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2018 … What’s Ahead

Sal Inserra

Agenda

- CECL Implementation Considerations
- Changing Standards …. Changing Landscapes
- SEC Focus Items
- From the PCAOB

CECL Implementation Considerations

What to consider when implementing a CECL methodology?

Historical Loss Information	Includes both relevant internal and external information or combination of both. Pooling or segmentation is based on identification of common risk charactersistics.
+ Current Conditions	Adjustments to adequately fit historic information to current conditions, i.e. current asset specific risk characteristics. This may be through qualitative or quantitative factors.
+ Reasonable and Supportable Forecasts	Adjustments to adequately reflect an entities forecast of economic impact on the asset in the future. These may be qualitative or quantitative in nature. Additionally, these adjustments may be made at the input level or as top of model adjustments.
+ Reversion to History	Entities are to revert to historical loss information when unable to make reasonable and supportable forecasts. This may be done at the input level or in aggregate. Reversion should follow a rational systematic approach.
= Expected Credit Loss	The end result should represent the expected credit loss over the remaining contractual term of the financial asset or group of financial assets.

The first two steps are similar to what we do today – just different math to get to lifetime loss and more moving parts.

Forecasting is interesting, but **history** is at the foundation

Making the CECL Transition

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Risk Identification

Understanding portfolio characteristics and key drivers of portfolio performance, including lending attributes, loan structures, prepayment risks, and changes in the macroeconomic environment. This component will enable the bank to appropriately segment and model the portfolios based on common drivers of risk.

Governance and Oversight

Understanding risk management practices surrounding the development, execution, and maintenance of the CECL model. This includes established roles and responsibilities of the board and senior management, as well as policies and procedures in place to articulate the expectations of the CECL model and ongoing execution of the model.

Data Inventory

Understanding the availability and limitations of data required to develop and maintain an effective CECL model. This includes the reliability and accuracy of data elements in addition to the historical time horizon of data availability.

Enabling Technology

Understanding the existing systems, including the capabilities and limitations of those systems that may support the execution of the CECL model. This includes source systems, data warehouses, modeling systems, financial statement spreading software, and vendor technology specially designed for CECL.

Resource Capabilities

Understanding the capabilities and limitations of the human resources identified to develop and execute on the CECL model.

Where to begin?

Risk drives the data needed

Data available drives the models and enhances models in the future

Models drive the current condition and forecasting application

Policies, processes, and documentation

Risk Identification/Data Inventory (not all inclusive!)

- Four categories of data to consider (example):

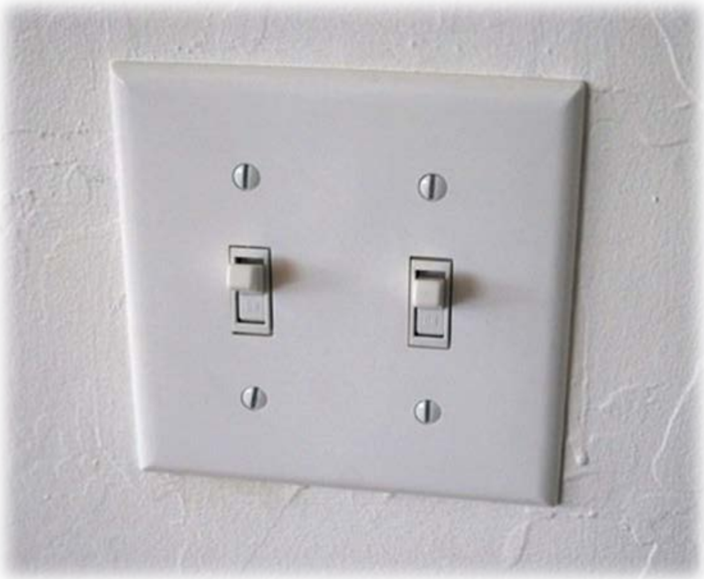
Loan Attributes	Credit Characteristics
• **Financial asset type** • **Size** • **Effective interest rate** • **Acquired or originated**	• **Risk rating** • **Credit score** • **Policy exceptions** • **LTV** • **DSCR or DTI** • **Historical credit loss patterns** • **Loss History Needed**
Structure	**Economic and Geographical**
• **Payment Type** • **Vintage** • **Term** • **Rate structure** • **Prepayments**	• **Collateral type** • **Economic sector** • **Industry of the borrower** • **Geographical information**

What is data governance?

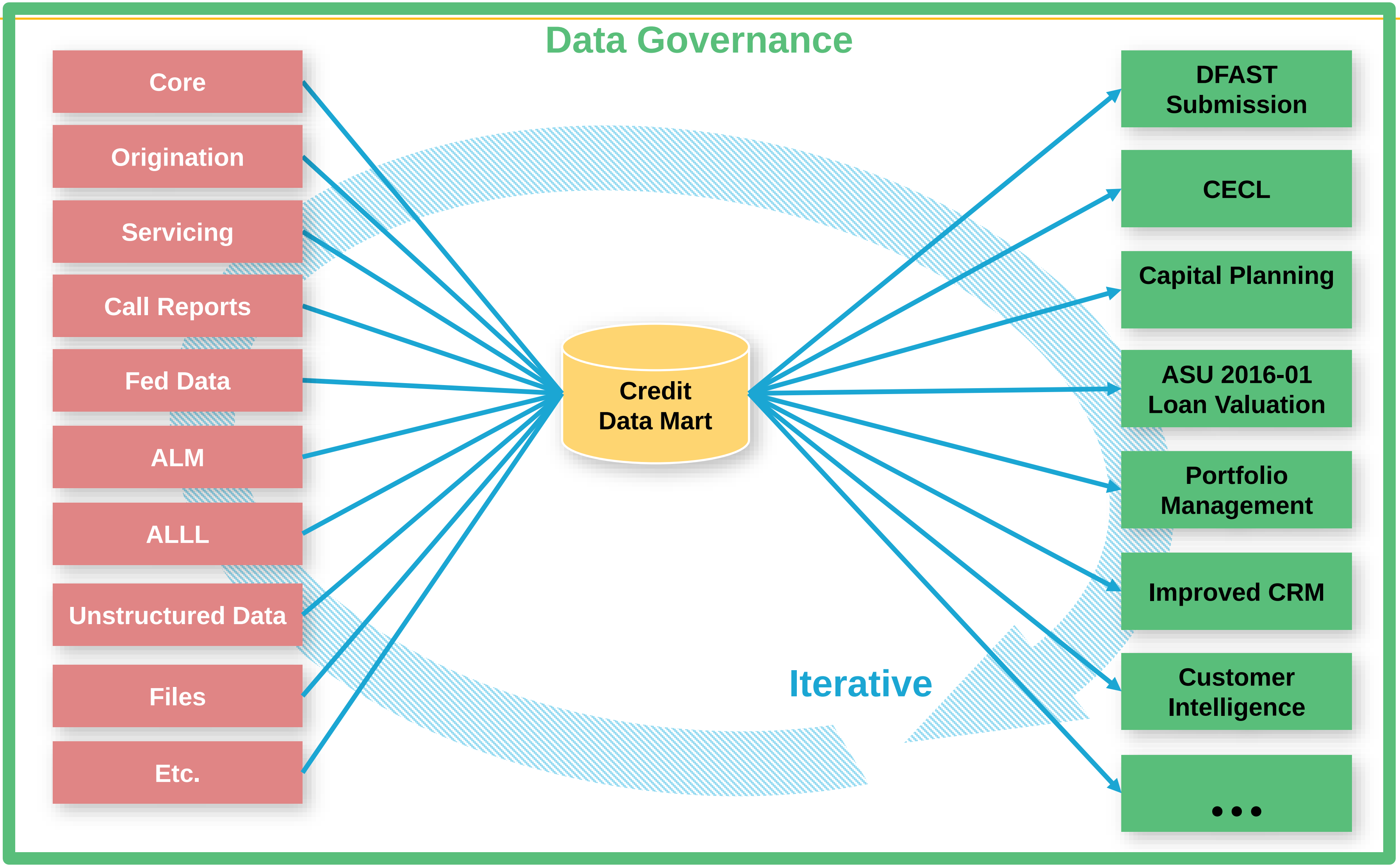
- There can be many definitions and perceptions of what data governance includes, but a key principle of data governance is its objective of **treating data as a business-critical organizational asset**

- The result of effective data governance practices is **trusted data**

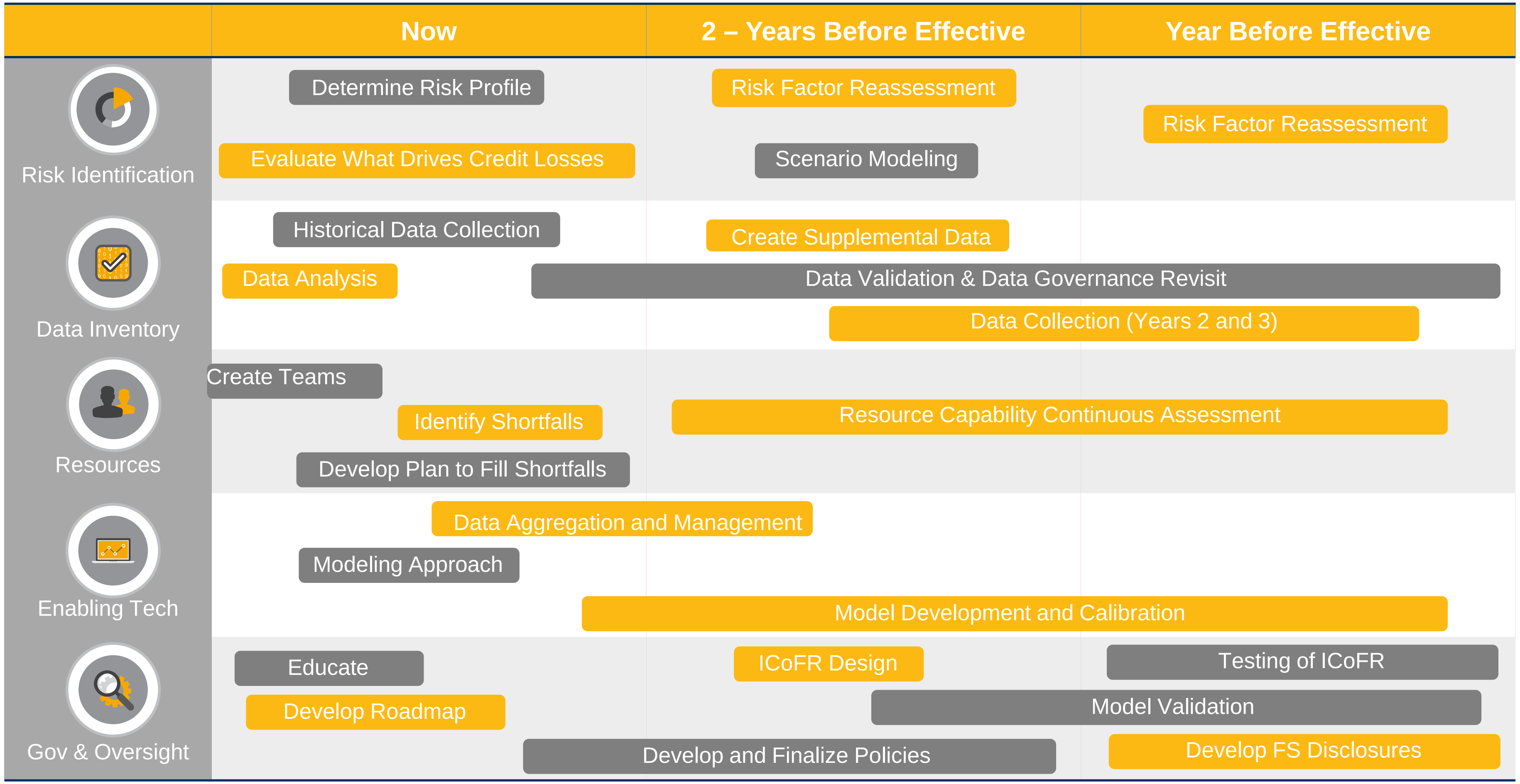
Data should be trusted without thought, much like an organizational "utility"



Goal is to have a core data that can be relied upon to drive many models (if not all)



What are Bankers doing? What does a Roadmap look like?



Changing Standards…

Changing Landscapes

Major Standards: Effective Dates

Beginning of fiscal year:

2018	2019	2020	2021	2022
Revenue Recognition / Financial Instruments: Recognition and Measurement				
PBE (Annual and Interim)	Non-PBE (Annual Periods Only)	Non-PBE (Annual and Interim Periods)		
Leases				
Early adoption permitted	PBE (Annual and Interim)	Non-PBE (Annual Periods Only)	Non-PBE (Annual and Interim Periods)	
Hedging				
Early adoption permitted	PBE (Annual and Interim)	Non-PBE (Annual Periods Only)	Non-PBE (Annual and Interim Periods)	
Credit Losses				
	Early adoption permitted	PBE that **are SEC Filers** (Annual and Interim)	PBE that **are not SEC Filers** (Annual and Interim) Non-PBE (Annual Periods only)	Non-PBE (Annual and Interim)

Definition of a Public Business Entity (PBE)

- FASB ASU 2013-12, "Definition of a Public Business Entity"
  - Issued Dec. 23, 2013
  - Defines "public" for financial reporting purposes, not legal purposes
  - Implications for effective dates, disclosure, recognition and measurement (e.g., PCC alternatives)

- In broad terms, a PBE is an entity that meets any of the following:
  a) Files with the U.S. Securities and Exchange Commission (SEC)
  b) Required to file under the '34 Act with a regulator other than the SEC
  c) Required to provide financial statements with a regulator for purposes of issuing securities
  d) Securities are traded, listed, or quoted on an exchange or an over-the-counter market
  e) Required by law or regulation to file financial statements and make them publicly available (and the securities do not have a contractual restriction)

Criterion "d"

Criterion "e"

- Clarifications
  - ABA PBE Discussion Paper
    https://www.aba.com/Tools/Function/Acct/Documents/DiscussPaperDefinitionsPrivateCompanyPublicBusinessEntity032017.pdf
  - AICPA Technical Question and Answers (TQA)

AICPA Technical Questions & Answers (TQA): Common Questions for Financial Institutions

Question 8: How evaluated in a tiered organizational structure?

Perform the evaluation on an entity by entity basis.

Question 11: Do banks subject to FDICIA meet the definition of a PBE?

Use entity by entity approach to evaluate the institution’s capital structure.

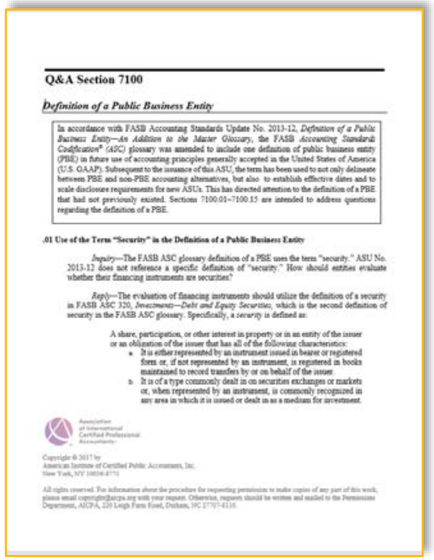
Question 12: Do mutual entities meet the definition of a PBE?

Evaluate sub-debt / secondary capital under (d).

Mutual thrifts subject to FDICIA assess unrestricted securities.

Question 13: How do brokered CDs impact a PBE analysis?

Determine whether CDs are traded or quoted under (d).



Q&A Section 7100

Definition of a Public Business Entity

In accordance with FASB Accounting Standards Update No. 2013-12, *Definition of a Public Business Entity—An Addition to the Master Glossary*, the FASB *Accounting Standards Codification®* (ASC) glossary was amended to include one definition of public business entity (PBE) in future use of accounting principles generally accepted in the United States of America (U.S. GAAP). Subsequent to the issuance of this ASU, the term has been used to not only delineate between PBE and non-PBE accounting alternatives, but also to establish effective dates and to scale disclosure requirements for new ASUs. This has directed attention to the definition of a PBE that had not previously existed. Sections 7100.01–7100.15 are intended to address questions regarding the definition of a PBE.

.01 Use of the Term “Security” in the Definition of a Public Business Entity

Inquiry—The FASB ASC glossary definition of a PBE uses the term “security.” ASU No. 2013-12 does not reference a specific definition of “security.” How should entities evaluate whether their financing instruments are securities?

Reply—The evaluation of financing instruments should utilize the definition of a security in FASB ASC 320, *Investments—Debt and Equity Securities*, which is the second definition of security in the FASB ASC glossary. Specifically, a *security* is defined as:

A share, participation, or other interest in property or in an entity of the issuer or an obligation of the issuer that has all of the following characteristics:

a. It is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer.
b. It is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment.

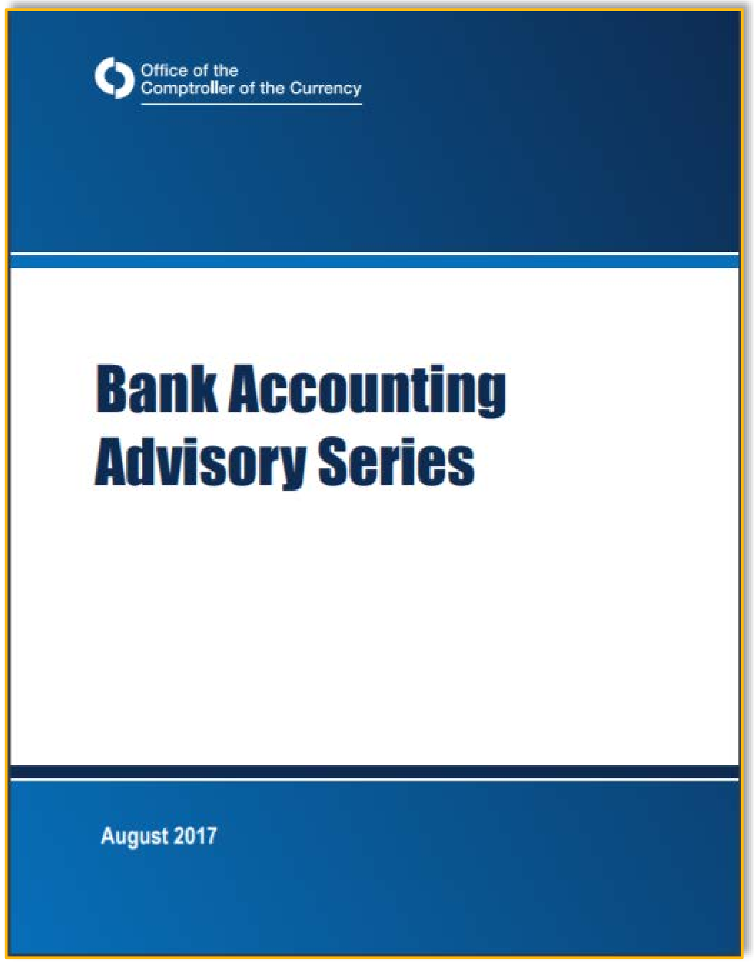
Association of International Certified Professional Accountants

Other topics include types of contractual restrictions and OTC markets.

OCC BAAS

- Office of the Comptroller of the Currency (OCC) Bank Accounting Advisory Series (BAAS)
  - Released on Aug. 15, 2017
  - OCC's interpretations of GAAP and regulatory guidance based on facts and circumstances presented for national banks and federal savings associations.
  - Includes revisions to topics related to new accounting standards issued by the FASB on recognition and measurement of financial instruments, leases, and revenue recognition as well as other updates.
  - Message from the Chief Accountant:
    - Includes a list of the topics which have been updated.
    - Describes the revised approach to include standards not yet effective which either must be adopted by public business entities (PBEs) in 2018 or can be early adopted.

Color coded by PBE/non-PBE for ease of reference both pre and post-adoption of various standards.



Revenue Recognition

Revenue Recognition

- ASU 2014-09, “Revenue from Contracts with Customers (Topic 606):
  - Issued May 2014
  - Effective Dates:
    - PBEs: fiscal years (and interim periods) beginning after Dec. 15, 2017
    - Non-PBEs: fiscal years beginning after Dec. 15, 2018, and interim periods within fiscal years beginning after Dec. 15, 2019; early adoption is permitted

1Q18 for 12/31 year-ends

12/31/19 for 12/31 year-ends

- Landscape
  - Comments from the SEC, including disclosures
  - Industry discussions
  - AICPA discussions

- Challenges for financial institutions
  - Scoping – what is in? what is out?

- Other
  - Internal control over financial reporting
  - Disclosures

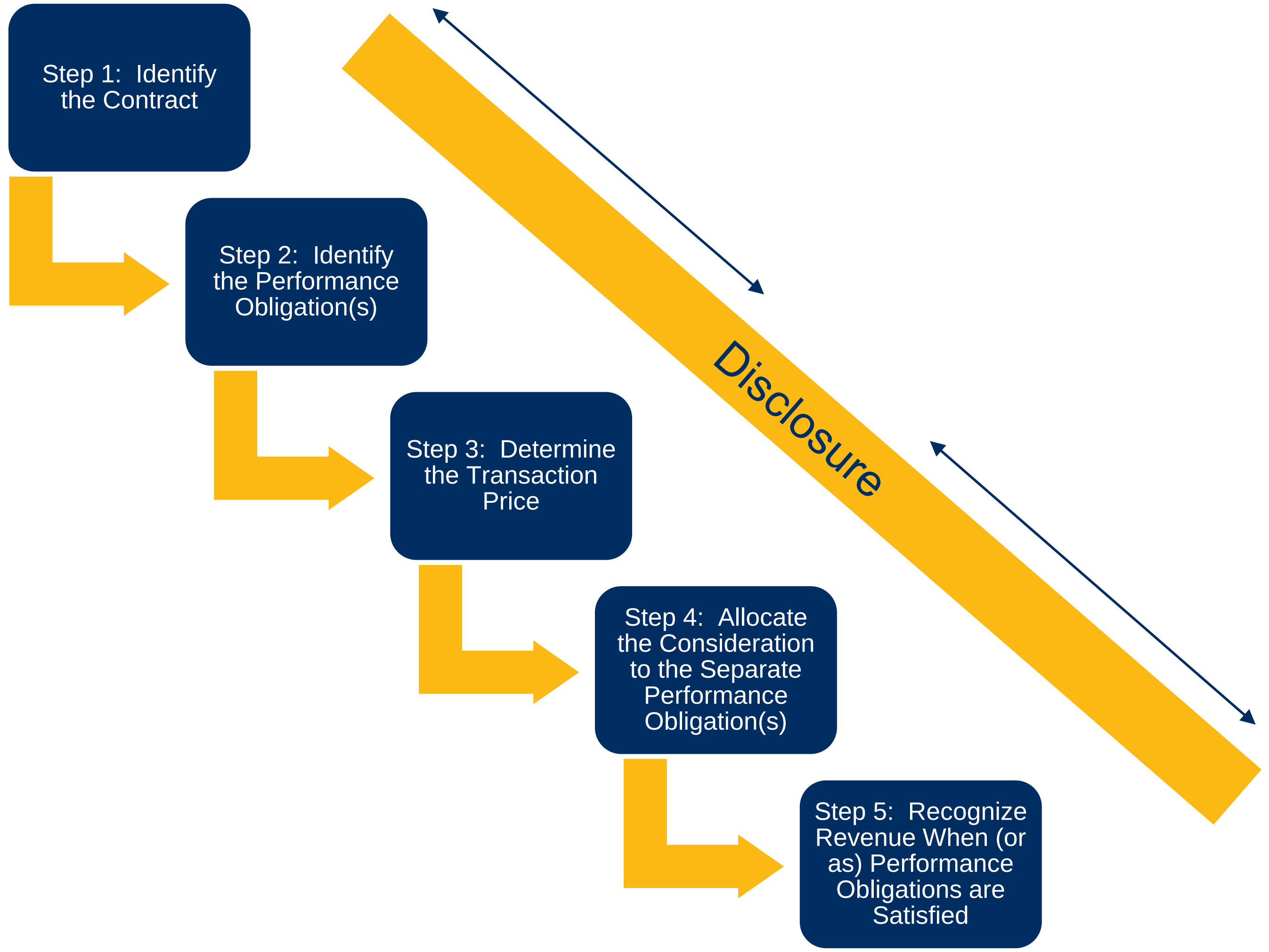
Revenue Recognition: Scoping for Financial Institutions

Out of Scope	In Scope
Interest Income	Service Charges on Deposit Accounts
Trading Revenue	Asset Management Fees
Loan Servicing Fees	Gains or Losses on Other Real Estate Owned
Credit Card Fees	Interchange Fees
Guarantee Fees	

- FASB Revenue Recognition Transition Resource Group (TRG
- July 13, 2015 meeting
  - Memo No. 36, Credit Cards
  - Memo No. 44, July 2015 Meeting—Summary of Issues Discussed and Next Steps
- April 18, 2016 meeting
  - Memo No. 52, Scoping Considerations for Financial Institutions
  - Memo No. 55, April 2016 Meeting—Summary of Issues Discussed and Next Steps

http://www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1176164066683

Recognizing Revenue and Related Disclosures



Note: Impact directly on your bank's financial statements may not be material but there may be a significant impact on the revenue recognition of your borrowers … impacts current debt service coverage calculations.

Revenue Recognition: Disclosures

- Objective: To understand nature, timing, and uncertainty (606-10-50-1)
  - Allowed to consider level of detail necessary to satisfy objective and how much emphasis to place on each disclosure requirement (606-10-50-2)

- Disclosures include:
  - Information about contracts with customers (606-10-50-4 through 50-16)
  - Significant judgments and changes in those judgments (606-10-50-17 through 50-21)
  - Assets recognized related to cost to obtain or fulfill a contract (340-40-50-1 through 50-6)

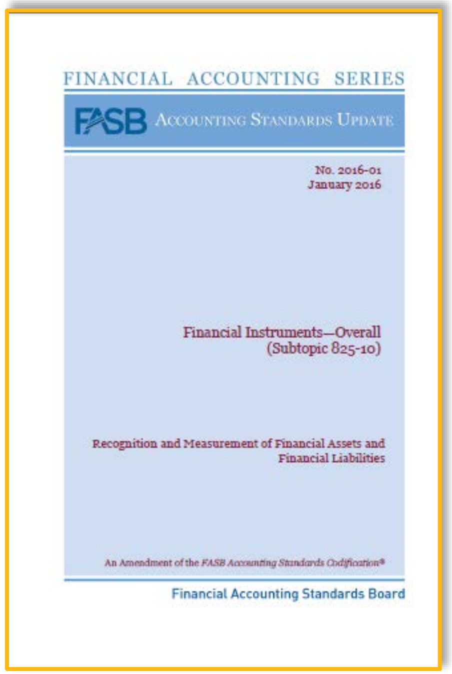
The disclosure requirements can be significant!

- Deposit Fees Example - Excerpts from FASB TRG Memo 52 regarding Deposit Fees
  - Typical depository arrangement is considered a short term day-to-day contract with ongoing renewals and optional purchases
  - Potential disclosure impacts from the FASB staff
    - Contract balances and remaining performance obligations related to the depository arrangements might not exist, so the disclosures in paragraphs 606-10-50-8 through 50-11, and paragraphs 606-10-50-13 through 50-16 **<u>might not apply</u>**
    - An entity generally would not need to make many judgments that would significantly affect the amount and timing of such deposit fee revenue, there **<u>might not be much</u>** to disclose about judgments (paragraphs 606-10-50-17 through 50-20).

Financial Instruments: Recognition & Measurement

Recognition & Measurement

- ASU 2016-01, “Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities” - Issued Jan. 5, 2016
  - Equity Investments
    - Eliminates of the available-for-sale (AFS) category – all will be carried at fair value with changes in earnings (trading)
    - Provides a practical expedient for equities without a readily determinable FV to be recorded at amortized cost, less impairment, adjusted for observable price changes
  - Valuation allowance for deferred-tax assets (DTA) on an AFS debt security
    - Assess in combination with other DTAs
  - Financial liabilities measured at fair value under the FVO election
    - Fair value change attributed to instrument-specific credit risk presented in OCI rather than net income


FINANCIAL ACCOUNTING SERIES

FASB Accounting Standards Update

No. 2016-01
January 2016

Financial Instruments—Overall
(Subtopic 825-10)

Recognition and Measurement of Financial Assets and Financial Liabilities

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

Recognition & Measurement con’t

- Disclosures
  - Assets and liabilities
    - On the balance sheet or in the footnotes, disclose all financial assets and financial liabilities grouped by measurement category and form (for example, securities or loans and receivables) of financial assets.

Significant change!

  - Fair value of financial instruments measured at amortized cost (formerly FAS 107)
    - PBEs - measure based an exit price, rather than the commonly used entrance pricing
    - Non-PBEs – have the option to remove this disclosure

1Q18 for 12/31 year-ends

12/31/19 for 12/31 year-ends

- Effective Date
  - PBEs
    - Fiscal years (and interim periods) beginning after Dec. 15, 2017
  - Non-PBEs
    - Fiscal years beginning after Dec. 15, 2018, and interim periods within fiscal years beginning after Dec. 15, 2019
    - Early adoption is permitted

Financial Instruments: Hedging

Derivatives and Hedging

- ASU 2017-12 “Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities”
  - Issued Aug. 28, 2017
  - Goals: Improve transparency, understandability, and reduce complexity

- Some elements considered during the deliberations were not changed
  - Highly effective threshold (80-125%)
  - Benchmark interest rate concept for fair value hedges of fixed rate financial instruments
  - Voluntary hedge dedesignations
  - Timing of qualitative hedge documentation

- Other aspects not changed
  - Need for detailed and specific hedge documentation
  - While complexity has been reduced, hedge accounting is not without its challenges

Cash Flow Hedges

Replaced benchmark rate concept with contractually specified rate

- Can now directly hedge prime interest rate
- Hedging prime will no longer require pooling like spreads or running complex models for mixed spreads to determine which loans paid first

Fair Value Hedging

- Retained benchmark rate concept, but added SIFMA Muni Swap Rate
- No longer requires change in fair value of hedged item to be measured using cash flows from the coupon of the hedged item, now permitted to use the benchmark rate component of the coupon; this will significantly reduce ineffectiveness
- Permits partial term hedging (e.g. hedge first 2 years of 10-year instrument, without causing ineffectiveness)
  - Allowed to assume the hedged instrument “matures” at the end of the hedge
- Fair value hedges impact carrying amounts of the hedged item, and for assets, will therefore impact credit impairment analyses

Leases

Leases

- ASU 2016-02, “Leases” (Topic 842)
  - Issued in Feb. 2016
  - Effective Dates:
    - PBEs (and employee benefit plans that file with the SEC) - fiscal years (and interim periods) beginning after Dec. 15, 2018
    - Non-PBEs - fiscal years beginning after Dec. 15 2019 and interim periods after Dec. 15, 2020

- Recognize all leases with a term more than 12 months
  - Operating leases would no longer be off-balance sheet items for lessees
  - Recognize a right-of-use (ROU) asset and a lease liability on the balance sheet
    - A “finance lease” (expense is front-loaded; ROU amortization + interest expense)
    - An “operating lease” (straight-line; rent expense)

Leases con’t

- Preparing for implementation
  - Inventory of leases (including embedded leases)
  - Analysis of impact on debt covenants if applicable
  - Analysis of impact on capital requirements
  - Evaluate premises & equipment requirements for statutory or regulatory purposes

- Regulatory capital treatmenthttp://www.bis.org/press/p170406a.htm
  - Basel Committee Leases FAQ
  - ROU asset not deducted from regulatory capital like an intangible asset
  - ROU asset should be included in the risk-based capital and leverage ratio denominators
  - ROU asset should be risk-weighted at 100%
    - Consistent with the risk weight applied historically to owned tangible assets and to a lessee's leased assets under leases accounted for as finance leases in accordance with existing accounting standards

  - Indirect consideration – impact on borrowers’ debt covenants

SEC Focus Items

Recent SEC Speechmaking 1st and 2nd Quarter…

	SEC Chief Accountant Wesley Bricker					Deputy Chief Accountant	SEC Fellow	Division of Corp Fin - Chief Accountant	
Topic	Mar. 21 Life Sciences	Mar. 24 Univ of TN	May 4 Baruch	Jun. 8 USC	Sep. 11 AICPA Bank	Sep. 21 FEI	May 8 Bloomberg	May 4 Baruch	Jun. 8 USC
Implementation of revenue recognition	X	X	X	X		X	X		
Implementation of credit losses		X	X	X	X	X			
Implementation of other standards including leases and classification and measurement		X		X		X			
Transition (SAB 74) Disclosures	X	X		X	X	X	X	X	X
ICFR and disclosure controls and procedures	X	X	X	X	X	X	X	X	
Role of the Audit Committee	X	X	X	X		X	X		X
Non-GAAP Measures and Operating Metrics		X	X					X	X
Auditor independence			X	X					
PCAOB and other auditing issues				X	X				
Use of technology			X	X	X				
Foreign matters			X	X	X				
Independence of standard setting			X						

https://www.sec.gov/news/speeches

Recent SEC Speechmaking 3rd and 4th Quarter

	SEC Chief Accountant Wesley Bricker		SEC Deputy Chief Accountant Sagar Teotia	Various (see article linked above)
Topic	Sept. 11 AICPA Bank conf.	Nov. 14 FEI	Sept. 21 FEI	Dec. 4 – 6 AICPA SEC Conf.
Implementation of revenue recognition		X	x	X
Implementation of credit losses	x	X	x	X
Implementation of other standards including leases and classification and measurement		X	x	X
Transition (SAB 74) Disclosures	x	X	x	X
ICFR and disclosure controls and procedures	x	X	x	X
Role of the Audit Committee		X	x	X
Non-GAAP Measures and Operating Metrics				X
Auditor independence		X		X
PCAOB and other auditing issues, including auditor's reporting model	x	X		X
Use of technology, including distributed ledger or blockchain technology	x	X		X
Foreign matters	x			X
Cybersecurity				X
Potential tax reform				X

https://www.sec.gov/news/speeches

From the PCAOB

Auditors Reporting Model (ARM)

- PCAOB audit standard, “The Auditor’s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.”
  - Adopted by PCAOB on June 1, 2017
  - Approved by SEC on Oct. 23, 2017

- Categories of changes:
  - Minor improvements to the auditors opinion
    - Addressee
    - Statement on independence
    - Captions
  - Disclosure of auditor tenure
  - Critical Audit Matters (CAMs)

Auditors Reporting Model (ARM) con’t

- Critical Audit Matters (CAMs) are matters that:
  - Have been or were required to be communicated to the audit committee
  - Relate to accounts or disclosures that are material to the financial statements
  - Involve especially challenging, subjective, or complex auditor judgment

  - External auditor must disclose:
    - Critical audit matters (CAMs) arising during the current period audit;
    - Considerations that led the auditor to make the CAM determination;
    - How the CAM was addressed; and
    - Reference to the relevant financial statement accounts and disclosures.

- Effective dates
  - Fiscal years ending on or after Dec. 15, 2017 for all provisions other than CAMs
  - Fiscal years ending on or after June 30, 2019 for CAMs for large accelerated filers
  - Fiscal years ending on or after Dec. 15, 2020 for CAMs for other filers

For calendar year ends	Large Accelerated Filers	Other Filers
Other than CAMs	Dec. 31, 2017	Dec. 31, 2017
CAMs	Dec. 31, 2019	Dec. 31, 2020