Banks and savings institutions

AICPA National Conference

Issues & Trends

September 2017

kpmg.com/us/frv

Contents

1 Meeting highlights

New accounting standards, especially the new current expected credit loss (CECL) standard[1], continued to be the primary focus of speakers at the 2017 AICPA National Conference on Banks and Savings Institutions held September 11-13 in Washington D.C.

"The clock is ticking," noted Shayne Kuhaneck of the FASB referring to the new standards, a thought reiterated by bank regulators and the SEC staff. Speakers shared implementation best practices and potential challenges. They also articulated concerns and debated interpretive accounting issues that still remain for the new standards.

One issue discussed was whether the method and period used to revert from the reasonable and supportable forecast period to historical losses under CECL should be considered an accounting policy election or an assumption made in developing the accounting estimate. Several speakers, including the FASB and SEC representatives, expressed the view that the method used to revert to historical losses needs to be thoughtfully determined and supported like any other significant assumption, and it would not be considered an accounting policy election.

Banks should "adopt then adapt," said Joanne Wakim of the Federal Reserve, which summed up several speakers' comments on CECL. Taking action now on the new CECL standard, despite uncertainty related to certain implementation matters, will hasten identifying and addressing issues as banks move closer to adoption.

Transition disclosures required under SAB 74[2] continued to be an area of focus. Wes Bricker, Chief Accountant, SEC's Office of the Chief Accountant (OCA) encouraged banks to, "describe information that is relevant, that you know, but don't say more than you know."[3]

Outside of the new accounting standards, conference speakers provided a mixed outlook on economic trends, industry performance and legislative developments.

---

[1] ASU 2016-13, Financial Instruments – Credit Losses

[2] SAB 74 (codified in SAB Topic 11-M), Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period

[3] Remarks before the AICPA National Conference on Banks & Savings Institutions: Advancing High-Quality Financial Reporting in Our Financial And Capital Markets, Wes Bricker, SEC's Chief Accountant, September 11, 2017

2 Current expected credit loss standard

Expected effect of CECL

Speakers described the expected benefits of the new standard including earlier recognition of expected credit losses, greater transparency about credit losses and closer alignment with how banks assess credit risk.

Hal Schroeder of the FASB indicated that the quantitative effect of the CECL standard will vary depending on many factors, including how banks apply current US GAAP requirements. He referenced recent studies suggesting that the increase in the allowance for credit losses might be in the single digits, rather than the 30 to 50 percent increase cited by some observers, but cautioned that the spectrum of expected changes is wide.

Speakers from the banking regulators indicated that they are looking for a "good faith effort" by banks to adopt the standard. The banking regulators also stated they do not have a CECL benchmark, target or range and they will not be "examining to the average." While there is no explicit expectation, speakers noted that it is generally thought that the allowance will increase under the CECL standard compared to the current incurred loss model. Bank regulators also clarified that they expect practice in this area to continue to evolve.

While the effect of CECL on regulatory capital has not yet been determined, the regulators indicated that banks should begin planning for an increase in required regulatory capital. To address the effect of CECL on regulatory capital rules, the Basel committee has approved transition plans that may be elected by each jurisdiction. Banking regulators are evaluating these transition plans.

Importance of governance

Speakers remarked that banks should implement a robust governance structure as part of adopting the new standard. Numerous business units – including credit risk, finance, financial reporting and operations – are expected to be involved in the initial implementation and ongoing reporting under the new standard.

It was emphasized that establishing clear roles and responsibilities, with sponsorship from senior management, is essential for successful adoption of the standard.

Internal control over financial reporting

Internal control over financial reporting (ICFR) is relevant to the adoption of and ongoing reporting under the new standard. Speakers from the SEC stated that transition plans should include initiatives for identifying and implementing necessary changes to ICFR.

Banks should consider the effect of CECL across all control framework components, which several speakers emphasized including SEC representatives. Specifically, banks should assess:

— **Control environment** – establish appropriate tone at the top and set expectations for responsible conduct;
— **Risk assessment** – perform an effective identification and assessment of risks of material misstatement;
— **Control activities** – consider whether the process changes arising from CECL bring additional areas into the scope of ICFR, even if certain functions historically have not been included in financial reporting;
— **Information and communication** – identify effects on the ICFR environment as a result of increased information requirements and increased use of technology to capture, process and report data; and
— **Monitoring activities** – implement appropriate plans to monitor and test newly implemented internal controls.

Data, data, data

Speakers encouraged banks to immediately begin retaining loan data for the CECL estimation model. The FASB and SEC speakers emphasized that data is critical to adoption, including understanding where and how data is being collected, as well as implementing appropriate internal controls.

However, speakers also noted how difficult it may be to identify what data is needed and available. While loan data is fundamental to banks, the ease with which that data can be accessed, processed and analyzed is a key planning consideration.

Once data requirements are defined, speakers suggested that banks perform a gap assessment by identifying both available and currently unavailable data. The assessment should include ownership of data, alignment of definitions between business units, impact on IT applications and internal controls.

Industry speakers remarked that banks should not overlook new disclosure requirements, including vintage-based information, when identifying data requirements.

Methodology and models

"[…][S]ystematic methodology and documentation practices in FRR 28 and SAB 102 will continue to apply when determining the allowance and provision for expected credit losses," noted Bricker.[4]

Bricker also noted that management's estimate should consider, "a methodology that is best suited for the characteristics of the institution and the loan portfolio." The theme that there is not a "bright line" or "one size fits all" approach to a CECL methodology was heard frequently during the conference.

Wakim suggested banks think about scalability for CECL methodologies the same way they would for existing allowance for loan and lease loss methodologies, noting that spreadsheet-based models might work for some

[4] FFR 28, Procedural Discipline in Determining the Allowance and Provision for Loan Losses to be Reported, of Section 401.09, Accounting for Loan Losses by Registrants Engaged in Lending Activities, to the Codification of Financial Reporting Policies; SAB 102, Selected Loan Loss Allowance Methodology and Documentation Issues

banks. Adapting existing stress testing models might also be a viable option, but caution should be used. Regulators warned that defaulting to stress testing models as the basis for the reasonable and supportable forecasts could result in judgments inconsistent with the CECL model. Wakim observed that a baseline stress test would be inherently conservative when compared to the theory underpinning the current expected credit loss model.

Some industry speakers expressed the view that fewer banks than initially expected are planning to leverage existing models and methodologies. Regulators reminded banks that management remains responsible for models and methodologies, assumptions and data even if external vendors are used.

Reasonable and supportable forecasts

The FASB staff noted that the reversion method is not a policy election and must be supported by management, similar to any other estimate. The SEC's Chief Accountant echoed this view by stating that the reasonable and supportable forecast period and reversion approach are assumptions used in developing management's estimate. If the reversion method were considered a policy election, each change to the policy would need to be evaluated for preferability, possibly limiting the ability of banks to make timely changes.

Banks continue to evaluate how to best determine the reasonable and supportable forecast period. Speakers indicated that as they work through this issue, banks should use the same principles as today, specifically that there is no one right answer and that they need to be thoughtful and document decisions. Speakers advised banks to also consider the consistency of the reasonable and supportable forecast period for CECL in conjunction with other forecasts. In supporting and documenting the entity's estimate of credit losses over the entire contractual life, including the forecast period, the SEC staff noted that the guidance outlined in FRR 28 and SAB 102 would be foundational. Regulators also warned that forecast periods cannot be assumed to be the same as stress-testing timelines without appropriate rationale and supporting documentation.

Other interpretive accounting issues

Topic	Highlights
Zero credit loss	Speakers noted that the Depository Institutions Expert Panel (DIEP) recently discussed asset classes that may be considered to have zero credit losses under CECL: — US Treasury Bonds; and — Ginnie Mae, Fannie Mae and Freddie Mac mortgage-backed securities. Speakers also noted that discussion of zero credit losses continues for certain other asset classes, including other sovereign debt and seasoned loans, as well as debt securities with underlying collateral that has a low loan-to-value ratio.

Topic	Highlights
	Speakers emphasized the need for sufficient documentation to support zero credit loss conclusions.
Effect of troubled debt restructurings (TDRs)	Speakers referenced the discussion at the September 6 FASB meeting about identifying and measuring "reasonably expected" TDRs.[5] The FASB agreed that when a loan is individually identified as a reasonably expected TDR all of its incremental effects should be reflected in the allowance for credit losses. The FASB's conclusion provides guidance on an existing interpretive issue.
Credit card portfolios	Estimating the life of credit card receivables continues to be an unresolved issue, speakers indicated. The FASB staff is preparing a position paper on credit card implementation issues, which will be discussed at the October 3 FASB meeting.
Regulatory charge-off, nonaccrual and TDR policies	While concern had been expressed about the interplay between the new CECL standard and existing regulatory policies, banking regulators indicated there are no current plans to revise existing guidance. The SEC staff observed that issuers could consult with the staff if they have concerns.
SEC staff consultation and pre-clearance	The SEC staff stated that they are open to discuss CECL implementation issues encountered by banks. For example, they are currently working on a consultation on an analogy to purchased credit-impaired loans. Further, banks should consider whether previous pre-clearances received from the SEC should be revisited under the new standard.

Speakers emphasized that banks should continue to monitor the TRG for Credit Losses meeting materials and publications[6] for updates on advancements in outstanding interpretive issues.

Next steps

Speakers emphasized that taking action now will help reduce potential future implementation issues and it is not possible to fully understand the population of potential issues until banks begin detailed adoption work in earnest.

[5] FASB Meeting September 6, 2017

[6] Transition Resource Group for Credit Losses

Speakers suggested that banks focus on next steps such as:

- starting early and sticking to project plan dates;
- engaging with constituents from relevant business lines to establish roles and responsibilities;
- establishing data requirements and collecting historical data;
- determining an overall methodology approach, including use of historical models and/or vendors; and
- analyzing disclosures, especially interim disclosures about the expected effect of recently issued accounting standards (SAB 74).

3 Revenue recognition

Implementation efforts

Speakers said that the efforts required to implement the new revenue standard[7] have generally been consistent with expectations. Banks are focused on determining which categories of noninterest revenues are within the scope of the standard, evaluating the effect on timing of revenue recognition and income statement presentation, and preparing for the expanded disclosures.

Some banks will need to change how they present gross revenue versus net revenue, and those that do will likely need to change a limited number of revenue streams. The timing of revenue recognition will not significantly change, as expected.

With the window for implementing the new standard narrowing, speakers said that banks are grappling with implementation issues such as determining the scope of the standard and identifying performance obligations, which affects presentation (gross versus net).

Determining the scope of the standard

The TRG for Revenue Recognition has determined whether commonly debated noninterest revenue types – such as mortgage servicing income, financial guarantee fees and deposit service charges – are in the scope of the new standard.[8] The SEC staff indicated that it has received consultations on scoping credit card interchange fees and rewards (in the fact pattern evaluated they would not object to netting rewards with interchange fees), as well as asset management fees (in the fact pattern evaluated they would not object to out-of-scope treatment). Banks have had a difficult time determining how they should account for asset management fees because they often involve a base-management fee as well as performance-based variable fees. Scoping has also been a challenge because certain noninterest revenue lines may include both in-scope and out-of-scope items.

Speakers emphasized that the quality of a bank's scoping analysis will drive the effort to adopt the standard. Banks should analyze noninterest revenues that are not clearly in or out of scope of the standard, which may be only a small portion of a bank's revenue. The scoping analysis can be done at various levels, including by income statement caption, general ledger account or line of business, the speakers noted.

---

[7] ASU 2016-12, Revenue from Contracts with Customers

[8] FASB Transition Resource Group for Revenue Recognition, Scoping Considerations for Financial Institutions, April 18, 2016

Identifying the performance obligation

Speakers noted that identifying the performance obligation for several revenue types will likely require judgment. Determining the performance obligation has been difficult when there are other promised goods or services associated with a transaction, or when services are not explicit in the contract or legally enforceable. For example, asset administration fees might encompass lockbox services, wire transfers, sweeps and other trust services – all bundled within one contract – making it difficult to identify the performance obligation.

In response, banks have evaluated example contracts and engaged in discussion with business line managers to obtain more detailed information to better inform decisions made to identify performance obligations. In addition, performance obligation disclosures will need to be robust and likely will be in a narrative format. This will be a significant change in disclosure, and will allow banks to more clearly articulate their decisions to financial statement users.

Next steps

The speakers advised that at this point implementation efforts should be well underway and nearing completion. Speakers noted that few, if any, banks have early adopted the standard. The next steps banks should focus on include:

- finalizing contract reviews and creating implementation documentation so these documents are ready to be reviewed by auditors before the effective date;
- preparing revisions to accounting policy documentation;
- drafting updated disclosures, especially interim disclosures about the expected effect of recently issued accounting standards (SAB 74), noting that the SEC staff emphasized at the conference the importance of robust disclosures; and
- communicating with investors.

If banks have not begun contract reviews, speakers suggested they start by reviewing contracts with defined durations. For contracts without durations, such as deposit agreements that can be cancelled by either party at any time, little or no change is expected in the timing of revenue recognition.

4 Hedge accounting

The long-awaited simplified hedge accounting standard[9] was viewed by several speakers as a positive development for the industry. Among other changes, the standard eliminates the requirement to separately measure and report hedge ineffectiveness, and requires the entire change in the fair value of a hedging instrument to be presented in the same income statement line as the hedged item. The standard also eases certain documentation and assessment requirements and provides new alternatives for applying hedge accounting to additional hedging strategies. It is expected that some banks will early adopt the standard, perhaps as soon as the fourth quarter of 2017. Speakers cautioned that early adopters should be thoughtful in transition, including considering internal control enhancements so that they do not "adopt themselves into a material weakness."

While there has been "folklore" related to the SEC staff's views about whether banks are eligible to apply the shortcut method under the existing hedging standard, Rachel Mincin from the SEC staff noted that the SEC expects issuers to implement the new standard as written. She also emphasized that banks should continue to focus on creating hedging documentation that is compliant with the new standard.

Bob Storch, FDIC Chief Accountant, reminded early adopters that revised US GAAP accounting under the new standard should also be reflected in Call Reports.

---

[9] ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities; Defining Issues 17- 19, Changes to hedge accounting

5 SEC & PCAOB highlights

Consultation trends

Mincin indicated that consultation activity is up by a third compared to last year, largely driven by the new revenue recognition standard, and it is expected that this trend will continue as banks adopt the other major accounting standards. She reiterated that the SEC staff is willing to accept well-reasoned judgments and stated that banks could consult when working through adoption issues.

Comment letter trends

John Nolan of the SEC's Division of Corporation Finance noted the SEC staff has sought to make the comment letter process more efficient by first calling registrants to verbally discuss questions in some situations. In addition, he said there have not been significant areas of frequent comments and most comments address one-off topics.

Importance of internal control over financial reporting

Both Bricker and Kevin Stout of the SEC's OCA emphasized the importance of internal control over financial reporting, particularly when transitioning to new accounting standards. Banks, including their audit committees, should consider how they design internal controls to keep pace with current business conditions, changes in the company and upcoming standards.

PCAOB standard-setting update

Speakers discussed the PCAOB's ongoing inspections of audit firms and its progress on its standard-setting agenda, including the most recent proposed auditing standards:

- Proposed Auditing Standard for Auditing Accounting Estimates, Including Fair Value Measurements; and
- Proposed Amendments to Auditing Standards for Auditor's Use of the Work of Specialists.

The Proposed Auditing Standard for Auditing Accounting Estimates, Including Fair Value Measurements would replace three current PCAOB standards, with an objective of driving consistency when auditing estimates.

6 Other accounting highlights

Topic	Highlights
Financial instruments – Recognition and measurement standard[10]	There will be disclosure changes under the new standard, which speakers said may require banks to disclose more complex estimates. Specifically, certain fair value disclosures will now be required to reflect exit prices, which may vary from current practice. Banks may not be currently focused on making these new disclosures.
Cloud computing costs	Stakeholders requested guidance on implementation costs associated with cloud computing arrangements considered in service contracts, which was added to the EITF agenda and discussed on June 20, 2017. Speakers noted that the FASB staff is researching the issue.
Public business entity (PBE) definition[11]	Many of the new accounting standards have different effective dates for PBEs and non-PBEs, which has increased the emphasis on the definition of a PBE. The AICPA Financial Reporting Executive Committee (FinREC) plans to release a Technical Question and Answer (TQA) paper clarifying the application of the PBE definition for certain banking topics. The recently released Interagency Frequently Asked Questions document[12] also addresses several banking industry questions about the PBE status of banks and their holding companies.
Effect of Compensation – Retirement benefits standard [13] **on loan origination costs**	Under the new ASU, the service cost component associated with defined benefit plans and other postretirement benefits will be broken out separately and will be the only component eligible for capitalization as a loan origination cost. Speakers

[10] ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities

[11] ASU 2013-12, Definition of a Public Business Entity

[12] Frequently Asked Questions on the New Accounting Standard on Financial Instruments – Credit Losses, December 16, 2016 and September 6, 2017

[13] ASU 2017-07, Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Costs

Topic	Highlights
	mentioned that banks need to begin quantifying the potential effects of the standard.
Premium amortization on purchased callable debt securities standard[14]	Speakers noted that the new standard conforms guidance to existing practices of many community banks by amortizing premiums to the earliest call date. Banks were cautioned to amortize to call price, not par.
Variation margin[15]	Speakers commented on the recently released guidance[16] on regulatory capital treatment for variation margin on certain derivative contracts. For centrally cleared derivative contracts categorized as settled-to-market (STM), the variation margin may be treated as a settlement payment rather than as collateral pledged by one party to the other. Speakers noted that this treatment is expected to provide regulatory capital relief for banks by reducing 'potential future' trade exposure used to determine regulatory capital requirements.

[14] ASU 2017-08, Premium Amortization on Purchased Callable Debt Securities

[15] KPMG's Defining Issues 16-39, SEC Staff Clarifies Effect of Rule Changes on Hedge Accounting

[16] Regulatory Capital Treatment of Certain Centrally Cleared Derivative Contracts Under Regulatory Capital Rules, August 14, 2017

7 Other highlights

Hurricanes and other natural disasters

Speakers discussed the need for banks operating in areas affected by the recent hurricanes to determine whether they incurred additional credit losses. For example, banks may need to evaluate the nature and extent of damage to borrowers' collateral. Depending on the type and location of the collateral, insurance coverage for flood damage could vary significantly. Estimates of losses should be made for specific reserves on newly impaired loans under ASC 310-10[17], and also for qualitative adjustments for incurred losses under ASC 450-20.[18] Qualitative adjustments might be required to reflect changes in value of collateral in affected areas or negative effects on economic activity.

Speakers from the OCC discussed banks' abilities to help customers by waiving fees and modifying loan terms. As it relates to loan payment relief, consideration of whether concessions are more than insignificant and whether borrowers are experiencing financial difficulty will be necessary to evaluate whether the modifications represent TDRs.

End of LIBOR

Industry speakers discussed the approaching "end of LIBOR" and actions undertaken by banks to assess the effect of transitioning away from the benchmark interest rate. Banks are currently identifying instruments linked to LIBOR (typically loans and derivatives) and evaluating what other contractual options are available. Speakers also discussed the need to assess the effect on hedging relationships, specifically cash flow hedges.

Economic and legislative topics

Conference speakers discussed the United States' economy and pointed out that the economic outlook continues to be mixed. The current economic expansion is starting to grow stale, with indications that there could be an economic contraction. Speakers identified four primary economic constraints: the unemployment rate/labor shortage, low worker productivity, limited start-up activity and weak business investment.

Speakers also discussed legislative and regulatory reform under the new administration and indicated there may be a light at the end of the tunnel. Speakers commented that new leadership at various regulatory agencies may be a driver for a changed supervisory approach, other than formal legislative policy. A recent example is the newly proposed rating system for

---

[17] ASC 310-10, Receivables—Overall

[18] ASC 450-20, Contingencies—Loss Contingencies

large bank holding companies issued by the Federal Reserve. Speakers said that the proposed rating system would bring changes to the approach to downgrade banks after regulatory findings, affording them additional time to remediate potential issues. Overall, speakers remained doubtful about the possibility of formal legislative policy changes.

Acknowledgments

This is a publication of the Department of Professional Practice of KPMG LLP in the United States.

We would like to acknowledge the efforts of the main contributors to this Issues & Trends:

Tom Canfarotta

Michael Hall

Sara Pendergast

Greg Ryerson

kpmg.com/socialmedia