2021 AICPA & CIMA Conference on Banks & Savings Institutions: DHG Highlights

The American Institute of Certified Public Accountants (AICPA) and Chartered Institute of Management Accountants (CIMA) held the annual Conference on Banks & Savings Institutions in-person and virtually on Sept. 20 - 22, 2021. DHG was honored to be an event sponsor this year. The following are selected comments from various speakers at this year's conference. This summary does not capture all discussions presented during the three-day period; rather, it is intended to highlight trending topics and recurring themes. The selected comments below are our interpretation of the speakers' comments and do not necessarily represent the opinion of DHG.

DHG's key takeaways from the conference included:

- Customers and investors are looking for financial institutions' reporting on environmental, social and governance (ESG) initiatives. Conference presenters discussed starting with publicly available data to learn what is important to your customers to build strategies to address these needs within your business.
- LIBOR transition and the replacement rate were discussed in several sessions. Panelists shared questions, considerations and what they are watching with U.S. regulators strongly encouraging Jan. 1, 2022, as the date to begin using a new reference rate and as the official end of LIBOR nears in June 2023.
- As financial institutions and consumers evaluate the post-pandemic economy, this downturn is different from previous recessions. Americans have increased personal savings but other challenges remain.

This summary represents a collaborative effort on the part of DHG professionals who attended the conference in-person and online.

The Economy

Economic Forecast 2022: Price Hikes, Shortages and Seismic Surprises

Marci Rossell, Ph.D. – Economic Forecaster, Former CNBC Chief Economist

Rossell once again kicked off the conference as a keynote speaker. Always willing to poke fun at herself, Rossell began by admitting that she is a terrible forecaster, based on her prediction at last year's conference that this COVID-19 pandemic would last about six months and then things would be back to normal. With hindsight being 20/20, she focused her remarks this year on the differences in this economy compared to prior downturns. Importantly, the pandemic started as a healthcare shock that moved into the economy and caused a demand shock as consumers initially pulled back on spending.

She noted that there are three main things about the pandemic that are different than economic shocks we have experienced in the past. First, the labor force was disrupted as many companies put employees on furloughs or terminated them early in the pandemic. Under prior downturns, the impact to labor is usually the last resort, but, during the pandemic, it was one of the first levers that employers used. As Rossell noted, the longer you have a workforce detached from their employer or profession, the likelihood that they return to that employer or profession is greatly diminished. This separation of the labor force from the employers has had a direct impact on the current talent shortages that are being felt in the economy. Second, the amount and speed of stimulus that has been injected into the economy is unprecedented and has allowed the workforce to be more selective and measured regarding when and where they re-enter the market. This is very different from prior downturns when stimulus was very slow to be distributed to those impacted. Lastly, prior to the pandemic, the personal savings rate (the percentage of their disposable income that people save) was approximately eight percent. Prior to the Great Recession, this rate was approximately zero percent. In contrast, the personal savings rate in March 2021 was 32-33 percent and remains high in July 2021 at 9.6 percent. It is estimated that there is approximately $5 trillion in excess savings today above and beyond what would have been saved prior to the pandemic with half this excess residing in the U.S.

As the government responded with unprecedented speed in pushing stimulus out into the economy, the demand shock did not last long and was quickly replaced with a supply shock. In addition to the supply shock, another key item that is different about this economy is how markets reacted. Usually markets related to stocks, bonds and real estate decrease in a recession or economic shock. During the pandemic, while there was a temporary impact to the stock market at the beginning of the pandemic, this reversed in record time and both recovered and then grew tremendously. The bond market remained strong and real estate, already experiencing a supply shortage prior to the pandemic, has increased in surprising fashion. Further, Rossell believes the pandemic "drop kicked" the global economy into 2030. Online shopping, remote learning, virtual medical care and virtual conferences like this one were forced to evolve using technology in a manner that may have taken another 10 years without the pandemic. The pandemic made us "upgrade" almost overnight especially as it relates to technology. This has resulted in the Big 5 technology firms growing even larger. These changes also had an impact on the real estate market. Potential homeowners were now looking for bigger houses, with "Zoom rooms" and bigger kitchens and more "high quality space." Already in motion prior to the pandemic was the migration of millennials from urban living to suburbs to start families. Importantly, the economy during this pandemic has seen stable income, stable wealth and stable housing.

There is still uncertainty in the economy, however. The supply shock has caused inflation fears. Rossell categorized the inflation issues into the three buckets of short-, medium- and long-term concerns. Short-term inflation is felt on things you need right now. Toilet paper was in short supply during the early weeks of the pandemic. While this shortage caused some transitory inflation, as the supply lines caught up, the inflation was not lasting. Rossell indicated that short-term inflation is not a concern and will be transitory. Medium-term inflation concerns pose some real fears for policymakers. Shipping containers and semi-conductors are all areas that are seeing inflation that will need to be addressed. The price to ship has increased from approximately $2,000 per container prior to the pandemic to approximately $10,000 currently. This is an issue in a fragile supply chain and will take some effort to control. Further, half of the world's semi-conductors are produced in Taiwan. This concentration of the supply chain will need to be addressed, and investment in true infrastructure will need to be made in production plants. Currently a new facility is being built in Phoenix, Ariz., but more will be needed, and such facilities take time to complete. In the long-term category, Rossell noted the biggest concern is the war for talent. Prior to the pandemic this talent shortage was mostly felt just in the financial services industries but are now being felt almost across the board. The talent pools are being squeezed by millennials moving away from jobs they took right out of college, but maybe did not love. Now they are taking this opportunity to shift occupations and geographies. Second, the baby boomers are accelerating their retirements. Usually in an economic shock, the workforce stays longer given a decline in retirement assets, but as previously noted, the market (stocks, bonds, real estate) has held strong during this shock, allowing the baby boomers to retire early. Approximately 1.3 million boomers have retired early because of the pandemic and are never returning to the workforce. This is resulting in shortages of qualified laborers and putting upward pressure on salaries for those remaining in the workforce.

In summary, Rossell noted that the economy is reacting very differently during this pandemic shock than it historically reacted under previous shocks. The disruption in the labor market will take time to recover. Technology advances are needed to compensate for the decrease in the labor pool, and the reduction in the massive amounts of stimulus in the economy will be a delicate balance for policymakers to navigate. She believes the good news is that the fundamentals of the economy are strong, and the personal savings rate increases are signs that we have at least learned from the Great Recession. How long those lessons stick with us remain to be seen.

Housing Update

Douglas Duncan, Ph.D. – Senior Vice President and Chief Economist, Fannie Mae

Duncan opened his comments with the fact that the housing market is still supporting the expectation of 18 percent appreciation in home values for 2021 - the largest single-year increase recorded - which is attributed to supply shortages in existing homes. While historically the housing supply correlated with the change in home prices, there was a divergence in 2007-2009 due to the Great Recession that has not been fully resolved. Normally, supply of available for-sale homes would have a five-to-six-month inventory. Currently, it is less than two months. This is further compounded by a decline in skilled labor for home construction and older individuals deciding to age at home instead of selling. Meanwhile, peak entry of millennials into the home ownership market is not expected for another four years. New single-family home sales and existing home sales are forecasted to decrease 3.9 percent and increase 4.4 percent, respectively, year-over-year in 2021, while the annual average 30-year fixed-rate mortgage rate is forecasted to tick up from 2.9 percent in 2021 to 3.1 percent in 2022. New and existing home sales are forecasted to increase 11.6 percent and decrease 3.6 percent, respectively, year-over-year in 2022, which is attributed to a need for builders to catch up with orders.

Duncan provided historical context for the appreciation, noting it was similar in 2007-2009. However, the environment of that time – extracting and spending equity on the assumption that house prices would go up forever while at the same time credit conditions eased – is not the same in 2021. Credit conditions are stricter (e.g., average debt-to-income and loan-to-values declined sharply in 2020, while average down payments continue to rise along with home prices). Fewer home equity line of credit (HELOC) loans are outstanding, and there is less delinquency with HELOCs since the Great Recession.

However, Duncan noted homebuying sentiment has hit an all-time low with 64 percent of those who say it is a bad time to buy basing their views on housing prices. He noted that office space, with many people still working from home, is still impacted by the pandemic, and while some could be repurposed, there may be a decline in the value of properties on a market-by-market basis. The impact on urban centers is also unclear as many people moved to suburban areas during the pandemic; however, he noted it mainly affected certain markets such as New York City and San Francisco. Finally, the impact of private equity groups purchasing properties for rentals is putting pressure on the supply chain, but timing aside, the impact on overall ownership could also be more subtle.

Forbearances are not likely to be as high as the 2007-2009 recession as homeowners have more equity, which they can use for pre-foreclosure sales as needed. Further, with the pickup of employment opportunities, individuals may have the money to recover.

While some economic data discussed indicates that there is greater pent-up demand, other data indicates some COVID-19-related hesitancy to spend (the consumer sentiment index is trending down in 2021). Employment remains below pre-pandemic levels with eight million more unemployed people than before the pandemic. Duncan noted in each of the four previous economic downturns it took longer to get back to pre-downturn unemployment levels and that the growth rate in jobs could have potentially flattened out. Leisure and hospitality declined most between January 2020 and August 2021 with a 10 percent decline. Given that some employees historically work in these industries before transitioning to college or another job, some may not return. Student loan delinquencies have declined significantly due to forbearance relief in 2020. While dining out and airline travel picked up around Labor Day, there has been a decline due to the most recent COVID-19 variant.

Regarding inflation, wood prices for construction have fallen from the May 2021 peak while other inputs are still rising. Housing will also impact inflation. One-to-three-year inflation expectations have drifted upward indicating expectations that the recent marked increase is expected to be largely transitory. Consumer expectations could move the Federal Reserve Bank (Federal Reserve) to begin tapering portfolio purchases soon, possibly beginning in November. There is concern of a run on mortgage rates once any tapering is announced. Duncan noted the Federal Reserve would likely want tapering mostly concluded before changing interest rate targets.

Bank Regulators and Regulatory Issues

Perspectives on the Regulatory Landscape

Rodgin Cohen – Senior Chairman, Sullivan & Cromwell LLP

Cohen shared his views on four main topics: mergers and acquisitions (M&A), the demise of the London Interbank Offered Rate (LIBOR), the rise in cryptocurrencies and ESG.

M&A

Cohen noted there has been a sharp resurgence in merger activity since fall 2020 and cited the following reasons for the activity:

- Value of scale – The value of scale has increased exponentially. The cost of marketing and technology can only be mitigated by scale.
- Increased competition – There is increased competition from both outside and within the banking industry. Fintech and nonbank financial service providers are seizing market share from banks beyond loans and deposits into payment services.
- Pent-up demand – There was little merger activity between March and October 2020 due to all the uncertainty associated with the COVID-19 pandemic.
- Regulatory cycle – At times, regulators support and encourage, and other times, they are skeptical and discourage. Within the last two to three years, the regulatory cycle has been positive, and regulators have been receptive to bank mergers.

Given the rise in bank mergers, Cohen noted this could cause changes in the framework that regulators follow to analyze and approve mergers. Most notably, the approval process may have a focus on the societal impact that a merger could cause (e.g., job losses to a community).

Cohen stated that he expects more M&A during the remainder of 2021 and in 2022 because the underlying economics are compelling.

Demise of LIBOR

Cohen noted that after June 30, 2023, LIBOR will no longer be quoted, and regulators have essentially prohibited U.S. banks from writing new LIBOR contracts after Dec. 31, 2021. He raised three key questions:

1. What happens to certain legacy contracts with LIBOR as the stated rate with a maturity after June 2023 and lack of language on an identified fallback rate? In many cases, the contracts may convert to a fixed-rate using the last quoted LIBOR rate. Cohen sees high potential for litigation on contracts that revert to a fixed-rate.
2. Will lenders use any replacement rate other than the Secured Overnight Financing Rate (SOFR)? Cohen believes that the regulators will require the use of SOFR; however, there is a concern by banks that SOFR is not an appropriate replacement, as LIBOR is credit sensitive and SOFR is not.

3. What constitutes a new contract? Cohen raised the issue that if you amend or fund an existing contract, is that a new agreement, and therefore, you cannot continue with LIBOR after Dec. 31, 2021? He noted that to date, the regulators have provided no official guidance on this issue.

Cohen stated his believe that certain replacement candidates, specifically the Bloomberg Short-Term Bank Yield Index (referred to as BSBY) and the American Financial Exchange's AMERIBOR rate, are out of favor with the regulators and could trigger more invasive examinations.

Rise of Cryptocurrencies

Cohen acknowledged the exponential growth in the use of cryptocurrency, but stated that there currently are no proposals by regulators or lawmakers to regulate the currencies. He warned that cryptocurrency could become so widespread that regulation, if not already established, would be ineffective.

Cohen noted the Federal Reserve is exploring the creation of a central bank digital currency (CBDC), with the release of a white paper on the topic coming soon. He stated the creation of a CBDC is a multi-dimensional, very complex undertaking, but cited several reasons why the U.S. needs to move in this direction, including creating a more rapid payment system, improving cross-border payments, providing a more liquid and secure cryptocurrency, preservation of the U.S. dollar as reserve currency and the fact that the U.S. can no longer afford to be using a nineteenth century payment system.

ESG

Cohen shared his views on ESG, noting it is a complex and difficult subject. With respect to environmental sustainability, Cohen noted that it is critical to distinguish between the aspirational and the practical when making ESG disclosures. He feels companies should only be disclosing practical, realistic goals that can be achieved, rather than aspirational goals that he sees as being a prime target for litigation. He also raised the question as to what responsibilities banks have for the environmental footprint of their customers and issuers of their investments. He questioned whether the environmental record of a bank customer or issuer of an investment made by a bank could be an issue for the bank itself.

Cohen noted that he believes the bar will continue to be raised with respect to social considerations and that the investment community will increasingly continue to pressure companies for diversity. From a governance perspective, Cohen shared his views that the focus may gravitate towards companies' political stance on key issues, such as voting rights: not only could companies be criticized for their positions taken, but they could also be criticized for not taking a position on an issue. Cohen recommended companies develop a framework that will provide guiding principles to make these critical decisions.

Cohen stated that while he feels these disclosures are important, he does not believe they should be included in a public company's period reports filed with the Securities and Exchange Commission (SEC) (e.g., Forms 10-K or 10-Q); rather, should be filed in a separate document.

Federal Banking Agencies: A Fireside Chat with the Chief Accountants – Part I

Moderator: Sydney K. Garmong, CPA, CGMA, Partner – Crowe LLP
Jeffrey J. Geer, CPA, Associate Chief Accountant – Office of the Comptroller of the Currency (OCC)
Lara Lylozian, CPA, Chief Accountant – Board of Governors of the Federal Reserve System (FRB)
John Rieger, CPA, Chief Accountant – Federal Deposit Insurance Corporation (FDIC)

With the current expected credit loss (CECL) adoption being old news for about seven percent of banks but 80 percent of bank assets, the regulator conversation addressed technical issues of CECL, and focused on two other new significant themes – ESG and digital assets, primarily cryptocurrency.

Opening Remarks

Related to CECL, Geer provided his insights on the allowance for credit losses (ACL) in year two for the early adopters. In general, noted both by Geer and Lylozian, the feeling was that CECL models operated as intended. Provisioning occurred in advance of actual credit losses. Once the economic forecasts started to improve, then reversal of provisions and actual charge-offs occurred that has led to lower ACL levels. It was discussed that the models were not built to account for drastic swings in the economy, and there was no way to predict how unprecedented fiscal stimulus and deferral of recognition of troubled debt restructured (TDR) loans would impact loss recognition. Geer also expressed that bankers should be cognizant of continued uncertainties due to the Delta variant of the COVID-19 virus, and the expectation of higher delinquencies and loss rates will rise when government support tapers.

Greer made an interesting comment related to current Financial Accounting Standards Board (FASB) discussions to allow the application of purchased credit deteriorated (PCD) accounting in business combinations to non-PCD loans. He believes it would not be appropriate accounting since, in his opinion, it defers the recognition of losses on acquired loans and is inconsistent with the intent of CECL.

Lylozian discussed the Federal Reserve's Scaled CECL Allowance for Losses Estimate (SCALE) model (www.supervisionoutreach.org/cecl/scale) for smaller banks. The SCALE method is a spreadsheet-based method designed and intended for smaller, less complex banks that uses publicly available data as a starting point for developing the ACL under CECL. The SCALE tool is not a regulator preferred tool or method, and there is no mandate to use it. The SCALE tool cannot be used by institutions greater than $1 billion in asset size.

Rieger provided a reminder that the Coronavirus Aid, Relief, and Economic Security (CARES) Act Section 4013 that provides the deferral in TDR accounting terminates the earlier of Jan. 1, 2022, or 60 days after the removal of the National Emergency and to follow applicable accounting and regulatory reporting instruction for all loan modifications. He encouraged awareness that no matter what type of relief provided, a bank is to consider the risks and apply the proper allowance. He also reminded the audience that the CARES Act Section 4013 does not prevent loans from being placed on nonaccrual. Systems that rely upon delinquency to determine nonaccrual status may need to be evaluated to make sure this is still sufficient due to COVID-19 system or report modifications that may have inherently understated nonaccrual loans.

Federal Banking Agencies: A Fireside Chat with the Chief Accountants – Part II

During the Q&A portion of the fireside chat, the three chief accountants discussed their observations on ESG, digital assets, tax allocation agreements, auditor independence and the LIBOR transition.

ESG

Lylozian stated that the Federal Reserve, considering its charter, is "primarily focused on the 'E' in ESG," mainly the impact of climate on banks (e.g., wildfires, hurricanes). This is the focus due to the potential impact on financial stability and assessing and dealing with risk within institutions. They are actively engaging with larger financial institutions on how they incorporate these risks into their enterprise risk management frameworks. This will inform future supervisory guidance and potential application to smaller banks. The question arose on how ESG impacts a small bank and currently, the Federal Reserve has not taken a view, and no regulatory guidance has been issued.

Digital Assets

The general feeling is that digital assets are here to stay even though the regulatory and accounting frameworks are behind in understanding and assessing these assets, as well as identifying the risks they bring to the banking system. One of the first steps any bank should take in evaluating digital assets, specifically cryptocurrency, is whether the investment or activity is legally permissible. Another early step would be to address the accounting and risk management.

It was discussed that the accounting model under generally accepted accounting principles (GAAP) is as an indefinite lived intangible asset for crypto assets that are not backed by tangible assets. This creates some unusual considerations and results from the impairment model inherent in that portion of GAAP.

Notice of Proposed Rulemaking - Tax Allocation Agreements

On May 10, 2021, the regulators invited comment on the proposed rules related to tax allocation agreements. This proposal codifies existing supervisory guidance and requires that banks that file as part of a consolidated group enter into a tax allocation agreement with other members of the consolidated group. The guidance covers how refunds and payments are to be allocated. In essence, the FDIC wants to make sure that tax refunds due to the institution are not out of reach of the FDIC in a failure situation. The proposal also codifies the regulatory capital treatment of deferred tax assets, specifically those related to net operating losses.

Auditor Independence and Part 363

Rieger provided a reminder to auditors and bankers that the preparation of financial statements by the auditor for those entities that are subject to Part 363 is an independence violation. Also, he reminded conference attendees that the use of indemnification/limitation of liability provisions in any bank engagement letter creates an independence violation and is an "Act Discreditable" under the AICPA Code of Conduct. He suggested periodic training for a bank's board and audit committee related to the independence of auditors under Part 363.

He also noted that there have been no changes in the Interim Final Rule (IFR) providing temporary relief from audit requirements under Part 363.

LIBOR

Lylozian noted two main issues related to LIBOR – what will be the replacement rate, and how will banks handle the transition? Agencies have not endorsed a specific rate to replace LIBOR in loan documents; however, the Alternative Reference Rate Committee (ARRC) has accepted the SOFR rate and the markets are seeing the increase in trades using SOFR. She noted that if not using SOFR, a bank would want to make incremental efforts to support the reasonableness of the rate selected. The expectation is that for whatever rate is chosen, that market participants should understand how the rate is constructed and the markets underlying the rate, including the fragility of the rate in volatile market periods.

Related to the operational issue or transitioning from LIBOR, the Federal Reserve has been warning about the operational and other challenges and that time is needed to provide a plan for changes. At this point, new contracts should not be written in LIBOR and regulators will question new contracts in LIBOR. The Federal Reserve issued SR-21-7 that outlines six operational aspects of the transition.

The New Frontier of Innovation: Perspectives from the Banking Agencies' Chief Innovation Officers

Moderator: Dennis Hild, Regulatory Affairs Managing Director – Crowe LLP
Beth Knickerbocker, Chief Innovation Officer – OCC
Kavita Jain, Chief Innovation Officer – FRB
Sultan Meghji, Chief Innovation Officer – FDIC

The Chief Innovation Officers from the FRB, FDIC and OCC held a fireside chat to discuss their views on how technology is changing the business of banking and what priorities and initiatives on which each of their respective agencies are focusing. Each of the panelists shared that the agencies are collectively focused on encouraging responsible innovation and promoting the adoption of new technologies by banks of all sizes to meet consumer needs, reduce compliance burdens, modernize the supervisory process and expand banking services in underserved communities.

Panelists described the various way the agencies have working closely together over the past two years, including releasing joint-agency resources such as Conducting Due Diligence on Financial Technology Companies - A Guide for Community Banks (federalreserve.gov), which is a guide intended to help community banks assess risks when considering relationships with fintech companies. The agencies also have been releasing other publications such as the FRB's Community Bank Access to Innovation Through Partnerships, which is intended to serve as a resource for community banks embarking on their innovation journeys.

Knickerbocker discussed trends with respect to digitalization and increased cyber threats, including ransomware as a service (RaaS) and the need for institutions to continue to be hyper-vigilant. The Federal Financial Institutions Examination Council (FFIEC) recently issued guidance as it relates to authentication (FFIEC Press Release). It was noted that this release does not necessarily contain new guidance, but rather previously issued guidance (2005 and 2011) that has continued to evolve, providing examples of effective authentication and access risk management principles and practices for customers, employees and third parties accessing digital banking services and information systems. Jain noted that there continues to be an increase in attacks, many as the result of increased partnerships with fintechs, as well as more and more people working from home due to the pandemic. She noted that while institutions have continued to access new technologies, the "bad guys" also have access to those and other evolving technologies resulting in new ways to attack.

The regulators all agreed that the key for financial institutions to successfully capitalize on innovation opportunities is to ensure their change management muscle is getting stronger with each implementation of new technologies and products. The panel participants also acknowledged this is true on the regulators' side as well as they explore opportunities to modernize the supervision process. Knickerbocker stated this will change how institutions interact with the regulators, noting that both sides need to be ready and emphasizing that change management is important.

The panelists stated that the agencies are committed to continuing to work together closely, while stressing the importance of the agencies' ongoing constituent outreach to hear concerns around risks and challenges as well as understand opportunities. They recommended that institutions and their auditors reach out to a bank's primary regulator to have a conversation on the topic of innovation and technology. Among other avenues is the Request for Information program, especially in areas such as digital assets (FDIC: FIL-35-2021: Request for Information on Digital Assets), which is also a way the agencies are gaining insights from the industry on issues and trends.

ESG

The Importance of ESG – An Overview

Moderator: Dom Giuffrida – Partner, Ernst & Young, LLP
Marc Siegel, CPA – Partner, Ernst & Young, LLP
Michael Tovey, CPA – Corporate Controller, Bank of America

We are currently in the largest wealth transfer of our nation's history as the baby boomers gift their assets to the next generation. These new, younger investors are different – they put their money into meaningful investments and are less concerned about the return. They want to feel good about the company they are investing in, especially its environmental, philanthropic or diversity posture. They put their money where their heart is, and this can create business risks and opportunities.

Tovey started off the discussion, stating "ESG is a journey," and we are currently just scratching the surface of it. They are seeing an increase in the amount of ESG information that companies are providing, most of it outside of public filing documents. However, in 2020 the SEC issued their first disclosure requirements for human capital and has become very active in this area. Additional regulation and guidance are expected to follow.

The presenters stated we should probably keep one eye on what Europe is doing on this topic as they are significantly ahead of the U.S. The European Union regulators are meeting with banks and building the Environment Disclosure and Risk Management Framework. If successful, the SEC may adopt this or one of the frameworks that Europe has already implemented versus creating their own.

Some of the disclosures that are being discussed are Green Asset Balance Sheet and Green Assets ratios. It is possible that there is a whole new method of accounting or disclosure that comes out of this, at which point Giuffrida stated, "ESG is the new CECL for the next decade."

U.S. companies are just starting to consider ESG. Tovey recommended that companies should start with a materiality assessment – what are the material risks and opportunities related to ESG. To determine this, they need to really know what is important to their investors and customers. Then, they need to build strategies to address these risks and opportunities. As companies begin to share more with the public, it will be important to provide transparency to what they are doing in this area.

The larger international banks are having to implement what standards do exist in various international jurisdictions that have different requirements. They would welcome consistency between standards and regulatory frameworks as they are investing significant resources to monitor and manage the processes.

In many ways, community banks may be in a better situation. They know their community and customers and can better communicate their story. The speakers emphasized that ESG is not going away and to start gathering information now so that appropriate data can be collected to support your story. A bank should not wait until it is mandated. They recommended preparing heat maps of the items that are important to your company and start the discussions in your organization.

Tovey noted that finance departments will have a significant role in the ESG process within the organization. While accountants may not be asked to calculate carbon emissions, ESG is all about science, and science has lot of assumptions and factors and can also be very complex and muddled. While the finance team may not own the ESG project, they may have the best skill sets to analyze this information, gather underlying data and develop processes and controls to ensure the accuracy of the data. Ultimately, public accounting firms may be asked to provide assurance on the company's disclosures and finance teams will be responsible for the accuracy of this information.

As Tovey has been working with his company on their disclosures, he has expanded his expectation of financial performance to being more than the just bottom line. ESG may create a whole new way of thinking and measuring your company's performance.

ESG – What Banks Should Consider

Catherine Ide, CPA – Managing Director, PwC
Dennis J. McGowan, CPA – VP, Professional Practice, Center for Audit Quality
Jamie Ezefili – VP of Corporate Social Responsibility, Northern Trust
Ben Miller – Director of Diversity & Inclusion, Performance Management and Reporting, Royal Bank of Canada (RBC)

The topics discussed by the panel included ESG matters applicable to financial institutions and the roles of boards, regulators, standard-setters and preparers in providing accurate and complete information.

Navigating Investors Regulatory Interest in ESG

During the panel, the panelists mentioned three different situations where ESG information can and should be provided: sustainability and corporate social responsibility reports, SEC filings and business strategy.

First, sustainability and corporate social responsibility reports can be provided to investors and other broader stakeholders with helpful information about an institution's community and ESG related efforts. As it relates to the SEC, ESG information can be incorporated into the filings, financial statements and related disclosures in many ways, such as risk factors, commitments and contingencies (e.g., environmental remediations) and information as it relates to the impact of climate risk factors on the financial statements. As ESG is encompassed in the terms of business strategy, examples include looking at loan portfolios in the context of physical risks related to the collateral of the borrowers and risk management around new products (e.g., green bonds), sustainability-linked notes and finally as it relates as to operations and how the bank itself has an impact on the environment.

As it relates to investors interests, it is important that each institution finds a way to tell their story of how they are addressing ESG matters.

McGowan stated the Center of Audit Quality (CAQ) recently performed research on the landscape of how companies are reporting on ESG information. The CAQ performed an analysis of publicly available ESG reporting for S&P 500 companies, which the data reflects the S&P 500 index as of March 12, 2021, and a company's most recently available ESG information as of June 18, 2021. It was noted that that 95 percent of S&P 500 companies had detailed ESG information publicly available. The information the CAQ examined was primarily outside of an SEC submission in a standalone ESG document or a sustainability, corporate responsibility or similar report. Of the remaining five percent, most companies published some high-level policy information on their website. Further, a small percentage of S&P 500 companies received some level of assurance from a public company auditing firm on some of their ESG information.

Areas of Focus for ESG Reporting

The panelists generally noted four areas companies should focus on relating to ESG reporting include: governance and reporting analytics, frameworks and metrics, data and process. A company must decide on two things initially – the company's ESG strategy and related metrics. Next, a company should determine its board involvement along with what functions (e.g., finance/accounting, risk, compliance, etc.) in the company should be involved in the discussion of what and where to report ESG. ESG strategy impacts multiple functions of a company, and it requires all of them to work together. It is very important to define governance over the ESG process in building a reporting structure. By ensuring a streamlined process and overarching governance, a company will be able to better tell their ESG story to investors. As it relates to what data to report, the recommendation is to start with the information already available. For example, it can be as simple as human capital management deriving from employee data or looking at policies and procedures in place for investing in the community and how that information is tracked. After analyzing what information is already available, it is important to perform a materiality assessment every two to three years to better understand what investors, employees, customers and other stakeholders are looking for as it relates to ESG.

Incorporating Climate Risk into Financial Projections and Portfolio Monitoring

Douglas Dwyer, Ph.D. – Managing Director – Research, Moody's Analytics

James Partridge, Ph.D. – Director – Credit Analytics, Risk & Accounting Solutions, Moody's Analytics

Representatives from Moody's Analytics gave an overview of climate risks with a focus on how this will necessitate the need to project financial information that considers climate change and the impact it will have in determining the value of an institution as a going concern versus the liquidation value. They also discussed approaches to facilitate projections of financial statements that could be utilized in determining credit risk in financial institutions' commercial portfolios. Key market trends included the economic costs of climate change, regulator pressures, investor expectations, a goal toward a net-zero carbon world and regulatory landscape highlights, including:

- Disclosure requirements – noting they are typically aligned with Task Force on Climate-Related Financial Disclosures guidance and industry best practices.

- A push to incorporate climate risk into risk management and supervision.
- Central banks taking the lead for establishing best practices for disclosures, risk management and green finance and integration into monetary policy.

As was heard during much of the conference, the speakers acknowledged that there is a wide range of where institutions are in their journey with respect to climate risk. Their general views on where institutions are today (or should be), based on size were described in a five-step model presented in the participant materials:

- Step 1: Education and Awareness – Considering the impact of climate on financial risk (Small Banks)
- Step 2: Risk Identification – Identifying physical and transition risk exposure (Regional Banks)
- Step 3: Risk Quantification – Incorporating climate risk into risk assessment (Domestic Systematically Important Banks)
- Step 4: Macroeconomic Scenarios – Making the link to climate pathways (Systematically Important Financial Institutions).
- Step 5: Reporting – Disclosing the exposure to regulators and the market.

A conceptual framework was presented that outlined both the economic and financial impacts of climate risk on the economy through a) physical risks, such as gradual climate change and extreme weather events and b) transition risks, such as technology and consumer preferences. This included how those risks drive various financial impacts and how they tie into key risk metrics (e.g., credit risk ratings, spreads and portfolio impacts – concentration and correlation risks). Financial statements are backward looking in nature, and the presenters discussed the analysis methodology, which Moody's Analytics has developed with climate risk incorporated with case studies.

SEC, PCAOB, FASB Updates and other Accounting Topics

SEC Updates from the Office of Chief Accountant (OCA)

Paul Munter, CPA, Ph.D. – Acting Chief Accountant, SEC
John Vanosdall, CPA – OCA Deputy Chief Accountant (Accounting Group), SEC

SEC Updates from Corporation Finance, Enforcement & OCA

Matthew Jacques, CPA – Chief Accountant, Division of Enforcement, SEC
Stephanie Sullivan, CPA – Associate Chief Accountant, Division of Corporation Finance's OCA, SEC
Kevin Vaughn, CPA – Senior Associate Chief Accountant, SEC

After providing an overview of their individual office or division, representatives from the U.S. Securities and Exchange Commission's (SEC) Office of the Chief Accountant (OCA), Division of Corporation Finance (DCF) and the Division of Enforcement (ENF) provided perspectives around several current topics and emerging issues. Each speaker spoke for themselves under the usual disclaimer, but there were very consistent messages across the presentations.

Consultation Trends

OCA representatives noted that COVID-19-related consultations peaked in the latter half of 2020, with the consultation volume then shifting to the more traditional "normal course" issues. In addition to addressing the accounting for unique transactions, OCA continues to field numerous consultations around revenue recognition, debt and equity classification, business combinations, consolidation and financial instrument accounting (including derivatives).

The OCA staff noted the need for professional judgement and an understanding that, even with similar transactions, differences in contractual terms can result in different accounting. The OCA staff also highlighted that sometimes registrants want to argue "there is no GAAP on point" or "existing GAAP did not contemplate our scenario" and therefore analogize to other guidance, but then selectively choose within that guidance rather than consider it comprehensively.

The OCA staff noted they had not received very many consultations on either the adoption of CECL or reference rate reform (i.e., LIBOR replacement), as further discussed below, but had received some on revenue recognition (including gross versus net presentation) in the fintech industry.

Independence

Both OCA and ENF representatives addressed auditor independence. OCA focused on rulemaking from October 2020 that became effective in June 2021 and changed the definition of "audit and professional engagement period" and added more judgment to the definition of a registrant's "affiliate" for purposes of the independence rules.[1] While these rule changes prompted an increase in independence consultations with OCA, Munter emphasized that the staff looks to the basic concepts in the general auditor independence rules in Reg S-X Rule 2-01, including whether a particular service would: a) create a mutual or conflicting interest between the auditor and client, b) place the auditor in the position of auditing their own work, c) result in the auditor acting as management or an employee of the audit client or d) place the auditor in a position of being an advocate for the client. Munter also emphasized the shared responsibility for auditor independence between management, the audit committee and the auditor, including consideration of the effects of future transactions with other entities with which the auditor may have a complex non-audit service arrangement.

CECL

OCA staff noted that they believed the relative few consultations around CECL adoption implied that there were not a lot of interpretive issues remaining at the implementation date. They acknowledged the FASB's efforts during the post-implementation review of the initial application of CECL by public companies and noted it was pursuing improvements to the standard for later adopters. The OCA staff emphasized that as time passes, changes may be made in an institution's CECL methodology that would need to be evaluated under the FASB's Accounting Standards Codification (ASC) 250 – *Accounting Changes and Error Corrections*. The staff encouraged careful consideration as to whether a change should be accounted for and disclosed as a change in principle, a change in estimate or a correction of an error.

Related to accounting for the allowance under CECL, Munter responded to a question about the reporting of decreases in the allowance in periods of economic recovery with continued uncertainty. He responded with his general belief that CECL provides better information based on the expected losses of an asset and that there was a need for context in the accounting for the allowance. He highlighted discussion of the significant drivers of the change in the allowance as providing particularly useful insight on management's perspective. Finally, it was noted by Vaughn that OCA was not involved in the creation of the Federal Reserve's "Scale CECL Allowance for Loss Estimator" model (SCALE) and had not yet had an opportunity to fully review its methodology or application. But the staff did note that while its initial thoughts were that SCALE would not be an appropriate methodology for a public company, if a registrant thought otherwise its implementation would need to be well-controlled and consistent with GAAP.

Not surprisingly, DCF's focus on CECL adoption and subsequent accounting was on disclosure. Sullivan noted that the estimate of the allowance for credit losses was likely a critical accounting estimate that would be disclosed as such in the registrant's Management's Discussion and Analysis (MD&A). She emphasized the related disclosure requirements, including why the critical accounting estimate is subject to uncertainty, how much the estimate and significant underlying assumptions have changed over a relevant period and the sensitivity of the reported amount to the underlying methods and assumptions. She noted that these MD&A disclosures should supplement rather than repeat the disclosures in the financial statement footnotes.

Sullivan noted that she had seen the following as effective disclosures: a) roll forward of the allowance, including amounts for new originations, charge-offs, and changes in specific quantitative and qualitative factors, b) tabular presentation of key factors, c) quantification of various scenarios and weights and d) sensitivity disclosures.

In a related topic, Sullivan reminded registrants that the implementation date for the September 2020 amendments to the SEC's Industry Guide 3, Statistical Disclosure by Bank Holding Companies (Guide 3), is for fiscal years ending on or after Dec. 15, 2021.[2]

ESG

Munter noted that investor interests continually shift and expand over time, but that any reaction by the SEC should be grounded in high quality reporting. He reviewed the current activities of the SEC staff taken because of past actions initiated by Commissioner Allison Herren Lee (the then-acting Commission Chair). Those are a DCF focus on compliance with existing climate-related disclosure guidance[3] and the opening of a public comment file for input on climate change disclosures.[4] He also cited a recent speech by Chair Gary Gensler where the SEC staff was directed to evaluate the need for disclosures around how investment funds brand themselves using "green" or similar descriptions.[5] Munter also noted that the SEC staff has a review of the recent human capital disclosures on its agenda, that the review is a priority of Chair Gensler and that the staff will be working to bring any recommendations to the SEC as soon as possible.

From an accounting perspective, the OCA staff noted that it was aware that some financial institutions had begun to include interest rates that varied on environmental measures, or changes in or targets for such measures, in the terms of lending arrangements. The staff noted that it had not received any consultations on such arrangements, but that there was a framework in GAAP for embedded features, which would be a reasonable starting point for an accounting analysis.

Reference Rate Reform

OCA staff noted that reference rate reform, or the transition from LIBOR to an alternative reference rate, was a top priority across the entire SEC given the pervasive effects it is having on markets and individual registrants. It was noted the transition had both operational and financial reporting aspects. The staff highlighted recent comments by Chair Gensler around his perceived flaws in the Bloomberg Short-Term Bank Yield Index (BSBY), drawing parallels between LIBOR and BSBY.[6]

Sullivan highlighted DCF's focus on disclosures around risk identification and mitigation to the extent the use of LIBOR was material for a registrant. She pointed to the SEC staff's 2019 public statement on LIBOR transition as a good source for disclosure considerations.[7] It was noted that relevant disclosures could occur in the Risk Factors, MD&A or Market Risk Disclosures sections of a registrant's filing, and that a registrant should consider how to tie those disclosures together to provide a complete picture of its transition efforts. Sullivan stated that DCF staff have seen a range of disclosures and encouraged registrants to be clear on where they were in the transition process (e.g., still assessing exposure, determined to be material but not yet quantified, etc.) and disclose the overall status of their efforts (e.g., ahead of or behind on their project schedule, date expected to be completed, etc.) She encouraged comprehensive disclosure on the progress of product and contract modifications, including for example: a) risks of not completing necessary modifications in time, b) extent of exposure to contracts that run past the discontinuance date for reporting a specific LIBOR tenor, c) how many contracts do and do not have fall back provisions and d) what new reference rates are expected to be used by contract type. Sullivan noted that disclosures are expected to evolve over time as the registrant is executing against its plan.

Digital Assets

OCA staff noted that digital assets were receiving attention at the SEC. They briefly reviewed the various types of assets and cited surveys that highlighted that a significant proportion of investors were asking their investment advisors about digital assets as investment alternatives. The staff noted that some assets may be deemed securities and others intangible assets after ruling out other types of assets. They noted that the FASB was asking for input on the inclusion of digital assets on its agenda in its recent Invitation to Comment (ITC), and that scoping of any project will be very important and require the views of financial statement users to determine what information is needed.

General ENF Observations

Jacques noted that ENF often approaches financial institutions for information as it conducts investigations into alleged activities (such as financial fraud) that were conducted through accounts at the institution (as opposed to being conducted by the institution). He noted while progress has been made in recent years in obtaining requested or subpoenaed information in a structured data format, some institutions continue to claim that requested information is not available in that format. He questioned whether that was actually the case in all situations, noting it would be difficult for an institution to manage its compliance and anti-money laundering controls without the ability to access and utilize such data. He also stated his believe that if it was truly the case, such an institution was missing an opportunity for better data management.

Finally, Jacques highlighted the ongoing ENF EPS Initiative, first discussed with two enforcement actions in September 2020. Under the EPS Initiative, risk-based data analytics are used to evaluate trends in earnings per share and other data that suggest fraudulent earnings management.

Public Company Accounting Oversight Board (PCAOB) Update

Glenn Tempro, CPA – Associate Director, Division of Registration and Inspections, PCAOB

Barbara Vanich, CPA – Acting Chief Auditor and Director of Professional Standards, Officer of the Chief Auditor, PCAOB

Representatives from the PCAOB (or the Board) provided an update on their standard-setting and research projects and discussed recent inspection results.

Standard Setting and Research Projects

Vanich shared an update on the PCAOB's progress on two standard-setting projects and two research projects. On the standard-setting front, the PCOAB continues work on an updated firm quality control standard following a concept release in 2019. The Board is working to develop a standard that would be scalable based on the size of the registered audit firm and similar to the International Auditing and Assurance Standards Board's ISQM 1. In addition, the PCAOB is preparing to revisit its project on the supervision of audits involving other auditors, which will lead to a stronger and more uniform approach to a lead auditor supervising the work of other audit firms used in an audit. The Board is expected to consider a supplemental comment period since the last comment period closed in 2017.

The Board is also focused on its research projects related to audit evidence (with a focus on evidence from technology-based tools and the use of external data) and data and technology (with a focus on testing whole populations, identifying unusual transactions and adding unpredictability to the audit). Vanich noted that the staff was working on other projects beyond those on the published agenda, including monitoring going concern considerations and ESG matters.

Inspection activities

Tempro noted that the PCAOB staff was continuing to conduct inspections remotely. He also shared that for 2020 inspections, the staff emphasized unpredictability in its selection process, specifically both increasing the number of randomly selected audits (versus risk-based selections) for inspection and reviewing areas within those audits that had not been a focus of past inspection efforts. The staff also reviewed areas likely affected by the pandemic, including impairments, going concern, the allowance for loan losses and the increased risk of fraud. Tempro noted that inspections also focused broadly on a firm's quality control standards affected by the pandemic, including client acceptance, consultations and communications from firm leadership.

Regarding inspections of the audits of financial institutions, Tempro noted financial institutions generally make up approximately 20 percent of the audits subject to inspections, stating that approximately 660 audits for the year ended in 2020 will be inspected in total for more than 150 audit firms. The PCAOB inspection staff has included both risk-based and non-traditional focus areas (such as deposits and debt). The allowance for loan losses and other estimates, including fair value measurements, comprise the most frequent areas of audit deficiencies both in auditing the account balances and the related internal control over financial reporting. With the allowance, the PCAOB staff frequently noted that auditors usually reviewed memos and methodologies but did not always obtain evidence supporting the underlying assumptions or document an understanding of how those assumptions were developed. Similar issues were noted around the testing of available-for-sale securities valuations, including controls around pricing. The PCAOB staff also noted frequent deficiencies in testing controls over the completeness and accuracy of data used in the execution of a control.

Related to CECL adoption, the PCAOB staff is currently reviewing audits of institutions that implemented CECL. Tempro noted that the PCAOB had spent time understanding the firms' readiness to audit the adoption of CECL, including interviews with firm leadership and engagement partners. He also acknowledged that auditing the onset of the COVID-19 pandemic and its effect on the new CECL model seemed to overshadow the auditing of the actual adoption in many cases. In concluding his remarks on CECL, he again shared that inspection teams continue to find deficiencies in testing of management review controls over estimation methods and assumptions within the audit of the allowance.

CECL and Beyond: The FASB Looks Ahead

Hillary Salo – Technical Director, FASB
Fred Cannon – Board Member, FASB
Susan M. Cosper – Board Member, FASB

Current Agenda-Related Activities

In June 2021, the Financial Accounting Standards Board (FASB) published an ITC to obtain feedback from stakeholders to determine the future focus of standard setting. Themes from that feedback include greater disaggregation in financial statements (e.g., expansion of statement of cash flows line items), recurring and non-recurring items, key performance indicators, ESG, emerging transactions (e.g., green items and governmental grants) and reduction in complexity of certain standards (e.g., variable interest entities). Cannon commented, from the perspective of a previous investor, the need for further disaggregation of information disclosed in the financial statements would likely not be targeted towards financial institutions but rather other industries such as technology companies. While the ITC feedback is still being processed (open comment through Sept. 22, 2021), FASB has compiled information collected thus far.

As a result of the investor outreach efforts, the FASB has targeted CECL and other financial instrument projects as agenda items for further refinements.

As a result of its post-implementation review (PIR) on the adoption of CECL, the FASB representatives shared feedback received from three stakeholder groups – users, adopters and non-adopters. Users indicated they were generally supportive of CECL disclosures and the additional information provided but noted that current disclosures lack consistency across institutions and may not be sufficiently detailed. Adopters (both financial institutions and non-financial institutions) provided feedback regarding successful CECL adoption as a result of robust planning, testing and controls throughout the implementation process. Feedback from adopters also included the challenges during implementation and ongoing application. Discussion points with financial institutions that have not yet adopted included development of implementation tools such as the SCALE and weighted-average remaining maturity (WARM) models continued implementation efforts without a significant delay, and that many plan to use an outside vendor for development of CECL models.

CECL Post-Implementation Standard Setting

Post implementation, stakeholders have identified certain areas of desired clarification or change within the CECL model, which the FASB is actively considering.

- Accounting for TDRs by creditors – The FASB is considering removing TDR recognition for CECL adopters and enhancing certain loan modification disclosures. Consensus from the feedback received is that CECL models already incorporate impact of concessions within the allowance. Enhanced disclosures could involve qualitative information regarding the types of modifications provided by the financial institution, as well as quantitative information of how the modifications are factored into the calculation of the allowance.
- Expansion of the scope of PCD loans to include all acquired loans – The FASB presenters shared that originally it was thought that PCD designated loans under CECL would represent the majority of an acquired portfolio; however, results of the top five acquisitions after CECL adoption have shown a range of 15-50 percent of the acquired portfolio classified as PCD. Cannon expanded on this topic from an investor's perspective, stating that investors want to isolate fair value adjustments due to interest rates from credit adjustments so that net interest margin is not distorted and may remain a comparable benchmark between acquisitive and non-acquisitive financial institutions.
- Vintage disclosures (charge-offs and recoveries) – The FASB is considering required disclosure for gross charge-offs and gross recoveries by year of origination within the vintage table disclosures. Without this information being disclosed, users of the financial statements are unable to decipher if trends in criticized loan percentages are attributable to credit improvements or increased charge-off activity.

Other Financial Instruments Projects on the Horizon

- Reference rate reform – The FASB is considering additional areas of GAAP that may need to be amended in response to the demise of LIBOR in an effort to avoid unintended impacts from the rate change. In addition, they are considering the development of a principles-based determination for a "benchmark rate" for use in hedging applications under ASC 815 - *Derivatives and Hedging*. As ASC 848 - *Reference Rate Reform* has a sunset date of Dec. 31, 2022, but certain tenors of LIBOR have been extended to June 30, 2023, FASB expects to extend the sunset date.
- Hedging - portfolio layer method – The FASB is evaluating the expansion of the last-of-layer hedging method to include multiple-layer strategies.
- Fair value measurement of equity securities subject to contractual sale restrictions – The FASB is evaluating this guidance to reduce diversity for measuring the fair value of equity securities that are subject to certain restrictions to sale, with consideration of whether the restriction is the characteristic of the asset or the entity holding the asset. The comment period closes in November 2021.

Sizzling CECL with a Side of Pancakes

Garver Moore – Managing Director, Abrigo
Neekis Hammond – Managing Director, Abrigo

The speakers opened the session by polling attendees on their suggested speaking topics. The topics selected by attendees were: a) the status of CECL late(r) in the pandemic, b) forecasting, c) auditor concerns and d) building allocations (inputs and overlays).

CECL Late(r) in the Pandemic

Moore and Hammond discussed managing CECL late in the pandemic versus early in the pandemic. They noted that late third quarter 2020 forecasts looked favorable, and most models were predicting improvements and releasing provisions quickly. They emphasized that the models were predicting releases, not necessarily the users of the models, and this was the primary topic of discussion during the quarter. Institutions were spending countless hours in October 2020 talking through how to manage this situation. The speakers stated it was helpful to many of their clients to run parallel models – the original run utilizing their base or normal forecast and another run utilizing the forecast but applying weightings to different scenarios to arrive at a blended forecast. These parallel model runs were used to help drive management's decisions. The challenging piece was determining weights for the different forecast scenarios. The speakers noted that their clients did not receive a lot of push back on their weighting decisions if the decisions were justified with supporting documentation.

Forecasting

The speakers opened this topic by stating that forecasting is the part of the estimate where you get to be wrong (in hindsight of course). They noted that the focus should not be on the actual forecast itself, but the impact of the forecast on the model results. This is where institutions should spend their time analyzing the results of different forecast scenarios. Additionally, they saw that institutions that used shorter forecast horizons with quicker revision periods tended to see less of a "seesaw" effect of booking provisions and releases.

Auditor Concerns

This topic was opened with a question from the audience regarding a recent publication by the PCAOB regarding deficiencies noted in the auditing of the allowance and whether that will result in the auditing profession having a more rigid response in their approach. Moore and Hammond noted that in their interactions with auditors, great effort was put forth to understand the methodology and the volatility of the CECL models in the first year of adoption, particularly in light of the COVID-19 pandemic. The speakers noted that a focus of auditors' concerns over the past year was related to the adequacy of the institution's documentation of key decisions. They stressed the importance of fully documenting the decisions made, as well as ensuring that proper internal controls are in place to execute the calculation of the loss estimate. Lastly, they concluded noting that they are seeing more questions from regulatory bodies around CECL in the current examination cycle as compared to the prior one.

Building Allocation (Inputs and Overlays)

The last topic was a discussion surrounding building the model and the use of inputs into the model and overlays (after-the-fact adjustments made outside of the model). In their experience, the speakers indicated that the use of better inputs, especially in regression-based models, reduced the institutions' reliance on overlays. They noted that many factors are evaluated as to their best use in how to build the model and whether it should began input or an overlay. Many factors do not become inputs as there is not enough strength or statistical power behind the factor to produce a mathematical determinate; thus, those that are "left behind" become the consideration of the overlays, or qualitative factors.

Breakout Sessions

Performance and Outlook for Banks

Catherine Mealor – Managing Director, Keefe, Bruyette & Woods

In her presentation, Mealor addressed a number of bank financial trends as well as certain market data points, the combination of which recently influenced Keefe, Bruyette & Woods' (KBW) decision to upgrade the entire banking sector to "Overweight."

Upon review of the fundamental drivers to 2021 earnings, the following themes were identified:

- Continued credit recovery
- Return on assets supported by the Paycheck Protection Program (PPP) and allowance reserve releases
- Excess liquidity weighs on net interest margins
- Yield curve / rate environment presents a headwind
- Loan growth has been challenging but is inflecting
- Mortgage banking highs are normalizing
- Banks continue to pull expense levers
- Capital management reboot

Credit and Provisions

Despite the cause for credit-related concern with the onset of the COVID-19 pandemic, non-performing assets and net charge-offs remain at very low levels. Substantial provisioning for loan losses, particularly observed during the first three quarters of 2020, have been partially mitigated through a trend of negative provisions during the first two quarters of 2021. However, on average the overall levels of reserve remain well above those from pre-pandemic levels in 2019 – 1.36 percent on June 30, 2021, versus 0.84 percent at the end of 2019. With more than 70 percent of banks having reported a negative provision in the second quarter of 2021, it is believed that the trend of negative provisions has reached its peak, and that banks will return to marginal levels of positive provisions prospectively, absent an unexpected downturn in credit quality trends.

Headwinds

Bankers are fully aware of the positive impacts that the robust mortgage market, PPP fees and reserve releases have had on earnings. As the favorable impacts of these items temper, it will be important for banks to become more efficient, deploy the buildup of cash reserves that has occurred and stabilize margin compression that has been occurring, but is believed to be close to a trough.

Merger Trends

While merger activity substantially ceased with the onset of the pandemic, it has now substantially returned to pre-pandemic levels. Thus far in 2021, deal multiples are largely representative of buyers' trading valuations: 164 percent of tangible book value (TBV), 17x last twelve months earnings per share (LTM EPS), and a one-day market premium at 20.9 percent.

Summary – Upgrading the Sector to Overweight

Overall, bank stocks have recovered from pandemic market trends, yet apparently remain undervalued relative to the market. For example, while the S&P 500's forward price earnings multiple is somewhat above 20x, the universal bank composite hovers around 15x.

Over 50 percent of U.S. banks are now rated at "Outperform." The market does not seem to have revalued bank stocks commensurate with other indices. There are early signs of inflecting loan growth, and cash redeployment for such should represent a substantial springboard for EPS, mitigating the headwinds of dwindling PPP fees, recent negative provisions and a cooling mortgage market. Obviously, the timing of these trends and expectations represents a significant variable. A delay in the return to suitable loan growth, rates remaining low and a continuation of elevated liquidity levels would postpone the expected positive implications to financial results.

LIBOR Transition

Jeannine Hyman, CPA – Director, Citigroup
Chris Malejko, CPA – Senior Vice President, Bank of America
Aaron Netten, CPA – Accounting Policy Manager, Wells Fargo Bank, N.A.
Mark Northan, CPA – Partner, KPMG LLP

The panel started the discussion with Netten providing an overview of what LIBOR is and how it is determined. He noted that after the financial crisis the market for inter-bank lending became very illiquid; therefore, LIBOR rates became primarily based on expert opinions from participating financial institutions rather than actual market data. This led to concerns that the rate could be easily manipulated. As a result, in 2017, United Kingdom regulators announced that LIBOR reference rates would cease to be published and provided an initial transition period for the currencies and economies that primarily relied on the rate (including the U.S.). The transition period has been extended several times but will be complete in June 2023.

In the U.S. the Alternative Reference Rates Committee (ARRC) was tasked with identifying an alternative rate and creating a transition plan with the goal of having the smallest economic impact possible as a result of the transition. It is estimated that there are approximately $223 trillion in contracts that are referenced to LIBOR, with a majority of those being derivatives.

The ARRC has selected SOFR as the new reference rate to be used in the U.S. SOFR is developed based on the very active repurchase market that exists in the U.S., addressing one of the main concerns that existed with LIBOR by using a market-based mechanism. The panel then discussed a number of the challenges of SOFR, including:

- It is a secured rate rather than unsecured, like LIBOR; therefore, a credit spread calculation must be done to adjust for contracts that referenced LIBOR. A solution and calculation to estimate this spread was done based on historical differences in the two rates. This adjustment will be calculated and published by the International Swaps and Derivatives Association (ISDA) going forward.
- LIBOR rates were forward looking and quoted in a number of terms ranging up to 12 months, with the most popular being three-month LIBOR. In contrast, SOFR is an overnight, historical view of rates. A method for addressing this difference is still being formulated.
- Numerous contracts that reference LIBOR do not have automatic language in them to transition to a new, "fall back" rate once LIBOR is no longer published.

In response to the third challenge, the panel indicated that two different actions had been taken. The first was the exploration of a federal law that would require amendment of contracts that reference LIBOR. This would facilitate the adjustment of contracts where amendment is difficult or impossible for various reasons. The second action was accounting relief, which was provided by the FASB through the adoption of ASC 848. The group then spent the remainder of their time discussing this new accounting standard.

The main provisions of ASC 848 are to allow for modification of contracts due to reference rate reform without triggering existing contract modification guidance that could disrupt accounting methods and results. Often modification requirements result in earnings volatility, and the FASB's goal was to provide broad relief from this volatility for narrow modifications related to reference rate reform.

The panel discussed in depth the relief provided in ASC 848 as it relates to hedging relationships. The members noted that there were important qualification considerations for contracts to be within the scope of the new standard, but if they were, the standard provided significant relief to allow for transition to a new reference rate while continuing hedge accounting. One of the notable items of relief that any entity with a hedge should adopt immediately is the ability to presume that a future cash flow based on LIBOR is probable of occurring, even if that cash flow is scheduled to occur after the date that LIBOR is discontinued. Assuming that a transaction is probable is a key threshold that has to be met in most common hedging relationships. There are other provisions regarding effectiveness assessments that allow for relief in the situation where the hedged item and the hedging instrument may be modified at different times given the presence of multiple counterparties.

The group also noted that if an entity had not started on a project to address reference rate reform, that they should do so immediately. The significant steps in that project would include identifying the population of affected contracts, creating a transition plan for each contract or type of contract, and executing that plan and accounting for it appropriately.

Community Bank Financial Reporting Hot Topics

Moderator: Jeffrey J. Geer, CPA - Associate Chief Accountant, OCC
Mike Lundberg, CPA – Partner, RSM US LLP
Todd Sprang, CPA – Principal, CliftonLarsonAllen LLP
Sydney K. Garmong, CPA, CGMA – Partner, Crowe LLP

Topics for the panel included observations of the current environment, CECL preparation and Community Development Financial Institutions (CDFI) grants.

Current Environment

The panelists used the phrase "murkiness" to describe the current economic environment, as they noted there is uncertainty as to whether stimulus funding deterred or delayed credit issues and what core earnings will look like after the impact of PPP loan originations and mortgage lending spikes subside. The panel also discussed the perceived benefit for small institutions that were eligible to delay the FDIC Improvement Act auditing requirement and commented that continued delays, if allowed, would be helpful to those companies given continued human resource constraints and remote work environment scenarios.

CECL Implementation – Looking Back

The panelists provided a recap of the FASB's presentation at the conference, including proposed alternatives related to the expansion of PCD loan designation to all acquired assets. The proposed gross up approach would require recording a Day 1 premium with an offsetting allowance. Geer stated his thoughts against the proposed gross up approach as he views the non-PCD loans and originated loans in the same manner and would not recommend different treatment for these two similar loan categories.

The panelists also discussed the new AICPA CECL Audit & Accounting Guide, which should be ready for release in October 2021. The update project includes two subgroups – auditing and accounting. Lundberg, as part of the auditing subgroup of the task force, provided insights from the CECL Audit Practice Aid that was released in September 2019. The Audit Practice Aid has been helpful for preparers as well as auditors. Leveraging the Audit Practice Aid, the Guide includes a chapter dedicated to Accounting Issues, as well as observations from early adopters. This Guide will reiterate that auditors should gain appropriate understanding about what management has done throughout the implementation process. There is also focus on the internal controls that should be developed around estimate.

CDFI Grants

The panelists briefly discussed the Rapid Response Program grants awarded in June 2021 to highlight the distinctions in financial reporting, noting financial institutions should carefully read the grant agreement, consider implementing new controls specific to compliance reporting and to lookout for additional guidance issued regarding single audit program requirements.

Community Bankers Panel: Facing Evolving Challenges

Moderator: Martin M. Caine, CPA – Principal, Wolf & Company, P.C.
Brian Canina, CPA – Executive Vice President – Chief of Finance and Shared Services, PeoplesBank
David Hedges, CPA – Executive Vice President, Chief Financial Officer, Auburn National Bancorporation, Inc.
Todd L. Capitani, CPA – Executive Vice President, Chief Financial Officer, Community Bank of the Chesapeake
Jeffrey White, CPA – Senior Vice President and Controller, Northwest Bancshares, Inc.

This diverse panel of CFOs and controllers shared their recent experiences, challenges and thoughts on the future regarding key topics common to community banks. Topics included operational and personnel challenges due to the pandemic, capital management, digital innovation, ESG, CECL and other strategic matters.

COVID-19 Operational Changes and Personnel Matters

The onset of the pandemic created initial issues with work from home strategies and dealing with how to get work completed in a remote environment. After being in the pandemic for a while, the topic of conversation has been how to deal with a hybrid work model and related challenges. The panelists were generally in favor of work from the office. However, most of the panelists are working on hybrid work model – in the office for a certain number of days and working remotely on others. One panelist noted that in a recent renovation of their headquarters, they have not reduced the footprint but have considered the use of the space and having more focus and collaboration areas.

It was noted that fraud has increased due to the inability to properly train staff due to remote or hybrid work models. Another panelist noted that they are rethinking the front office staffing model – i.e., whether the teller and other front office staff are still non-exempt personnel. These positions have high turnover, and the quality of personnel suffers as a result, so changing to a more career-oriented position may have better results.

Capital Management

The discussion centered around the use of subordinated debt, and the thoughts were generally positive due to a) the low interest rate environment, b) minimal yield opportunities on the asset side of the general ledger and c) providing the ability to grow for the current shareholders. However, each institution is different and the use of subordinated debt depends upon each institution's plans for growth and capital structure. Stock buybacks and dividends were very much in favor with the mix depending heavily upon the nature of the shareholder base. If there is a more local community base, dividends may be favored over stock buybacks.

One panelist noted that the excess liquidity has artificially lowered their leverage ratio. They are monitoring the ratio by adding back the dilution, in essence planning on the excess liquidity to leave the bank at a certain point.

Digital Innovations

All of the panelists noted investment in digital tools such as data mining, video ATMs and robotic processes, while digital banks have played some role in their strategy. If the need is for deposits, then a digital bank may be a reasonable strategy to gather deposits outside of their primary market. For branch optimization, video ATMs may be a tool to use to merge or close branches while maintaining customer contact. Certain bots can be used to complete repetitive tasks such as loan quality control checks to maintain efficiency as costs of employees continue to rise. These are trends that are here to stay and are necessary to be competitive.

ESG

The consensus was that community banks were already doing a little in this area – building efficiency, monitoring charitable contributions, using minority vendors and complying with the Community Reinvestment Act. However, the tracking and compilation of all the activities has been difficult. One of the institutions has created an ESG Council to start compiling and monitoring activities to report to their board. The panelists believe that this will become more important as time goes along and is not going away.

CECL

Almost all panelists agreed that if you had not started the CECL process or were just starting, you should put forth the effort to speed up the process. As the Jan. 1, 2023, implementation date gets closer, it will be harder to find the necessary vendors to assist in the process but to also provide the necessary model validation services. Other pitfalls are related to the volume of information and working across departmental lines that increase the need for communication and that may slow down the adoption process. One bank was adopting early just for these reasons. From the current adopters, they liked the CECL framework better than the incurred loss framework as it made it more auditable with better governance around the model. There was discussion around qualitative factors, particularly in that one panelist felt that the need for qualitative factors was minimal if the risks were captured in the model, while another panelist noted that developing a qualitative factor framework was one of the most worrisome aspects of implementing CECL. One panelist noted that the model being used is a Probability-of-Default/Loss-Given-Default model with a mix of internal and peer loss rate data, depending upon the asset class.

Strategy

The panelists noted that their institution's strategy pre- and post-pandemic really is not expected to change. It may accelerate some items such as digital innovation, but there will not be a lot of changes in the basic strategy of serving the customer. Action items that are high on the list are maintaining or improving efficiency through the use of technology to offset the increased cost in personnel. As net interest margins continue to shrink, investment in these innovations is critical.

Mid-Size Bank Chief Accounting Officer Panel

Moderator: Michael Hall, CPA – Partner, KPMG LLP
David Cornish, CPA, Chief Accounting Officer and Corporate Controller, Santander US
Brad Kimbrough – Controller and Chief Accounting Officer, Regions Bank
Ryan Richards – Corporate Controller, Zions Bancorporation

Several items were discussed by a panel of mid-sized bank chief accounting officers.

CECL: Lessons Learned

One surprise that the panelists learned through the two years of CECL was how important qualitative factors and other management adjustments has become, particularly in periods of uncertainty like the COVID-19 pandemic. Cornish urged those institutions who have not adopted the standard yet to think about how reactive the models will be to the economic environment and how to create appropriate forecasts for the models. Having a plan in place to make management adjustments or overlays when the models produced unexpected results was important for the initial round of adopters.

The panelists also discussed the importance of considering the institution's Sarbanes–Oxley Act of 2002 (SOX) compliance program when implementing CECL. Key stakeholders, such as internal audit, should be involved in all stages of implementation and ensure that controls around implementation are considered and documented accordingly.

Current Work Environment

The panelists discussed the current work environment, which continues to mostly function in a hybrid model. They discussed the challenges of assimilating new hires into their institution's culture and developing their teams.

Some institutions onboarded new hires in the office for a period time to make the transition easier and to begin the development of relationships. While the remote environment provides benefits and flexibility, employees have missed the opportunities to engage with coworkers and managers that would arise if working together in an office.

Cornish noted that he was surprised how well both closing the books and the secondary process of being audited –by both their regulators and their external auditors – went in a remote environment. He credited having a strong team and process as well as adopting a hybrid model for his team. The panelists noted that they expect a hybrid approach to regulatory exams and audits to continue into the future.

Fintech Partnerships

The panelists discussed fintech and how the emergence of these businesses has impacted the banking landscape. They noted that developing relationships with fintech partners as helped them grow their business as a new source of loan growth. Fintech arrangements can be beneficial to banks as an opportunity to innovate, rather than a threat as they were seen earlier.

Ask the Experts – Large Banks

Lee Keel, CPA – Accounting Policy and SEC Reporting Manager, Wells Fargo
Linda B. Bergen, CPA – Director of Corporate Accounting Policy, Citigroup
Richard Juntilla, CPA – Accounting Policy Director, US Bancorp
Chris Ackerlund, CPA, MBA – Head of Accounting Policy, Bank of America
Rebecca Carey, CPA – Managing Director, JP Morgan Chase & Co.

This session consisted of various accounting and financial reporting hot topics, including CECL, reference rate transition and Guide 3 disclosures.

CECL: Lessons Learned

The panelists discussed the focus on continued improvement on documentation and support for CECL model assumptions by regulators and auditors. They agreed that their institutions are all attempting to be more transparent on their economic factors and being able to provide trends for model users to more clearly see the changes quarter to quarter. They noted that the pandemic showed the need to be nimble with their models and processes to capture the unexpected. During the current year, one of the panelists noted that continued communication with regulators, external auditors and internal auditors was important in relation to changes and transparency within their modeling processes and results. Also, comparing their financial reporting to peers, and looking at what others are doing and disclosing, in an effort to improve their own disclosures and discussion on CECL was an important process.

The majority of the panel was in favor of updating the current TDR accounting and disclosure requirements to reflect how CECL models now treat these loans and to be more consistent with how institutions are managing their loan portfolios. Additionally, they found compiling the required vintage disclosures to be challenging and less meaningful as most do not manage their portfolio from that perspective.

Reference Rate Transition

Each institution has a LIBOR transition/support team to help with this transition away from LIBOR and believe that they are on track with the sunset deadline.

Guide 3: Modernization of Statistical Disclosures for Bank Holding Companies

With the first major update to Guide 3 disclosures in 30 years, each of the institutions has a team determining the changes to be made for the upcoming Form 10-K reporting cycle. Panelists noted that while some of the old disclosures were removed from the guidance, they were planning to leave them in their financial statements because they believe the disclosures are still relevant for investors. With regard to one of the new disclosures related to uninsured deposits, they cautioned that this information is not as easy to gather as it originally sounded. Overall, they felt their teams were ready for the changes.

Merging with a Special Purpose Acquisition Company

Graham Dyer – Partner, Grant Thornton

Matt Esposito – Partner, Grant Thornton

Special Purpose Acquisition Companies (SPACs) are not a new concept but have seen a dramatic resurgence in the past year. A SPAC, also known as a blank check company, is a public company holding cash from its initial public offering (IPO) essentially in a trust to be used to acquire an operating company in a specific industry or industries as outlined in its IPO registration statement. The formation of and accounting for SPACs was discussed by Dyer and Esposito in their presentation. The vast majority of their presentation was not specific to financial institutions but rather focused on industry-agnostic basic SPAC accounting. However, they noted financial institutions that lend to a SPAC or to a SPAC's operating company target may want to understand the process of "deSPACing" (where the SPAC acquires its target) and the resulting financial reporting as credit-related risks could emerge. Specifically, the presenters noted:

- Due to the application of reverse merger/reverse capitalization accounting at the time of the deSPAC transaction, the public SPAC's equity structure will replace that of the private operating company, and thus a bank may want to understand the nature of that equity structure.
- DeSPACing transactions were taking an average of 21 days in January 2021 and 78 days in July 2021. That increased timeframe can offer more distractions to management of the operating company, increasing risk in both the SPAC and the operating target.
- Various accounting complexities can arise in the process of deSPACing and the related accounting which can increase restatement risk to the newly public operating company, including, for example, issues around cheap stock accounting (stock options granted prior to deSPACing by the operating company at a price less than the SPAC purchase price), treasury stock transactions (for similar reasons as cheap stock) and debt or equity classification and accounting for certain new and/or legacy equity-related instruments and derivatives.

For additional information on SPAC transactions and accounting, see DHG's resource page at dhg.com/services/assurance/special-purpose-acquisition-companies-spac.

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SOURCES

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[3] Release No. FR-82 – "Commission Guidance Regarding Disclosure Related to Climate Change – Feb. 8, 2010

[4] March 16, 2021 Public Statement – "Public Input Welcomed on Climate Change Disclosure"

[5] Sept. 1, 2021 Speech – "Remarks before the European Parliament Committee on Economic and Monetary Affairs"

[6] June 11, 2021 Public Statement – "Prepared Remarks Before the Financial Stability Oversight Council"

[7] July 12, 2019 Public Statement – "Staff Statement on LIBOR Transition" from DCF, Division of Investment Management, Division of Trading and Markets, and OCA