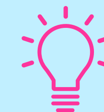
Addressing top-of-mind banking and capital markets issues

Q1 2024

Content



Insights

A unique view on the 10 key regulatory challenges that will shape the landscape in 2024.

Ten Key Regulatory Challenges of 2024

The banking industry in 2024 is challenged but undaunted with brighter days in the year ahead.

2024 Banking trends

A rapidly changing industry demands a more active bank board

2024 bank audit committee agenda

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

KPMG

© 2024 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. USCS013497-1A

Risk and regulatory

Safety and soundness. enterprise risk management (ERM), operational risk, and compliance remain front and center for the regulators. Recent regulatory updates and proposals address foundational elements, including **Heightened risk standards** and the adequacy of risk and compliance programs and processes, data governance processes, and resolution and resiliency planning, sustainability, and BSA/AML.

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.

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

Potential actions

- **For the foreseeable future, anticipate increased scrutiny from the regulators**, especially in areas such as ERM, capital, liquidity and concentrations, timeliness of MRA remediation, regulatory reporting, issues management (including consumer complaints), and governance around new products and technologies. Further, the regulators are expanding their coordination and collaboration to close any potential gaps in regulatory coverage.
- As the interest rate environment remains challenging, **expect increased regulatory focus on operational resiliency, stability/composition of earnings** (including appropriateness of fees), access to credit, consumer fraud/complaints/claims, and adequacy of disclosures and including any use of models, algorithms, and artificial intelligence (AI) applications.

Thought leadership

- Ten Key Regulatory Challenges of 2024
- Regulatory Intensity
- Regulatory Perimeter: Expanding Financial Service Coverage
- Resolution & Living Wills: FDIC and Joint (FDIC/FRB) proposals
- Heightened Risk Standards: Focus on Data Management (& BCBS 239)

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 six quarters and have significantly exceeded pre-COVID-19 levels, while both CRE and C&I charge-offs have also increased substantially over the last year. Banks continue to **tighten lending standards for all loan** types, primarily by requiring increased spreads and premiums on riskier loans.

Property values are down 21 percent from their 2022 peak, with declines in nonoffice CRE values expected to stabilize in mid-2024. 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**. Multifamily supply/demand imbalance continues to elevate vacancy rates and limit rent growth.

Personal savings rates are currently lower than prepandemic 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 prepandemic levels.

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.
- Limited CRE sales and general market conditions have resulted in external appraisers having limited data to directly support sales comparison valuations and capitalization rate assumptions. **Heightened analysis and challenge** to underlying data and assumptions in third-party appraisals should be applied.
- **Assess the level of consumer credit risk**, with a particular focus on nonprime borrowers who are more susceptible to higher rates of delinquencies and defaults.

Thought leadership

- CECL Pulse Check Q1 2024
- Credit Markets Update Q4 2023

KPMG

© 2024 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. USCS013497-1A

Climate disclosures

On March 6, 2024, the SEC issued final rules for the enhancement and standardization of climate-related disclosures. The final rules, while scaled down, require financial statement (Regulation S-X) and climate-related disclosures (Regulation S-K) as well as assurance on greenhouse gas (GHG) emission reporting, with key changes from the proposed rules, including:

- Eliminating Scope 3 GHG emissions disclosures for all registrants. Disclosure of Scope 1 and Scope 2 GHG emissions still required within MD&A if material and only required for large accelerated and accelerated filers.
- Removing requirements to disclose financial impacts on individual lines in the financial statements from transition activities and climate-related risks. The final rules only require financial statement disclosure of costs and losses from severe weather events and other natural conditions, subject to 1 percent thresholds (based on operating income or equity). Other disclosure requirements are qualified based on the long-standing definition of materiality.
- Expanding the safe harbor from private liability for forward-looking climate-related disclosures to include transition plans, scenario analysis, use of an internal carbon price, and targets/goals.
- Extending the timeline over which compliance with the final rules will be phased in. For large accelerated filers, financial statement and climate risk disclosures are required beginning with fiscal year 2025, GHG emissions disclosures are required beginning with fiscal year 2026 with limited assurance over such disclosures beginning with fiscal year 2029, and reasonable assurance beginning with fiscal year 2033.

Keep in mind that for companies that are US multinationals or do business in California, there are requirements from the EU, ISSB, and the state of California that do require Scope 3 reporting and contain different GHG emission reporting and assurance timelines.

Thought leadership

- Understanding the SEC's climate proposal

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.

We identified 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:

- **Strategic business reconfiguration** (e.g., self-service portal development, account service-level realignment, and branch network optimization).
- **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)

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 such as cloud, digital, and AI for operational streamlining and scalability.
- **Manage cost drivers:** Review and control underlying cost factors for long-term efficiency.

Thought leadership

- Build a cost efficiency strategy that drives growth and value

KPMG

© 2024 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. USCS013497-1A

Growth and profitability

With the shift away from the global slowdown, and inflation appearing to slow, banks are now looking at how to manage margin and costs in the changing environment.

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, banks and capital markets firms are thoroughly examining their existing product ranges, identifying opportunities for increased fee-based revenue, prioritizing **funding requirements**, evaluating possible divestitures of lower-performing business lines, and **proposing additional financial products** to their existing customers.

Potential actions

- **Focus on specific growth prospects**, including, 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 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

- Ten key regulatory challenges: Growth & Resiliency
- How to preserve capital and promote growth in uncertain times

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.

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

Potential actions

- Monitor developments in the Basel III Endgame proposals and prepare to **reevaluate capital and liquidity modeling** as proposed rules begin to come into focus.
- **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

- Capital Requirements: Proposed "Basel III Endgame" & GSIB Capital Surcharges
- Basel III Endgame and the potential impact to bank tax departments

KPMG

© 2024 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. USCS013497-1A

The CIO's Agenda

Marked by rapid technological advancements, evolving risks, and shifting business paradigms, Financial services technology leaders are undergoing a seismic shift affected by digital workforce initiatives (i.e., GenAI and robotics) and ever-present concerns about cyber resiliency. While focusing on ongoing needs, they are also charged with maintaining both a solid and agile technology base expected by the industry's regulatory authorities across the globe.

With these challenging priorities, we see financial services technology leaders balancing their efforts of "changing the bank" and "running the bank" with more comprehensive **modernization** programs, such as **digital transformation** through **automation, Gen AI/robotics, cloud migration**, and **digital-first business models**; and fostering a **continuous performance improvement mindset** through metrics, reporting, incentives, and cultural change programs to create an opportunity to be more **agile and resilient**, while being more effective and cost efficient.

Potential actions

- **Lead growth through technology modernization:** Stay current on the latest products and capabilities available in the market. Actively get involved with development of the bank strategic growth initiatives. Make Innovation a center of your IT organization culture.
- **Develop a core transformation strategy:** Re-evaluate your technology toolset and its operating costs (i.e. system development/engineering, change management, IT operations and info/cyber security, disaster recovery/resiliency).
- **Employ emerging technologies** such as cloud, digital, robotics, data analytics and AI for operational streamlining and scalability of IT processes.
- **Consider Agile resource capacity:** Agile capacity methodologies and tools are now widely available and getting constant improvement. Transition to Public Cloud or XaaS can bring significant benefits—but also can present IT functions with new risks and cost considerations.
- **Include resilience as one of the key components:** Combine technology and humans to reduce cyber vulnerability and build a strong resiliency culture.

Thought leadership

- The future of IT - KPMG Global

Artificial intelligence

Financial executives are among the early users of AI and early adopters of GenAI, the subset of AI that is gathering so much attention and investment. For banks, many of them midstream in their digital transformation initiatives, adding AI/GenAI fits with outcomes sought. Banks, often with consulting help, can select the AI or GenAI capabilities that fit their goals and operations, resulting in market differentiation.

Banks are developing AI/GenAI use cases to assist with due diligence and underwriting, contract generation, compliance checks, AML monitoring, among many others. The key moving forward with any AI is designing, building, and deploying systems in a safe, trustworthy, and ethical manner.

Economists believe the true benefits of AI won't be realized for at least another five years. The importance now is taking the initial steps to reshape, reskill, and reorient the workforce to take full advantage. GenAI is the emerging technology that will impact employees as much as it will impact operations. Uncertainty with GenAI requires a framework for managing risks associated with data leaks, data privacy, and AI biases. New AI-focused regulations are in the works but lag the technology already in use.

Potential actions

- **Build a rigorous framework** for use case selection and adoption.
- **Adopt a multidisciplinary approach** with representatives from risk, legal, compliance, information technology (IT), and cybersecurity.
- Conduct a robust process to select, **develop, operate, and maintain controls** related to the bank's use of GenAI.

Thought leadership

- Generative AI in asset and wealth management: The art of possible
- Generative AI in the modern workplace – KPMG Global
- 2023 KPMG Generative AI Survey Report
- KPMG generative AI survey report: Financial services

KPMG

© 2024 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. USCS013497-1A

Cyber

The **US Securities and Exchange Commission (SEC)** has refined its regulations, introducing comprehensive new rules that mandate organizations to prioritize cyber risk management.

Prior to this regulation, materiality of a cyber incident was determined through financial assessments based on actual losses and effects on stock value. However, **under the new guidelines, an incident can now be considered material even with minimal financial loss**.

The increased publicity of an incident enhances its materiality. As a result, companies are **now required to evaluate cyber risks by considering both qualitative and quantitative factors**, to determine their material impact on the company's operations, clients, shareholders, and reputation.

Moreover, advancements in artificial intelligence (AI) pose additional risks to cybersecurity. Researchers have demonstrated that **AI systems can be manipulated to generate code for cyberattacks**. This technology enables individuals with minimal or no programming expertise to launch sophisticated cyber threats.

Cybersecurity focus for CISOs

- **Ensure accuracy and 10-K filings:** The SEC has updated its regulations, instituting extensive new rules that require organizations to give top priority to managing cyber risks. This mandates specific alterations in industry protocols for incident response and communications.
- **Adopt an objective framework for incident evaluation:** Companies must develop a methodology for assessing incidents both objectively—considering the perspective of an average investor—and quantitatively, in order to allocate costs to associated risks accurately.
- **Begin developing a strategy for deploying secure AI:** CISOs venturing into the realm of AI should prioritize crafting a secure AI deployment strategy. This involves conducting risk assessments, implementing security by design, fostering cross-functional collaboration, and staying updated on regulatory compliance.

Thought leadership

- SEC finalizes cybersecurity rules
- SEC doubles down on cyber risk management accountability
- The Leadership Guide to Securing AI

Digital transformation

Financial services firms are capitalizing on the digital wave by **incorporating modern technology** that opens the door to **enhanced customer experience**, as well as **boosts growth**. Whether the shift to digital is driven by the need to better serve customers or compete against other banks, carrying out a digital transformation makes smart business sense.

To reap the benefits of modernization, banks should focus on three primary areas: **modern technical architecture** and **advanced data and analytics**, increased **operational efficiency** and **scalability**, and enhanced **user and customer experiences**.

For banks, digital transformation is a multiyear journey that requires transitioning from legacy systems and embracing digital capabilities. Commercial lending executives often struggle to clearly articulate value-based outcomes for expensive, time-consuming digital transformations that can take years to mature. However, it is well worth the effort with outcomes like reducing operational costs and increasing user proficiency.

Potential actions

- Assess the bank's current platforms for **alignment with strategic objectives** and develop a **digital roadmap** for moving forward.
- **Close any identified capability gaps** by evaluating digitalization options that bridge the gap and advance capabilities.
- **Develop a business case** that connects strategic objectives with target state capabilities.

Thought leadership

- Capitalizing on the digital wave in commercial lending
- Fraud protection comes first as a banking software provider eyes cloud transformation
- 2023 KPMG US Technology Survey Report
- Risk modernization | Part 2: Digital Acceleration
- The future of auto finance

KPMG

© 2024 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. USCS013497-1A

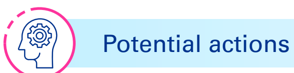
Tax

Tax-related comments received on proposed Basel III Endgame regulations focused on the impact of (i) lowering the threshold calculation for temporary difference deferred tax assets, and (ii) an increase in the risk weighting of certain tax equity investments. Tax departments are seeking opportunities to mitigate potential impacts of the proposal and to increase tax capacity, particularly in stress scenarios.

Proposed regulations were released in Q4 of 2023 that **could impact how bad debt deductions are taken into account for tax purposes**, if finalized. The proposed regulations would **leverage financial accounting mechanics** to determine deductions amounts.

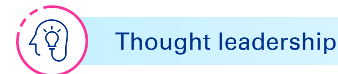
Form 4626 and instructions were released to facilitate reporting associated with the corporate alternative minimum tax (CAMT); the Form 4626 is substantially the same as the draft form released in 2023. Draft Form 7208 has been released to facilitate reporting associated with the excise tax. However, until final regulations/forms are released, **taxpayers should refrain from reporting the excise tax to the Internal Revenue Service or paying the tax**. Meanwhile, taxpayers should collect the necessary information and set aside the funds to be in the right position once finalized.

Pillar Two is a new tax regime aimed at making sure multinational groups with revenues of €750million or more pay their "fair share" of taxes (i.e., 15 percent) in every jurisdiction in which they do business. Various complicated rules apply, but if the minimum tax rate of 15 percent has not been met in a particular jurisdiction, then companies will need to pay the shortfall. This requires complicated and data-intensive calculations for every jurisdiction in which the company has operations, based on a hybrid of tax and financial accounting concepts. The rules are expected to be implemented in various jurisdictions over time. The rules are, at least in part, **enacted and in force beginning in 2024 across a number of major economies (e.g., Australia, Canada, UK, EU, Japan)**.



Potential actions

- Model the impact of potential method changes to **have a regulatory capital playbook ready** if needed for tax capacity or capital in stress scenarios.
- Evaluate the proposed bad debt regulations alongside current methodologies to **determine where there could be differences or other considerations**.
- Review Form 4626 to facilitate CAMT reporting and prepare for excise tax reporting/payment while forms and regulations are being finalized.
- For those impacted by Pillar Two, **develop the processes and systems required** to report the effect of Pillar Two in income tax provisions, consider potential financial statement disclosure, and assess whether safe harbor provisions could apply.



Thought leadership

- KPMG Report: New proposed regulations on bad debt deductions for certain qualifying entities
- KPMG Report: House passes bipartisan tax extenders legislation
- KPMG Report: Final Form 4626 and instructions
- KPMG Report: Reporting and paying the stock repurchase excise tax - not quite yet
- Pillar Two Gameplan

© 2024 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. USCS013497-1A

Learn about us: kpmg.com

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

© 2024 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization. USCS013497-1A