Banks and savings institutions

AICPA National Conference

Issues & Trends

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Meeting highlights

With year-end approaching, many institutions will be nearing the adoption date of the current expected credit losses (CECL) standard.[1] Speakers at the AICPA National Conference on Banks and Savings Institutions, which took place September 9-11 in Greater Washington D.C., covered accounting and auditing topics relevant to financial institutions. Similar to last year[2], CECL was the focal point, with the FASB's proposed changes to effective dates, implementation progress and challenges, and SAB 74[3] disclosures frequent topics of discussions.

As our recent survey indicates[4], while banks have made implementation progress, they should not "rest on their laurels." Remaining time should be used to address data gaps, forecasting, parallel runs, establishing or modifying internal controls, capital planning and as highlighted by the FDIC Chief Accountant, Robert Storch, "generally integrating the results of CECL into business processes."

Speakers also discussed the PCAOB's new auditor's reporting model for critical audit matters (CAMs)[5] that is effective for audits of large accelerated filers with fiscal years ending on or after June 30, 2019. Another hot topic was banks' transition to alternative reference interest rates from LIBOR, which speakers highlighted is expected to be discontinued by 2021.

Marci Rossell, former Chief Economist for CNBC and former economist with the Federal Reserve Bank of Dallas, commented that the global economy is in a state of uncertainty. While a "no deal Brexit," increased trade tensions between the US and China, and the inverted yield curve are sources of uncertainty, it is not clear whether a recession is on the horizon or if historical metrics used to predict recessions are still relevant. Other speakers drew connections between economic forecasts and their potential effect on estimates of credit losses.

Speakers also discussed emerging topics such as Fintech and cybersecurity, which promise to become increasingly significant.

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1 ASU 2016-13, Measurement of Credit Losses on Financial Instruments

2 KPMG's Issues & Trends, 2018 AICPA National Conference on Banks & Savings Institutions

3 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

4 CECL implementations gather steam amid uncertainty: KPMG CECL survey 2018

5 AS 3101: The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion

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Current expected credit loss standard

Countdown to adoption

It is full steam ahead with the adoption of CECL as larger institutions with calendar year-ends move into the final quarter before the standard becomes effective. Speakers shared a general consensus that large banks are well underway with implementation efforts. Large banks said that they formed multidisciplinary task forces that met regularly, addressed data gaps, finalized modeling selections, determined reasonable and supportable periods and reversion methodologies, and began running parallel models.

While many banks are progressing, they are still grappling with CECL implementation challenges as the effective date nears, such as addressing parallel run findings, developing qualitative frameworks, completing model validation, implementing and documenting internal controls, and developing transition and effective date disclosures. During implementation, banks have raised issues that the FASB is deliberating, such as the accounting treatment for negative allowances.

The FASB spoke about its proposed deferral of CECL to 2023 for private companies and public companies that qualify as smaller reporting companies.[6] Several speakers highlighted the need for banks to use the potential additional time wisely to take an integrated and holistic business implementation approach rather than treating adoption as a "compliance exercise." FASB Board member Hal Schroeder[7] provided a cautionary note stating "if the Board votes to provide the 90-ish% with extra time there'll be an even greater expectation for high-quality implementation efforts."

With additional time, Schroeder urged banks not to treat the deferral as "an extra year off" and to use it as an opportunity to improve data quality, estimation processes and internal controls. For those banks that are not acquainted with the standard, Schroeder prompted them to start now, saying "if you've yet to break the book's binding, do it today."

Schroeder shared that "the FASB has been told that the effort to adopt CECL has resulted in widespread improvement of data quality, internal controls, estimation processes and internal coordination and communication."

CECL panel themes

Over the course of the three-day conference, preparers, auditors, regulators and standard setters discussed topics related to CECL.

6 See Smaller Reporting Companies on the SEC's website.

7 Hal Schroeder speech, Financial Instruments: The Way Forward, September 9, 2019

Data

Speakers reiterated the importance of data and discussed its challenges. Larger institutions that are further along on their CECL journey have found that gathering data has taken longer than anticipated. Bank representatives said it has been difficult to identify and capture the key data attributes that drive credit losses, evaluate the quality of historical data when it exists outside of the financial reporting process, identify the "golden source" of data, accumulate new data, respond to system limitations, and evaluate additional considerations when external data is used. Speakers encouraged banks that may receive a deferred effective date to use the additional time to continue to invest in the accumulation, validation and storage of data.

Model validation

Model validation was discussed throughout the conference as some banks plan to use more models to determine their allowance under CECL than they have used under the existing incurred loss model. Larger banks warned that model validation takes time and requires appropriate internal controls and documentation.

Use of vendors

Speakers highlighted the need to perform upfront due diligence on vendors and their capabilities before engaging them. Banks were reminded that they retain responsibility and ownership of the CECL estimation process and calculation even if they have engaged a third party. Questions circulated around model validation, the availability (and nature) of System and Organization Controls Reports (SOC 1 reports[8]), documentation requirements and auditor expectations. Speakers referred banks to the meeting minutes[9] of the AICPA's CECL Task Force Auditing Subgroup for additional considerations when using vendors in the CECL estimation process.

Reasonable and supportable forecasts

Several banks disclosed the anticipated length of their initial reasonable and supportable forecast periods, which ranged from 12 months to the contractual life of the asset. Panelists reiterated that determining the length of the reasonable and supportable forecast period requires judgment, and the forecast period assumption should be reevaluated on a periodic basis within an appropriate governance framework.

There were mixed reactions when banks were asked how they planned to capture economic uncertainty in their CECL methodology; some will plan to incorporate probability weightings within their quantitative models while others will include economic uncertainty as a qualitative adjustment.

Internal control over financial reporting

When speakers turned their attention to internal controls, it was evident that banks were aware of the importance of having a strong control framework over

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[8] A SOC 1 report is issued by an auditor, and is specifically intended to meet the needs of entities that use service organizations (user entities) and the CPAs that audit the user entities' financial statements (user auditors), in evaluating the effect of the controls at the service organization on the user entities' financial statements.

[9] AICPA CECL Task Force Auditing Subgroup, April 29, 2019 and June 27, 2019 – Vendor Meeting Takeaways

the CECL implementation, but some were not as far along in the process as they wanted to be.

When the large banks were asked about changes to their controls, they classified them into four buckets:

- data controls;
- model execution controls;
- allowance governance controls (i.e. management review controls over methodology decisions, including economic forecasts and qualitative adjustments); and
- disclosure controls.

Some banks saw an increase in the implementation of new controls while for others it was about bringing existing controls under the financial reporting umbrella. As CECL provides increased flexibility and the execution of judgment, properly designed and executed management review controls will play an important role to support management's best estimate of expected credit losses.

Qualitative adjustment framework

With many banks finalizing the development of their quantitative models, they're now turning their attention to reevaluating their qualitative adjustment frameworks. When panelists were asked if they plan to use their current qualitative framework as a starting point or to begin with a clean slate, there were mixed responses. Some indicated that they plan to start with their existing frameworks and make adjustments for CECL, while others took the opportunity to transform their process.

Panelists reminded banks that the purpose of a qualitative framework is to adjust the allowance for known flaws in the model and/or data that can result in an increase or decrease to the allowance. Adjustments should be "supportable and quantifiable." Banks were encouraged to take a fresh lens approach to their qualitative adjustments as the nature and magnitude may be different under CECL.

Parallel runs

Banks highlighted the importance of running their CECL estimate process in parallel with their existing incurred loss estimate for a period of time before CECL's effective date. However, there is diversity in practice with some banks having completed several parallel runs with controls while others expect to start parallel runs in the third quarter of 2019.

Panelists advised those who may benefit from the deferral to "start parallel runs earlier," because doing so allows more time to resolve process and control issues that may be identified before formal adoption. Each parallel run provided additional information about the impact of CECL and how the process could be improved. Christopher Boyles and Reza van Roosmalen from KPMG highlighted common pitfalls to a successful parallel run, which included postponing disclosures until the last parallel run cycle, postponing internal control and governance considerations, and failing to allow sufficient time to validate and refine models.

Disclosures

SAB 74

SEC filers are required to provide information on the status and the impact that CECL is expected to have on their financial statements. With the 2020 adoption date nearing, the SEC discussed their continued focus on the sufficiency and transparency of SAB 74 disclosures.

Sagar Teotia, Chief Accountant at the SEC, said the "implementation process works particularly well when stakeholders identify and raise questions early and keep investors informed with SAB 74 disclosures."[10] Investors are increasingly interested in how the new standard will impact banks on day one, and more importantly what the allowance for credit losses will look like on a prospective basis.

One area where large banks have taken different approaches is the placement of the SAB 74 disclosures. Some banks have made disclosures in MD&A, others in the notes to the financial statements, and some others in both places. Representatives from banks described different plans for the placement of their transition disclosures, as well as for the content of third quarter and year-end disclosures.

The SEC staff has been focused on the quality and timeliness of the disclosures, and referred to existing SAB 74 guidance regarding placement of such disclosures, making no commentary about the specific placement. Regardless of the placement, Marc Panucci, Deputy Chief Accountant at the SEC, and Kevin Vaughn, Senior Associate Chief Accountant at the SEC, commented that they have observed progress with disclosures, but acknowledged that there is a range of what is currently included and the accompanying level of detail in those disclosures. They "…certainly appreciate the advancement in those disclosures and would expect that that would continue as we get closer to the effective date of the standard," Vaughn said.

Banks seemed to be aligned that the CECL transition disclosure will not be considered a critical accounting estimate until the standard is effective in 2020. In discussing critical audit matters, Panucci commented that it is a balancing act whether the SAB 74 disclosures give rise to a CAM. Auditors will need to consider management's implementation progress and the level of detail included within those disclosures. Panucci elaborated that the closer banks are to completion, and depending on the level of judgment by the auditor and the significance of the number in the disclosures, the auditor could conclude it is a CAM. Only those disclosure that are included in the notes to the financial statements would be evaluated as a potential CAM.

Post-adoption disclosures

A number of panelists emphasized the need to think about post-adoption disclosures as part of the transition process and not as an afterthought. Investors will want to understand what's affecting the CECL estimate. Lessons learned from the adoption of the revenue and leases standards have shown that early analysis was helpful.

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[10] Sagar Teotia, The Importance of Financial Reporting and Auditing, Domestically and Internationally, September 9, 2019

John Nolan and Lindsay McCord from the SEC's Division of Corporate Finance discussed the potential change to non-GAAP disclosures relating to the adoption of CECL. McCord encouraged preparers to refer to the principles described in the SEC staff's Compliance and Disclosure Interpretation (CD&I)[11] when developing non-GAAP measures. She indicated that the Division of Corporation Finance is open to dialogue and encouraged industry representatives to collectively reach out to the SEC staff if there is a measure or adjustment for CECL that will be broadly applied.

Interpretive accounting issues

Both the SEC and FASB noted that they are prepared to continue to answer implementation questions from stakeholders and are committed to a smooth transition.

Topic	Highlights
Negative allowance for purchased financial assets with credit deterioration	During the conference, representatives from the FASB received questions on the status of the proposed ASU for additional codification improvements of ASC 326[12], specifically on the treatment of negative allowance for purchased financial assets with credit deterioration (PCD). The FASB expects to issue the proposed ASU in the near term.
Double counting CECL on non-PCD assets in a business combination	The FASB received questions to discuss the risk of double counting of the CECL reserve on non-PCD assets in a business combination. The FASB continues to discuss this topic, including most recently at the September 18, 2019 Board meeting.[13]
Advances of taxes and insurance	The AICPA issued a draft white paper[14] to evaluate whether lenders' expectations of future losses on payments of tax, insurance premiums and other costs should be included in the estimate of expected lifetime credit losses before the lender advances the funds or incurs costs. Comments are due October 15, 2019.

The FASB speakers were asked when the Board would stop making changes to the CECL standard, and responded that implementing an accounting standard is an evolving process. They said the Board would continue to make amendments to be responsive to constituents, and if a change is made, they will provide guidance to ensure a smooth transition.

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11 SEC's Compliance and Disclosure Interpretations

12 Proposed ASU, Codification Improvements to Topic 326, Financial Instruments—Credit Losses

13 See the FASB's September 18, 2019 Agenda Prioritization and the Tentative Board Decisions.

14 Working Draft: Allowances for Credit Losses Implementation Issues

Regulatory highlights

At the federal banking regulators' session, the focus of the prepared remarks was on CECL, taking stock of the industry's implementation progress, themes from supervisory outreach and monitoring activities, and discussing regulatory capital.

As part of supervisory efforts over the past year, Sydney Menefee, Chief Accountant of the Office of the Comptroller of the Currency (OCC), provided "shout outs" for best practices when implementing CECL. Those practices included conducting sensitivity analyses to assess the magnitude of model decisions, instituting contingency plans to address model weaknesses and data gaps, forming well-designed approval and challenge functions for forecasting adjustments, developing an expected troubled debt restructuring (TDR) framework, and considering capital planning as part of CECL implementation efforts.

FDIC Chief Accountant Robert Storch highlighted that the CECL regulatory capital transition rule was approved by the regulatory agencies in December 2018.[15] The final rule provides an optional three-year phase-in on the day one effect on regulatory capital from adopting CECL. In addition, the 1.25% of risk-weighted assets limit on allowances includable in Tier 2 capital now applies to allowance for credit losses (ACL).

The OCC's Menefee discussed their supervisory focus areas for the upcoming year. In 2020, credit card payment allocation methods, declines in allowance for wholesale portfolios, expected recoveries of amounts deemed uncollectible, concentrations in third-party CECL vendors used by banks, and implementation progress for banks who are afforded a delay in implementation will be top of mind when examining the ACL.

Regulators frequently echoed each other's comments that CECL is a paradigm shift and that governance and controls should be in place around the allowance process. Regulators indicated that examiners will not require banks to achieve a certain level of reserves. This is supported by the newly Proposed Interagency Policy Statement on the Allowance for Credit Losses[16] that states "when assessing the appropriateness of ACLs, examiners should recognize that the processes, loss estimation methods, and underlying assumptions an institution used to calculate ACLs require the exercise of a substantial degree of management judgment. Even when an institution maintains sound procedures, controls and monitoring activities, an estimate of expected credit losses is not a single precise amount and may result in a range of acceptable outcomes for these estimates."

Other resources

The AICPA's Credit Losses Auditing Task Force has issued the *Allowance for credit losses – audit considerations* practice aid[17] to assist auditors when communicating with management and audit committees on CECL. Speakers

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15 Regulatory Capital Rule: Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments to the Regulatory Capital Rule and Conforming Amendments to Other Regulations

16 Interagency Policy Statement on Allowances for Credit Losses

17 Allowance for credit losses - audit considerations practice aid

highlighted that preparers of financial statements may also find the practice aid helpful when developing their accounting estimates and the controls over the estimates.

The Center for Audit Quality's (CAQ) Tool for audit committees[18] was highlighted as a resource for audit committees. The CAQ developed this tool to help audit committee members execute their oversight responsibilities. The tool provides audit committees with important questions to consider and incorporates a brief overview of the standard's core principles, considerations when evaluating the company's CECL impact assessment and the implementation plan, and other implementation considerations.

18 Center for Audit Quality's Tool for Audit Committees

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PCAOB & auditor's reports

Critical audit matters

CAMs are here. The portion of the PCAOB's standard (AS 3101[19]) that requires the auditor to discuss CAMs within the auditor's report became effective for audits of large accelerated filers this year (beginning with years ending on or after June 30, 2019), with auditors adopting the guidance for all other entities in 2021. The SEC, the PCAOB and auditors discussed how CAMs are viewed in the marketplace, the considerations by the auditor when determining CAMs, the considerations related to drafting CAMs, and the benefits realized by firms that have implemented dry run programs.

Megan Zietsman, Chief Auditor at the PCAOB, noted that the PCAOB's Economic & Risk Analysis Group has performed an interim analysis of CAMs issued to date. The analysis noted that there have been approximately 55 auditor's reports with CAMs that have been issued since the effective date of the standard. Those issued reports have resulted in an average of approximately 1.8 CAMs per auditor's report, and the most common topics included goodwill and intangible assets, revenue recognition and income taxes.

Various panel discussions referenced areas that could give rise to industry-specific CAMs based on dry run programs such as the allowance for loan losses, the valuation of investment securities, derivatives or mortgage servicing rights. There could also be nonrecurring CAMs related to a business combination or certain income tax matters. The PCAOB continues to monitor audit reports issued with CAMs to evaluate the implementation of the standard.

Some market participants have wondered whether the presence of a CAM in an auditor's report could indicate something negative about management's financial statement process. The SEC's Panucci commented that CAMs are not a reflection on management or its financial statement process. Rather, they represent the viewpoint of the auditor and those areas of the audit that involve especially challenging, subjective or require complex auditor judgment. He added that whether areas involve auditor judgment is not something which management can influence.

As banks consider what areas of an audit may give rise to a CAM they can look at their own critical accounting policies (CAP) and critical accounting estimates (CAE) disclosed within their SEC filings to determine what areas may create a CAM. Although the definitions of CAM, CAP or CAE are not identical, there are similarities. CAP and CAE likely contain risk profiles that are more likely to give rise to areas that require especially challenging, subjective, or complex auditor judgment. What is uncertain at this point is how investors will view CAMs that are included in an auditor's report.

As part of the auditor's requirement to communicate CAMs to the audit committee, management should take time to read and understand the auditor's

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19 PCAOB Auditing Standard 3101: The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses and Unqualified Opinion

perspectives so that they are prepared to answer any questions that may arise during investor and analyst communications.

During the CAM panel discussion, large audit firm representatives discussed how their firms have executed dry run programs with their large accelerated filer clients over the past year to ensure a smooth implementation of the standard. These dry run programs have focused on refining the auditor’s processes to determine CAMs as well as their drafting of CAMs. The determination of CAMs is an iterative process throughout the audit.

Although auditors may have identified CAMs early on in the audit as part of their planning and risk assessment, both auditors and management should be prepared for the identification of CAMs late in the year (e.g. fourth quarter and year-end reporting process) arising from changes in the auditor’s risk assessment, transactional activity of the company, or an auditor’s response to audit misstatements or internal control deficiencies identified that could give rise to a CAM.

Because transactions, audit misstatements, or internal control deficiencies occurring late in the year may not have been previously disclosed publically, auditors and management should work to ensure the draft CAM is shared timely with the audit committee and the relevant disclosures of the company are appropriate so that the auditor is not in a position of introducing new or original information.

The PCAOB has been clear in its guidance that the determination of CAMs should be specific to a particular company and the current year under audit. Although some industries may have common recurring topics for CAMs, such as the allowance for loan losses within the banking industry, the considerations that give rise to a CAM will not only be specific to a company’s own process and methodology, but could change from year to year.

Once CAMs are determined, auditors are finding that their drafting process is taking longer than initially anticipated. The PCAOB has focused on the auditor being able to articulate the principal considerations as to “why” something gives rise to a CAM, and at the same time the auditor must be careful not to introduce new or original information that has not already been made public by management. Most importantly, the auditor must focus on making the CAM useful to the users of the audit report, which is the PCAOB’s main objective with this standard, including avoiding the use of complex accounting or auditor jargon.

Panelists reiterated that CAMs are the biggest change to occur to the auditor’s report in a long time. They are meant to give more insight and transparency into how the auditor thinks about an audit and what the auditor does to address those areas that require more auditor judgment. Early and timely discussion between auditors and with management and audit committees will be key in ensuring a smooth reporting process.

PCAOB’s strategic plan

While the PCAOB has been busy drafting and publishing new auditing standards and providing enhanced guidance to the public, the PCAOB also published a strategic plan last year.

SEC’s Teotia commented that the SEC supports the PCAOB’s mandate to improve audit quality and shares the same goal. He applauded the PCAOB’s execution and efforts and said "… we are already starting to see the benefits of the new focus – for example, the new strategic plan emphasizes proactively engaging with preparers, audit committees, investors, and the audit profession, among others, to drive enhanced transparency in fulfilling its mission."

PCAOB's new auditing standards

On July 1, 2019 the SEC approved a new estimates standard[20] and amendments related to using the work of specialists.[21] Both standards are effective for audits of financial statements for periods ending on or after December 15, 2020. The new standards focus on a robust risk assessment and planning process, in addition to clarifying guidance on the auditing of estimates and the use of specialists in an audit.

The PCAOB explained how the new estimates standard, AS 2501, combines three former auditing standards into one, provides a uniform risk based approach to estimates, including specific direction in evaluating the relevance and reliability of information. The amendments on the use of specialists include evaluating the work of a company's specialist, whether employed or engaged by the company, and supervisory considerations for both auditor-employed and auditor-engaged specialists. The PCAOB staff released additional guidance on the adoption of these standards in August 2019.[22]

The PCAOB also discussed their recently released guidance on the required communications when an auditor has identified a violation of the independence rules. PCAOB Rule 3526(b),[23] *Communications with the Audit Committee Concerning Independence*, provides auditors with additional technical assistance needed to foster timely and robust communications between the auditor and audit committee.[24]

Brokers and dealers

The Dodd-Frank Wall Street Reform and Consumer Protection Act expanded the PCAOB's oversight responsibilities to include audits of brokers and dealers. While a temporary inspection program has been in place since late 2011, the PCAOB is considering the need to implement a more permanent inspection program of auditors of SEC-registered brokers and dealers. Teotia emphasized his support of the PCAOB as they evaluate this program, but noted that regulation is best when the requirements imposed are commensurate with the risks. The SEC noted that a cost benefit analysis should be performed before a permanent program is put in place.

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20 PCAOB Release No. 2018-005, Auditing Accounting Estimates, Including Fair Value Measurements and Amendments to PCAOB Auditing Standards

21 PCAOB Release No. 2018-006, Amendments to Auditing Standards for Auditor's Use of the Work of Specialists

22 Auditing Accounting Estimates, Including Fair Value Estimates: The Auditor's Use of the Work of Specialists

23 PCAOB Rule 3526, Communication with Audit Committees Concerning Independence

24 For more information on the new estimates and specialists standards and the PCAOB rule, see KPMG's Defining Issues, SEC approves new PCAOB auditing standards; and PCAOB issues new guidance for auditors and audit committees.

4 LIBOR transition

Preparing for discontinuation of LIBOR

The London Interbank Offered Rate (LIBOR) refers to reference rates published in various jurisdictions that seek to represent a short-term rate for funds to be borrowed by banks within an interbank market in that jurisdiction. Schroeder highlighted, "an estimated $350 trillion in loans, derivatives and other financial contracts reference LIBOR rates."

As part of the discontinuation of US dollar LIBOR, which is expected to be by 2021, the Federal Reserve Board and the New York Fed created the Alternative Reference Rate Committee (ARRC), which was tasked with ensuring a successful transition from US dollar LIBOR to a more robust reference rate.

The Secured Overnight Financing Rate (SOFR) was created after many deliberations. Lara Lylozian, Associate Chief Accountant from the Federal Reserve Board (FRB) indicated that as part of supervisory efforts for the coming year, the FRB is considering drafting a question and answer document along with supervisory insights on LIBOR transition for smaller entities.

The consistent message from speakers has been "don't wait" to begin planning for LIBOR transition. Panel participants discussed LIBOR transition and highlighted the importance of banks assessing their firmwide exposure to fully understand the implications of the transition challenges across all business lines and functions, including data, systems and processes and individual contracts. With such vast impacts, it is no surprise that the SEC's Teotia mentioned that "this move away from LIBOR as a benchmark could have a significant effect on financial markets, and not surprisingly, there has been a focus on the financial reporting implications."

The SEC published a statement in July 2019[25] that encouraged market participants to proactively manage the transition away from LIBOR. The statement highlights that risks will be exacerbated if the necessary transition work is not completed in a timely manner. Transition issues can span a number of areas, including modification of terms within debt instruments, hedging activities, inputs used in valuation models and income taxes.

Banks that are impacted by LIBOR transition should consider establishing a cross-functional task force or steering committee to prepare for the discontinuation of LIBOR. The banking industry is finding that the impact of the LIBOR transition is more far reaching than originally anticipated. Banks should have a robust method of assessing scope and capturing the necessary changes to their processes throughout the organization.

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[25] See the SEC's Staff Statement on LIBOR Transition staff statement, and the related press release

Accounting and disclosure

On September 5, 2019, the FASB issued a proposed ASU[26] that addresses the accounting for reference rate reform and the impact on financial reporting. The proposed ASU's comment period ends October 7, 2019.

Overall, immediate reaction from bank representatives was very favorable on the proposed ASU. Bank representatives highlighted the relief for contract modification accounting that is proposed under the ASU, which will allow an entity to modify the terms of contracts to replace LIBOR without assessing whether there is an extinguishment of an existing or a new contract. The proposed ASU would not affect other modifications not related to replacing LIBOR such as modifying the structure of a loan from term to revolver. The practical expedient is meant to provide relief as it relates to debt modification accounting to ease the transition to a new reference rate and expedients for accounting for contracts, including loans, debt and leases.

Bank representatives also discussed the impacts of this proposed ASU on hedging activities. In particular, it would provide relief under derivatives and hedging guidance[27] when there are modifications to critical terms of an existing hedging relationship resulting from reference rate reform. They focused on how the proposed ASU provides expedients related to both fair value and cash flow hedge accounting. The ASU's relief may be applied at the individual hedging relationship level.

Most notably for fair value hedges where the benchmark interest rate is changed, bank representatives discussed how the proposed ASU provides alternatives to either recalculate the hedge accounting basis adjustment or to maintain the existing basis adjustment at the date of modification.

For affected cash flow hedges, the bank representatives thought the biggest area of relief was the FASB's decision to suspend the cash flow hedge effectiveness requirements until LIBOR is no longer a component of the hedged relationship. At that time the bank would resume using the derivatives and hedging guidance under ASC 815. It was emphasized that institutions affected by this ASU would need to amend their hedge documentation during this interim period.

As the expected end date of LIBOR looms in 2021, banks will need to evaluate their progress and how they can keep investors informed through their disclosures.

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[26] Proposed ASU, Facilitation of the Effects of Reference Rate Reform on Financial Reporting

[27] ASC 815, Derivatives and Hedging

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Other accounting highlights

Topic	Highlights
Hedging – Layering in last-of-layer method	As ASU 2017-12[28] was being adopted, the FASB received feedback that the ability to hedge a single layer within a closed portfolio of fixed-rate, pre-payable assets may not be particularly useful in a last-of-layer method. While ASU 2017-12 does not allow for multiple layers to be included in a last-of-layer hedging relationship, the FASB has conducted informational sessions to discuss the potential options in hedging additional layers and whether expanding the last-of-layer method would be useful. At the FASB's August 2019 meeting, the FASB staff discussed potentially providing further guidance on accounting for fair-value hedge basis adjustments, for both the existing single-layer model and the proposed multiple-layer model.[29] The FASB expects to make decisions on the expansion in the next few months.
Distinguishing liabilities from equity	On July 31, 2019, the FASB issued a proposed ASU[30] with the objective of improving understandability and reducing the complexity of the accounting for instruments with characteristics of liabilities and equity. The comment period ends October 14, 2019.

28 ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities

29 FASB Tentative Board Decisions, August 21, 2019

30 Proposed ASU, Debt with Conversion and Other Options; and Accounting for Convertible Instruments and Contracts in an Entity's Own Equity

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Other highlights

Regulatory capital simplifications

In July 2019, federal banking agencies adopted a final rule[31] to simplify certain aspects of their regulatory capital rule for non-advanced approaches institutions. The rule increases common equity tier 1 (CET 1) capital threshold deductions from 10% to 25% for mortgage servicing assets (MSAs), deferred tax assets (DTAs) arising from temporary differences, and investments in the capital of unconsolidated financial institutions.

The rule also removes the 15% CET 1 capital threshold deduction for MSAs, DTAs, and significant investments in the capital of unconsolidated financial institutions. In addition, the rule simplifies the determination of the amount of minority interests includable in regulatory capital and retains the 250% risk weight for non-deducted amounts of MSAs and temporary difference DTAs. The rule takes effect April 1, 2020 for changes to threshold deductions and minority interests. Revisions to the Call Report regulatory capital schedule for the simplification rule are in the process of being developed and will be issued for public comment once finalized.

Fintech

Speakers stated that over the past five years the banking industry has changed its perception of Fintechs from "competitor" to "potential partner." The Fintech industry has raised the bar on customer service, or at least reestablished the benchmark for customer experience. While banks want to grow and build their customer relationships, they also want to do so efficiently and decrease costs when possible. This can be achieved by working with new partners and creating new operating platforms and processes.

Cybersecurity

When asked what the next major crisis to impact the banking industry will be, Rodgin Cohen, Senior Chairman at Sullivan & Cromwell, speculated that it might be precipitated by a cyberattack on a major financial institution where customers' access to bank accounts is blocked, leading to widespread panic throughout the banking industry.

Cohen was not alone in highlighting the threat of cybersecurity. Lindsay McCord discussed the threat cybersecurity presents "to our capital markets, to companies operating in all industries." She shared that "given the frequency, magnitude, and cost of cybersecurity incidents, commission leadership has emphasized that it is critical that public companies take all required actions to inform investors about material cybersecurity risks and incidents in a timely fashion."

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31 Regulatory Capital Rule: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996

McCord reminded participants about the SEC's statement on cybersecurity disclosures[32] that provides guidance to public companies. Lastly, she highlighted that while boilerplate disclosures around cybersecurity risks and incidents should be avoided, companies were not expected to publicly disclose technical information that would provide a "road map as to how to breach their cybersecurity protections."

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32 Commission Statement and Guidance on Public Company Cybersecurity Disclosures, February 2018

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