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2021 Accounting & Business Update

October 27, 2021

Fintech Panel Discussion

Patrick Morin, Julieann Thurlow, Lisa Gold Schier

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RESOURCES

ABA

- aba.com

ABA Endorsements & Strategic Partnerships

- aba.com/endorsed

ABA Core Platforms Committee

- aba.com/core

Alloy Labs Alliance, an ABA Strategic Partnership

- ***ABA members receive pricing benefits – mention ABA member***
- www.aba.com/banking-topics/technology/alloy-labs-alliance
- www.alloylabs.com

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Swaps for Community FIs: Weighing the "Whys" and the "Why Nots"

Hot Topics for the Banking & Financial Services Industry

Chatham FINANCIAL

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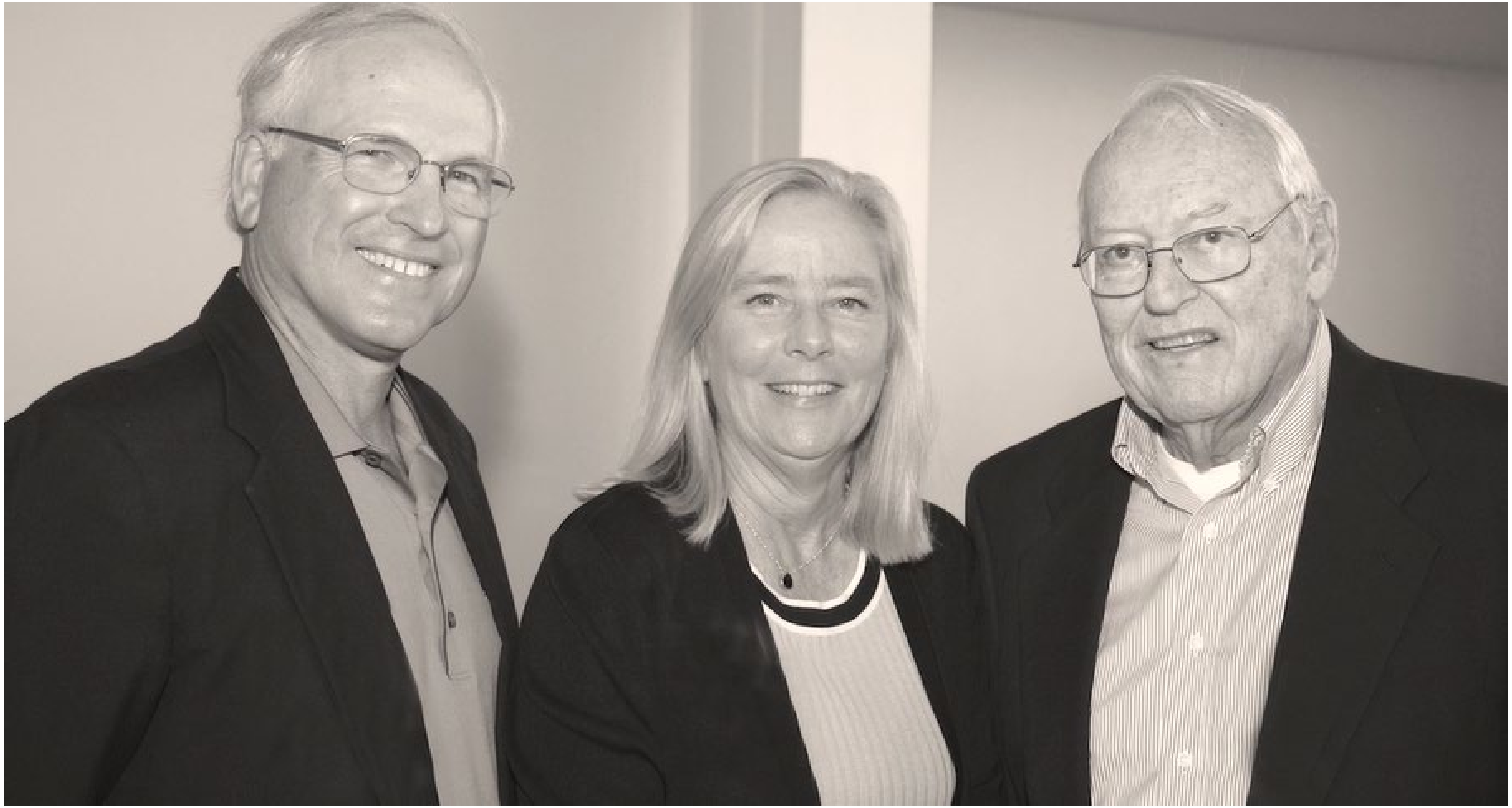
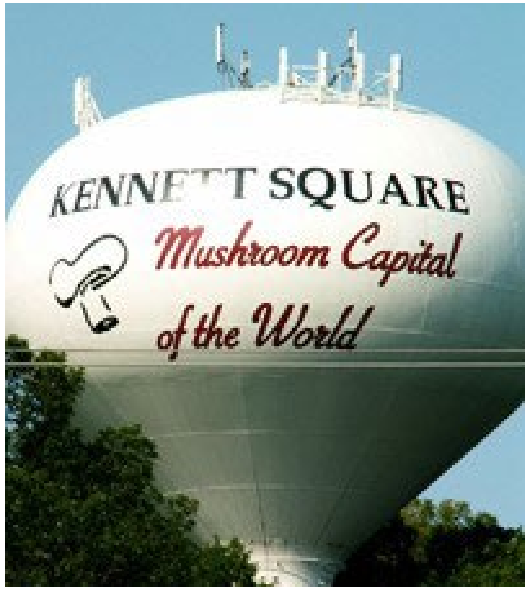
Disclaimer: No relation to Tom



Chatham?

Massachusetts

Pennsylvania



Agenda / Learning Objectives

1. History of the interest rate swap market and basic mechanics
2. Fear vs. Facts: The most common reasons that swaps are avoided
3. Three widely-used applications for swaps
4. Four pillars that comprise the foundation to swaps in the toolkit

1. History of the Swap Market

Interest Rate Swaps: The 1980's

Fed Funds Target Rate

Interest Rate Swaps: The 1980's – End of an era / Start of an era

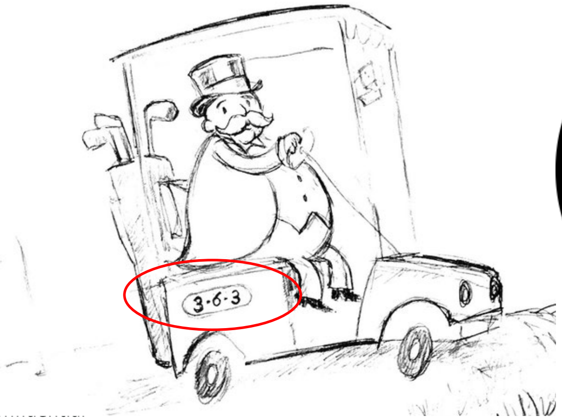
6.00% Loans

6.00% Income

<u>-3.00% Expense</u>

=3.00% Profit

3:00 Tee Time!



3.00% Deposits

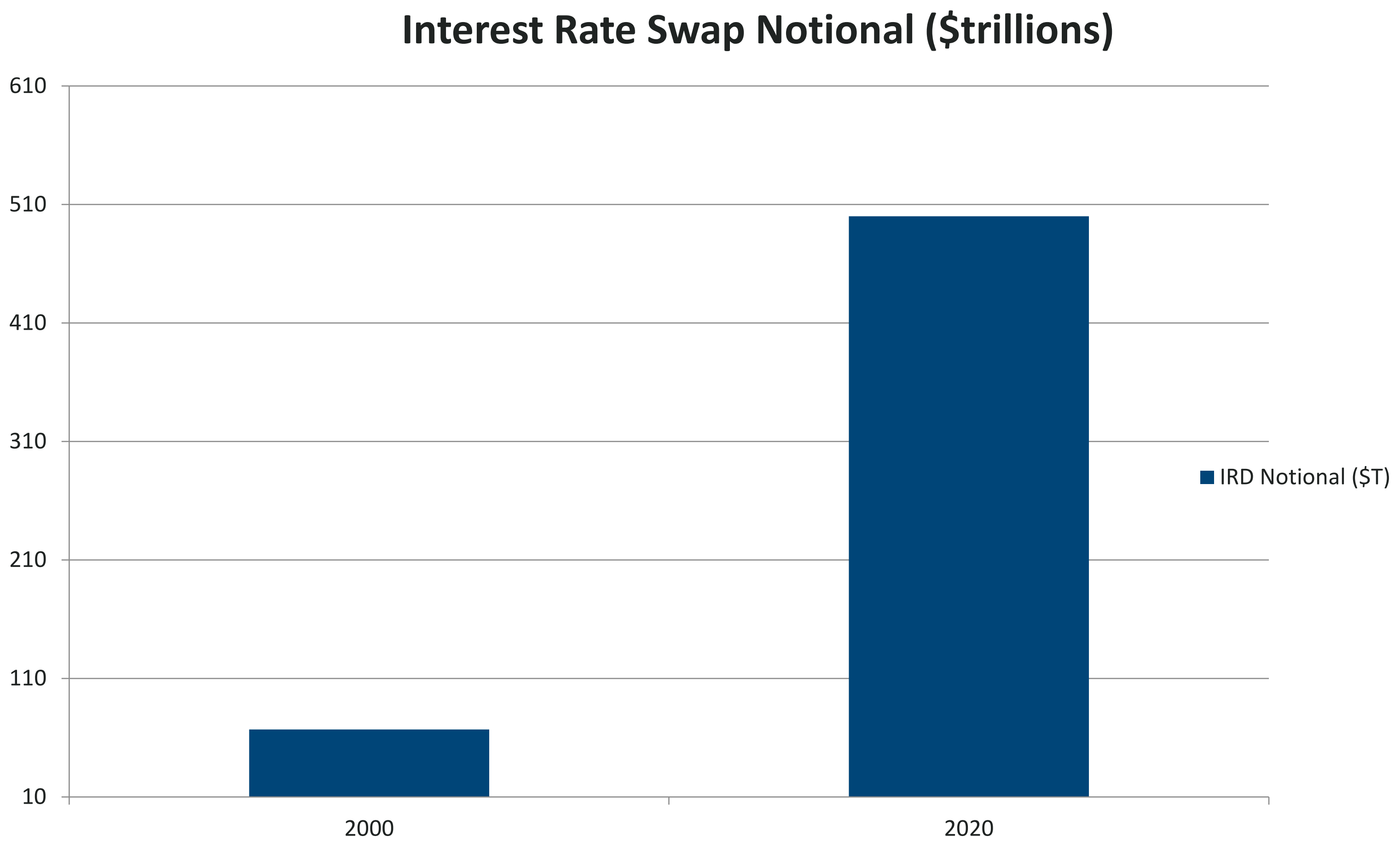
Interest Rate Swaps: The 1990's

Interest Rate Swaps: The 2000's

- FAS 133 puts swaps onto the balance sheet

Interest Rate Swaps: The 2010's

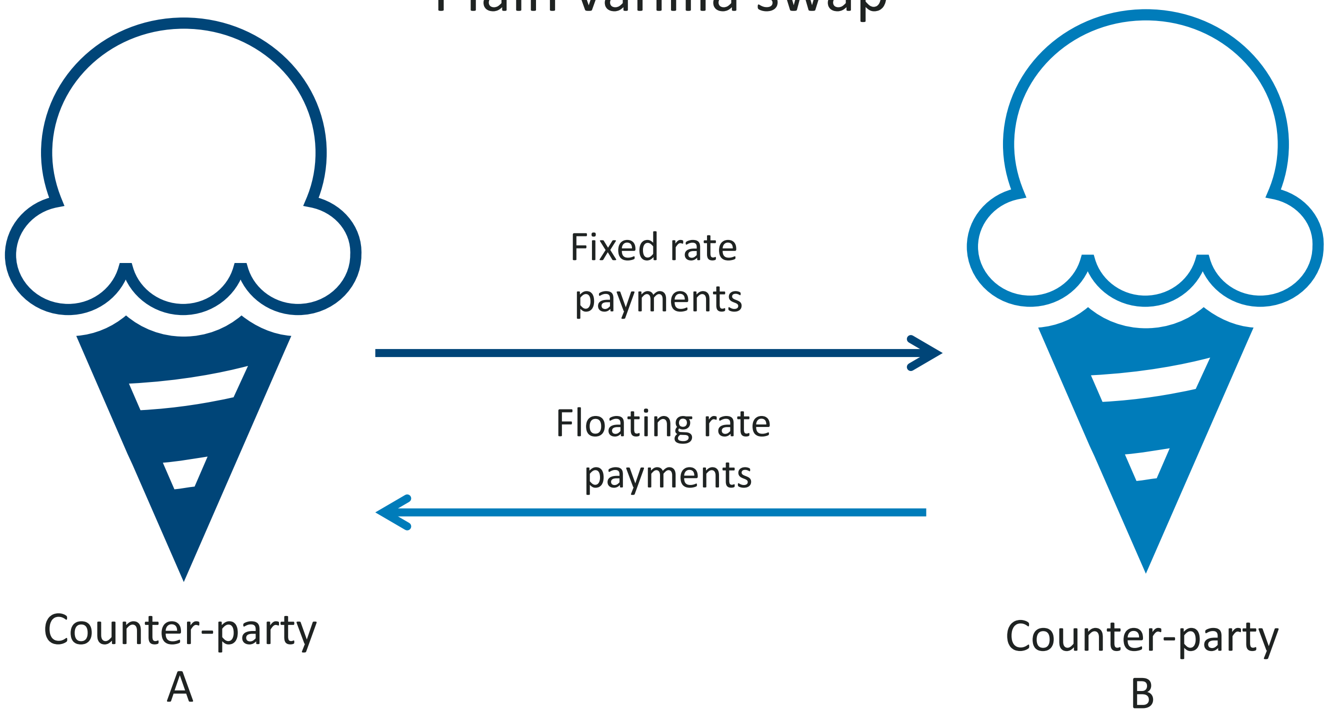
Interest Rate Swaps: Growth since 2000



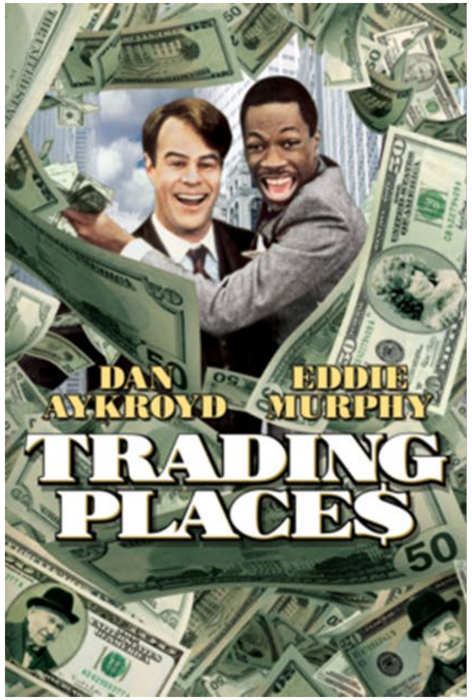
Why ?

Interest Rate Swaps: Basic mechanics

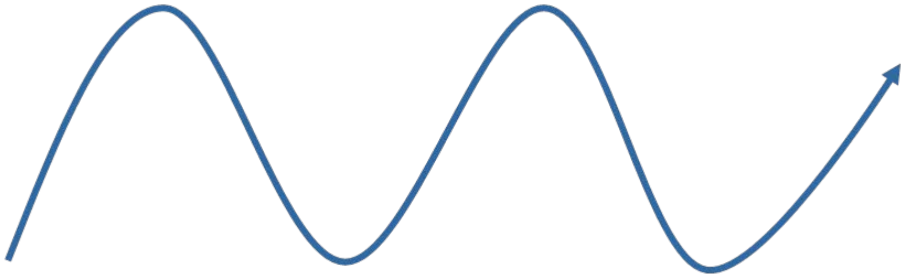
Plain vanilla swap



Take control of one of your biggest risks

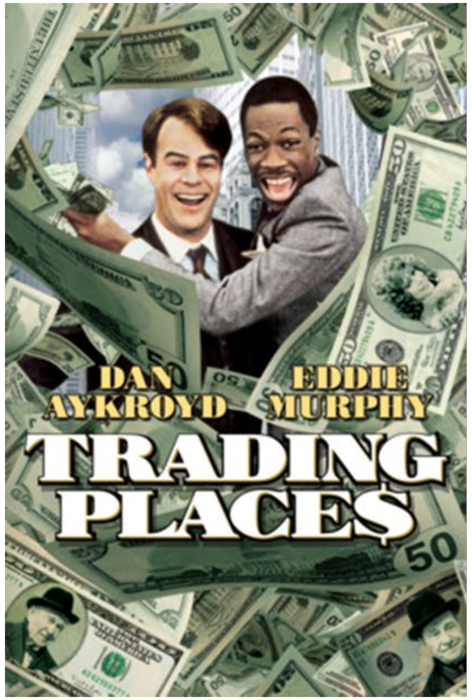


Deposits



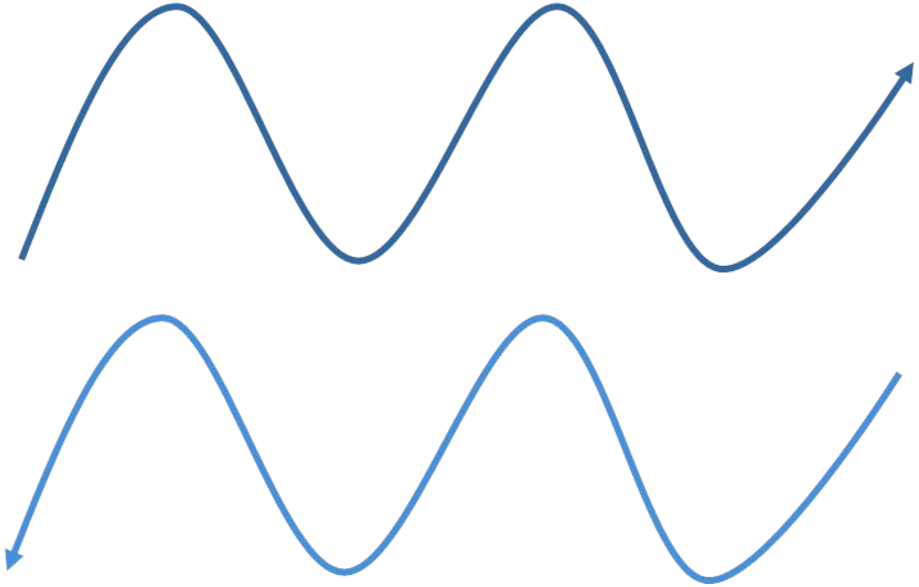
Loans

Take control of one of your biggest risks



Deposits

Loans



2. Fear vs. Facts: Why avoid swaps?

Let’s Play The Feud!

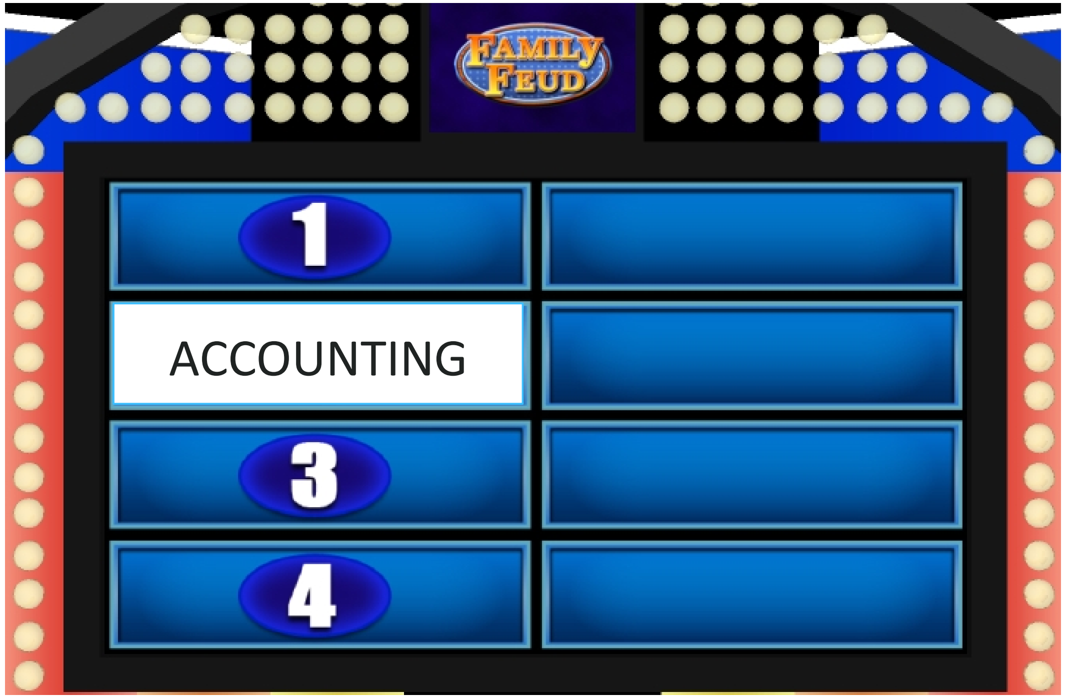
Name the top reason why community banks typically avoid derivatives.

TOO RISKY!

Name a reason why community FIs typically avoid derivatives…

ACCOUNTING!

Name a reason why community FIs typically avoid derivatives…

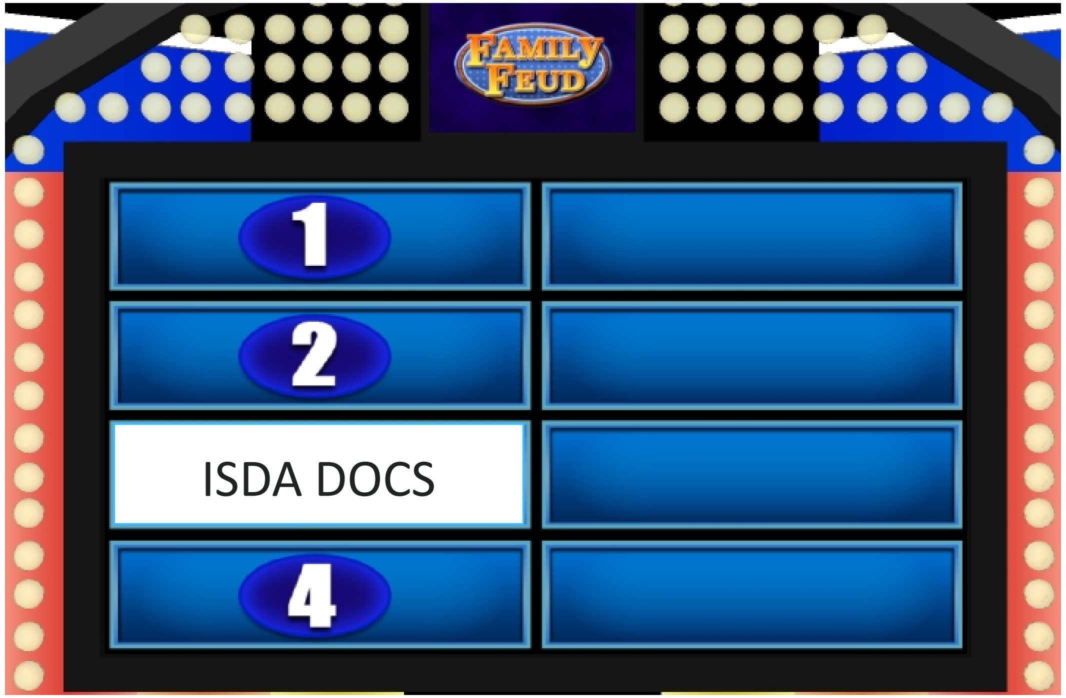


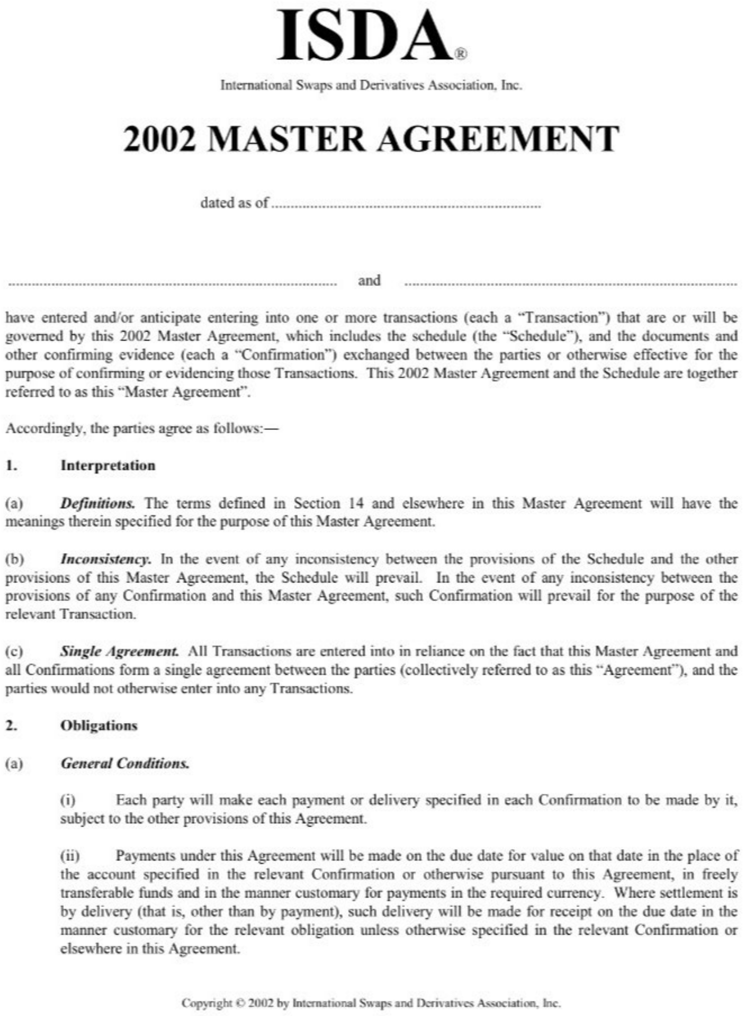
FASB

ASC 815
ASU 2017-12

ISDA DOCUMENTS TOO CUMBERSOME!

Name a reason why community FIs typically avoid derivatives…





ISDA®

International Swaps and Derivatives Association, Inc.

2002 MASTER AGREEMENT

dated as of ....

.... and ....

have entered and/or anticipate entering into one or more transactions (each a "Transaction") that are or will be governed by this 2002 Master Agreement, which includes the schedule (the "Schedule"), and the documents and other confirming evidence (each a "Confirmation") exchanged between the parties or otherwise effective for the purpose of confirming or evidencing those Transactions. This 2002 Master Agreement and the Schedule are together referred to as this "Master Agreement".

Accordingly, the parties agree as follows:—

1. Interpretation

(a) ***Definitions.*** The terms defined in Section 14 and elsewhere in this Master Agreement will have the meanings therein specified for the purpose of this Master Agreement.

(b) ***Inconsistency.*** In the event of any inconsistency between the provisions of the Schedule and the other provisions of this Master Agreement, the Schedule will prevail. In the event of any inconsistency between the provisions of any Confirmation and this Master Agreement, such Confirmation will prevail for the purpose of the relevant Transaction.

(c) ***Single Agreement.*** All Transactions are entered into in reliance on the fact that this Master Agreement and all Confirmations form a single agreement between the parties (collectively referred to as this "Agreement"), and the parties would not otherwise enter into any Transactions.

2. Obligations

(a) ***General Conditions.***

(i) Each party will make each payment or delivery specified in each Confirmation to be made by it, subject to the other provisions of this Agreement.

(ii) Payments under this Agreement will be made on the due date for value on that date in the place of the account specified in the relevant Confirmation or otherwise pursuant to this Agreement, in freely transferable funds and in the manner customary for payments in the required currency. Where settlement is by delivery (that is, other than by payment), such delivery will be made for receipt on the due date in the manner customary for the relevant obligation unless otherwise specified in the relevant Confirmation or elsewhere in this Agreement.

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NOT WORTH THE TIME AND EFFORT!

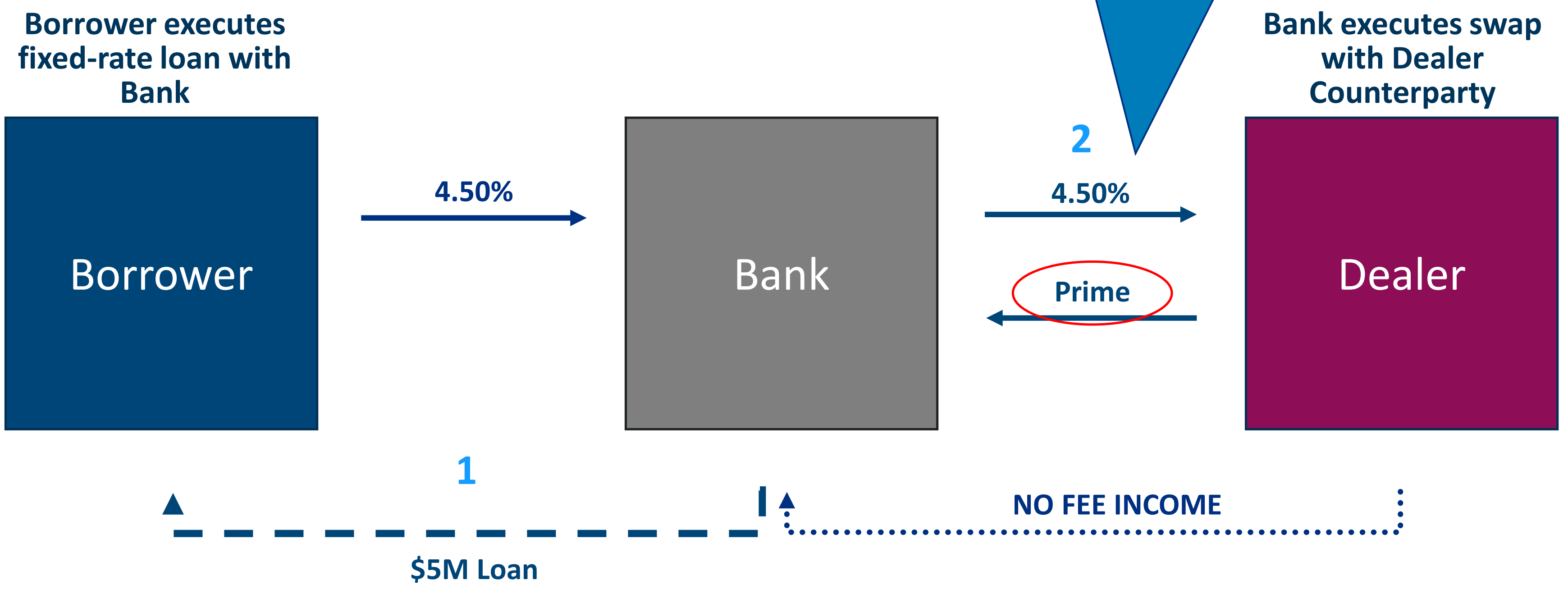
Name a reason why community FIs typically avoid derivatives…

3. Three widely-used applications for swaps

1.(a) Hedged Fixed-Rate Loan- Mechanics

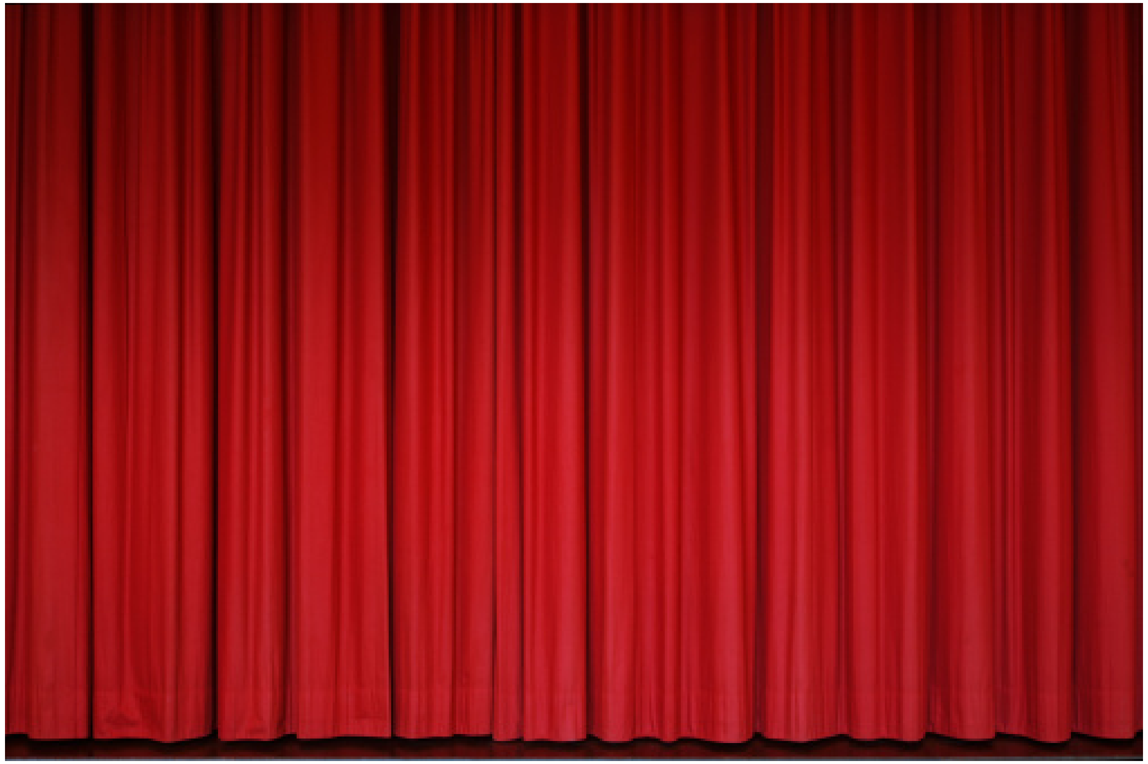
Loan
- $5 million loan
- 4.50% Fixed
- 10yr term / 25yr amort

Loan Fixed Rate = 4.50%
Subtract "Wholesale" Swap Rate = 4.50%
Swap Back to Prime Flat



Rate indications provided as of October 8, 2021 and inclusive of fees and market costs

1.(a) Hedged Fixed-Rate Loan- Mechanics



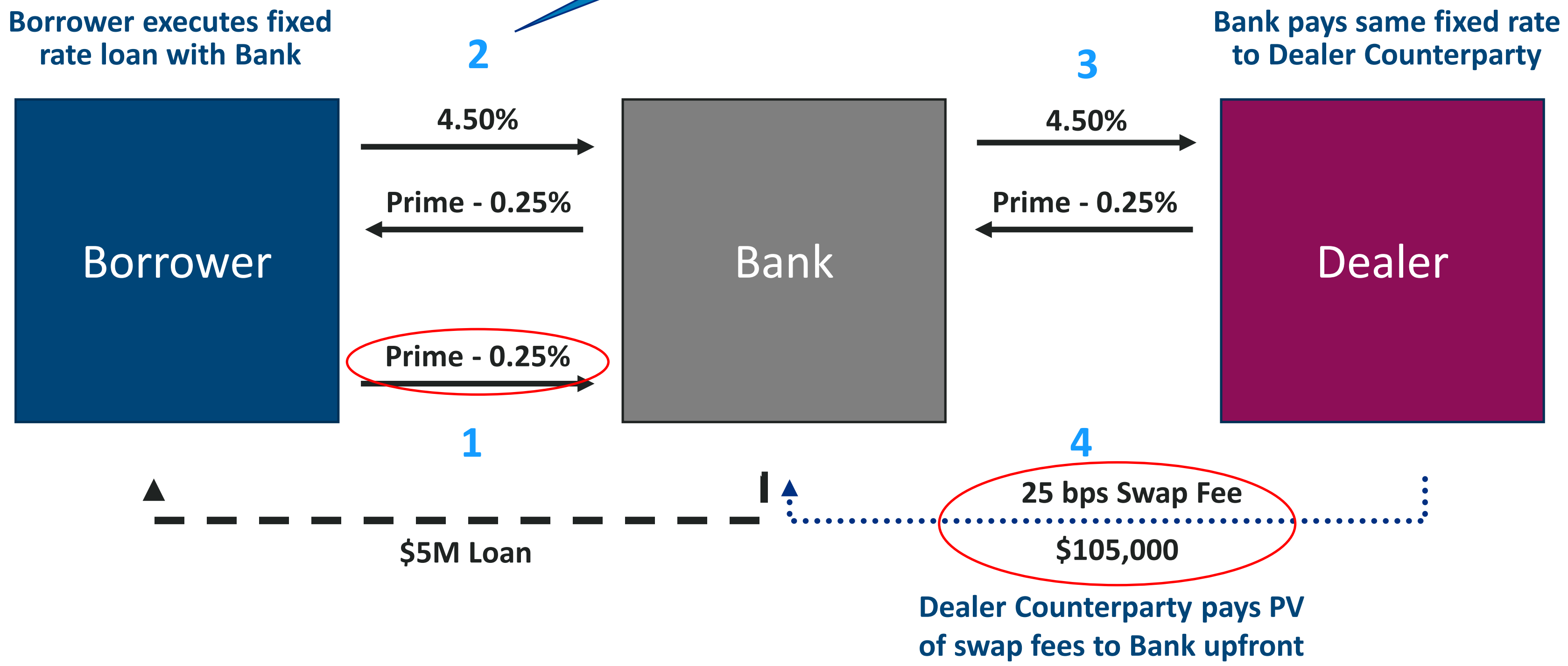
Hedged Fixed-Rate Loan:

- No swap for the borrower
- Bank executes swap to create "synthetic" floating rate loan (or portfolio)
- Swap qualifies for hedge accounting
- Prepayment language is key
- No fee income recognized

1.(b) Back-to-Back Swap - Mechanics

Loan
- $5 million loan
- 1mo Prime - 0.25%
- 10yr term / 25yr amort
- PV01 = $4,200

"Wholesale" Swap Rate = 4.50%
Credit Spread = (0.25%)
Swap Fee = 0.25%
"Retail" Swap Rate = 4.50%



Rate indications provided as of October 8, 2021 and inclusive of fees and market costs

1.(b) Back-to-Back Swap - Mechanics

Back-to-Back Swap:

- Borrower relationship is 100% local #communitybanking
- Bank retains 100% control of credit decision and loan collateral (no subordination)
- Swap and loan payments sync up on same day
- ISDA documents protect both parties (fears overblown)
- Great fee income source

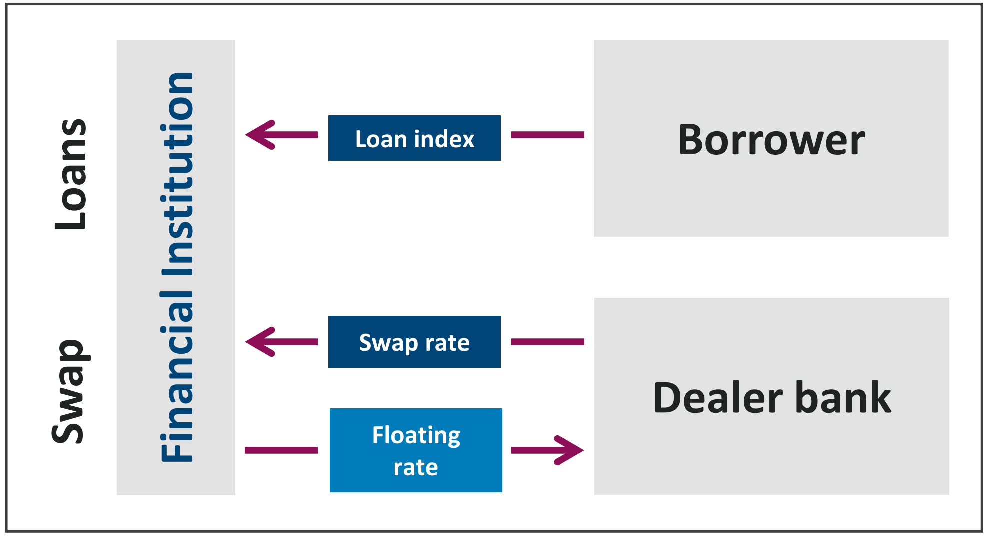
2. Receive Fixed Swap – Yield Enhancement Strategy

Monetize the Shape of the Curve and Reduce Asset Sensitivity

Strategy

- Concerned with rates staying low, or the forward curve drifting lower
- Reduce asset sensitivity to increase margin today
- Cash flow hedge strategy

Receive Fixed Swap on Floating Rate Loans



Positive carry in basis points

Tenor	1M LIBOR	Fed Funds	PRIME
3 Year	38	31	28
5 Year	70	63	60
7 Year	93	85	82
10 Year	114	106	102

Example: LIBOR Loan @ + 150. Current LIBOR setting = 0.08%

Loan Yield at LIBOR + 150 = 0.08% + 1.50% = **1.58%**

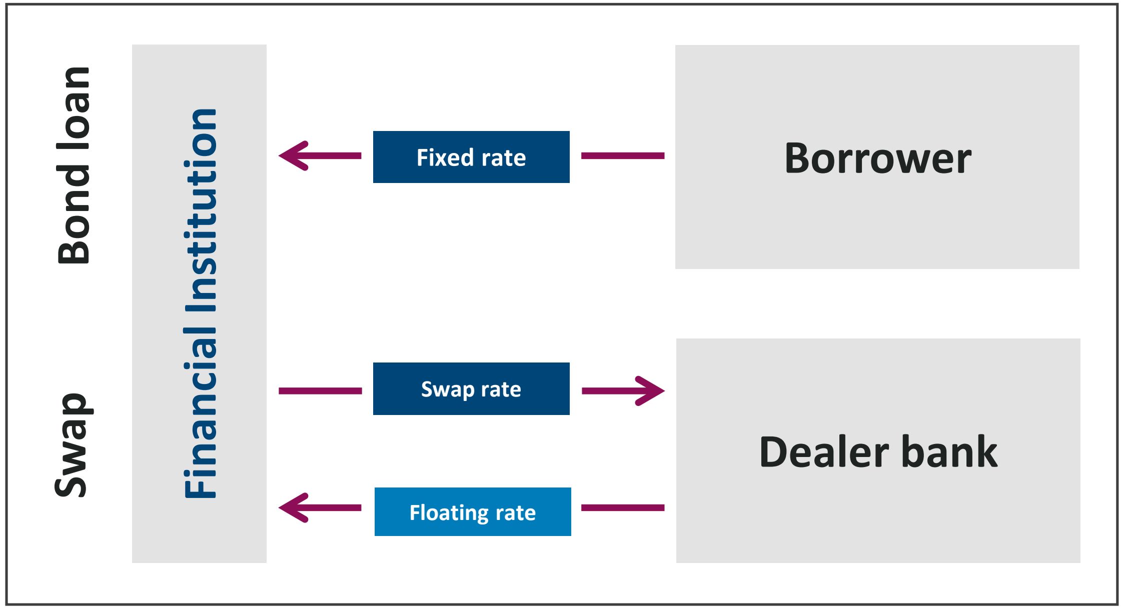
Loan Yield with 5 Year Swap = 0.08% +1.50% + 0.70% = **2.28%**

70 Bps Increase

3. Swaps on fixed-rate assets (Loans / Bonds)

Strategy

- Manage the balance between current income and future price sensitivity
- Fair value hedge strategy
- Helps offset the impact of AFS portfolio rising rate risk on TBV

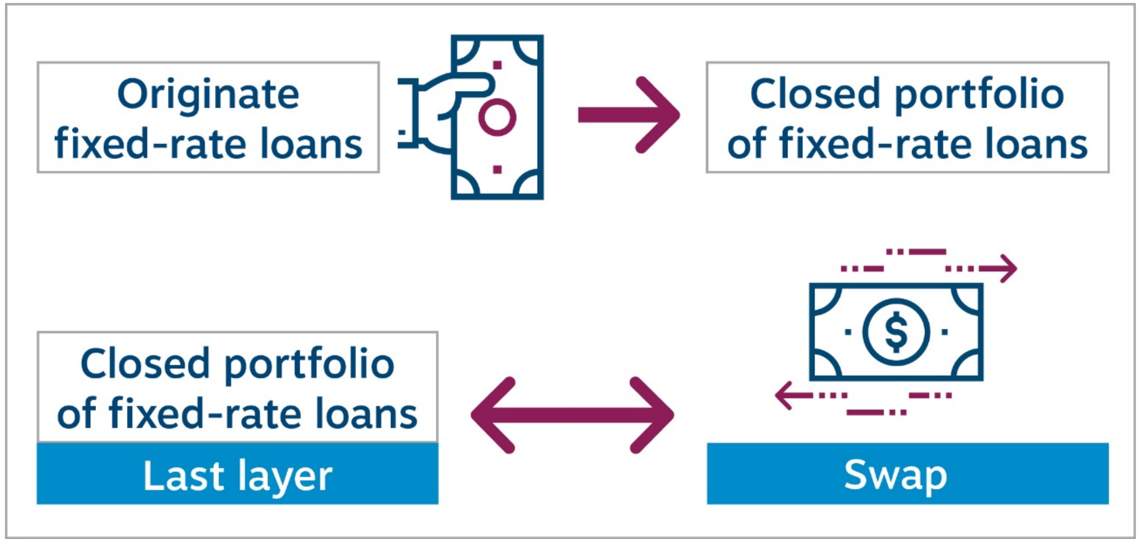


Considerations

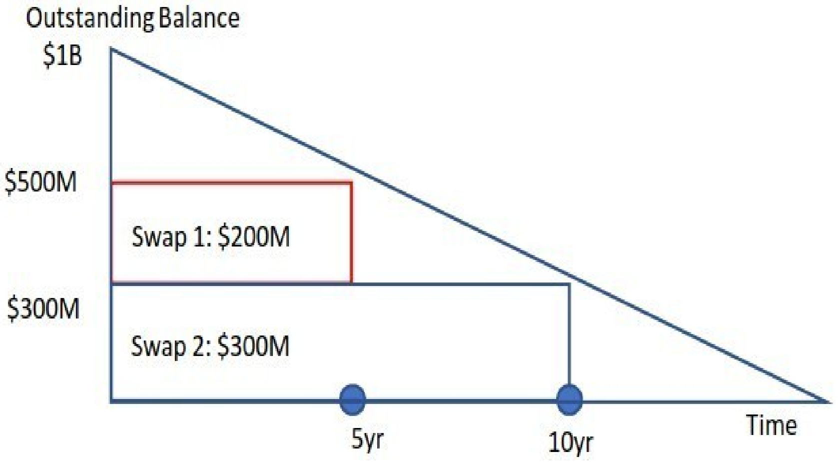
- Assets with stable and predictable cash flows are the easiest to work with
  - Agency CMBS
  - Long duration municipals with long call lock out or bullet maturities
  - Treasuries
  - Residential Mortgages (Bonds or Loans)
- Managing a portfolio vs managing the exposure of single purchases (flexibility vs efficiency)
- Assets can still be pledged as collateral for liquidity purposes
- Using a forward starting swap increases current portfolio income while managing future price sensitivity.

Last-of-Layer Designation

1. Create a pool of hedgeable fixed-rate assets
    a) Assets do not need to have the same coupon
    b) Must be prepayable in the term hedged
    c) Contractual maturity must be on or after the hedge maturity date
2. Determine size and duration of risk exposure and compare to average retention period of assets
3. Designate the last layer of a closed portfolio of fixed-rate assets (i.e., $800 million portion that is not expected to prepay of a $1 billion portfolio)
4. Execute a bullet plain-vanilla swap with the same notional as the last layer and a duration that address the risk exposure
5. Any prepayments that occur are assumed to apply first to the undesignated portion of the closed portfolio. *Calculations of the changes in the fair value of the hedged item ignore prepayment risk for the purposes of applying hedge accounting*
6. Stop hedge accounting once prepayments exceed undesignated portion of the closed pool and encroach into the designated last layer amount
7. Consider redesignation of the swap to a new portfolio



Portfolio Layer Method



Example Application of Proposed Guidance

- All assets must have contractual maturity greater than 5 years and be prepayable by year 10.
- If there is a shortfall, the 5 year swap would lose hedge accounting first.

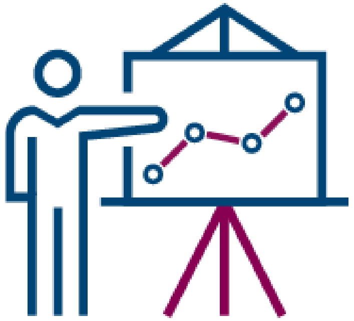
Summary of Proposed Guidance

- Portfolio Construction
  - All assets in the closed portfolio should have a contractual maturity date on or after the end of the earliest-ending hedge period of hedges associated with the closed portfolio.
  - All assets in the closed portfolio should be or should become prepayable by the end of the latest-ending hedge period of hedges associated with the closed portfolio.
- Overhedging Impact
  - If the aggregate amount of the hedged layers currently exceeds the amount of the closed portfolio (that is, a breach has occurred), an entity would be required to sequence the order that hedging relationships would be discontinued based on the hedging relationship with the shortest remaining period until the hedged item's assumed maturity date.
  - If there are multiple hedged layers with the same assumed maturity date, an entity would be required to discontinue hedging relationships using a "last-in, first-out" approach.
- Modified retrospective approach to reporting basis adjustments.
- One-time reclassification of securities from HTM to AFS, if eligible for the portfolio layer method.

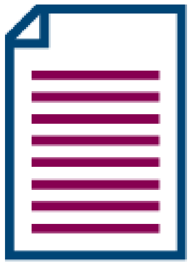
4. Where to start?

Swaps in the Toolkit:

Four pillars to establish the foundation

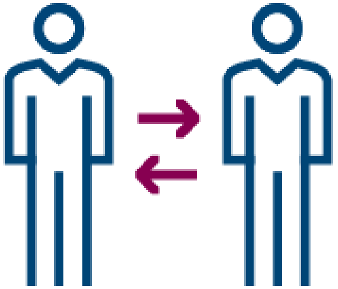


Education



Policy

Regulatory



Counterparty

Questions?

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2021 Accounting & Business Update

October 27, 2021

2021 Banking Tax Update

Tabitha Lamontagne

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Here with you today.

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Tabitha specializes in corporate and multi-state taxation of businesses, with a particular focus on financial institutions. She has experience with financial products taxation, mergers and acquisitions, multi-state taxation, and stock compensation, as well as shareholder tax compliance and consulting and ASC 740.

Tabitha Lamontagne

Tax Principal

tlamontagne@bnncpa.com

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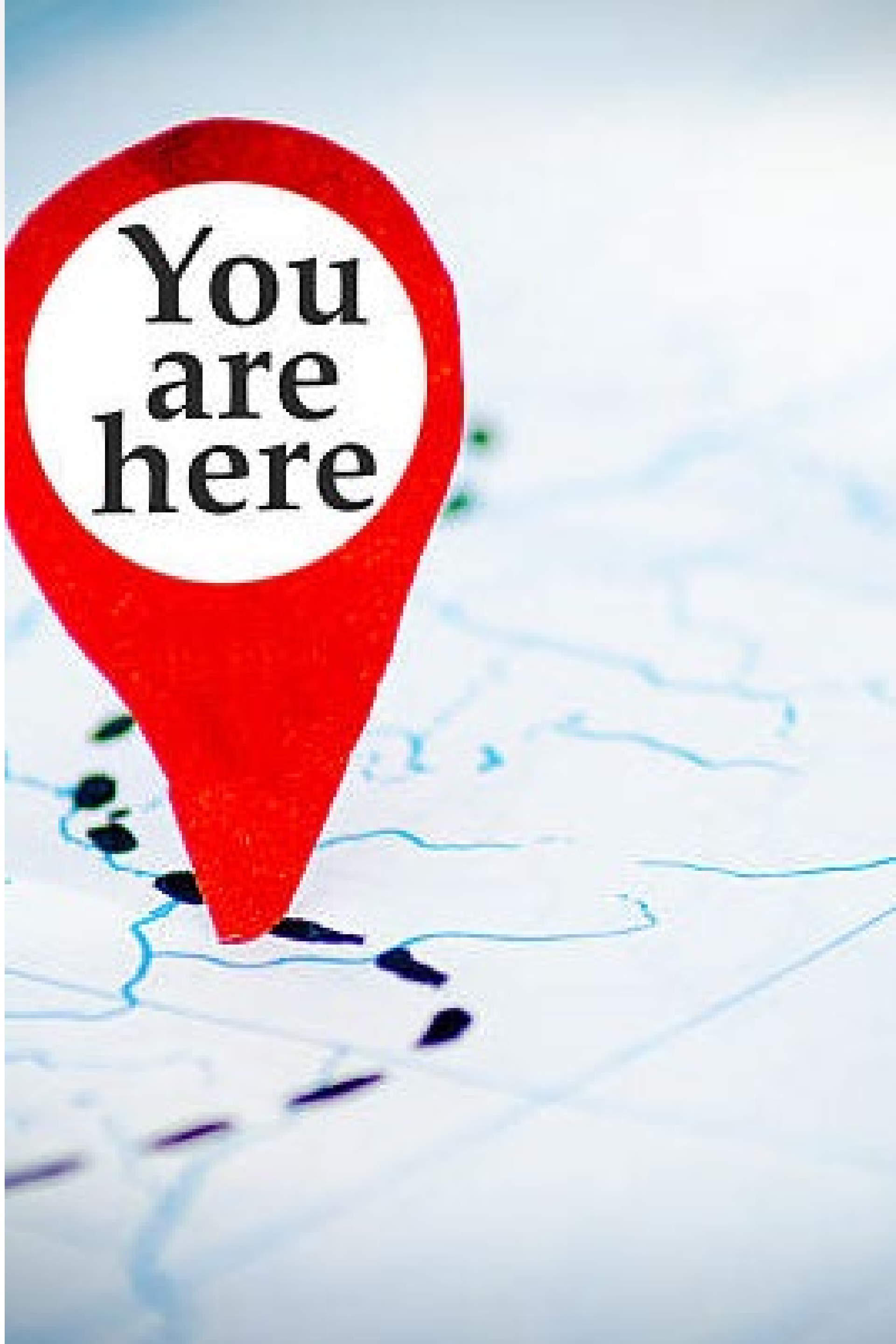
Where we are.



Coronavirus Relief Bill

BAKER NEWMAN NOYES

- Business meals from qualified restaurants 100% deductible for expenses incurred 1/1/2021 through 12/31/2022
- Charitable contribution limitation increased 25% of the corporation's taxable income through 2021
- Paid Sick and Family Leave Credits
  - Extended for payments made from December 31, 2020 through March 31, 2021. (Extended through Sept. 30, 2021)

Coronavirus Relief Bill (cont.)

- Extenders-provisions extended:
  - Solar energy credit
  - New Markets Tax Credit - 2025
  - Work Opportunity Credit - 2025
  - Employer Credit for Paid Family and Medical Leave - 2025
  - Exclusion from income of employer payment of student loans - 2025
    - An employer is allowed to pay and deduct up to $5,250 per year in educational assistance programs for an employee without that amount being included in the income of the employee.
    - Principal and interest payments made on qualified education loans to be included in the definition of qualified programs.
    - The payments must be made in 2020 after March 27 and can be made to either the employee or the lender.

Employee Retention Credit

- For essential businesses credit eligibility is very facts and circumstances driven
- Eligibility Requirements:
  - 1) Experience a significant decline in gross receipts during the calendar quarter
  - 2) Operations are fully or partially suspended due to orders from an appropriate government authority limiting commerce, travel, or group meetings due to COVID-19
- Available regardless of size (size does determine calculations – 100 employees for 2020 and 500 for 2021 is the key)

Employee Retention Credit (cont.)

BAKER NEWMAN NOYES

- For banks most were essential businesses and remained opened in some capacity and did not suffer a significant decline in receipts. To be partially suspended:
  - An appropriate governmental authority imposes restrictions on the operations
  - The order limits commerce, travel, or group meetings due to Covid-19 AND
  - The order affects an employer’s operations of its typical operations
- Ways to meet partial suspension:
  - Government limits hours
  - Suppliers are unable to make deliveries of critical goods due to governmental orders
  - The order requires an employer to remain open for some purposes but not others

Employee Retention Credit (cont.)

BAKER NEWMAN NOYES

- Examples where partial suspension will not have occurred without other facts:
  - Shutting down voluntarily to protect employees
  - Loss of customers (though may have a significant decline in receipts)
  - Workplace is closed due to governmental order but employer is able to continue operations comparable to operations prior by requiring employees to telework
- For a partial shutdown to occur more than a **nominal** portion of the business must have been suspended by a governmental order.

Employee Retention Credit (cont.)

BAKER NEWMAN NOYES

Q&A #11 in Notice 2021-20 addresses the issue of nominal for essential businesses and defines nominal as:

Solely for purposes of this employee retention credit, a portion of an employer's business operations will be deemed to constitute more than a nominal portion of its business operations if either (i) the gross receipts from that portion of the business operations is not less than 10 percent of the total gross receipts (both determined using the gross receipts of the same calendar quarter in 2019), or (ii) the hours of service performed by employees in that portion of the business is not less than 10 percent of the total number of hours of service performed by all employees in the employer's business (both determined using the number of hours of service performed by employees in the same calendar quarter in 2019).

Employee Retention Credit (cont.)

BAKER NEWMAN NOYES

- Banks must carefully look to their own facts and circumstances and determine whether or not more than a nominal portion of operations were shutdown due to a governmental order.
- BNN article resource: https://www.bnncpa.com/resources/new-employee-retention-credit-guidance-in-irs-notice-2021-49/

Please reach out with specific questions pertaining to calculation of the credit as these slides focus on eligibility.

State & Local Tax (SALT)

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- Nexus can be created through lending and other activities
  - Economic nexus vs. Physical nexus
  - Physical location of employee (including remote employees)
  - Location of collateral often can trigger a filing requirement
  - Wayfair may prompt more states to consider economic nexus provisions
  - Some states have bright-line nexus triggers for banks:
    - NY: $1,000,000 in receipts
    - CT: $500,000 in receipts
    - MA: 100 or more customers, $10,000,000 in MA assets, $500,000 receipts
    - NC: $5,000,000 or more in loans

State & Local Tax (SALT) (cont.)

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- Market-based vs Cost of Performance
- Apportionment Formulas
  - State receipts/Everywhere receipts
  - State payroll/Everywhere payroll
  - State property/Everywhere property
- Franchise/Income

State Tax Considerations

- Employees working from home
  - Do they work in a state the bank currently does not have nexus in?
  - Is the work from home situation temporary due to COVID-19 or expected to last?
  - Payroll tax consideration for remote employees.
  - Rules vary state by state for remote working and some states have short-term COVID-19 exceptions.
- State Tax Credits
  - NH – CDFA
  - MA - CITCC

Tax Credit Considerations

- **Research and Development Credit:**
  - Can apply to banks often via software development or process development

BNN article resource:

https://www.bnncpa.com/resources/the-research-and-development-credit-applies-to-banking

Tax Credit Considerations (cont.)

BAKER NEWMAN NOYES

The IRS has prescribed a four part test that can help determine whether a business is engaging in qualified research activities. And while one of those tests requires the involvement of hard sciences, those sciences extend beyond those typically performed in a lab to engineering and computer science as well. The other three tests indicate that there needs to be:

1. An intent to develop or improve a business component – a business component would include a product, process, formula, or software and improvement would be demonstrated by increased performance, reliability, or quality though there is no requirement that the endeavor be a success
2. An attempt to eliminate uncertainty – there must be an attempt to eliminate uncertainty around the development or improvement of a product or process
3. A process of experimentation – the company must demonstrate that they have evaluated alternatives through trial and error, modeling, or some other means of experimenting

Tax Credit Considerations (cont.)

Low Income Housing Credits

New Markets Credit

Work Opportunity Credit*

Historic Tax Credit

Solar Credits

Alternative Fuel Vehicle Refueling Property Credit

* https://www.dol.gov/sites/dolgov/files/ETA/wotc/pdfs/WOTC_Fact_Sheet.pdf

PPP Fees

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- Two potential tax treatments:
  - As a FAS91 Fee
    - Treated same as other FAS91 Fees
  - As a Service Fee
    - Treated as income in year received

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Where are we heading?

Potential Tax Changes

Currently	Biden's Plan	Ways & Means Bill
Flat 21%	Flat 28%	Graduated: **0 - 400k = 18%** **400k-5 million = 21%** **Over 5 million = 26.5%** **Lower rates would phase out for taxable income over $10,000,000**

Other Changes in Ways & Means Bill

- Changes to historic tax credit
  - Change rate to 20% for tax years beginning before 2020, 30% for 2020-2025, 26% for 2026, 23% for 2027, and 20% thereafter
  - Certain smaller projects will have 30% rate for QREs capped at $2,500,000. Smaller project is one where QREs do not exceed $3,750,000 and there was no prior credit for two years preceding the first year expenditures are incurred. This is an election between small project credit and regular HTC.
  - Remove basis reduction requirement

Other Changes in Ways & Means Bill (cont.)

- R&D expenses as currently constituted can be capitalized or expensed as incurred. Under current law starting in 2022 they must be capitalized. The bill would extend expensing option through 2025.
- Section 265
    - A small issuer would be considered at $30,000,000 (indexed for inflation) instead of the current $10,000,000

Other Changes in Ways & Means Bill (cont.)

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- Permanent extension of new markets credit
- Changes to dividends received deduction
  - Current 50% rate would become 60%
  - Current 65% rate would become 72.5%
- Changes to 162(m) accelerated such that it would include top 5 earners in addition to CFO and CEO (currently includes top 3)

Planning for a Rate Change

- Tax rates going up would be the reverse of what occurred after the rate went down at the end of 2017:
  - Would try to accelerate income and defer deductions
  - Would change pricing and value of BOLI, municipal investments, and other tax exempt vehicles
  - Banks with DTAs would record tax benefits due to the deferred tax asset revaluation
    - Revaluation will occur for quarter in which a bill is signed
  - Temporary difference could provide permanent savings with careful planning

Planning for a Rate Change (cont.)

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- Items to consider with a rate change:
  - PPP Fee income (acceleration of income for tax purposes)
  - Depreciation (opting out of bonus and Section 179)
  - Deferring fixed asset additions until a future year
  - Accelerate timing of upcoming revenue contracts (i.e. credit card company contracts)
  - Postponing the tax year to apply pension contributions and/or when contribution is made (electing to not deduct based on the extended due date/applying to the year payment made)
  - Not meeting accrued bonus deductibility (fixed, determined, board approved at year end) so deduction is recognized in the year paid (assuming year end straddles old to new tax rate)

Planning for a Rate Change (cont.)

BAKER NEWMAN NOYES

- Items to consider with a rate change:
  - If prepaid election in place avoiding large prepaid insurance or other qualifying prepaid expenditures until following year
  - Paying out accrued bonuses and vacation more than 2.5 months after year-end
  - Sale of securities with an unrealized gain (and not selling securities with a loss)
  - Charitable contributions payout timing
  - Consideration of investments in municipal market, BOLI market, and tax credit markets

Other Discussion Item

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- Reporting to the IRS in American Families Plan
  - Potential for additional IRS reporting requirements on customer accounts
  - Banks would need to track and submit to the IRS information on aggregate inflows and outflows of every account above $600 ($10,000) during the year
  - The American Bankers Association has spoken out against this proposed requirement
  - Could be effective for 2023

Questions?

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Get in touch!

Our banking team thrives on solving complex business challenges and delivering results with accuracy, integrity, and confidence.

Tabitha Lamontagne

Tax Principal

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Thank You!