
Classified	--	--	--	--	--	($680)
Non-Accrual	--	--	--	--	--	($680)

Quickly See Your Portfolio In Meaningful Ways

LOAN QUALITY INDICATORS

+ Tables & Charts

Dataset Date 12/31/2022

Tags Entire portfolio

Borrower, Note Number, Relationship

STANDARD REPORTS

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Loan Quality Indicators Balance by FFIEC Code

Loan Portfolio								
FFIEC Code		Loan Count	Balance	Exposure	1-Year Growth	3-Year Growth	Special Mention	Classified
1A1	ruction	8	$2,095,363	$3,039,364	3.95%	635.44%	0.00%	0.00%
1A2	Dev'l	1	$302,765	$392,000	-14.20%	--	0.00%	0.00%
1B		42	$12,758,946	$14,368,946	-0.08%	21.92%	0.36%	0.00%
1C1		27	$582,963	$1,547,486	181.56%	142.82%	0.00%	0.00%
1C2A	st Lien	512	$16,666,949	$16,666,949	42.01%	69.80%	0.24%	0.00%
1C2B	1-4 Family Resi Mortgage: Jr. Lien	47	$1,417,229	$1,417,229	163.31%	26.43%	0.00%	0.00%
1E1	Secured by OOCRE	65	$15,959,443	$17,362,780	-10.58%	72.77%	0.00%	0.00%
1E2	Secured by Non-OOCRE	142	$19,322,237	$20,105,759	9.71%	80.83%	0.64%	0.00%
3	Agricultural Production Loans	56	$7,826,603	$9,250,631	17.93%	60.34%	0.76%	0.00%
4A	Commercial & Industrial Loans	127	$8,148,634	$10,221,503	-7.64%	80.98%	0.00%	0.00%
6C	Auto Loans	82	$1,583,686	$1,583,686	8.14%	9.82%	0.00%	0.00%
6D	Other Consumer Loans	132	$1,963,756	$1,969,016	1.87%	-5.18%	0.00%	0.00%
Unmatched	Unmatched	2	$47,933	$47,933	379.36%	--	0.00%	100.00%
		1,243	**$88,676,509**	**$97,973,282**	**8.22%**	**61.52%**	**0.30%**	**0.05%**

GROUP BY

- FFIEC Code
- Band
- Risk Grade
- Loan Officer
- Vintage
- Participations

If You Have Your ILDR/Flat File – Look What It Could Do For You

CREDIT OVERVIEW + Tables & Charts Recent 12/31/2022 Prior 10/31/2022 Tags Entire portfolio

Borrower, Note Number, Relationship

STANDARD REPORTS

- Credit Overview
- Loan Quality Indicators
- Concentration Report
- Top Borrowers & Concentrations
- Risk Grade Distribution
- Past Due Distribution
- Non Pass Loans
- Delinquent Loans
- Pricing for Risk
- Vintages

CUSTOM REPORTS

- Report Builder
- Custom Query
- Pivot Table

ADMIN

- Custom Groupbys

PERIOD TO PERIOD CHANGES PAST DUE TRENDS RISK GRADE TRENDS

Past Due Trends

	Recent Period 12/31/2022		Change		Prior Period 10/31/2022	
Days Past Due	**Balances ($)**	**% of Total**	**Change ($)**	**Change (%)**	**Balances ($)**	**% of Total**
0-14 DPD	$85,506,345	96.43%	$2,237,680	2.69%	$83,268,665	97.37%
15-29 DPD	$1,375,413	1.55%	$317,528	30.02%	$1,057,886	1.24%
30-59 DPD	$973,282	1.10%	$668,422	219.26%	$304,860	0.36%
60-89 DPD	$432,986	0.49%	$245,259	130.65%	$187,727	0.22%
90+ DPD	$388,482	0.44%	($311,548)	-44.50%	$700,030	0.82%
Total	**$88,676,509**	**100.00%**	**$3,157,341**	**3.69%**	**$85,519,168**	**100.00%**

Balance Distribution

METRIC Balance

Improve Your Q Factor Process

CREDIT OVERVIEW

+ Tables & Charts

Recent 12/31/2022 Prior 10/31/2022 Tags Entire portfolio

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ADMIN

- Custom Groupbys

PERIOD TO PERIOD CHANGES PAST DUE TRENDS RISK GRADE TRENDS

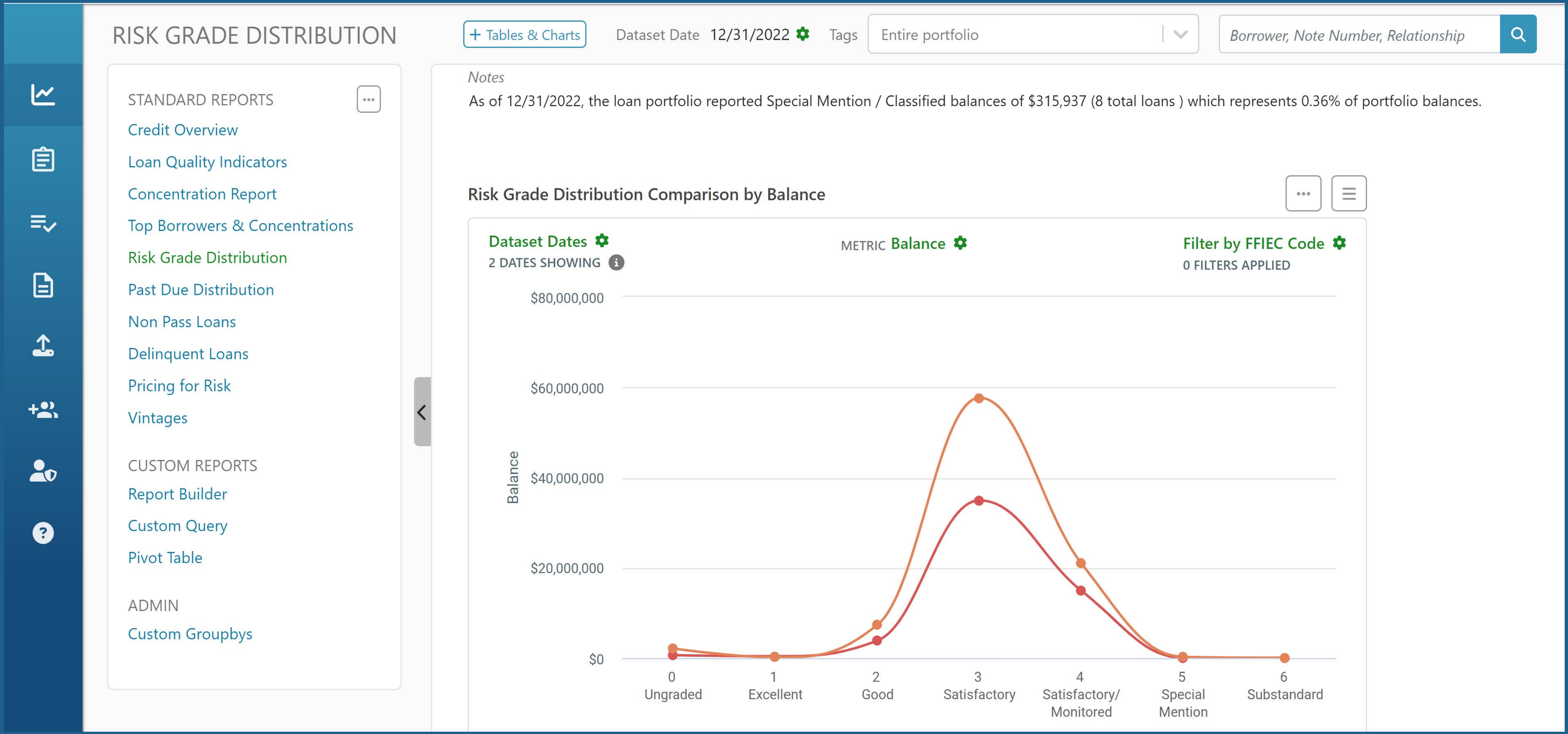
Risk Grade Trends

	Recent Period 12/31/2022		Change		Prior Period 10/31/2022	
Risk Grade	**Balances ($)**	**% of Total**	**Change ($)**	**Change (%)**	**Balances ($)**	**% of Total**
Pass	$65,282,074	73.62%	$2,509,566	4.00%	$62,772,509	73.40%
Weak Pass	$20,957,102	23.63%	$595,450	2.92%	$20,361,652	23.81%
Special Mention	$268,004	0.30%	($2,262)	-0.84%	$270,266	0.32%
Classified	$47,933	0.05%	($680)	-1.40%	$48,613	0.06%
Ungraded	$2,121,396	2.39%	$55,268	2.67%	$2,066,128	2.42%
Total	**$88,676,509**	**100.00%**	**$3,157,341**	**3.69%**	**$85,519,168**	**100.00%**

Balance Distribution

METRIC Balance

Monitor Changes Over Time



Portfolio Analytics: Data mine Your Portfolio DNA (Business Intelligence)

- We're different from the Great Recession where only one industry was the focus (1-4 family housing)
- Data mine all aspects of the broader portfolio, loan review findings, and ar[...] reviews
- Ferreting out hotspots [...]ame of the game for perh[...] come
- Early det[...]ed losses

Goal: Write your own credit quality script!

While balances and risk are correlated – they are not one in the same.

ICBA Preferred Service Provider®

QwickAnalytics®

IntelliCredit™
A division of QwickRate

Interest Rate Discussion Moving From How High, To How Long? How will this impact the industry?

Tangible Common Equity/Tangible Assets % TCE/TA %	# of Banks at 3/31	# of Banks at 6/30
Less than 0	12	16
.01% to 1%	9	12
1.01% to 2%	24	22
2.01% to 3%	37	38
3.01% to 4%	73	83
4.01% to 5%	137	148

Affordable Fintech Solutions for Real Bank Problems.

QwickRate®

- Non-brokered Funding and Investing
- DTC CDs, Other Fixed Income Investments *(QwickBonds)*

IntelliCredit™

- Loan Review Services *(by our experts)*
- Loan Review Tool *(for your internal team)*
- Annual Review Tool
- Portfolio Analytics and more

QwickAnalytics®

- CECLSolver Compliance Tool
- Credit Stress Test
- Bank Research, Performance Metrics and Analysis

Thank You for Attending!

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