Notes from the Ambassador Bank Vault **December 3, 2018**

Highlights from the KPMG 2018 Banking and Finance Symposium

We attended KPMG's annual banking symposium in Philadelphia last week, and left with the sense that banks remain in excellent financial condition, but there are more economic and accounting headwinds today compared with the same time, last year. As was the case with other banking events that we recently attended, there was much discussion on how banks have a rising need to use technology to attract and retain customers. Regulatory and accounting issues, particularly the implementation of CECL, will command much management attention.

- The KPMG annual seminar provided industry color from the accountant/auditor perspective. The seminar, which attracted approximately 150 attendees, was geared to accounting, technology, and economic developments, which are likely to most affect community banks.

- Financial institutions are devoting more resources to technology in order to lower operating costs and improve efficiency ratios. It was suggested that bigger banks have a greater ability to use technology compared with smaller banks, which may not have the necessary financial, managerial, or employee scale to develop meaningful technology platforms as quickly.

- Because cyber-security demands more than a defensive strategy, management time and technology costs are ongoing, rather than one-time events. Banks must contend with an increasingly complex regulatory environment, a shortage of IT talent, and possible over-reliance on third party vendors. Data breaches are likely to lead to reputational risk, regulatory fines, and additional expenses in order to fix systems.

- Several observers noted credit quality remained strong through the third quarter of 2018 and probably couldn't get much better. The same comments were made at last year's KPMG banking seminar.

- The most impactful upcoming accounting change is the implementation of the Current Expected Credit Losses (CECL) model, which will become effective in 2020 for SEC filers. All other filers have an additional year. This accounting method takes into account expected losses over the life of the loan of both non-impaired loans and investment securities and is a significant change over the incurred loss model.

- CECL will likely place more reliance on qualitative, or judgmental, factors, vs. the incurred method. The establishment of CECL should necessitate higher initial reserves vs. the incurred method, but it appears that SEC policies do not encourage banks to lift reserves today.

- The initial adjustment to loan loss reserves will be made through stockholder's equity on the balance sheet, and not via the loan loss provision. All other things being equal, this will improve returns on equity, which we doubt was the intent of FASB.

- A preliminary estimate is that loan loss reserves levels could be 20-30% higher under CECL vs. the current, or incurred loss, method. Although the accounting method will change, the economic impact (cash flows) will be the same.

- A key regulatory focus for 2019 is the development of the CECL model and the preparation for SEC disclosures. We expect that most of companies will be disclosing qualitative information, rather than quantitative data, until CECL models are more fully tested.

- The adoption of CECL will impact loans and investment securities accounted as Held To Maturity (HTM). Securities portfolios will be modeled on a collective basis; and not as individual securities.

Please feel free to contact Rick Weiss at 610.351.1633 or rweiss@ambfg.com with questions or comments.

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