Credit Union Insights – Fall 2021

Presented by: Barry M. Pelagatti | Partner, Financial Services Industry Practice Leader

David Royal | Product Manager, nCino

Housekeeping Items

- The webinar will be recorded and shared as soon as it is available via email
- Today's materials will be shared in the chat box
- All lines are muted
- NASBA CPE requirements – in order to receive CPE for this webinar:
  - Participants must be connected to the session (both audio and presentation) for its entirety
  - Participants must answer six questions/elements of engagement
  - One (1) hour of CPE in the field of accounting and one (1) hour in the field of management services will be granted if you meet these requirements

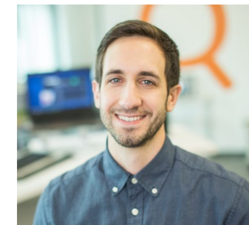
DISCLAIMER: The presenters, Barry Pelagatti, David Royal, nCino and RKL LLP and its subsidiaries/affiliates are not held responsible for information that has changed or will change and makes no representation or warranty as to the ongoing accuracy of the information presented orally or in writing. Attendees should consult with legal, accounting and other advisors.

Your Presenters

Barry Pelagatti, CPA

Partner, Audit Services Group

Barry is a Partner in RKL's Audit Services Group and leader of the firm's Financial Services Industry Group. With more than two decades of service to financial institutions throughout the Mid-Atlantic, Barry directs the strategy, growth and management of RKL solutions for banks, credit unions and other institutions, ranging from assurance and tax services to data security assessments and business continuity planning. Barry also serves as Managing Partner of RKL's Exton Office.



David Royal

Product Manager, nCino

David Royal grew up in Las Vegas, Nevada and graduated from Brigham Young University in 2013. David has worked with nCino's Portfolio Analytics since 2015 where he has been a product manager for the past four years. He loves his wife and children, enjoys playing guitar, hustling pickleball courts, playing Zelda video games, and (because he loves having his heart ripped out repeatedly) watching BYU football.

Before we begin –

- Welcome "back"
- We hope to see you all again in person in 2022
- Let us know what else you need from us. Please submit your request for future webinar topics over the next few months to:
  - Info@rklcpa.com
- Please fill out the survey that will pop up in your browser at the conclusion of this webinar
- Thank you and congratulations to Jim Pruzinsky on his retirement from RKL LLP on December 31, 2020!!!!

Agenda –

A "veritable cornucopia" of topics to usher in the fall season

- CECL
- "Post" Pandemic Observations / Trends
- Subordinated Debt
- nCino, Top 10 Loan Reports

Content for this presentation was provided by Allison Henry from the PICPA.

POLLING QUESTION - #1

To be eligible for CPE, 6 polling questions must be answered.

CECL considerations:

- Lessons learned from SEC filers and early adopters
  - Management of Model Risk – additional slides
  - Common Areas of Regulatory Concern – additional slide
  - Environmental and Forecast Factors – source date
    - Industry trends
    - Loss rate forecasting
    - Unemployment
    - Consideration by portfolio segment
  - Mergers and Acquisitions
    - Need for acquired institution data
    - Complex changes to prior purchase credit deteriorated assets (talk to auditors)
  - Disclosures
    - Extensive and complex regardless of elected method
    - Generate processes for all required tables
    - Typically an out-of-scope audit area
- WARM versus SCALE
- Implementation Assistance – permitted activities versus prohibited activities

CECL: Lesson Learned – Model Risk

Errors occur for two main reasons:

- Models have fundamental errors and may produce inaccurate outputs when viewed against objective and intended uses:
    - Model theory
    - Mathematical calculations
    - Choice of sample design
    - Selection of inputs and estimation techniques
    - Information system integration
    - Shortcuts, approximations, etc.

- Models may be used incorrectly or inappropriately

MODELS MUST BE MANAGED!

CECL: Model Management

Start by creating:

- Model risk management framework
- Comprehensive model inventory
- Model risk assessment

Follow a concept of "effective challenge"

- Perform a "critical analysis by objective, informed parties who can identify model limitations and assumptions and produce required appropriate changes."
- Effective challenge can be heavily impacted by:
  - Incentives,
  - Competence, and
  - Influence

Consult with your third parties advisors and ask the difficult questions. Be prepared for auditor inquiries on model management.

CECL: Common Regulatory Concerns

- Model documentation
  - Lack of robust entity specific model analysis
- Model limitations
  - Failure to identify situations where the model isn't stable
- Support for assumptions
  - Over-reliance on peer information
  - Failure to consider statistical "problems" in loss drivers
  - Lack of formalized procedures and controls around assumptions
- Model validation
  - Lack of robust internal or third party model validation
- Ongoing monitoring
  - Lack of formal sensitivity and stress testing
  - Lack of back-testing
  - Failure to establish model performance metrics and thresholds

CECL: WARM vs. SCALE –which method is right for you?

Choosing a CECL method that is right for your institution depends on many factors. Between the historical data available, management objectives, and associated operational costs, it can get complicated learning about all the different options available. While different methodologies can be used for various portfolios, some methods stand out as being the simplest for **community based** institutions.

For smaller institutions, the most straightforward solutions are the Weighted Average Remaining Maturity (**WARM**) method or the newly released **SCALE** model.

CECL: WARM method

The WARM Method uses your institution's historical charge-off rates and your loan portfolio's remaining life to estimate the Allowance for Credit Losses (ACL). For amortizing assets, the remaining contractual life is adjusted by the expected scheduled payments and prepayments (i.e., pay downs). The average annual charge-off rate is applied to the amortization adjusted remaining life of the loan to determine the unadjusted lifetime historical charge-off rate.

WARM is an ideal methodology for many institutions because it leverages your historical Call Report data and portfolio characteristics to calculate the ACL under CECL.

CECL: SCALE method

SCALE is a new methodology option in the form of a spreadsheet template offered by the Federal Reserve. As of Q1 2021, **it is only based on information derived from the 87 banks** that meet the criteria of "community banks under $10 billion that have already adopted CECL". This methodology uses Call Report data to derive a proxy "CECL ACL lifetime loss rate". This proxy loss rate is then adjusted with q-factors and multiplied against loan balances, and the loss rate is a "peer-based expected loss rate."

Can only be used by institutions with total assets of less than $1 billion.

CECL: Critical consideration matters – WARM vs. SCALE

The proxy loss rate used in the SCALE model does not consider an individual institution's historical credit performance and is based on a small national average. **National proxy loss rates may not be appropriate for every bank or credit union**, which may or may not make sense for all individual banks and credit unions. The SCALE Tool is also provided 'as-is' with no support for the calculation, q-factors, or documentation and is essentially a manual spreadsheet you can use to get your in-house calculation started.

The WARM Method may be more accurate for many institutions since it uses your historical loss information instead of a **peer-based proxy rate**. The proxy rate is based on data from banks with portfolios that may be different from the typical bank or credit union and could have much higher loss rates.

CECL: Implementation Assistance – be careful not to cross a line!

Permitted Activities for Auditors:

a. Develop and provide training to attest client personnel on the effects of the standard

b. Research, provide advice, make recommendations and assist management in identifying financial statement balances, contracts, and transactions to be assessed under the standard

c. Assist the attest clients with summarizing their analysis and policies related to accounting position under the standard

d. Provide observations and recommendations on management's overall project plan timeline to adopt the standard

e. Assist management in drafting implementation strategies or methods used to implement the accounting standard

CECL: Implementation Assistance

Prohibited Activities for Auditors - independence **would be impaired** if an auditor:

a. Leads any implementation team at the attest client

b. Makes decision on how to implement the accounting standard

c. Sets any policies or procedures related to the accounting standard

d. Designs new or redesigns existing internal controls over financial reporting

e. Designs new or redesigns existing financial information systems

POLLING QUESTION - #2

To be eligible for CPE, 6 polling questions must be answered

rkl ADVISORS for WHAT'S NEXT

"Post" Pandemic Observations / Trends

- Branches Evolving Role
- Digital Banking
- "Big Bank" versus Community Institutions
- Fraud & Security
- The Economy & Fostering Small Business Recovery

Branches’ Evolving Role

- Although the pandemic temporarily shuttered branch lobbies and moved many transactions online, it didn't accelerate that decline. But as digital banking increases during COVID-19, what happens at the branch is morphing at a faster clip.
- No longer transactional hubs, branches are more often where members go for advice, sales and services. Think of branches as storefronts where members can talk about their finances and get the help they need. Credit unions are updating branches' look, feel and function to reflect those changes. Branch cultures are also shifting as front-line employees move to more advisory roles.
- Organizations will continue to look for ways to streamline operations and reduce expenses, but wholesale branch closures would be counterproductive. Instead, many credit unions are investing in brick and mortar, using branches to establish a presence in new markets with good growth opportunities. Rolling out a new, more innovative branch model one storefront at a time helps organizations stagger the costs and learn lessons as they go.

Digital Banking

- The pandemic led credit unions and their members to lean into digital banking capabilities. Now that those options are more about necessity than convenience, people of all ages are more willing to use digital alternatives for managing accounts, making payments, transferring money and other activities. For example, a May 2020 consumer survey from Fiserv found that 27 percent of those who use mobile check deposit had increased use since the pandemic began, and 66 percent expected that increase to be permanent.
- 2020 accelerated many credit unions' digital strategies, but it goes beyond prioritizing technology. It's about focusing on technology in a way that makes members' lives simpler. Is using mobile banking easy and intuitive for new users? Can a borrower start an application online and finish it in the branch? How simple is it to pay who you owe? An integrated approach simplifies financial processes and streamlines members' experiences.

"Big Banks" versus Community Institutions

- According to an November 2020 report from Raddon, a Fiserv company, 45 percent of U.S. consumer households named one of the nation's three largest banks as their primary financial institution – a percentage that has been slowly increasing since 2018. That trend won't likely reverse unless and until community banks and credit unions change their perception.
- Unfairly or not, many consumers don't believe credit unions have the same technology solutions as the largest institutions, which prioritize promotion of digital capabilities and mobile banking. Marketing credit unions' advantages, including the latest technology, will help change that perception, especially with younger consumers.

Community Institutions – Strategy vs. Execution

- In Strategy:
  - Relationship driven
  - Trusted advisor
  - Leverage strong commercial team
  - Employees focused on creating member efficiency
- In Execution:
  - Price driven
  - Reprice "promos" at lower rates
  - Incent commercial lenders on volume
  - Support functions are incented on "no audit comments"

ARE YOU LIVING YOUR STRATEGY?

Relationship driven strategy characteristics

- Align operations with member interest
- Executive salaries are relatively modest
- Top management has open door policy
- Employee compensation is relatively higher, training is longer, and retention is better
- Hiring practices focus on employees that are passionate about customer service
- Consider corporate culture a competitive advantage
- Marketing costs tend to be lower and customer satisfaction is higher

Fraud & Security:

Emphasis on Ransomware Cybersecurity

Recently, ransomware cybersecurity has been a key area of focus for regulators, and given the recent high-profile cyber events affecting the industry, their scrutiny will likely ramp up going forward. This will be reflected, in part, by the number of (and types of) assessments that they may expect financial institutions to perform on an annual basis, including the familiar Cybersecurity Assessment Tool (CAT) and newer, non-compulsory Ransomware Self-Assessment Tool (R-SAT) developed partly by the State regulatory bodies.

In addition, at the federal level, the Cybersecurity and Infrastructure Security Agency (CISA) has recently developed its Cyber Security Evaluation Tool. This tool is not specific to the financial industry but rather designed to apply to multiple industries. And the National Credit Union Association (NCUA) decided earlier this year to move away from using its version of the CAT, known as the Automated Cybersecurity Evaluation Toolbox (ACET). It's now prioritizing a modified InTREx for Credit Unions (InTREx-CU), which is designed to enable credit unions to identify and remediate potential high-risk areas, including within the cybersecurity controls domain.

Fraud & Security:

Changes with Cyber Insurance

Major shifts are also happening with cyber insurance. Because of excessive losses by the insurance industry, there will very likely be increased deductibles, increased exclusions, and decreased limits for covering cyber losses. Cyber insurance coverage -which is not an absolute requirement by regulatory agencies—is going to be more difficult and expensive to obtain.

So, the lesson is: As insurance policies come due, **don't automatically renew** before you assess what has changed in terms of the coverages, exclusions, and limitations, and make sure you've documented your cost-benefit decision.

Fraud & Security:

New Guidance on Architecture, Infrastructure, and Operations

In June, the FFIEC released a new Architecture, Infrastructure, and Operations booklet in its Information Technology Examination Handbook series. The updated guidance, which replaces the "Operations" booklet issued in July 2004, acknowledges the inextricable link between an institution's operations, architecture, and infrastructure.

The booklet recognizes different treatments for smaller or less complex institutions and adopts a different approach to data classification by factoring in value with criticality and sensitivity. All financial institutions are expected to adhere to the guidance.

In addition, there are also pending new rules for incident notifications for financial institutions, service providers, and core providers.

Examiners are also expecting more detailed board reporting, such as showing how an institution's business continuity management plan, business strategy, and risk appetite are all aligned.

Fraud Initiatives - 2019

- 67% currently use exception reporting or anomaly detection techniques
- > 50% use automated monitoring of red flags or violations of business rules
- Over the next 2 years, the use of AI and machine learning is expected to triple
- 26% currently use biometrics
- 16% expect to deploy biometrics
- 9% currently use blockchain or robotics
- 55% expect to increase their anti-fraud technology over the next 2 years

The Economy*: Diversity of Opinion

- When participants felt economic growth would return back to normal. Nearly three quarters of participants responded not until 2022 at least, and over one third responded even "beyond Q2 2022."
- When consumer spending habits would return back to normal. Answers were split nearly across the board, ranging from Q4 2021 to beyond Q2 2022.
- When borrowing habits would return back to normal. Three quarters of participants responded not until at least 2022.
- Are there areas you feel consumers will continue to spend more on than others? Home improvement and travel were popular answers.
- Will there be a run-off on deposits as consumers start to spend again/more? Some (41%) said no, while 35% said yes.
- When will credit unions need to think about attracting deposits again between now and beyond 2024? One third said 2022 and one third said 2023.

(*) Based on survey prepared by Back Office support CUSO Aux of credit unions ranging in size from $5 million to $6.7 billion

Fostering Small Business Recovery

- Small businesses are essential to our communities, yet many are struggling. From January to December 2020, the number of open small businesses decreased by 39.7 percent – a staggering, depression-like outcome for Main Street. Service-sector businesses, including restaurants and retail, were hardest hit by the pandemic, according to a report by Yelp.
- Developing commercial expertise and diversifying offerings will position community institutions as allies for hard-hit small-business owners. Credit unions can play an important role in helping Main Street rebuild and recover in 2021 and beyond.

POLLING QUESTION - #3

To be eligible for CPE, 6 polling questions must be answered.

Subordinated Debt

Recently the National Credit Union Administration's board approved a rule clearing the way for all credit unions to issue subordinated debt to investors and use the proceeds to meet regulatory capital requirements.

What's New with Subordinated Debt

- The new rules bring some additional things to consider before taking on subordinated debt, including:
  - In addition to low-income-designated credit unions previously allowed to take on subordinated debt in the form of secondary capital, complex credit unions and new credit unions are also now permitted to issue subordinated debt.
  - It can only be offered, issued and sold to "entity accredited investors" or "natural person accredited investors."
  - Upon approval to issue subordinated debt, a credit union must create an "offering document" for each issuance of subordinated debt.
  - Minimum maturity of the subordinated debt is now five years and maximum maturity of 20 years.
  - Generally, a credit union cannot be both the issuer and an investor in subordinated debt.
  - Authority to issue subordinated debt is valid for two years after either the date of NCUA's approval of the initial application or the "approved for use" date in the offering document.

Treatment of Subordinated Debt

Subordinated debt will be treated differently for credit unions based on their membership base and asset size.

- **Complex credit unions (over $500 million in assets):** Subordinated debt will be contributed to the risk-based capital ratio under the risk-based capital rule, not the statutory net-worth ratio.
- **Low-income credit unions (membership primarily meets certain low-income threshold):** Subordinate debt will contribute to their net worth, similarly to how secondary capital is currently handled.

Secondary Capital as Subordinated Debt

Although the new rule will not take effect until Jan. 1, 2022, it has brought a renewed interest in secondary capital to the forefront.

- Secondary capital is essentially an uninsured loan the issuing credit union is permitted to include as regulatory capital, which is taken in the form of subordinated debt. The secondary account holder's claim must come after any other claims from shareholders, creditors and the National Credit Union Share Insurance Fund (NCUSIF).
- However, not every credit union can obtain secondary capital. Today, only those considered a low-income designated credit union are able to obtain it with a proper plan approved by the NCUA.
- Often, low-income credit unions would leverage issuing secondary capital as a strategic growth option to restore capital to a regulatory minimum, support future asset growth, enhance earnings or gain operational efficiencies.
- During unique times, like those we are currently experiencing due to COVID-19, subordinated debt can be used to help bridge the gap as a result of increased deposits and lower capital.

Thank You for Joining Us

Whatever your next move, we're here to help.

Barry Pelagatti

bpelagatti@rklcpa.com

POLLING QUESTION - #4

To be eligible for CPE, 6 polling questions must be answered.

Break