THE AUDIT & RISK ISSUE | SEPTEMBER 2016

# Bank Director®

GUIDED BY ONE PRINCIPLE: STRONG BOARDS BUILD STRONG BANKS

FORECASTING THE FUTURE

# THE AUDIT & RISK ISSUE

COMMERCIAL REAL ESTATE HEATS UP

THE CECL TRAIN IS COMING

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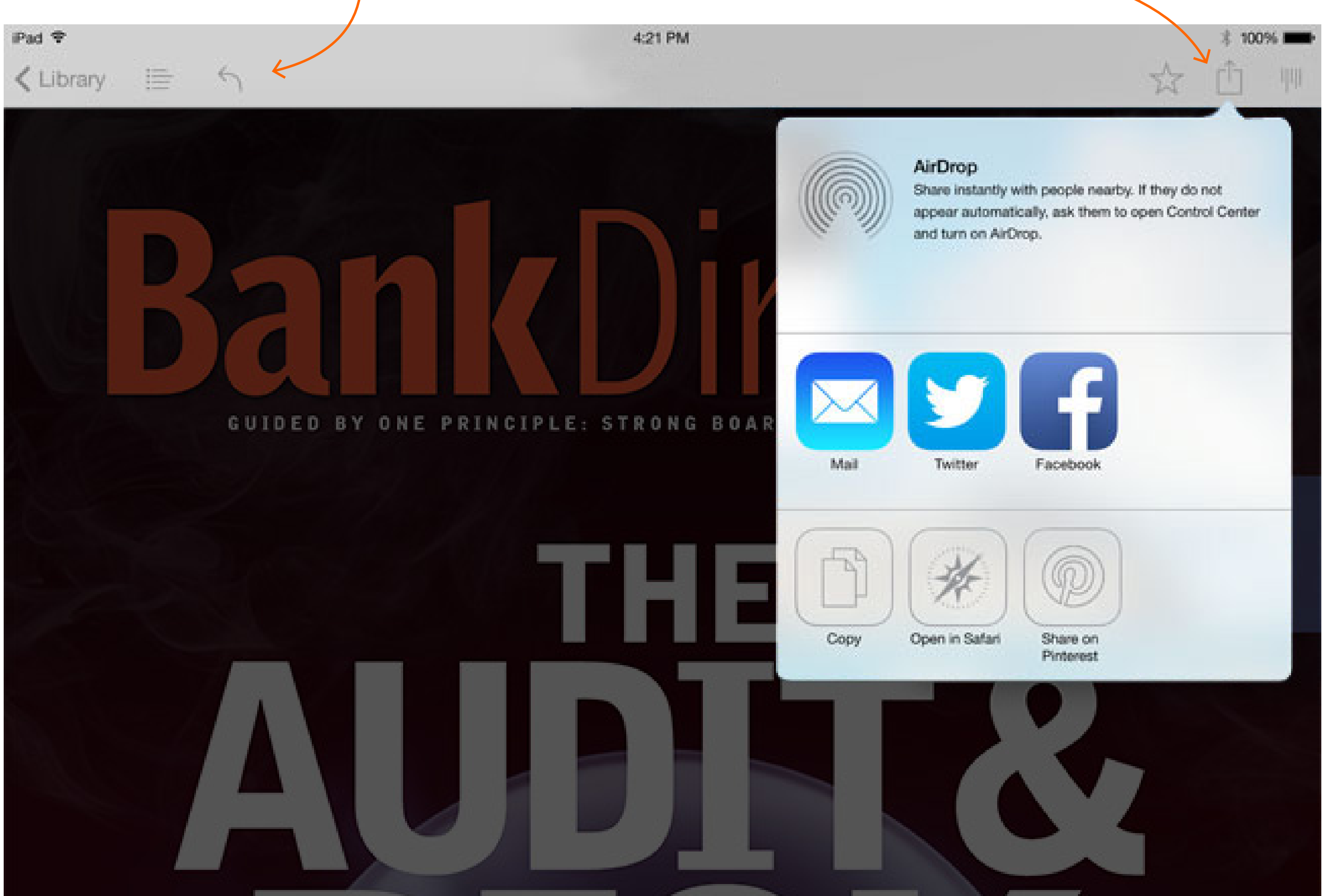

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# THE AUDIT & RISK ISSUE
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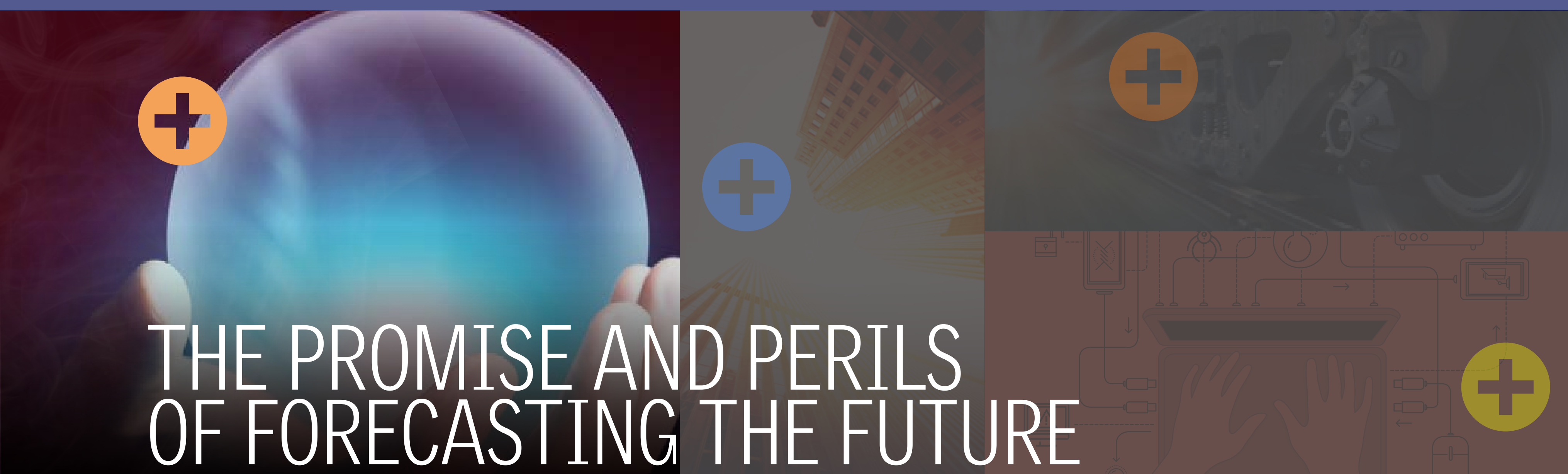

## THE PROMISE AND PERILS OF FORECASTING THE FUTURE

Banks need to forecast the future for a variety of reasons. But how?

*Becoming a Superforecaster*



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# A PERILOUS GAME

**Predicting the future is a game of chance.** Banks have always made estimates as part of credit risk and interest rate risk management. But a series of regulatory changes are pushing bankers to make even more assumptions about the future, and for longer time periods. It started with stress testing under the Dodd-Frank Act and moved quickly into enterprise risk management, where bankers were encouraged to do enterprise-wide assessments of all their risks and how they impact each other.

This is problematic for the simple reason that human beings are terrible at predicting the future. Improved analytics and computer algorithms don't seem to be making this any better. Most polls predicted that voters in Britain would vote to stay in the European Union last spring. They didn't. Nate Silver, the famous statistician who accurately predicted much of the 2008 and 2012 elections, inaccurately predicted that Donald Trump was an extremely unlikely contender for the Republican nomination for president. In this issue, John Maxfield looks at how banks use predictions in their planning, and the shortcomings, especially where strategic planning is concerned. University of Pennsylvania professor Philip Tetlock also offers some of his advice into what makes someone a superior prognosticator.

Another area where bankers are expected to make more

**Naomi Snyder** is editor for *Bank Director.*

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**Naomi Snyder** | nsnyder@bankdirector.com

# A PERILOUS GAME

makes someone a superior prognosticator.

Another area where bankers are expected to make more predictions is the new GAAP rule for estimating loan losses. The rule will require all banks to predict losses over the life of their loan portfolios, and to provide detailed descriptions of how they came to these predictions. Bank Director explores this topic in this issue, as well as the increasing concentrations of commercial real estate in bank portfolios, and why that's making regulators nervous. Finally, we explore the joint regulatory Cybersecurity Assessment Tool and how to implement it at your bank.

As banks increasingly look to the future to make predictions and manage risk, research has shown this is perilous territory indeed. Perhaps some measure of humility and a gigantic grain of salt might be needed for bankers, regulators and investors, too. In words sometimes attributed to baseball playing genius Yogi Berra, "It's tough to make predictions, especially about the future."

**Naomi Snyder**
is editor for
*Bank Director.*

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# BRIEFLY NOTED

**Keeping track of developments** that pertain to the audit or risk committee is hard to do. We've compiled a few items of note for bank boards about recent developments in financial reporting and risk governance.

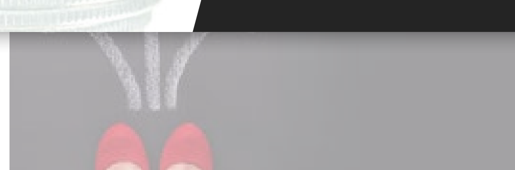
**Naomi Snyder** is editor for *Bank Director*.

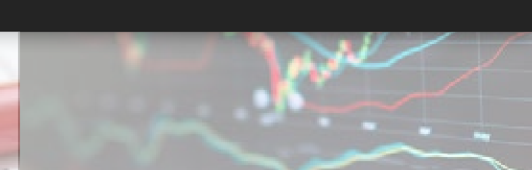
**Tap the numbered icons to cycle through topics**

1 2 3 4

## MIND THE GAAP

The Securities and Exchange Commission has **updated its guidance** warning against misleading use of non-GAAP measures in financial reports amid increasing concern for the way companies report non-GAAP metrics. A recent **FactSet survey** reported the average difference between GAAP and non-GAAP earnings per share was 30 percent in 2015, up from 12 percent in 2014.





# Adapting to CECL: Beyond the Accounting

By **Michael J. Budinger** and **Ryan A. Michalik**

The new Financial Accounting Standards Board (FASB) rule for estimating expected credit losses has been dubbed the most significant change in the history of bank accounting. In addition to changing the way they calculate credit losses, most banks and financial services companies (insurance companies, finance companies, and credit unions) will need to make significant process changes in the way they collect data and adapt their existing technology, financial models and governance structures to comply with the new standard.

The current expected credit loss (CECL) standard removes the existing "probable" threshold for loss recognition and requires banks to calculate credit losses using a more forward-looking approach to encompass lifetime expected losses. Determining the lifetime of a financial asset could prove challenging as banks factor expected prepayments (or anticipated troubled debt restructurings) in to the estimate.

## More Than an Accounting Issue

The impact of the new standard extends far beyond accounting and financial reporting. The credit management function is directly affected as banks must continue to actively monitor, analyze and manage their portfolios in a way that improves income and maximizes capital efficiency, even as they adapt their allowance calculation policies and processes to accommodate the new standard.

Credit risk management programs will need to be even more proactive in identifying developing trends in portfolios by way of frequent risk assessment and re-evaluation of risk appetite. This heightened activity could have an impact on recommendations for certain newer credits, terms and structures adopted and on the analysis of different metrics for CECL forecasting purposes. Banks also must reassess their model risk management approaches and implement new processes that address the changes to adopt a CECL model.

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Above all, adopting a CECL model to comply with the new standard might require

# Adapting to CECL: Beyond the Accounting

By **Michael J. Budinger** and **Ryan A. Michalik**

that address the changes to adopt a CECL model.

Above all, adopting a CECL model to comply with the new standard might require much more data gathering than was required for previous credit loss calculation methods. Banks might have to consider the need to redefine their data management requirements to include more robust portfolio data, borrower and economic data, exposure-level data, historical balances, risk ratings, charge-off and recovery data, and appropriate peer and industry data.

Although no simple solutions exist, it is possible to outline a comprehensive program to assess the challenges and begin planning for the changes over the next few years. At the highest level, such a program would be composed of the following components:

- **Risk identification:** Understand portfolio characteristics and drivers of portfolio performance, including lending attributes, loan structures, prepayment risks, and changes in the macroeconomic environment. This component will enable a bank to appropriately segment and model its portfolios based on common drivers of risk.
- **Governance and oversight:** Understand risk management practices surrounding the development, execution, and maintenance of the CECL model. This includes established roles and responsibilities of the board and senior management, as well as policies and procedures in place to articulate the expectations of the CECL model and ongoing execution of the model.
- **Enabling technology:** Understand the existing systems, including the capabilities and limitations of those systems that might support the execution of the CECL model. This includes source systems, data warehouses, modeling systems, financial statement spreading software, and vendor technology specially designed for CECL.

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# Adapting to CECL: Beyond the Accounting

By **Michael J. Budinger** and **Ryan A. Michalik**

financial statement spreading software, and vendor technology specially designed for CECL.

- **Accounting and regulatory alignment**: Assess the ability of the CECL model to meet accounting and regulatory needs and objectives.
- **Data inventory:** Understand the availability and limitations of data required to develop and maintain an effective CECL model. This includes the reliability and accuracy of data elements in addition to the historical time horizon of data availability.
- **Resource capabilities.** Understand the capabilities and limitations of the human resources identified to develop and execute on the CECL model.

## Next Steps

Most banks and financial services companies face a challenging road ahead. Outlining a comprehensive and achievable approach to adapt to these extensive changes is a positive first step to successfully transition to the new CECL model.

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THE AUDIT & RISK ISSUE

Banks need to forecast the future for a variety of reasons. *But how?*

# THE PROMISE AND PERILS OF **FORECASTING THE FUTURE**

BY **JOHN J. MAXFIELD**

**You'd be excused for thinking** that the growth of big data combined with the increased sophistication of computer algorithms would make it easier to forecast the future. But that isn't true.

This was made clear on June 23, the day a majority of voters in the United Kingdom cast ballots in favor of leaving the European Union. "I don't think anybody saw that coming," says Philip Tetlock, a professor at the University of Pennsylvania's The Wharton School, and one of the world's leading experts on forecasting.

Prediction markets had priced in an 85 percent probability that the U.K. would remain in the EU. A poll of polls by the Financial Times implied that 48 percent of people would vote to stay in the union compared to 46 percent who would cast their vote to leave. And on the day of the referendum, before results were in, equity markets in both the United States and Europe closed higher.

This reminder about the frailty of forecasts comes at an opportune time for the bank industry. Stress testing and the desire to avoid the mistakes that led to the financial crisis has made peering into the future an indispensable part of a bank's planning and risk management processes. [See also the article in this issue on the new CECL accounting standard emphasizing future forecasts.] But as a conversation with bankers at two regional banks shows, the forecasting process isn't the only thing that matters. Equally significant is what one does with those forecasts. "Plans are useless," Dwight Eisenhower once said, "but planning is indispensable."

Forecasting is nothing new to banks, of course. "We used it for credit. It was for asset/liability management. Banks with trading operations used it to calculate value at risk," a way to gauge potential trading losses, says Darren King, chief financial officer of M&T Bank, a $124 billion bank based in Buffalo, New York. But what the stress tests have done is to tie these pieces together. "All the different parts of a bank are now included in the process, which means we have more minds around what could go wrong and what that would mean for loss rates and thus the capital position of the bank," King continued.

From a strategic perspective, however, forecasting remains largely a defensive tactic, used to test the resiliency of a bank's balance sheet rather than to make bets on interest rates or asset prices. "We try to run the bank as much as we can so that we don't have a position in the direction of interest rates, commodity prices or anything else," explains King. "We're not oblivious to them, but we're not making speculative bets on their direction."

It's easy to understand why when you consider the volatility of energy prices, which weigh heavily on the broader economy. "In 2014, nobody in the oil and gas industry was expecting prices to fall as much as they did," says Mark Cranmer, head of energy finance at Cullen/Frost Bankers, a San Antonio, Texas-based financial holding company with $28 billion in assets. "We were forecasting for around $75 a barrel and the futures market was around $90 a barrel." The actual price of West Texas Intermediate crude fell from a peak of nearly $110 a barrel in June 2014 to below $30 a barrel less than two years later.

Where a bank must use forecasts to set loan policy and make other strategic decisions, in turn, as is the case with oil and gas prices at Cullen/Frost and other energy lenders, the forecasts are only the starting point. Layered on top is a substantial margin for safety.

In Cullen/Frost's case, it incorporates several layers of "discounting" to build a buffer between its forecasts and what might actually come to fruition, explains Cranmer. With respect to oil

"Running the bank only on models would be dangerous, but running the bank only on subjective judgment would also be dangerous. **The power is putting the two together."**

**— Darren King,**
chief financial officer, M&T Bank

and gas production loans, which make up the large majority of the bank's energy exposure, Cullen/Frost limits loan commitments to 65 percent of an estimated value of the underlying reserves, based on a conservative price estimate. Additionally, borrowers must be able to service their loans fully even if energy prices come in 25 percent below the assumed price.

M&T frames the strategic value of forecasting in a similar light. "Where the models can be really helpful is in understanding tail risk and how bad things could go," says King. This is the point of the annual stress tests, but it also has positive business implications. King explained that it helps M&T determine if it's too heavily concentrated in a particular industry and whether the bank is appropriately pricing in its risk.

Another point M&T and Cullen/Frost agree on is the role that subjective judgment—what Cranmer refers to as a banker's "intangibles"—continues to play in the forecasting process, despite the growth of big data and the sophistication of computer algorithms. "Running the bank only on models would be dangerous, but running the bank only on subjective judgment would also be dangerous," says King. "The power is putting the two together."

There is nothing mystical or powerful about accurate intuition, Tetlock writes in his book "Superforecasting: The Art and Science of Prediction." It's pattern recognition. It's about using one's experience to tie together what may otherwise seem to be unrelated observations.

A story that Cranmer shared bears this out. "In 2014, the average wait on a Saturday night for a restaurant in Midland, Texas, was one hour, and only half of the restaurant was open because they didn't have enough wait staff because everyone had gone out to the oil fields," recounts Cranmer. "It was at that point that I first suspected oil prices were too high."

Thus, while forecasting has gained prominence in response to new regulations and the growth of big data and computing power, it's still a function of both art and science. David Ruffin, co-founder and chief strategy officer of Credit Risk Management Analytics, says this explains why the use of forecasting and predictive analytics to set strategy, as opposed to stress test a portfolio of loans or other assets, remains in its infancy. **|BD|**

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## What Does It Take to Be a Superforecaster?

Philip Tetlock has spent his professional life studying the accuracy of forecasts. His latest book, "Superforecasting: The Art and Science of Prediction," delves into his latest research, revealing the traits that make some people better forecasters than others. Here are five of the most important traits that so-called superforcasters share.

1. **Be pragmatic, not dogmatic:** "For superforecasters, beliefs are hypotheses to be tested, not treasures to be guarded."
2. **Break it down:** "[S]uperforecasters often tackle questions in a roughly similar way–one that any of us can follow: unpack the question into components."
3. **Practice:** "To get better at a certain type of forecasting, that is the type of forecasting you must do–over and over again..."
4. **Synthesize others' views:** "Superforecasters constantly look for other views they can synthesize into their own."
5. **Perpetual beta:** "The strongest predictor of rising into the ranks of superforecasters is perpetual beta, the degree to which one is committed to belief updating and self-improvement."

**John J. Maxfield** is a writer and contributor to *Bank Director*.

# MAGIC 8 BALL FORECASTING

Predictions are hard to make.
View expert predictions to three tough questions.



## HIGH CONCENTRATIONS OF CRE ARE MAKING REGULATORS NERVOUS.

# COMMERCIAL REAL ESTATE HEATS UP

BY **JOHN ENGEN**

**Commercial real estate loans** on bank balance sheets reached an all-time high at the end of June, up 11.5 percent over the previous year to just shy of $1.9 trillion, according to Federal Reserve System data. They also are making up a greater proportion of the industry's risk-based capital, at 88.44 percent at the end of the first quarter, according to BankRegData.com.

Some institutions boast commercial real estate (CRE) ratios of more than 800 percent of risk-based capital, according to a research report on publicly traded banks from investment bank Keefe, Bruyette & Woods.

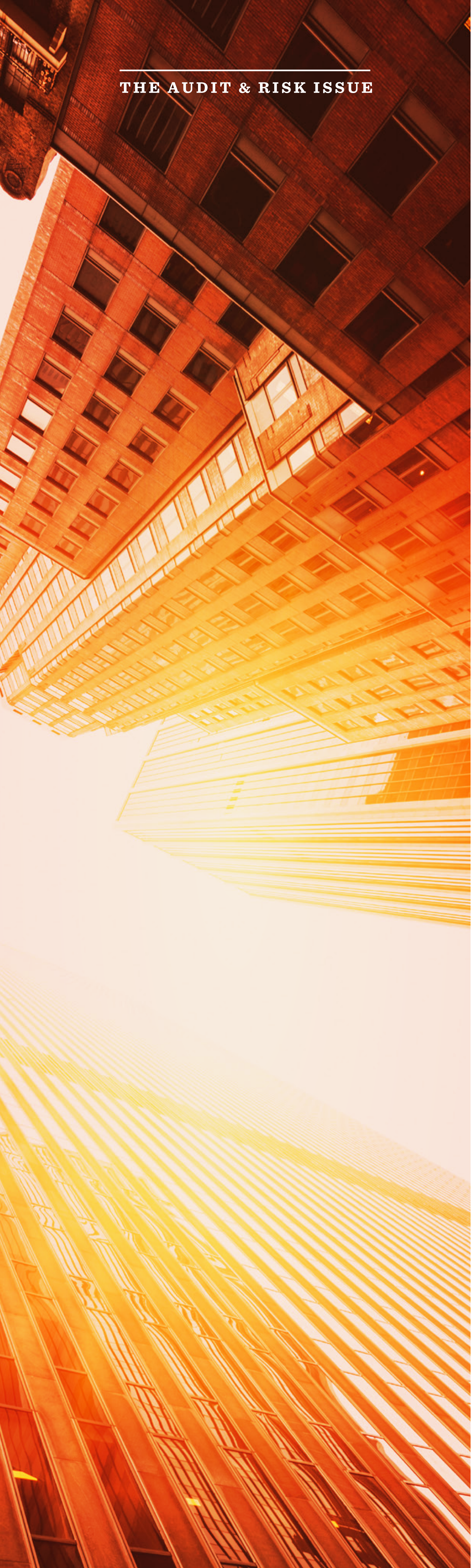
Whether that's something to worry about is a matter of considerable debate. CRE lending remains one of the few bright spots for many community and mid-cap banks—a source of both growth and profits—and there's little evidence of impending, widespread doom.

But high concentrations of anything make banking regulators nervous, especially when they're accompanied by rapid growth and apparently slackening loan terms and underwriting. So last December, the federal agencies issued a joint statement reiterating 2006 warnings that banks may be subject to greater regulatory scrutiny when CRE loans equal more than 300 percent of a bank's total risk-based capital and outstanding balances have increased 50 percent or more during the prior 36 months, or when construction and development loans equal to at least 100 percent of capital.

"CRE portfolios have seen rapid growth, particularly among small banks," Comptroller Thomas Curry said in remarks at a July risk conference. "At the same time we are seeing this high growth, our exams found looser underwriting standards with less-restrictive covenants, extended maturities, longer interest-only periods, limited guarantor requirements, and deficient-stress testing practices."

**88.44%**
Percentage of industry's risk based capital in commercial real estate loans.
*BankRegData.com*

For now, CRE loans are performing well. Just 1 percent of construction and development loans and .26 percent of multifamily loans were reported as noncurrent at the end of the first quarter of 2016 by the Federal Deposit Insurance Corp.



AT THE SAME TIME WE ARE SEEING THIS HIGH GROWTH, OUR EXAMS FOUND LOOSER UNDERWRITING STANDARDS WITH LESS-RESTRICTIVE COVENANTS, EXTENDED MATURITIES, LONGER INTEREST-ONLY PERIODS, LIMITED GUARANTOR REQUIREMENTS, AND DEFICIENT-STRESS TESTING PRACTICES."

*Comptroller Thomas Curry*

"There hasn't been a decline in the quality of assets, and it's a profitable area for banks. So why is it remarkable to see banks going over this tripwire of 50 percent growth over three years?" asks John Beaty, a partner at Venable LLP, a Washington, D.C., law firm.

Beaty, a former FDIC lawyer, calls it "strange" that regulators are ramping up concerns right now. "Of course banks are growing those loans. That's how you make money right now."

The regulatory thresholds might seem too generalized for a business that is, by definition, dependent on local market conditions and nuanced with many different subsections, including construction and development, multifamily, office and retail.

Nevertheless, Bert Ely, a regulatory consultant in Alexandria, Virginia, says that underlying sentiment—that even a well-run bank could get burned by too much exposure to a market that appears poised to overheat—is valid. "You can do a great job managing your own book, but if CRE prices drop 30 percent across the board, you're going to get hurt," he says.

Anecdotally, bankers say loan quality is declining in some markets, and stories abound of banks giving no- or limited-recourse loans and slashing loan pricing to win the business. Capitalization rates (the ratio of a property's net operating income to its value) have fallen below 3 percent in many markets, well below historical norms.

"What we're hearing everywhere is, 'irrational competition, irrational pricing, irrational structures,'" says Collyn Gilbert, an analyst with Keefe, Bruyette & Woods. "It makes a ton of sense that the regulators are focusing on this area."

The lights may be flashing yellow. Even so, a lot of banks aren't easing up. And that's ok. The regulatory pronouncement doesn't say banks can't have higher concentrations, only that their CRE

**1%**
of construction and development loans were noncurrent in the first quarter of 2016.
*FDIC*

risk-management practices will be given a harder look if they do.

The guidance essentially amounts to a test of faith for boards of institutions hovering near the line: Do they have confidence that the bank's policies, processes and procedures are good enough to hold up under additional scrutiny?

For some boards, the answer is no. Dave Seleski, CEO of Stonegate Bank, a $2.4 billion-asset CRE lender based in Pompano Beach, says some of his south Florida competitors are scaling back their CRE lending, "not because they're worried about the credit itself, but because they're worried about the additional regulatory scrutiny."

Bet wrong, and the agencies could bring an enforcement action. In May, Carver Federal Savings Bank entered into a formal written agreement with the OCC that includes establishing a written plan for managing CRE risk. The $754 million asset New York institution had 57 percent of its loan book in construction, multifamily and non-owner occupied loans.

On the whole, however, years of oversight improvements have left a lot of banks thinking they have a good handle on managing CRE risks. An analysis by KBW found that 141 of the 222 banks in its coverage universe tripped at least one of the triggers, including 42 that surpassed both the concentration and growth thresholds.

**141 of 222**
public banks tripped regulatory thresholds for CRE concentrations.

*Keefe, Bruyette & Woods*

Banks in the Northeast showed the greatest tendency to exceed the limits, while those in the Midwest were most likely to be below the caps. But in a tough interest-rate environment, banks everywhere are pushing the limits.

In Florida, where the economy is driven by real estate, Seleski estimates that more than 60 percent of banks exceed one of the thresholds. "As a commercial bank here, where else are you going to make money?" he asks, adding that some banks are raising additional capital in order to lower CRE ratios.

# COMMERCIAL REAL ESTATE LOANS ON BANK BALANCE SHEETS REACHED AN ALL-TIME HIGH AT THE END OF JUNE, UP 11.5 PERCENT OVER THE PREVIOUS YEAR TO JUST SHY OF $1.9 TRILLION.

*Source: Federal Reserve System*

"We have no concerns about CRE concentrations," says George Gleason, chairman and CEO of Bank of the Ozarks, a $14 billion asset institution in Little Rock, Arkansas. Gleason's bank, long a CRE specialist, had a CRE-to-capital ratio (excluding owner-occupied) of 461 percent at the end of the first quarter, and Gleason expects big growth from the business.

The FDIC and state regulators conducted a "targeted CRE exam" of Gleason's bank in April, which included some the FDIC's "big, more national-oriented CRE examiners." It was more grueling than in the past, but regulators better "understand our plans and expectations" regarding CRE growth, he says, while bank officials gained better insights about oversight expectations.

"We're not trying to slow it. We expect more dollars in CRE growth in 2018 than we have this year," Gleason says. "The guidance doesn't say let off the accelerator. It says if you have a concentration, you've got to be extra attentive, and we have always been extra attentive."

Boards of banks that break the concentration or growth thresholds need to demonstrate their understanding of specific lending types and local geographies. They also must ensure they have adequate policies, processes and procedures in place to keep risks in line with the board's established risk appetite. Those efforts typically include scenario planning and stress testing the portfolio for worst case scenarios.

"The regulator code words are identification, measure, monitor and manage," Venable's Beaty says. "If you're doing a lot of CRE lending, this is something examiners are going to be looking at, so you'd better have your act together." **|BD|**

**John R. Engen** is a writer and contributor to *Bank Director*.

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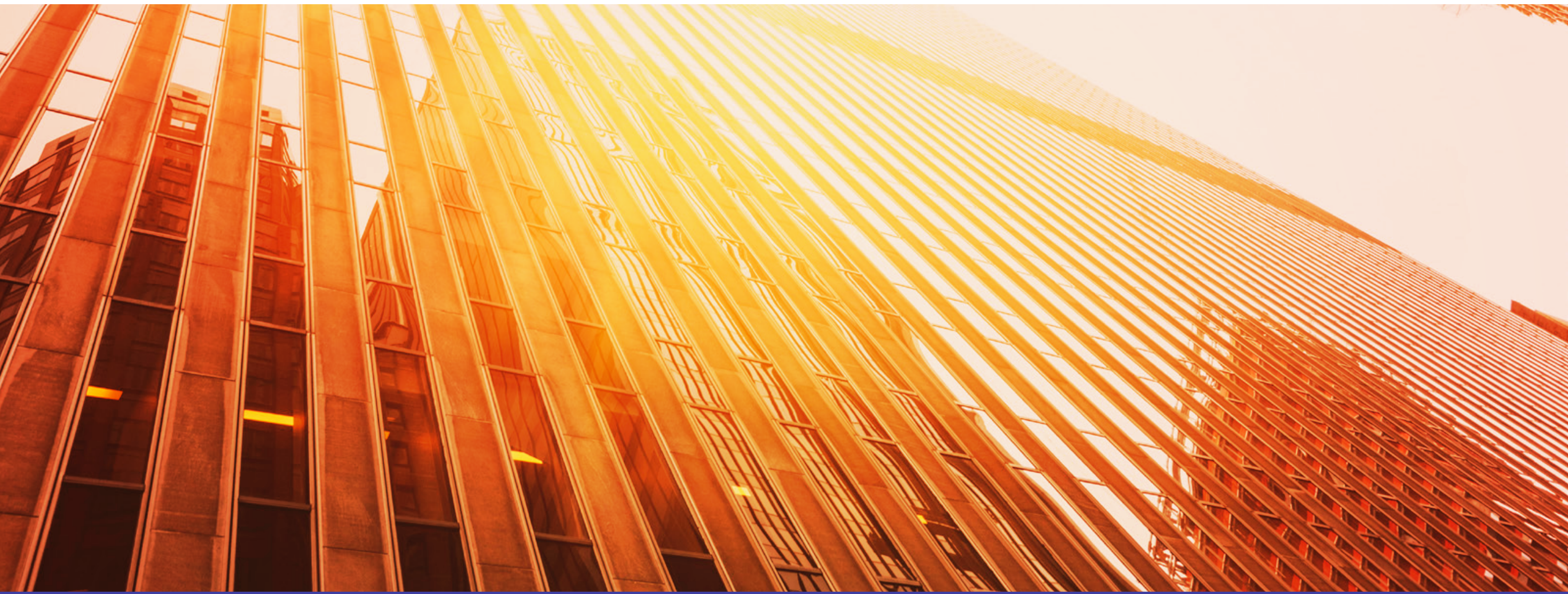
## ADDITIONAL RESOURCES:

+ Statement on Prudent Risk Management for Commercial Real Estate Lending
+ 2006 CRE joint guidance

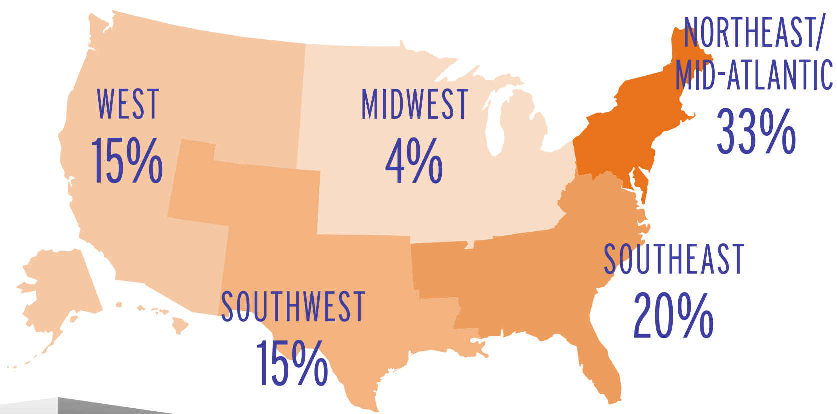


# COMMERCIAL REAL ESTATE FACTS

## THE AVERAGE COMPOSITION OF BANK LOAN PORTFOLIOS FROM 2004 TO 2007

- $ 25% CRE
- $ 23% residential
- $ 18% commercial & industrial
- $ 14% consumer
- $ 9% construction
- $ 11% other

## NORTHEAST HAS HIGHEST CONCENTRATION OF CRE-HEAVY BANKS




(The percentage of small and medium sized publicly traded banks that trip regulatory benchmarks for high CRE concentrations* in each region)

## THE AVERAGE COMPOSITION OF BANK LOAN PORTFOLIOS FROM 2012 TO 2015

- $ 36% CRE
- $ 23% commercial & industrial
- $ 20% residential
- $ 11% consumer
- $ 5% construction
- $ 7% other

## THE TOP 5 PUBLIC BANKS WITH HIGHEST CRE CONCENTRATIONS

1. Opus Bank, $6.4 billion asset bank
2. Flushing Financial Corp., $5.7 billion asset bank
3. Customers Bancorp, $8.3 billion asset bank
4. ConnectOne Bancorp, $3.8 billion asset bank
5. Signature Bank, $34 billion asset bank

Source: KBW report from June 2016, based on its coverage universe of 222 publicly traded small and midsized banks. *tripping regulatory benchmarks in this measurement means having at least 300 percent of risk-based capital in CRE loans and experiencing at least 50 percent CRE loan growth in the last three years. Excludes owner-occupied CRE.

THE AUDIT & RISK ISSUE

# THE CECL TRAIN IS COMING

BY **NAOMI SNYDER**

## Here is how not to get run over by the new accounting standard.

**Ingrid Stafford, board member** of Wintrust Financial Corp., a $24 billion asset, Chicago-area holding company with 15 separately chartered banking subsidiaries, is getting ready for what could be the biggest change to bank accounting in decades. The new standard is known by the acronym CECL, or current expected credit loss, and it will require all banks to estimate losses on loans and a few other assets over the entire life of the assets, and do it from the moment they acquire them.

"Effectively, you're saying every time you make a loan, you're not going to collect 100 cents on the dollar," says Stafford, who is the chair of the audit committee and member of the risk management committee. "It will be a major change to operationalize it."

Simply put, the new standard will impact loan loss provisioning, earnings, data collection, modeling, internal controls, asset/liability and risk management. It could even impact capital levels, particularly in the first year of its adoption. Your bank's executive management will need to start planning for it right away, as will the board.

The regulators have said as much. As soon as the Financial Accounting Standards Board (FASB) finalized the new standard in June, banking regulators issued a joint statement saying the change "requires the attention of each financial institution's board of directors and senior management." Although regulators say they will take into account a bank's complexity and size when assessing its adherence to the new standard, it applies universally to all banks and some other financial institutions.

"Boards really do need to see this as a change in how banks are going to manage themselves," says Mike Gullette, the vice president of accounting and financial management for the American Bankers Association. "It's not just an accounting change. You have to engage your whole company to make sure it's done right."

**"EFFECTIVELY, YOU'RE SAYING EVERY TIME YOU MAKE A LOAN, YOU'RE NOT GOING TO COLLECT 100 CENTS ON THE DOLLAR. IT WILL BE A MAJOR CHANGE TO OPERATIONALIZE IT."**

— **Ingrid Stafford,** board member, Wintrust Financial Corp.

## What has changed?

The CECL standard goes into effect for U.S. Securities and Exchange Commission filers for fiscal years starting after Dec. 15, 2019, and for nonpublic banks after Dec. 15, 2020. It replaces the current incurred loss model. To simplify, when a bank makes loans, it estimates the potential losses based on historical data in the allowance for loan and lease losses (ALLL). But the new model requires financial institutions to look much longer into the future, based on the risk that the loans and other types of assets will experience losses over the life of the loan or life of the portfolio. You can still use historical data to make estimates, but you would not want to use the simple average annual loss rates currently used at many financial institutions, says Chad Kellar, a partner at Crowe Horwath LLP. That's because the likelihood of loss changes over the contractual life. You might have a higher likelihood of loss in a portfolio in years two or three after origination, and much lower loss potential at the end of the contract term if the loan is amortizing, for example. If you think this through, you'll realize that in the future, it will be possible for your bank's delinquencies to rise, while your ALLL won't, because you established a reserve for your estimated losses when you booked the loan.

## Why was this implemented?

Many investors and regulators have supported the move as a way to provide more clarity for stakeholders in a bank. Investors and others complained during the financial crisis that they couldn't get an accurate picture of future credit losses, in part because banks were required by accounting rules to reserve for impairment once it had occurred. So while loan volume increased before the financial crisis, reserves were actually going down, says

FASB member Hal Schroeder. Even bankers complained during the crisis that they were unable to book the losses they expected in the portfolio, he says.

## What is the impact?

The investment banking firm Keefe, Bruyette & Woods estimated in October 2015 that the median bank in its coverage universe of publicly traded banks would increase loan loss reserves by 6 percent if the standard were enacted as of the third quarter of 2015, although each bank is going to be different based on the risk inherent in its portfolio and a variety of other factors. Some banks may actually see their loan loss reserves decline. Banks with longer term loans such as fixed-rate mortgages may see their loan loss reserves rising more than others, says Balvinder Sangha, a partner at Ernst & Young. It's not just loans but also some other kinds of assets such as held-to-maturity securities that will need CECL loan loss estimates for the first time. But the new rule will give banks flexibility in accounting for future losses, in part because each bank gets to choose how they will project future losses. The standard requires that the forecasts you use are "reasonable and supportable," Sangha says.

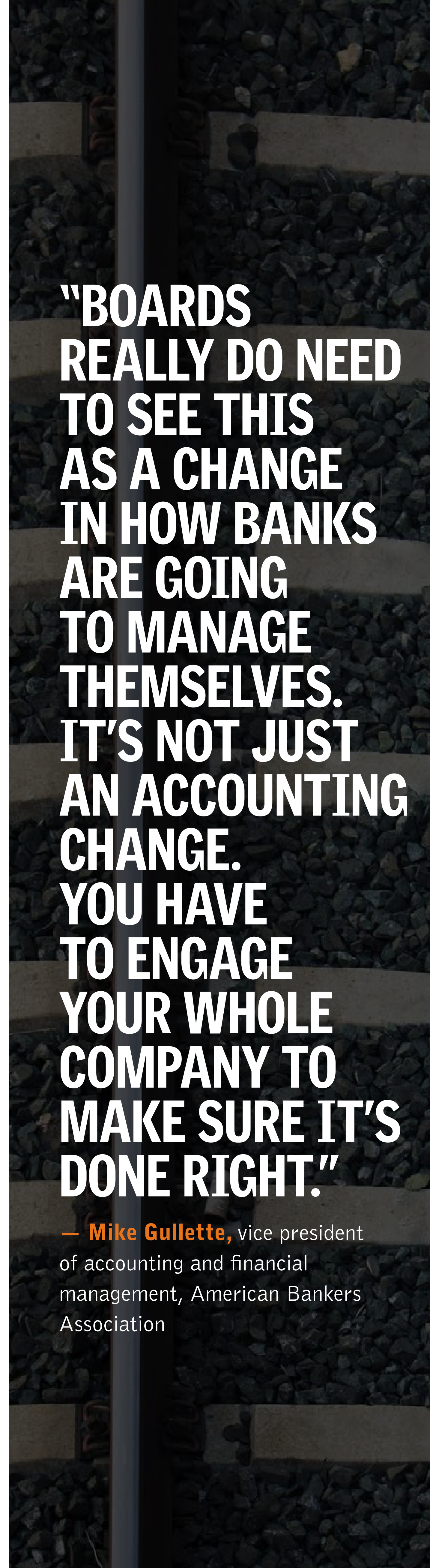
There will be other impacts as well. Pricing or underwriting may change as banks begin to calculate risk differently, Gullette says. Data collection will be much more intense than in the past. Some banks may not have the data they need, as most banks don't retain life of loan data. The new rule requires publicly traded banks to disclose how they make their life of loan loss estimates and future forecasts, says John Gallagher, an executive director at Ernst & Young. Internal audit will have to determine whether the assumptions are reasonable.

## How does this impact small banks?

Small banks will have to comply with the new standard. Regulators have said they will take into account the size and complexity of the bank. There is no requirement that a small bank go to a vendor or consultant to get data or models, nor will they have to forecast losses for each individual loan; they can forecast losses for a portfolio of loans instead. If they can't reasonably forecast losses beyond two to three years, it will be possible to revert to the historical losses to project the future, says Sangha.

## What's good about this new rule?

"Good" may be in the eye of the beholder. If you're a bank investor, you may like the idea that this will provide greater clarity on future losses. If you're a bank, this may encourage a deeper dive into your portfolio of loans and long-term assets, perhaps causing your bank to do a better job of pricing loans for the risk involved. Purchase accounting, especially for impaired loans that are acquired, is fairly confusing under the current standard as the purchase discounts often dramatically inflate the subsequent net interest margins. CECL simplifies this with a "gross-up" that creates an ALLL upon purchase of credit-impaired loans, according to the ABA.



**"BOARDS REALLY DO NEED TO SEE THIS AS A CHANGE IN HOW BANKS ARE GOING TO MANAGE THEMSELVES. IT'S NOT JUST AN ACCOUNTING CHANGE. YOU HAVE TO ENGAGE YOUR WHOLE COMPANY TO MAKE SURE IT'S DONE RIGHT."**

— **Mike Gullette,** vice president of accounting and financial management, American Bankers Association

## When should your bank get ready?

Now. Although implementation dates don't start for SEC filers until the fiscal year after Dec. 15, 2019, data collection will have to improve at many banks. Staff will have to start figuring out what data they need to collect and boards will have to oversee this process to make sure it runs smoothly. Senior management will have to make estimates about the future. Banks may want to start running CECL calculations a year in advance of the actual implementation date, just to see the impact, as well as how this could affect other aspects of the bank's financials and even future underwriting. Early implementation is permitted for all institutions for fiscal years beginning after Dec. 15, 2018. For banks that follow the International Accounting Standards Board for some parts of their businesses, the timeline will be even more aggressive, as new international standards go into effect for periods beginning after Jan. 1, 2018.

## How should the board approach this?

Kellar says to ask questions of management about how the bank plans to implement the new rule, the timeline and the impact on the bank. "It will impact capital on day one," he says. Who are the people assigned to this? When will they report to the board on the progress? Are there controls in place to verify the data? At Wintrust, Stafford says the audit committee already has been briefed on the bank's plans to implement the new rule using existing staff and data, some of it beefed up in response to rules requiring stress testing at banks above $10 billion in assets. The bank's finance committee, which reviews all changes to financials and ALLL, also will be involved in reviewing the changes.

The risk management committee at Wintrust is assigned to look at asset quality, so it will be charged with overseeing whether the new standard and its revelations necessitate a change to lending standards, Stafford says. |BD|

**Naomi Snyder** is editor for *Bank Director*.

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## Additional resources:

- FASB: Financial Accounting Standards Board's accounting standards update on credit losses.
- IFRS 9: The International Accounting Standards Board has finalized a similar rule for international organizations regarding "expected loss."

GENERAL ELECTION

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Yes No

Do you want lending solutions offering low marginal costs?

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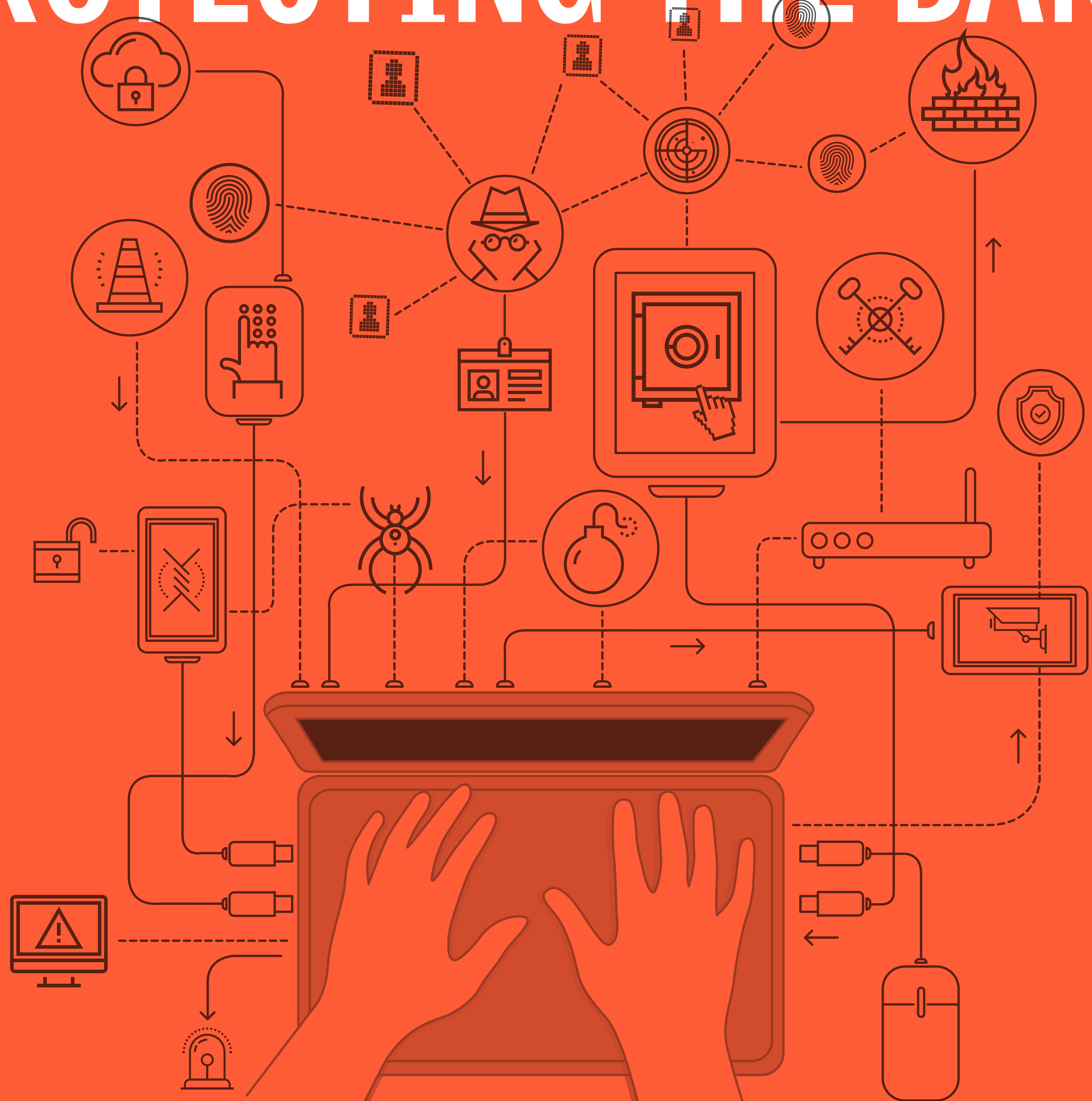
I want to Learn More!

# PROTECTING THE BANK



BY **SANDY SMITH**

## Banks haven't quite mastered the new Cybersecurity Assessment Tool.

**As the Federal Financial Institutions Examination Council's (FFIEC) Cybersecurity Assessment Tool** turns 1 year old, it is growing into something more than just another form to fill out. Consider this a living, breathing document. In other words, simply filling it out isn't enough; it should become the basis of a regularly updated plan.

But even with that bit of clarity, there is some uncertainty—and that starts at the beginning. Is it mandatory? Technically, no.

Beth Dugan, deputy comptroller for operational risk, Office of the Comptroller of the Currency, reiterates that completing the assessment is optional, but that bank examiners will ask to see it as part of an effort to "gain a more complete understanding of the bank's inherent risk, risk management practices and controls related to cybersecurity." OCC examiners will not require banks to complete the assessment, she says. "If a bank has completed the assessment; however, examiners may ask the bank for a copy, as they would for any risk self-assessment performed by the bank."

**62% say their bank has completed the assessment.**

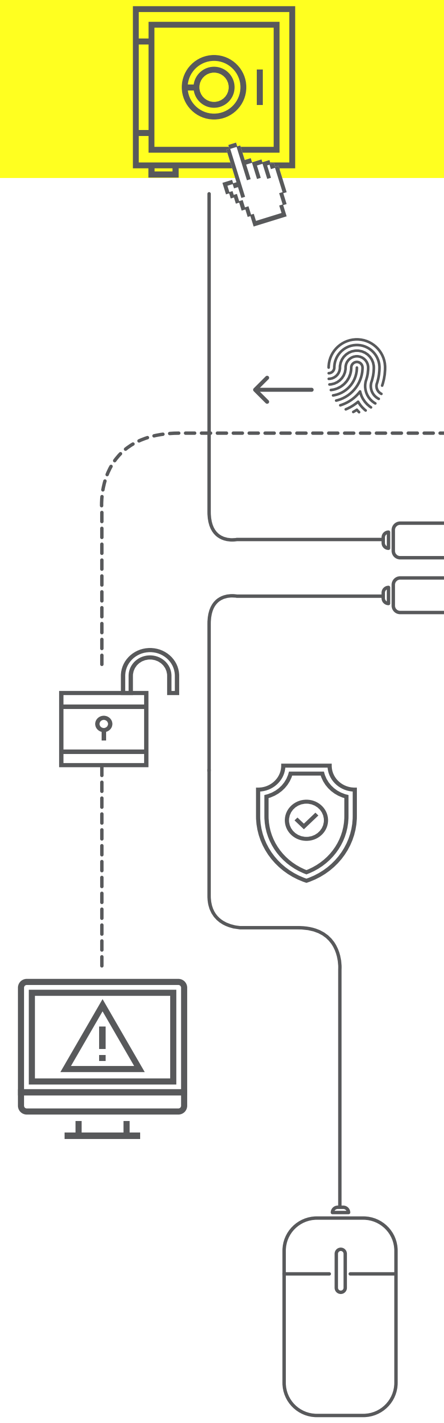
Bank Director's 2016 Risk Practices Survey

But in practice, the expectation is certainly there, believes Sai Huda, senior vice president and general manager at Risk, Information Security and Compliance (RISC) Solutions, FIS: "De facto, it's an expectation that you do it. If you don't, [regulators] will."

One aspect is clear: There is an expectation that banks focus intense efforts on cybersecurity threats. John Geiringer, regulatory section leader of the Financial Institutions Group at Barack Ferrazzano Kirschbaum & Nagelberg LLP, says some of his bank clients have received specialized IT and cybersecurity examination teams since the deployment of the Cybersecurity Assessment Tool. "That's where we will see a problem. When you have an expert team in an area, they're bound to find more problems."

So how are banks doing with completing the assessment? Geiringer says his clients are taking it seriously—and seem to be doing well at finishing up the complex document. "Time will tell over the next examination cycle," he says. While they may find value in it, whether that effort is successful will depend upon how examiners view the self-assessment—and how it influences their own take on the banks' cyber preparedness.

## The Tool in Practice



Some banks are already well into the exercise of completing the assessment. It walks institutions through an intensive process of determining their inherent risk levels, including the number of internet connections, technologies that may create targets (such as ATMs and customer-facing websites) and the type of services offered. Institutions then assess their maturity level in five areas: cyber risk management and oversight; threat intelligence and collaboration; cybersecurity controls; external dependency management; and cyber incident management and resilience.

The questions are extremely detailed. In determining inherent risk, one question asks banks for the number of internet service provider connections throughout its institution, including branches. Banks are then given guidance to determine their risk levels, ranging from least to most, based on the answer to that question. For example, banks with no internet service provider connections will land in the category of least risk, while banks with more than 200 connections are at the most. Those in between will determine whether their risk is minimal, moderate or significant, based on the number of internet connections.

Dugan notes that OCC examiners will evaluate the policies, controls and processes in place to "determine if the institution has attained specific statements within the assessment. OCC exam-

iners will discuss any observations derived from the assessment and other examination procedures with bank management." Examiners will use the assessment during future exams, updating information as needed, she says. "Examiners will also adjust supervisory strategies as necessary, based on the results of their examination findings."

Geiringer says the Cybersecurity Assessment Tool is similar to the way that every bank has its own Bank Secrecy Act/Anti-Money Laundering (BSA/AML) profile. "It becomes incumbent upon them to figure out what their risk profile is, based on the products and services they offer."

But that is no easy task. In written comments provided to the FFIEC, the Financial Services Sector Coordinating Council (FSSCC), a coalition of trade organizations that works on issues related to financial sector resilience including cybersecurity, estimated that smaller institutions would incur hundreds of hours to complete the assessment. Dugan notes that the expectations for community banks are largely the same as others. "Scaling the tool for different size institutions was considered in the development, but continues to be a challenge for all sizes of institutions," she says. The FSSCC estimated that medium-sized and large institutions could spend as much as 2,000 or more hours completing the tool.

Small wonder, then, that banks haven't quite mastered the self-assessment. Sixty-two percent of respondents to Bank Director's 2016 Risk Practices Survey, sponsored by FIS, had completed the assessment but only 39 percent had validated the results. "Our survey identified that banks are completing it, but they're not quite where they need to be," says Huda.

He says that many banks do not have a plan in place to monitor cyber threats; the survey shows that 82 percent have not considered

**"Directors can't absolve themselves by saying, 'I don't know anything about computers."**

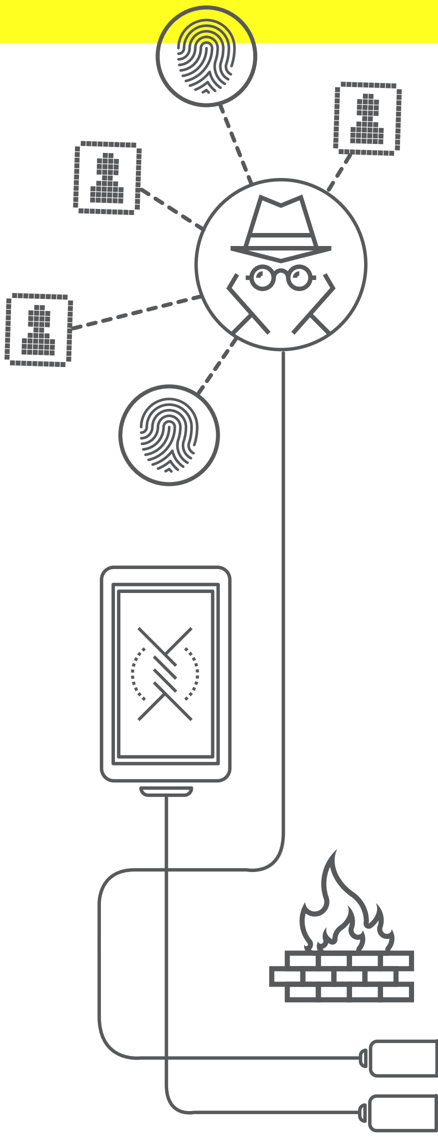
**John Geiringer,**
Barack Ferrazzano Kirschbaum & Nagelberg LLP

what actions might trigger the need for an updated cyber plan, an aspect covered by the tool's cybersecurity controls portion. Adding to the challenges: "Regulators haven't given any guidance on what's baseline," says Huda. "How do you know if you're the right track?"

Ultimately, it falls to directors to ensure that there is a solid plan, Geiringer says. The document specifically states that directors need to provide oversight for management on implementation of the tool. "If directors don't take this seriously, nobody else will. Directors can't absolve themselves by saying, 'I don't know anything about computers.' That is unacceptable."

## Expanding Expectations

As if its use by federal bank examiners was not reason enough to complete the Cybersecurity Assessment Tool, Huda points to Maine and Massachusetts, which have recently required that banks complete the assessment. That's stronger language than the guidance from the FFIEC. "The states have gone beyond what the federal is requiring. That's a key development."



And the states are not alone in regulating cybersecurity practices. The Consumer Financial Protection Bureau recently fined online payment processor Dwolla $100,000 for failure to take reasonable precautions in protecting consumer data and for misleading consumers about its security practices. Dwolla also must submit semi-annual risk assessments of its cybersecurity practices to the CFPB. Dwolla, by the way, says it had never had a cybersecurity breach. While Dwolla is not a bank, the fine does serve as a reminder that the CFPB is another agency taking a close look at cybersecurity.

## Shifting Focus

John-Paul Besong, former senior vice president and chief information officer for defense contractor Rockwell Collins, faced cybersecurity threats every day. "We were aware of this issue before it was cool," he says.

He now is a director for Moline, Illinois-based QCR Holdings, a multi-bank holding company with $2.5 billion in assets. "In this digital economy, every business is a technology business," he says.

**"Banks are actually becoming technology companies with a banking license."**

Besong believes it is crucial for directors to understand the threats—and to ensure that the banks are managing the risks well. "The power of technology that keeps you so close to your customer becomes a threat to the bank." The access to convenience that today's customers demand—such as mobile banking, remote deposits and customer-facing websites—"puts the bank at risk." It is clear that cybersecurity will remain on the agenda of regulators as well. Both Huda and Geiringer anticipate additional actions from the FFIEC later this year. Huda predicts that a similar self-assessment tool will be announced for technology service providers by year's end. While that may increase the complexity, it also may help banks better manage their cybersecurity risks. **|BD|**

**Sandy Smith** is a Nashville-based freelance writer and editor.

|BD|

VIDEO INTERVIEW

# SUCCESS STRATEGIES FOR ENTERPRISE RISK MANAGEMENT

**Bill McKendry, the executive vice president** and chief risk officer at Bank of North Carolina, embarked on an enterprise risk management program for his $6.7 billion asset bank two years ago. Speaking with Bank Director Editor in Chief Jack Milligan, he describes the benefits, lessons learned and why you don't have to start from scratch.

# A BOARDROOM CONVERSATION

## *Risk Management, Not Risk Avoidance*

**Bob Rivers** is president and chief operating officer of Eastern Bank.

**Bob Rivers is no stranger to innovative technology.** As president and chief operating officer of the $10 billion asset mutual Eastern Bank in Boston, he has helped guide the bank toward creating an innovation lab, introducing voice-recognition software in the call center and a business loan that processes in less than five minutes with funds available as early as the next day. Rivers, who will take over as the bank's CEO Jan. 1, 2017, talks to *Bank Director* digital magazine about how his bank mitigates the risk of innovation

**Tell me about your express business loan.**

It's fully digital. There's no paper. It's up to $100,000. We looked at how we were manually underwriting these loans and what we could do to digitize them. We also looked at all the questions we were asking that didn't really factor into the decision at the end of the day, and eliminated them. It's an unsecured small business loan. If you don't meet the criteria, it asks you if you would like an SBA loan and that takes another couple minutes.

We made it initially available only to existing customers but we're in the pilot phase for making it available to everyone in our [geographic footprint]. We've received a lot of industry interest in terms of licensing this software. We are working with a number of banks now and are in process of establishing a separate subsidiary to offer this product as part of a licensing agreement [to other banks]

SWIPE UP

# A BOARDROOM CONVERSATION

*Risk Management, Not Risk Avoidance*

**Bob Rivers** is president and chief operating officer of Eastern Bank.

sidiary to offer this product as part of a licensing agreement [to other banks].

**What's the delinquency rate?**

The express business loan has seen delinquency rates as low as the previous kind of loan product that Eastern had been offering before it. We are happy with the results.

**How do you mitigate the risk of underwriting a loan in less than five minutes?**

The machine is doing the underwriting, not the person. There is a ton of underwriting. In this regulatory environment, as you know, anything that reduces the level of qualitative judgement is very helpful. If I'm an examiner, I really like this product. All the documents are available digitally. I can understand the decision because all the code is outlined for all the decisions that were made. We're verifying what's held in state databases. The portfolio is monitored just the way any other portfolio would be. Our goal is to ultimately digitize all the loans we make and everything we do. With larger commercial loans it's a lot harder, and riskier, but we are implementing a new commercial loan origination platform for large loans that will adopt many of the principles we've adopted with the express loan that will result in greater efficiency and an improved customer experience. We are trying to automate

SWIPE UP

# A BOARDROOM CONVERSATION

*Risk Management, Not Risk Avoidance*

adopted with the express loan that will result in greater efficiency and an improved customer experience. We are trying to automate data processing and data gathering. It will still have some manual tasks but it will focus people more on the underwriting judgement analysis than the data gathering.

**Bob Rivers** is president and chief operating officer of Eastern Bank.

**Do you have more risk management staff than other banks your size?**

I don't know but I don't think so. [The bank has increased enterprise risk staffing by 45 percent in the last 18 months to 47 people]. The ramp up we've had in the last two years has probably brought us to par with others. What really drove that was we were approaching $10 billion [in assets]. All the rules as you approach $10 billion are more stringent.

Barbara Heinemann [EVP of enterprise risk management] took our existing compliance and other security functions and put them under this umbrella [called enterprise risk management] and added to it substantially. We hired Steven Antonakes, the former number two at the Consumer Financial Protection Bureau, to be head of compliance and he reports to her. Credit risk management is a different function in the bank.

Barbara and her team have been at the very front of everything we're doing in the innovation space. Barbara is a member of our innovation advisory committee of the board, which is populated by several members with knowledge of these matters and

SWIPE UP

# A BOARDROOM CONVERSATION

*Risk Management, Not Risk Avoidance*

of our innovation advisory committee of the board, which is populated by several members with knowledge of these matters and members of management. It's about risk management. It's not about risk avoidance. How do we come together and solve problems in a way that makes everyone happy? You've got to get [risk management] involved early, which is why Barbara sits on our management committee and our innovation committee.

The tonality is critical so you don't shut down ideas. In many places, and at times in our own shop, we're hardwired to just glance at it and say, "No, that's crazy," especially when you're saying, "Let's do a fully automated, digital small business loan of up to $100,000." Barbara does a great job of sitting down and saying, "Okay, in order to get this done, here are the things we can compromise on and here are the bright lines you can't cross." It has been a very collaborative relationship from the beginning.

**Bob Rivers** is president and chief operating officer of Eastern Bank.

SWIPE UP

# I worry most about the following risk:

**BankDirector.** **Strong Board.** Strong Bank.

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# Bank Director

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THE AUDIT & RISK ISSUE






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