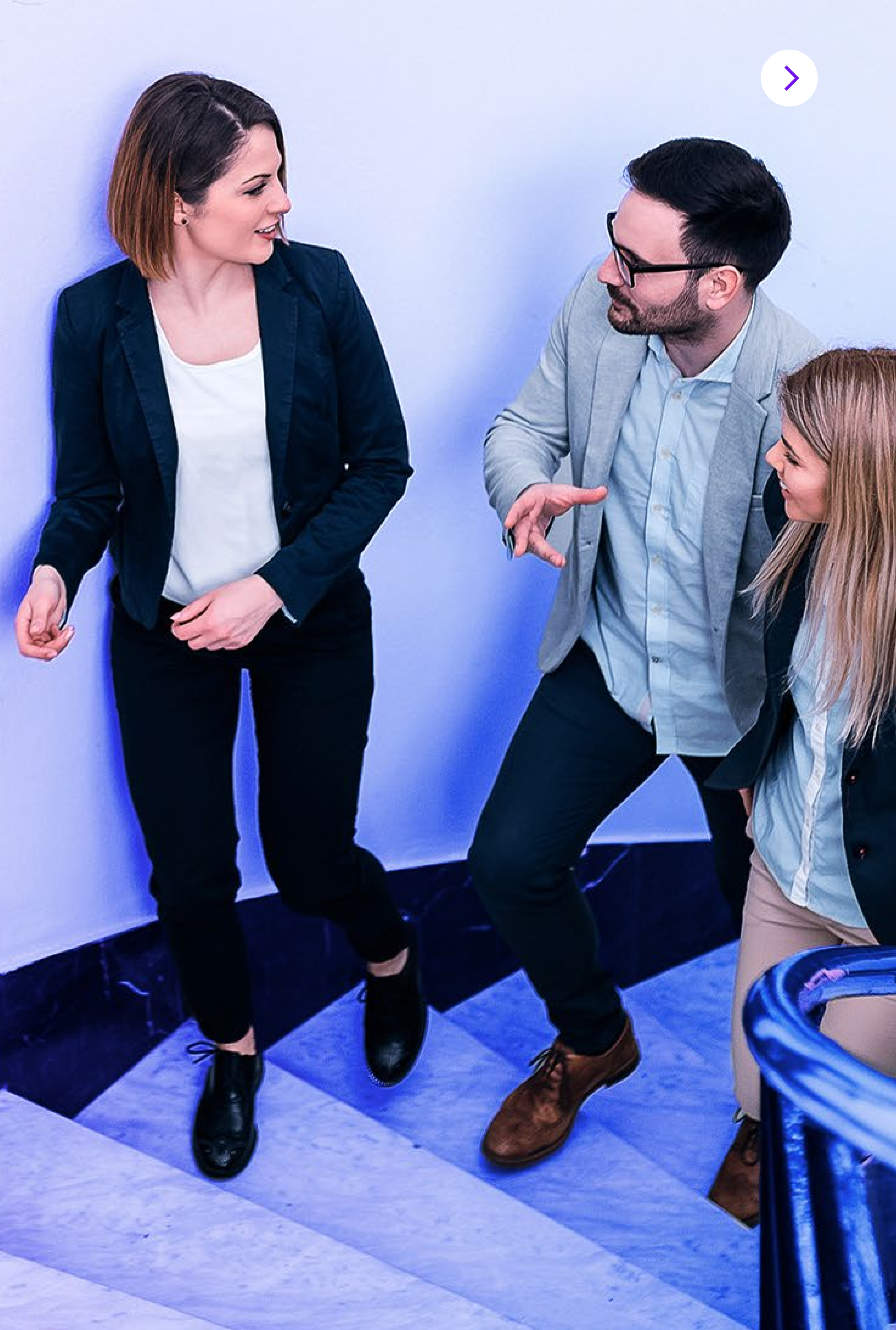
Addressing top-of-mind banking and capital markets issues

Q4 2023



Content

Insights

Stay informed and prepared for the changes ahead with Regulatory Insights, offering a unique view on the 10 key regulatory challenges that will shape the landscape in 2024.

Ten Key Regulatory Challenges of 2024

The conference highlights from the AICPA & CIMA Conference on Current SEC and PCAOB Developments.

AICPA CIMA Conference Highlights

A source for unbiased economic intelligence to help improve strategic decision-making.

KPMG Economics

KPMG can help banks navigate the growth and revenue challenges affecting the sector today.

KPMG Banking and Capital Markets Insights

Risk and regulatory

Traditional **safety and soundness** infrastructure components are front and center for the regulators. Recent regulatory updates and proposals relate to capital (Basel III Endgame), long-term debt holdings, resolution planning, and a renewed focus on heightened standards.

Given the continued economic pressures facing consumers, regulators also remain focused on **customer and investor protections**, looking for evidence that institutions are treating all customers/investors fairly and equally, and are being appropriately responsive to any customer/investor concerns or complaints.

Regulatory intensity has increased to a level rarely seen, not only due to the high volume of regulatory issuance, but also the complexity and breadth of regulatory supervision and the impact that these changes impose across organizations.

Data governance protections (e.g., accuracy, transparency, recordkeeping, and privacy) remain a focal point of supervision and enforcement. Institutions must establish a robust program to evaluate exposures, mitigate risks, and enhance compliance as regulators prioritize efforts in these areas.

Potential actions:

- **Anticipate increased scrutiny from the regulators**, especially in areas such as enterprise risk management, capital, liquidity and concentrations, timeliness of MRA remediation, regulatory reporting, and new products and technologies.
- In this interest rate environment, **expect increased regulatory focus on operational resiliency, stability/composition of earnings**, access to credit, consumer fraud/complaints/claims and adequacy of disclosures and including any use of models, algorithms, and AI applications.

Thought leadership:

- Ten Key Regulatory Challenges of 2024
- Regulatory Intensity
- FRB Reports: Supervision and Regulation; Financial Stability
- Resolution & Living Wills: FDIC and Joint (FDIC/FRB) proposals
- Long-Term Debt Requirements: Interagency Proposed Rule
- SEC Fall 2023 Regulatory Agenda

Credit

For both large and small banks, the growth in the allowance for credit losses (ACL) is significantly outpacing the growth in commercial and industrial (C&I) and commercial real estate (CRE) loan portfolios, **reflecting higher loss expectations**. CRE delinquencies have risen sharply over the past four quarters and have significantly exceeded pre-COVID levels. C&I charge-offs have also increased substantially in 2023. As a result, most banks are **reporting tightening lending standards for all loan types**, primarily by requiring increased spreads and premiums on riskier loans.

Market participants expect further declines in CRE values in 2024 driven by the continued impact of **higher capital costs and worsening property fundamentals**. At the same time, record levels of CRE maturities in the next 18 months at low interest rates will require strategic decisions on refinancing at significantly higher rates, which will likely lead to **increased defaults and repossessions**, further depressing property values.

Personal savings rates are currently lower than pre-pandemic levels. At current drawdown rates, the excess savings accumulated during the pandemic will likely be depleted by 2Q24. **Delinquencies are increasing for most loan types**, with credit card and auto delinquencies returning to pre-pandemic levels, while the impact of the removal of the repayment pause on student loans has yet to be seen.

Potential actions:

- Conduct a **comprehensive assessment of the framework and processes used to develop the ACL estimate** to help ensure it incorporates current and projected trends and conditions effectively.
- Proactively **examine the existing exposure** in the CRE market to identify and mitigate risks related to maturity, refinancing, and collateral values. Review and refine documentation of key risk rating considerations and decisions for Commercial Loans to ensure proper transparency upon audit and inspection.
- Temporary **operational resource reallocations and proactive cross-training of professionals** for CRE, workout, and other real estate-owned (OREO) management may be required to navigate the next 12 months effectively.
- **Assess the level of consumer credit risk**, with a particular focus on non-prime borrowers who are more susceptible to higher rates of delinquencies and defaults, as well as borrowers with student debt who may experience cash shortfalls as payments resume.

Thought leadership:

- CECL Pulse Check Q4 2023
- Credit Markets Update Q3 2023

ESG

In late October, the banking regulators issued the **final principles for climate-related financial risk management** for large financial institutions with over $100 billion in assets. The interagency guidance is similar to prior drafts released by each federal banking agency, which were substantively similar to one another. The SEC also added climate change disclosures to is April 2024 agenda.

In early October, California signed into law bills SB 352 and SB 261. The bills apply to companies with greater than $1 billion of annual revenues (SB 352) or $500million of annual revenues (SB 261) doing business in California. SB 352 requires reporting of a company's Scopes 1, 2 and 3 emissions beginning in FY 2025 and would require limited assurance of scope 1 and 2 emissions beginning in 2026 rising to reasonable assurance in 2030. SB 261 requires biennial disclosure of climate-related financial risks and measures adopted to reduce and adapt to such risks with the first disclosure required on or before January 1, 2026.

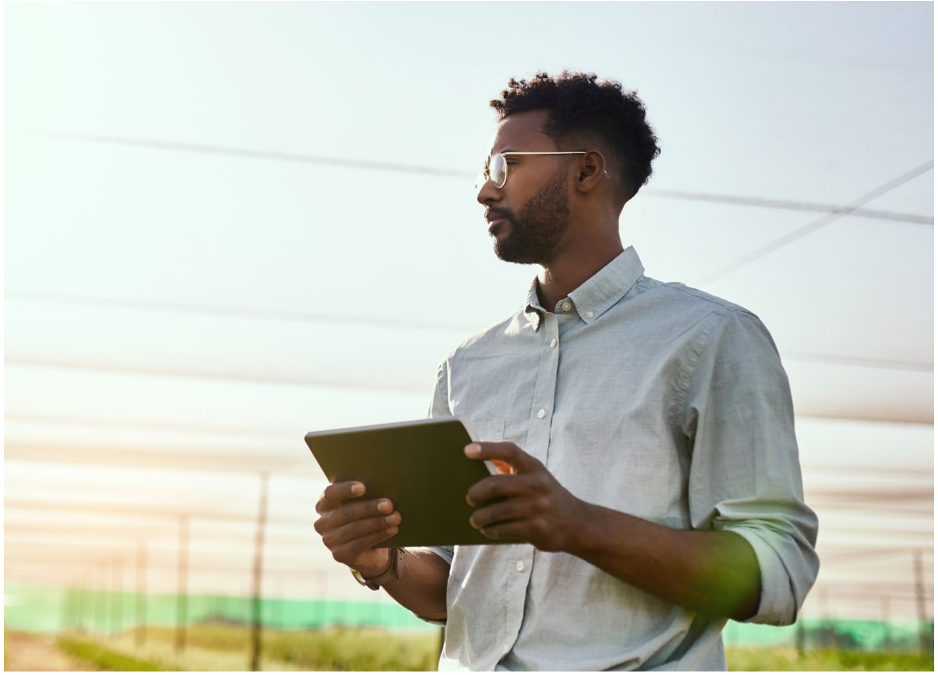
As part of California's suite of climate laws, the Voluntary Carbon Market Disclosures Act introduces **annual disclosure obligations** for the purchase or use of voluntary carbon offsets and emissions reduction claims made by companies operating in California. The disclosures necessitate information about the offset program and/or vendor, as well as the GHG emissions linked with claims, including the method used to determine the claim's accuracy and how interim progress is assessed.

Insights from recent ESG survey of large financial institutions:

- The majority of large banks have a **chief sustainability officer** responsible for overall ESG strategy and half of large banks have a **dedicated ESG controller** overseeing ESG disclosures.
- Large banks are investing in **climate data infrastructure** and in **technology** to enhance ESG disclosure and reporting capabilities.
- Large banks are **prioritizing data management** by standing up data governance structures, implementing processes and controls for data collection through disclosure, and contracting with external data management vendors.

Thought leadership:

- Banking sector leans into ESG
- California introduces climate disclosures and assurance
- California imposes ESG reporting related to carbon offsets
- Final Principles for Climate-Related Financial Risk Management



Cost optimization

As financial services companies strive to navigate the current economic climate notable for the recent high inflation and a drop in valuations, the emphasis on reducing costs and improving efficiency has grown stronger.

Three cost-focused strategies that could help businesses unlock opportunities for growth: pursuing near-term **"low-hanging fruit"** to boost immediate earnings; accelerating digital transformation through **automation**, **cloud migration**, and **digital-first business models**; and fostering a **"continuous performance improvement"** mindset through metrics, reporting, incentives, and cultural change programs.

Some of the common cost-reduction efforts include:

- **Increased digitization and automation** of complex processes (e.g., onboarding and underwriting)
- **Outsourcing** high variable volume processes (e.g., KYC and AML monitoring)
- **Location strategies** (e.g., offshoring specific corporate functions or adopting hybrid work)
- **Strategic business reconfiguration** (e.g., self-service portal development, account service-level realignment, and branch network optimization).

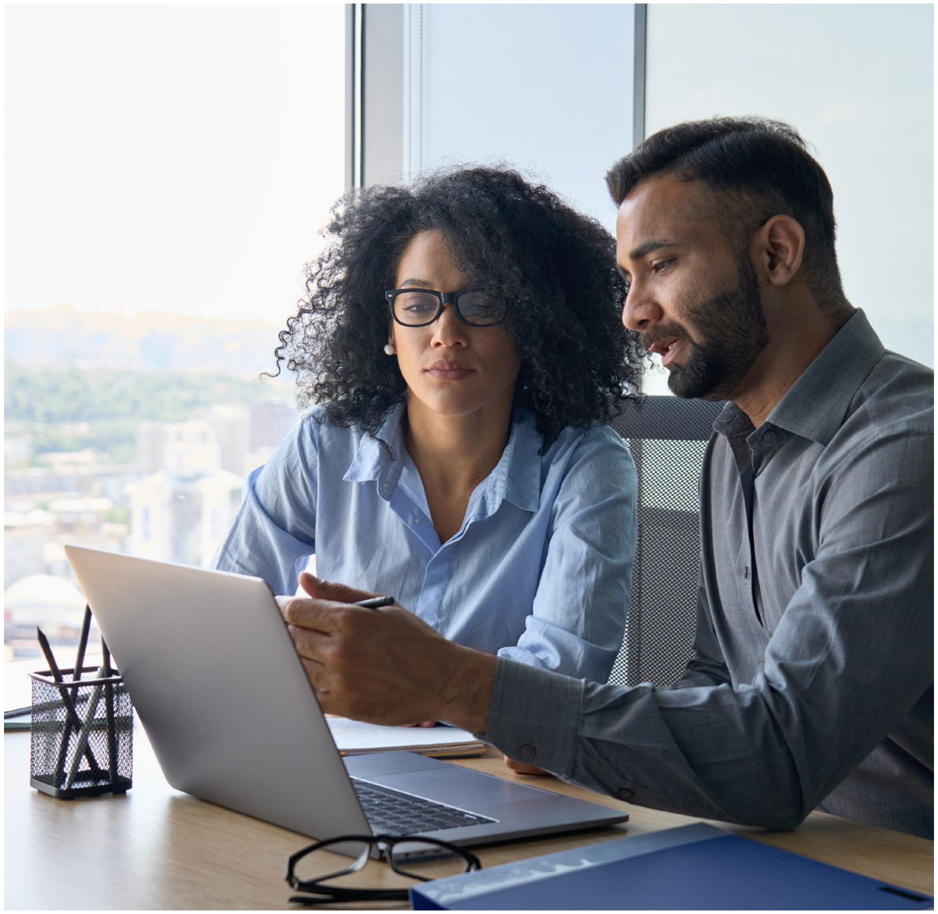
Banks are increasingly turning to artificial intelligence (AI) to optimize their offerings, drive innovation, and enable cost savings, while policymakers globally are sharpening focus on overseeing AI implementation.

Potential actions:

- **Reassess capacity:** Adjust resources based on changing demand levels.
- **Optimize funding:** Utilize analytics, pricing tools, and value propositions for better cost management during high- or volatile-rate environments.
- **Examine procured cost bases:** Consider alternative vendors, contract renegotiation, and demand management to reduce expenses.
- **Develop core transformation strategy:** Employ emerging technologies like cloud, digital, and AI for operational streamlining and scalability.
- **Manage cost drivers:** Review and control underlying cost factors for long-term efficiency.

Thought leadership:

- Cost optimization: Drive profitability and efficiency



Growth and profitability

With the global economic slowdown, financial companies are scrambling to minimize operational costs while employing robust credit and management strategies to safeguard their profitability.

Adopting alternative business models, such as embedded finance, API-led open banking, and banking as a service (BaaS), once exclusively associated with challenger banks and nontraditional competitors, are becoming increasingly mainstream. Regulatory scrutiny of BaaS and embedded finance strategies relying on partner networks for origination and distribution may intensify.

In addition to top-line revenue, bank and capital market firms are thoroughly examining their existing product ranges, prioritizing **funding requirements** and, evaluating possible divestitures of lower-performing business lines, **proposing additional financial products** to their existing customers.

Potential actions:

- **Focus on specific growth prospects,** including ESG and green-linked finance, commercial treasury services, and "deep vertical" niche.
- During the recovery, **preserve capacity for origination and servicing.** Avoid risking two- to three-quarters' growth in 2024 by rebuilding and rehiring to satisfy eventual recovery demands.
- Collaborate by investing in complex fintech ecosystems, and explore nonfinancial service activities to boost growth, **"insource" innovation** and **expand market reach.**
- Enhance business strategies and portfolio with higher-risk, innovative tactics engineered for long-term growth and more stable, predictable legacy business.
- Reassess suboptimal market shares and return on investments (ROIs) by identifying and implementing the necessary changes.

Thought leadership:

- Pulse of Fintech – KPMG Global
- Profitability: Innovation for revenue and growth

Capital management

Cost takeout. Improving efficiency. High interest rates and cost of capital. These are the major challenges facing financial services companies as they navigate today's economic and business complexities. Over the last quarter, the priority has shifted to liquidity and effective capital management.

The adoption of the **Basel III Endgame capital standards**, with increased operational risk capitalization and numerous capital, leverage, and liquidity requirements, may bring transformational changes to the current US capital rules and increase required capital levels. Banks may begin de-risking the balance sheet, exiting segments that are not viable, or exploring strategic loan sales.

Long-term debt requirements for banks larger than $100 billion will contribute to higher funding costs.

Moreover, during the election year, regulatory decision-making is expected to slow down, potentially impacting M&A and proposed regulatory regimes.

Potential actions:

- Reevaluate capital and liquidity modeling in light of the latest Basel III Endgame guidance, including implementation timelines.
- Optimize lending portfolio by examining capital efficiency at segment and product levels to find opportunities for capital releases or capital arbitrage opportunities.
- Align with the new capital requirements and liquidity management by reviewing business portfolios and optimizing through acquisitions or divestments for better capital allocation.
- While politically sensitive, implementing capital return strategies such as dividends and buybacks might be appropriate in cases where banks generate excess capital compared to internal investment opportunities. Activist shareholders are also focusing on returning capital to shareholders.

Thought leadership:

- The big reversal – M&A trends in financial services

Artificial intelligence

Changing business needs are driving the adoption of breakthrough technologies such as artificial intelligence (AI). Organizations are heavily relying on AI-driven solutions to achieve higher operational efficiencies and superior customer service.

With the advent of large language models (LLMs) such as generative AI, **prompt engineering is critical** to reducing inaccurate or irrelevant responses and extracting optimal outcomes. Financial organizations are increasingly prioritizing effective prompt writing, which involves **creating high-quality training data and crafting well-structured prompts** to guide the model's behavior.

While generative AI presents new value creation opportunities within the advanced analytics and AI landscape, it is **crucial to establish literacy and governance of these solutions** to ensure trustworthiness, customer privacy, and alignment with organizational standards. Instituting frameworks, controls, processes, and tools for ethical AI design and deployment can empower banks to accelerate value creation while maintaining integrity.

Financial institutions are developing use cases to assist with due diligence and underwriting, contract generation, compliance checks, AML monitoring, and many others.

Potential actions:

- Develop **well-crafted prompts that effectively guide the model's behavior**, leading to accurate and relevant AI-generated responses.
- **Regularly assess risk associated with the usage of AI-powered solutions** and devise mitigation strategies to safeguard against potential issues, including data accuracy, privacy, security and ethical concerns.
- **Establish proper governance and training** to ensure AI outputs are not trusted blindly, as outputs may be unrealistic or inaccurate.

Thought leadership:

- Generative AI in the modern workplace – KPMG Global
- 2023 KPMG Generative AI Survey Report
- KPMG generative AI survey report: Financial services

Cyber

Evolving cybersecurity regulations: With regulatory intensity on the rise, organizations must adapt to the complex landscape of cybersecurity risk management. CISOs are called to proactively align with evolving standards and ensure compliance with multifaceted regulatory demands.

Data security and privacy: Security and privacy controls must be enhanced to protect data in light of regulatory focus on fairness and maintaining trust in predictive and automated systems.

Proactive approach to cyber threats: Strengthening defenses against a widening range of cyber threats is vital. Companies need to develop advanced strategies for detecting, mitigating, and remediating cyber risks.

Securing AI systems: As AI becomes increasingly integrated into various organizational functions, it is crucial to ensure these systems remain secure. Attacks on AI systems can lead to breaches of sensitive data, manipulation of AI algorithms, or complete system failures. CISOs and organizations must prioritize safeguarding AI systems as an essential component of their cybersecurity strategy.

Cybersecurity focus for CISOs:

- **Proactive compliance**: A collaborative, organization-wide effort is essential to meet heightened risk standards and embed cybersecurity practices.
- **Enhance data management**: Improving data management systems through automation and AI can strengthen cybersecurity defenses and streamline regulatory compliance.
- **Clear cybersecurity frameworks:** Establishing guardrails for responsible AI use is critical to manage risks and ensure effective threat response.
- **Cybersecurity culture**: Building a strong culture of security within the organization is key. Continuous education and awareness can help mitigate risks and build a resilient organizational defense against cyber threats.

Thought leadership:

- SEC finalizes cybersecurity rules
- Ten Key Regulatory Challenges of 2024
- The Leadership Guide to Securing AI

Digital transformation

Digital transformation is no longer optional for banks—it's a strategic must-have to thrive amid disruptive threats and evolving customer expectations. This **transformation goes beyond technology, impacting the entire enterprise from strategy to culture**. By strengthening their data foundations and building integrated ecosystems, financial organizations can streamline processes and position themselves for long-term success.

Banks must **prioritize modernizing processes, such as deposits, payments, and lending**, to accelerate digitization. By leveraging advanced technologies such as cloud computing and AI, banks can innovate, enable real-time processing, stay competitive, and meet the demands of today's digital-first customers.

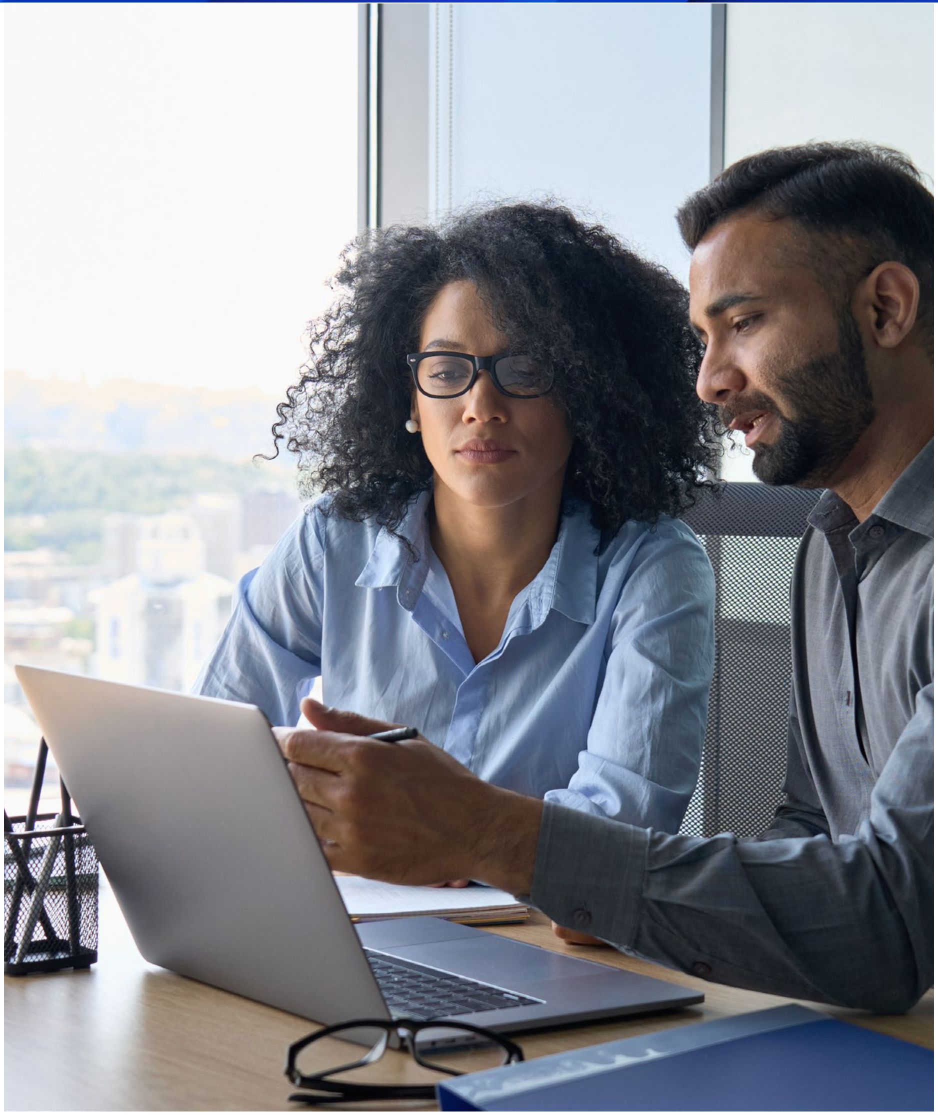
Moreover, digital transformation entails a massive change management effort. To be successful and sustainable, it is essential to **focus on aspects beyond technology, such as governance and its impact on culture**. Leaders must demonstrate value to all stakeholders and align organizational structures with new technologies to ensure adoption.

Potential actions:

- Prioritize **strengthening foundational elements,** including strategy, people, and culture.
- Focus on **establishing an integrated ecosystem** that supports collaboration and delivers consistent experiences across channels.
- **Digitize core operations** such as deposits, payments, and lending to pave the way for a successful digital transformation. This is crucial for banks to enhance efficiency and meet the shifting demands of a digital-first marketplace.

Thought leadership:

- Digital transformation in banking
- Corporate Controller & CAO Hot Topics: Digital Transformation Spotlight
- Empowering banks to be future-ready
- Future of commercial banking



Tax

New provisions effective in 2023: The "corporate alternative minimum tax" generally imposes a 15% alternative minimum tax on "adjusted financial statement income" of certain large corporations. Many uncertainties continue to exist on the application of this new regime. Even if banks are not expecting to be subject to the tax, they will need to document their position, satisfy reporting requirements, and incorporate the regime into regulatory capital calculations.

The "stock buyback excise tax" generally imposes a 1 percent tax on the fair market value of stock repurchases during the year, netted against issuances (subject to certain exceptions. Tax departments should confirm they have the information to satisfy the filing and payment requirements on April 30, 2024.

Section 451(b) subjects "specified fees" to the financial statement acceleration rule where specified fees are recognized for tax no later than when they are taken into account on an applicable financial statement. Specified fees are generally fees from debt instruments that are recognized upfront for financial statement purposes that would otherwise be deferred and recognized over the life of the debt instrument as OID for tax purposes. Banks should consider whether they have a population of specified fees subject to this rule and determine whether a non-automatic method change needs to be filed for tax.

Bank-owned life insurance (BOLI): Banks may be considering adjustments to existing BOLI policies to, for example, increase the rate of return on the underlying investments. When considering these changes, consult with tax departments to verify there are no unintended tax implications as changes could result in realization of tax gain/loss or future increases in policy value to be taxable. Tax departments should also confirm that appropriate tax documentation and other requirements are satisfied to maintain favorable tax treatment on BOLI.

Annual reminders to consider:

Revisit elections, identifications, and other processes to confirm they are working as intended. Consider the following:

- **Section 475(b) identification**: Ensure appropriate identification of securities exempt from MTM to avoid unfavorable or unintended tax treatment.
- **Treasury Regulation Section 1.1221-2(f) hedging identification**: Confirm hedging transactions meet requirements to avoid unfavorable tax rules.
- **Bad debt conformity election**: If using the conformity method, obtain documentation from regulators for each exam and verify tax methodologies are appropriate at each relevant entity.
- **Tax-exempt investments**: Verify correct tax rule application for tax-exempt investments, as the investments will likely have a larger impact on taxable income due to rising interest rates. . Confirm proper treatment of market discounts, OID, or premium accruals and compliance with Section 265 interest expense disallowance rules.
- **Nonautomatic method changes**: Consider accelerating taxable income through elections if business costs result in forecasted losses or insufficient tax capacity to use credits.

Thought leadership:

- Proposed regulations: Information reporting and transfer for valuable consideration rules for section 1035 exchanges
- A Tax Practitioner's Guide to Section 451(b) and Specified Fees
- KPMG website on CAMT and excise tax

kpmg.com/socialmedia

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