Growth and profitability

There continues to be an increased focus on reducing the cost of operations, proactive credit monitoring, and management to safeguard profitability amid the increasing probability of a recession. Alternative business models, including embedded finance, API-led open banking, and banking-as-a-service, originally the domain of challenger banks and nontraditional competitors, are becoming more mainstream and likely to drive earnings growth at decisive “heritage” banks in 2023 and beyond.

Potential actions to take include:
- Target specific growth opportunities of interest, including commercial treasury services, ESG and green-linked finance, and “deep vertical” niche plays.
- Preserve capacity for origination and servicing in the recovery—establishments that need to rehire/rebuild to meet eventual recovery demands risk missing out on 2-3 quarters’ growth in 2023-2024.
- Partner with and invest in complex fintech ecosystems to “insource” innovation and expand market reach.
- Optimize business portfolios and strategies with a mix of higher-risk innovation “bets” designed to drive long-term growth and more stable and predictable established businesses.

Thought leadership:
- Profitability: Innovation for revenue and growth

Cost optimization

With macroeconomic warning signs flashing, focus on cost reduction and efficiency improvement continues to increase. We see three layers of cost-related initiatives in the industry: (1) near-term “low hanging fruit” takeout to drive in-year earnings improvement, (2) investment in digitization, automation, and cloud migration, and development of digital-first business models, to lead to more efficient and scalable business models; and (3) development of metrics, reporting, incentives, and cultural change programs to support the transition from a periodic “cost takeout” mindset to a “continuous performance improvement” mindset.

Potential actions to take:
- Take an aggressive look at procured cost bases – procurement and strategic sourcing are less developed at many banks than at their industrial and manufacturing peers—now is the time to look hard at alternative vendors, contract renegotiation, and demand management.
- Re-evaluate benefits programs – consider whether offerings balance employee needs versus costs, and consider vendor offerings and analyze specific claim cost drivers to ensure offerings are providing cost-effective solutions.
- Develop core transformation strategy – evaluate cloud-based alternative cores versus latest offers from traditional providers, consider migration strategies (e.g., parallel implementations) as current contracts age out.
- Transform underlying cost drivers – enterprise and product architecture simplification initiatives, transformation of “institutional metabolism,” and decision-making pace.

Thought leadership:
- 2022 KPMG Inflation Survey: Banking Report
- Cost optimization: Drive profitability and efficiency

Credit

Economic concerns result in an intuitive increase in expected credit loss. Many economic forecasts and resultant CECL models are responding more slowly or less severely than bankers’ expectations, creating more pressure on qualitative reserves or model overrides.

The pandemic-related measures to assist households resulted in a significant drop in delinquencies across consumer loan products in 2020 and 2021. However, delinquency rates are starting to increase and will likely reach the 2019 level in late 2023. The timing will depend on how inflation and real wages evolve and whether the economy enters a recession.

Borrowers have softened their inventory financing and investment needs and borrower appetite for C&I loans declined as banks tighten their C&I lending standards. Tightening CRE lending standards slowed lending for construction and CRE lending as a whole.

Commercial real estate appraised values are coming down in Q4 versus Q3 unless there is a property-specific event that is offsetting to the higher capital requirements.

Potential actions to take:
- Provide more high-value financial advisory and financial infrastructure services to manage the impact of inflation and increases in credit costs.
- Ensure loan pricing models are appropriately balanced between expected credit costs and the increasingly competitive lending environment due to higher interest rates and slowing loan demand.
- Re-examine loss estimate processes and governance to ensure risks are thoroughly contemplated in the ACL estimate.

Thought leadership:
- CECL Survey Q4 2022
- Credit Markets Update Q3 2022
Regulators have called cyber risk the foremost risk to financial stability. Given the highly interconnected nature of the banking sector and its dependencies on critical third-party service providers, all participants in the financial system must implement risk mitigation and resilience initiatives relative to both frequency and impact of cyber threats. Current or emerging threats, including malware (e.g., ransomware), supply chain risk, and sophisticated distributed denial of service, coupled with an uptick in adversarial activity and attacks, increase the probability of cyber events occurring.

Key focus areas for CISOs include:

- Aligning business with security: Cyber teams must flex their priorities to support evolving business needs and technology strategies.
- Digital trust: Customer expectations around stewardship, data protection, and transparency are elevated by new and enhanced customer engagement methods.
- Cloud transformation: A cloud-first security strategy and approach, including cloud-native controls, cyber resilience, cloud provider security evaluation, and cloud security governance, must be developed by cloud security teams.
- Evolving cybersecurity teams: Utilizing managed service providers, creative resourcing strategies, and investments in employee upskilling, may close capacity gaps in key skill areas.

Thought leadership:

- 2022 KPMG U.S. Technology Survey Report
- Cyber trust insights 2022
- Cyber considerations for the Metaverse
- Incentive based insider threats

In December 2022, the Federal Reserve Board (Federal Reserve) released draft principles for climate-related financial risk management targeted at institutions with over $100 billion in assets, but all banks should understand and consider the framework outlined by the Federal Reserve. In November 2022, the EU adopted the Corporate Sustainability Reporting Directive (CSRD), which will create new, detailed reporting requirements for large, listed companies on sustainability matters such as environment rights, social rights, human rights, and governance factors. As bank regulatory guidance continues to evolve and the desire for ESG data by stakeholders continues to grow, institutions are grappling with the uncertainty around the scope and timing of the SEC’s ESG-related disclosure rules (climate, cyber, board diversity, and human capital), making it challenging for institutions to determine the next best actions to take on their ESG journeys.

Evolving economic conditions with high inflation and the potential for a recession in 2023 have institutions focused on cost management and where to invest, including ESG initiatives.

Steps to take to progress toward readiness for ESG regulation:

- Establish a cross-functional team to implement reporting and control structure, including collaboration from the controllership, SOX, IT, and internal audit groups.
- Assess whether sufficient levels of expertise or technology solutions for SEC reporting exist within the company and/or if engagement with climate experts, third-party vendors, or upskilling internal resources are appropriate next steps.
- Take the next step in identifying and calculating greenhouse gas emissions, including considering how that data is collected and by who, and what controls are in place.

Thought leadership:

- Climate Risk: FRB principles for climate-related financial risk management
- Podcast: ‘No Regrets’ moves on ESG reporting

There is a renewed focus on key foundational elements of risk management, governance, accountability, and transparency and how those are applied to traditional offerings as well as new asset categories and technologies.

Data governance and protections (e.g., accuracy, transparency, recordkeeping, privacy) remain a focal point of supervision and enforcement. Given the recent turmoil in the digital assets markets, institutions must establish a robust program to evaluate strategy and exposures, mitigate risks, and enhance compliance as regulators prioritize efforts in these areas. There is continued focus on operational resiliency and risk assessments on third- and fourth-party relationships as inflationary pressures, cyber threats, and supply chain disruptions have not yet abated. And given those continued economic pressures for consumers, regulators remain focused on customer and investor protections, looking for evidence that institutions are treating all customers/investors fairly and equally and are appropriately responsive to any customer/investor concerns.

Potential actions to take:

- During inflationary times, expect increased regulatory focus on fee income (including overdraft/insufficient funds), consumer complaints (responsiveness, equitable treatment), adequacy of disclosures, and application of "fairness" broadly (UDAAP) such as within AI applications.
- Anticipate increased coordination among regulators, especially in areas such as digital assets and crypto, CRA, third-party risk management, climate-related risk management, and new products and technologies.

Thought leadership:

- Ten Key Regulatory Challenges of 2023
- Focus on Non-Bank Financial Firms, P2P Platforms, and Crypto Exchanges
- Regulatory Recap – November 2022
- Regulatory Scrutiny of Technology and Data
- Actions to Operationalize Your Climate Risk Framework

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Digital transformation

Core modernization is one of the top agenda items across the C-suite of leading financial institutions. They all recognize that this is a method to unlock things like product innovation, speed to delivery, and real-time processing.

Many banks are undergoing or contemplating three to five core modernization efforts—such as deposits, payments, consumer and commercial lending, and mortgage lending—and on top of all of those, financial systems transformation.

Potential actions to take:
- Banks’ number one imperative for the success of their technology initiative, such as a core modernization, is to have clearly defined business goals that your technology architecture is in service of.
- Work with a trusted adviser with a proven track record to accelerate your efforts and avoid failure.
- Develop a horizontally integrated team for an agile technology ecosystem. Agility requires a one-team approach that allows end-to-end integration covering security, compliance, policies, and controls; this approach allows all key stakeholders’ requirements to be incorporated up front.
- Unite your front, middle, and back offices to equip your workforce, and create seamless interactions that strengthen the connection with your customers, as a digital-first, future-ready bank.

Thought leadership:
- Empowering banks to be future-ready
- Core Modernization: Fortify the foundation Podcast
- Connected Banking Insights
- The foundational elements of core modernization for banks

Tax

Banks are assessing the impact that rising interest rates have on the balance sheet and the associated tax methodologies:
- Large changes in valuations combined with potentially punitive rules for misidentification could create unanticipated tax results.
- New products and service offerings may also require institutions to reevaluate their tax identification statements (IDs) for mark-to-market securities.
- Tax uncertainty around treatment of MSR hedging could put pressure on realizability of realized and unrealized tax losses in MSR hedging portfolio. The Inflation Reduction Act adds new provisions for green energy projects:
  - Tax credit project Initial Prevailing Wage & Apprenticeship Guidance was issued in Notice 2022-61 on November 30, 2022, beginning 60-day clock on applicability for bonus credit rates.
  - Imposes new record-keeping requirements on the taxpayer entitled to the credit—cannot rely on certifications from contractors or subcontractors.

Potential actions to take:
- Analyze new tax credit opportunities and potential impacts to tax equity investing and credit markets (i.e., pricing, demand, transferability) due to legislative and accounting changes for tax credits.
- Review and update mark-to-market tax ID statements, for application to all products and service offerings.

Thought leadership:
- Initial Impressions: Notice 2022-61 Prevailing Wage and Apprenticeship
- Tax provisions in IRA relevant to the banking industry
- Analysis and Observations: Tax law changes in the Inflation Reduction Act of 2022

Liquidity management

The COVID-19 pandemic led to an increase in deposit balances and a decrease in demand for loans, leaving banks with significant excess liquidity. The question of “when will the excess liquidity drain?” is finally being answered. Banks are starting to feel the pinch as deposit outflows grow amid the Federal Reserve’s rapid interest rate increases.

Many banks are increasing rates paid on deposits to stem the outflow. As rates rise, consumers and commercial clients are now paying attention to the interest earned on their excess cash in bank accounts.

Traditional banks of all sizes are feeling the pressure as deposit outflows increase. Online banks are making competitive strides as they attract deposits from traditional banks by offering savings accounts with higher interest rates than you might earn at a traditional bank.

Available-for-sale securities, a significant source of liquidity for many banks, have experienced historic levels of unrealized losses due to rising interest rates. Institutions are weighing the need to sell securities at realized losses to reposition the balance sheet to higher-yielding assets, and closely monitoring the effect of these losses on capital.

Potential actions to take:
- Ensure deposit outflows are being monitored and risk limits are calibrated.
- Preemptively increase liquidity buffers by tapping off-balance-sheet sources of unused liquidity.
- Dust off your Contingency Funding Plan to ensure the lines of communication are open and operational mechanics are functioning.

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