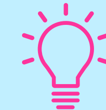
Addressing top-of-mind banking and capital markets issues

Q2 2024

Content



Insights

Perspectives at mid-year plus insights on what to expect going into 2025 amidst ongoing regulatory intensity and election uncertainties..

Ten Key Regulatory Challenges of 2024: Mid-year Look Forward

The U.S. Banking Industry Outlook Survey captures the challenges and opportunities faced by the banking sector amidst economic, regulatory, and technological disruptions.

2024 U.S. Banking Industry Outlook Survey

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

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Risk and regulatory

Enterprise risk management (ERM), operational risk, and compliance remain front and center for the regulators. Recent regulatory updates and proposals continue to highlight **heightened risk standards** and the adequacy of risk and compliance programs and processes, data governance processes, resolution and resiliency planning, and Bank Secrecy Act/anti-money-laundering (AML). A preponderance of regulatory findings still highlight deficiencies in several foundational elements, including (1) capital planning, (2) liquidity risk management, and (3) governance and controls.

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 responsive to any customer 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:

- **Anticipate increased scrutiny from the regulators,** especially in areas such as ERM, cybersecurity, capital, liquidity and concentrations, timeliness of MRA remediation, regulatory reporting, issues management (including consumer complaints), and governance around new products and technologies. Increasingly, examiners are holding firms to higher financial and nonfinancial risk standards—comparing risk practices within/across same/higher category "peers".
- As the interest rate environment continues to present challenges to banks and consumers, **expect increased regulatory focus on operational resiliency; stability/composition of both earnings and funding sources;** access to credit; consumer fraud/complaints/claims; and adequacy of disclosures, including any use of models, algorithms, and AI applications.

Thought leadership

- Heightened Risk Standards: Focus on Data Management (& BCBS 239)
- Ten Key Regulatory Challenges of 2024: Mid-year Look Forward
- Regulatory Intensity
- Resolution & Living Wills: FDIC and Joint (FDIC/FRB) proposals

For more information around risk and regulatory issues, contact Amy Matsuo, US Regulatory Insights & Compliance Transformation Lead.

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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 are nearing historical highs, 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.

In 2023, office loans underlying CMBS experienced their worst payment performance since 2007, with only 35% paid when due. Moody's projects 73% of office loans in CMBS due in 2024 will be difficult to refinance.

Property values are down 21% from their 2022 peak, with declines in nonoffice CRE values expected to stabilizeby the end of 2024. At the same time, significant levels of CRE maturities in the next 12-18 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, with the excess savings accumulated during the pandemic largely depleted in 2Q24. **Delinquencies are increasing for most loan types**, with credit card and auto delinquencies returning to prepandemic levels

Potential actions

- **Continue to proactively examine the existing exposure** in the CRE market to identify and mitigate risks related to upcoming 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 challenges** to underlying data and assumptions in third-party appraisals should be applied.
- **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.

Thought leadership

- CECL Pulse Check Q2 2024
- Credit Markets Update Q1 2024

For more information around credit issues, contact Clay Gaitskill, National Lead, Commercial Lending & Credit Risk.

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Digital transformation

For banks and financial institutions, the possibilities with digital transformation are expanding. The goal posts are moving fast with advances in AI and generative AI (GenAI) tools. Predictive algorithms, data mining, scenario modeling, and process automations—all these capabilities can have a transformative impact. Larger institutions may develop these tools internally, while smaller institutions tend to look for external solutions

These innovations are an opportunity for banks to level the playing field with more agile fintech competitors. Legacy organizations can catch up by developing a systematic approach for the qualification and delivery of emerging technology projects. Just as in other industries, GenAI addresses a pressing issue for banking and capital markets: the burden of manual processes. By automating labor-intensive tasks, banks can reduce the risk of human error, free up valuable resources, and enable real-time insights. This can pave the way for improved standards in innovation and customer service.

In achieving successful transformation, the workforce remains the key. With the right investments in training and skills, employees can unlock the full potential of emerging technologies.

Potential actions

- Whether using an internal or external solution, develop clear processes to evaluate models, vet AI-generated content, and ensure data integrity and security.
- In the service delivery model, identify ways to move from value preservation to value creation using centralized data and analytics.
- Empower employees and customers with a superior, individualized service experience.

Thought leadership

- Generative AI will help banks accelerate digital transformation
- 6 superpowers of the AI-enabled finance team
- Next generation of service delivery models
- Supercharge your Finance workforce with GenAI

For more information around digital transformation issues, contact Celeste Diana, Financial Services Strategy`

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Cost optimization

There remains a continued focus on cost optimization. Inflation persists, although the trajectory of inflation appears to have plateaued in recent months. As a result, interest rates remain higher than originally anticipated at the stage of the cycle.

Focus remains on three key areas, namely: 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., know your customer and AML monitoring)
- **Location strategies** (e.g., offshoring specific corporate functions or adopting hybrid work)
- **Resegmenting clients** (e.g., ensuring clients meet the right criteria for their service offerings)

Banks are increasingly turning to 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
- Optimize, not just cut, costs: How to manage costs during uncertainty

For more information around cost optimization, contact Henry Lacey, Financial Services Integration and Strategy.

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Growth and profitability

As banks enter the second half of 2024, many are now beginning to consider mergers and acquisitions (M&A) to drive growth and profitability. By growing client segments and markets through acquisitions, banks can gain increased market share, and access to new products and markets. However, headwinds remain due to an unfavorable interest rate environment, the resulting impact on loan and securities values, and uncertainties with the upcoming election.

Given 2024 is an election year, we expect any approvals for M&A deals to be slower than normal—with heightened political scrutiny and comment.

In addition, examining existing portfolios, client bases, and markets, and making some tough decisions on which ones to keep versus which ones to sell/exit, is critical. Making bold decisions now can set the organization for future growth going forward.

By examining 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**, banks can focus on delivering value to their core customers.

Potential actions:

- **Focus on specific growth prospects,** including commercial treasury services and "deep vertical" niche products focused on the most profitable customer segments.
- During the recovery, **preserve capacity for origination and servicing** by rebuilding and rehiring to satisfy eventual recovery demands.
- Leverage third-party firms that are ahead on AI development and implementation, **"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.
- **Additional securitization/access to private credit** could drive the ability to grow and reinvest into existing products and new markets.

Thought leadership

- Ten Key Regulatory Challenges of 2024: Mid-year Look Forward
- How to preserve capital and promote growth in uncertain times

For more information around growth and profitability, contact Henry Lacey, Financial Services Integration and Strategy.

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Capital deployment

Capital management remains front of mind for many organizations—with interest rates continuing to be higher than anticipated at this point, banks continue to assess how to manage capital going forward.

While still being deliberated, and subject to aggressive politicking on both sides of the argument, 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.

We expect continued comment and focus on Basel III Endgame as banks push back to minimize the "perceived" impact on them. The key will be to distinguish between what value and protection comes from Basel III and conjecture.

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. Identify and begin or continue efforts on "no regrets" work.
- **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

For more information around capital management, contact KB Babar. Treasury, Resolution, Recovery & Liquidity Risk Management, and Mark Nowakowski, Risk, Regulatory and Compliance.

The CIO's agenda

Financial services technology organizations are undergoing a shift due to advancement of computing capabilities, use of digital workforce initiatives, digital identity presence, and all and ever-present concerns about cyber resiliency.

Focusing on today—Leading technology organizations are fully vested or well on the way with comprehensive modernization programs. Effective modernization programs should focus on a strategy that considers the use of latest technologies and methods of governance, agility of operations, use of AI/robotic process automation/cloud, and resiliency.

Looking toward tomorrow—Emerging topics across the financial services technology community include:

- **Quantum computing**—Quantum computers can break encryption methods at an alarming speed, rendering ineffective encryption tools that are widely used today to protect everything from banking and retail transactions to business data, documents, email, and more. This alone makes **quantum affecting cyber risk** planning a priority.
- **Digital trust**—Digital trust is the expectation by individuals that organizations providing digital technologies and services will protect all stakeholders' interests and uphold societal expectations and values. **Organizations that demonstrate high levels of digital trust have become the preferred choice for customers.**

Thought leadership

- The future of IT
- Quantum is coming and bringing new cybersecurity
- Does your technology drive stakeholder trust?

For more information around the CIO agenda, contact Matt Johnson, National Technology Assurance Leader.

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Artificial intelligence

While banking and capital markets organizations continue to work on integrating AI, they will make future decisions based on sustainable returns on investment. Productivity gains, employee satisfaction, and revenue generation will remain on the radar. To realize the potential from AI, GenAI skills are a key enabler.

Going forward, leaders will need to apply a broader lens to evaluate returns from GenAI, with help from the right metrics and assessments of its impact on employee stress and burnout. With new performance indicators to evaluate AI improvements, there will be a broader impact beyond productivity gains.

In the long run, success will be determined by investments in risk management, data security, customer experience, and responsible AI governance. AI will eventually be expected to reshape business models, enhance productivity, and create new revenue streams.

Potential actions

- For successful adoption, enable cross-disciplinary integration at both the board and functional levels.
- Identify areas of impact and create roadmaps for governance frameworks and workforce preparedness.
- Along with training and education, have regular monitoring and human oversight to ensure the ethical use of GenAI.

Thought leadership

- KPMG GenAI Study: the path to sustainable returns
- Generative AI will help banks accelerate digital transformation

For more information around AI issues, contact Mark Shank, Cloud Engineering.

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Cyber

In the rapidly evolving landscape of the financial services sector, a significant focus has been placed on the **challenges around modernizing the Security Operations Center (SOC)** and optimizing associated processes.

These enhancements aim to reduce operational costs and **effectively display return on investment (ROI)**. A key strategy in achieving these improvements involves leveraging AI and machine learning (ML) technologies to streamline Tier 1 triage activities, reducing the need for extensive human resources in initial incident assessments.

Moreover, organizations should adopt a holistic strategy that goes beyond merely integrating the latest tools within the SOC. It's imperative to enhance data ingestion strategies to avoid vendor lock-in and to prepare for the evolution of SOC tooling and capabilities expected in the near future. This approach ensures not only the adaptability and scalability of security operations but also positions organizations to promptly leverage emerging technologies and methodologies for more effective threat detection and response.

Cybersecurity focus for chief information security officers (CISOs):

- **Adopt SOC modernization strategy:** Reduce resource needs for Tier 1 triage: Utilize AI/ML technologies to automate initial incident triage, minimizing manual labor and expediting response times. By automating routine processes, financial institutions can significantly cut operational costs and demonstrate tangible improvements in ROI.
- **Advanced data strategy:** Companies are advised to craft a long-term strategy aimed at liberating their cybersecurity architecture from vendor lock-in, thereby gaining agility in selecting and deploying cybersecurity tools. It is beneficial to explore leveraging advanced data orchestration or data lake technologies. Such an approach provides the flexibility needed to keep pace with the rapidly evolving landscape of cyber threats and capabilities.
- **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

- Cybersecurity Strategy: ONCD, GAO
- Cybersecurity considerations 2024—KPMG Global
- SEC doubles down on cyber risk management accountability
- The Leadership Guide to Securing AI

For more information around cyber issues, contact Matt Miller, Cyber Security Services.

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Tax

Proposed regulations on the stock buyback excise tax were recently released. The proposed regulations provide that **redemptions of additional Tier 1 preferred stock is excluded** from the 1 percent excise tax. Issuances of additional tier 1 preferred stock is similarly excluded from the so-called "netting rule."

The proposed excise tax regulations contain additional guidance, including guidance on the so-called "**funding rule.**" The proposed regulations generally indicate that a US subsidiary could be subject to the excise tax if it funds by any means, directly or indirectly, a foreign parent's repurchase of stock and a principal purpose of such funding was to fund, directly or indirectly, such repurchase. This proposed rule has been criticized by industry participants as being overly broad and it places significant uncertainty on the scope of the excise tax for inbound organizations.

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. It remains to be seen when and to what extent these rules will be finalized. It is possible that guidance could be released this summer.

Pillar Two is a new tax regime aimed at making sure multinational groups with revenues of €750 million 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:

- **Review the proposed excise tax regulations** and model out its potential impacts. For taxpayers seeking to raise concerns and suggestions, **comment letters on the proposed regulations were due by June 11, 2024.**
- Model the impact of potential method changes to **have a regulatory capital playbook ready** if needed for tax capacity or capital in stress scenarios.
- For those within scope of Pillar Two, **assess whether any safe harbor provisions could apply**. For those impacted by Pillar Two, **develop the processes and systems required** to report the effect of Pillar Two in income tax provisions, and consider potential financial statement disclosure.

Thought leadership

- KPMG report: Initial analysis of stock repurchase excise tax proposed regulations
- Bank tax podcast: Tax planning for regulatory capital growth in banking
- Pillar Two Gameplan

For more information around tax issues, contact Liz L'Hommedieu, Banking & Capital Markets, National Tax Industry Deputy Leader.

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Climate disclosures

In early April 2024, the Securities and Exchange Commission (SEC) voluntarily stayed its recently finalized rules on climate-related disclosures pending the completion of judicial review by the US Court of Appeals for the Eighth Circuit, which was selected as the court that will decide all the challenges brought against the SEC's final disclosure rules. The SEC stated its intent to continue vigorously defending the final disclosure rules in court.

In May 2024, the Federal Reserve Board (FRB) issued a summary report outlining results and insights from its pilot climate scenario analysis exercise with six large U.S. bank holding companies (participants). The exercise was announced in September 2022 and began in January 2023. The key insights from the exercise were:

- Construction of detailed risk scenarios varied by participant and was largely driven by business models, risk views and appetite and access to data.
- Current gaps in data (real estate exposures, insurance, etc.) were filled by third-party vendor models/data and/or proxy estimates; however, data gaps presented challenges throughout the exercise,
- Continued enhancement of risk management, including expansion of risk governance, internal controls, internal audit oversight and testing, and model risk management.

While the SEC's climate rules are argued in the courts, and the California climate bills have also come under legal challenge, banks may be pushed for more climate-related disclosure from various sources, corporate sustainability reporting directive (CSRD) requirements (if applicable), including the banking regulators, investors, analysts, customers and others. As a result, banks should:

- Continue to assess current disclosures for compliance with regulations applicable to the company.
- Consider the level of effort necessary to comply with such regulations and where appropriate, perform incremental activities such as conducting a materiality assessment, collecting and aggregating greenhouse gas emissions data, or enhancing risk management and internal control structure over such data.

Thought leadership

- Climate Risk: FRB Report on Scenario Analysis Pilot

For more information around climate disclosure issues, contact Adam Levy. Risk, Regulatory, and Compliance.

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