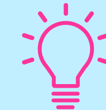
Addressing top-of-mind banking and capital markets issues

Q3 2024

Content



Insights

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

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2024 U.S. Banking Industry Outlook Survey

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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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Growth and profitability

Banks are increasingly considering their growth strategies by leveraging mergers and acquisitions (M&A). The transition to a new administration in January 2025 could reshape the regulatory approach towards bank M&A and make the landscape easier to navigate as banks look towards their growth. The most recent KPMG Banking industry Outlook Survey reflected key insights including:

- 59 percent of banks believe profitability will grow inorganically
- 29 percent of banks are considering spin offs or divestures in order to strengthen balance sheets
- 38 percent of banks see acquiring another bank as a growth strategy, with focus on consolidating the marketplace for banks with less than $150 billion in assets

The FDIC recently issued its Final Statement of Policy (SOP) on Bank Merger Transactions, highlighting the increased scrutiny on proposed mergers. The SOP focuses on competitive, financial risk and stability, and public hearings on proposed transactions resulting in combined assets of greater than $50 billion.

Economic uncertainty and market pressures have resulted in banks looking to transactions such as securitizations, credit risk transfers, and restructuring of bank owned life insurance (BOLI) to reduce balance sheet risk and increase earnings. The market is showing heightened focus on net interest margin and cost containment as the long-awaited rate cutting cycle begins.

Potential actions:

- **Leveraging partnerships with private equity/securitization** to release capital to help grow high margin and revenue products or segments
- **Manage product ranges** to focus on growth areas to leverage falling interest rates and inflation (for example, mortgages and HELOCs)
- High-net-worth clients—**target share of wallet/product penetration** to maximize client revenue and "stickiness"
- **Leverage third-party firms** who are "best in market" in client service, AI, etc., to increase speed to market
- **Critically assess market presence** and locations to maximize cost savings and growth potential.

Thought leadership

- 2024 U.S. Banking Industry Outlook Survey
- Growth & Resiliency
- 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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Cost optimization

As banks enter the final quarter of the year and anticipate interest rate cuts, coupled with continuing declines in inflation, cost optimization will remain a focus. While interest rates have remained higher for longer than many people anticipated, this has had the perceived positive impact of reducing the likelihood of a recession.

Many banks will feel they have targeted the "**low-hanging fruit**" and now the focus shifts to a more sustainable "**continuous performance improvement**" mindset with metrics and reporting that are identifiable to the markets, as well as their people. Firmly embedding this culture will be the key to continued success.

Many banks continue to pursue GenAI opportunities. Given the early stages of GenAI development, some cost benefits are easily identifiable, but its full benefits have not yet been fully understood or delivered. The deployment of GenAI and specific use cases will continue to evolve throughout the medium term.

Into 2025, cost optimization will remain a key focus for banks to achieve their overall profitability goals. The market will remain focused on understanding what banks are doing, what they are going to achieve, and importantly, by when. Markets may be unforgiving if cost optimization targets are missed.

Common cost-reduction initiatives continue across banks:

- **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—geopolitical events have led some banks to reconsider their offshore strategies and look for onshore or near shore alternatives)
- **Resegmenting clients** (e.g., ensuring clients meet the right criteria for their service offerings).

Thought leadership

- 2024 U.S. Banking Industry Outlook Survey
- 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 & Strategy

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Credit

Growth in the allowance for credit losses (ACL) continues to outpace the growth in commercial and Industrial (C&I) and commercial real estate (CRE) loan portfolios, **reflecting higher loss expectations.** CRE delinquencies have more than doubled, and both CRE and C&I charge-offs have increased substantially, over the past two years. Regulators are focused on appropriate capturing and measurement of CRE risk in the ACL as well as sufficiency of documentation for qualitative adjustments.

Banks and other lenders are seizing control of distressed commercial properties at the highest rate in nearly a decade. Lenders' Q2:2024 inventory of foreclosed CRE collateral increased 13% from the prior quarter, reaching its highest level since 2015.

Property values are down 20% from their 2022 peak. Elevated interest rates have negatively impacted valuations, but market participants expect forthcoming rate cuts will stabilize or improve values. CRE loans totaling $2.2 trillion, many originated at historically low rates, are expected to mature by the end of 2027, leading to the risk of **increased defaults and repossessions.**

Personal savings rates are currently lower than pre-pandemic levels, with excess savings accumulated during the pandemic largely depleted, **Delinquencies are increasing for most loan types,** with 90+ day credit card and auto delinquencies exceeding pre-pandemic levels.

Potential actions to take include:

- Proactively **examine existing exposure** 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 and valuation of foreclosed properties 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 non-prime borrowers who are more susceptible to higher rates of delinquencies and defaults.

Thought leadership

- CECL Pulse Check Q3 2024
- Credit Markets Update Q2 2024

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Capital deployment

Capital management remains front of mind for many organizations—with the Fed beginning its long-awaited interest rate reduction cycle with a 50-basis-point-cut in September; longer-term rates have declined significantly providing easier credit conditions and increased asset values.

Vice Chair for Supervision Fed Governor Michael Barr announced that the **Basel III Endgame capital standards** would undergo reproposal, with a new comment period and a one-year period to implement the final rule. The announcement included:

- **Return of the Tailoring Rule,** with different rules and requirements for banks of different asset sizes
- Maintain unrealized losses in securities portfolios being reflected in capital
- Market Risk (a/k/a Fundamental Review of the Trading Book), or FRTB only applies to Category I and II institutions, or smaller banks with significant trading activity
- Reduced risk-weights for several classes of credit products including residential real estate and retail
- Simplified/Reduced operational risk requirements
- Adjustments to G-SIB surcharge.

Potential actions to take include:

- Monitor developments in the Basel III Endgame reproposal when issued and continue to **reevaluate capital and liquidity modeling** as proposed rules 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, and re-evaluate investment holdings, funding mix, and hedging as interest rates decline.
- Align with the new capital requirements and liquidity management by **reviewing business portfolios and optimizing through acquisitions or divestments** for better capital allocation.

Thought leadership

- Capital: FRB Remarks Outlining Basel III Endgame Re-Proposal

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

Digital transformation

In a fast-moving market, meeting changing customer experience expectations across channels continues to be a priority for banking leaders. It is about meeting customers where they are with a seamless, reliable experience. To this end, **customer experience remains a strategic area for investment.** Banking leaders are investing in online banking and mobile banking to ensure organizations are well-equipped to meet expectations.

Organizations will also need to **invest in emerging digital channels and partnerships.** These will include open banking application programming interfaces (APIs), digital wallets, email, and SMS banking. Advances in enablers such as biometric authentication, predictive analytics and AI-driven personalization through chatbots and virtual assistants are expected to improve the user experience and drive greater adoption. Existing data can be used to gain insights into customer behaviors, habits and preferences to develop tailored products and services.

New technologies will also mean new ways of working. Leaders remain keen on exploring ways to use them to address workforce challenges. Generative AI (GenAI) can also improve productivity and help employees utilize time for more value-added work. This will require providing people with the support they need to upskill. As for working arrangements, a hybrid model is here to stay for most organizations.

Potential actions to take include:

- While working on customer touchpoints, focus on ways to **create experiences that matter.**
- Continue digital transformation to organize and govern structured/unstructured data in a way that supports **personalization.**
- **Prioritize investments** in data-driven insights and personalization capabilities.
- **Reskill and upskill the workforce** with GenAI knowledge and skills.
- **Evaluate and implement hybrid work models** to promote employee well-being and address potential burnout.

Thought leadership

- 2024 U.S. Banking Industry Outlook Survey

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

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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 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.

Fintech disrupting banking technology—Chief information officers (CIOs) of leading banking organizations are monitoring technology and business innovations by fintechs. Fintechs have become an established part of the financial services environment. The fast pace of innovation within the sector, allied with fintechs' ability to understand and serve customers' needs, has resonated with consumers and businesses eager for customer-friendly products that speed up transactions and widen choice. That said, fintech now finds themselves under the watchful eye of regulatory agencies.

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.
- **Recordkeeping**—The FDIC recently proposed rules related to recordkeeping for bank deposits received from third party, non-bank companies. Banks should assess its recordkeeping capabilities in advance of a potential final rule.

Thought leadership

- Voice of CIO
- The bright side of fintech regulation: Opportunity
- Does your technology drive stakeholder trust?

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

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GenAI

Banking leaders see the promise in GenAI to shape their future strategies and remain competitive. They continue to explore and implement GenAI for diverse use cases. Some of the most common applications are directly correlated to current top agenda items for the industry—**cybersecurity, fraud, and compliance and risk.** As budgets and resources to fight cybercrime, protect data and customers, and comply with intensifying regulatory requirements have skyrocketed, executives are looking to GenAI as a potential solution.

Technology can also help banks improve process efficiency, gather intelligence, and become more predictive. This includes customer service and sales where GenAI capabilities can help get analytics and insights quicker to optimize and personalize customer interactions. **Information technology systems and software** is another important area for deployment.

At the same time, leaders are also aware of the risks of GenAI. As the industry is still in the early stages, organizations will need to **address technological and regulatory hurdles** to fully seize the value. Security and compliance challenges, integration with existing systems and processes, and legacy IT infrastructure, will be key focus areas.

Potential actions

- **Prioritize GenAI investments** in areas that can provide the greatest near-term impact, such as cybersecurity, fraud detection, and compliance.
- **Identify opportunities** to deploy GenAI in back-office IT systems to drive process efficiencies and productivity gains.
- **Pilot GenAI applications in customer-facing areas** like service and sales to enhance personalization and customer experience.
- **Address key challenges around security,** compliance, integration, and legacy infrastructure when deploying the technology at scale.
- **Develop a comprehensive GenAI strategy** that aligns initiatives with overall business goals and a digital transformation roadmap.

Thought leadership

- 2024 U.S. Banking Industry Outlook Survey
- AI in financial reporting and audit: Navigating the new era

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

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Cyber

In the dynamic landscape of the banking and capital markets sector, cybersecurity has emerged as a critical focus area for organizations and their regulators. The increasing regulatory scrutiny from the **Digital Operational Resilience Act in the EU and the Office of the Comptroller of the Currency and the Federal Reserve Board** in the US has brought forth a wave of regulatory actions targeting end-of-life (EOL) policies, vulnerability management, cloud services, and configuration management. The majority of banking clients are grappling with these challenges, necessitating a proactive and sustainable approach to address these domains.

Horizontal exams conducted by **US regulators across Tier 1 banks have revealed common regulatory findings,** highlighting the industry-wide nature of these issues. One of the primary concerns is the inadequate management and governance of asset management data, a problem exacerbated by the rapid adoption of cloud technologies. As banks migrate their infrastructure and applications to the cloud, ensuring the accuracy, completeness, and governance of asset management data becomes increasingly complex.

The key challenges faced by banks include:

- **End-of-life (EOL):** Managing and updating EOL policies and procedures to ensure systems and software are properly decommissioned and replaced before they become unsupported and vulnerable.
- **Vulnerability and patch management:** Prioritizing patches effectively across infrastructure and applications while demonstrating end-to-end completeness of the overall program and remediation efforts.
- **Privileged access management:** Maintaining visibility and control over privileged access in cloud environments, particularly for information technology professionals accessing production systems.
- **Cloud security:** Establishing consistent security policies, controls, and monitoring mechanisms across multicloud ecosystems.
- **Configuration management:** Ensuring proper configuration of systems, applications, and security controls to minimize vulnerabilities and maintain a secure environment.

Thought leadership

- Cybersecure vehicles
- 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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Risk and regulatory

As speculation continues about the future direction and intensity of regulatory activities given the upcoming elections, **enterprise risk management (ERM), governance, and compliance** remain foremost for the regulators. Recent regulatory updates and proposals, along with regulatory actions taken on financial institutions, continue to emphasize the need for **heightened risk standards** and the adequacy of risk and compliance programs and processes, data governance processes, financial and operational resolution and resiliency planning, and controls over financial crimes (BSA/AML).

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 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 comprehensive programs to evaluate exposures, mitigate risks, and enhance compliance as regulators prioritize consumer protection efforts in these areas.

Potential actions to take:

- Regardless of the current electoral cycle, **anticipate increased scrutiny from the regulators**, especially in areas such as ERM, cybersecurity, liquidity and concentrations, timeliness of matters requiring attention (MRA) remediation, issues management (including consumer complaints), and governance around new products and technologies. Increasingly, examiners are holding firms to higher financial and nonfinancial risk management standards—comparing risk practices within/across the same/higher category "peers", thereby **raising the bar** on those firms approaching or surpassing size and complexity thresholds (category change).
- **Expect continued regulatory focus on operational resiliency, stability/ composition of both earnings and funding sources**, access to credit, consumer fraud/complaints/claims and adequacy of disclosures, and including any use of models, algorithms, and artificial intelligence (AI) applications. Regardless of potential political changes on the horizon, expect the regulatory focus on AI and cybersecurity to remain intense.

Thought leadership

- Ten Key Regulatory Challenges of 2024
- Regulatory Recap and Look Forward
- Resolution and Living Wills: FDIC/FRB Final Guidance
- 2025: The Year of Regulatory Shift

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

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Tax

Many banks are considering investment **portfolio rebalancing** transactions. These transactions can have tax implications, particularly when **selling available-for-sale securities at a loss.** It is important to consider the character of losses (capital or ordinary), as well as the applicability of wash sale rules for tax, among other tax considerations that could impact financial statements.

Guidance was recently released **on how to report and pay the one percent stock buyback excise tax.** The excise tax became effective for repurchases of certain stock occurring on or after January 1, 2023. The final regulations provide that, for calendar-year taxpayers, the 2023 excise tax should be paid and reported on Form 720 by October 31, 2024. For subsequent tax years, the excise tax should be paid and reported annually on Form 720 (due April 30, 2025 for calendar year 2024). Form 7208 must be attached with each Form 720 filing that provide details associated with the excise tax. **Bank tax departments should ensure that they have the information necessary to comply with these requirements by the upcoming due date of October 31, 2024.**

Banks will need to report information associated with the corporate alternative minimum tax on Form 4626 for the first time on their 2023 tax returns, due by October 15, 2024 for calendar-year taxpayers with extension. CAMT guidance is expected in Q3 2024, but is still outstanding. **Banks should be thoughtful about the various uncertainties associated with the CAMT** (e.g., reporting for partnership investments) when reporting amounts/adjustments on form 4626. The internal revenue service (IRS) announced that it would waive penalties for a corporation's failure to pay estimated income tax with respect to its CAMT liability for the 2023 tax year (assuming calendar year); however, **corporations must file Form 2220 with their federal returns to qualify for this penalty relief. Proposed regulations on the CAMT** were published to the Federal Register on September 13, which primarily provide guidance regarding international, M&A, partnership, and mechanical issues.

The IRS recently released Rev. Proc. 2024-30, which indicates that a **method change to deduct bad debt expenses under the proposed allowance charge-off method is an automatic method change** made on a cut-off basis. This guidance clears up a transition issue that existed if taxpayers wanted to adopt the proposed regulations for the 2023 calendar tax year. Note that other uncertainties and issues associated with the ACM continue to exist. Thus, taxpayers considering changing to the ACM should weigh the pros and cons against current methodologies.

Potential actions to take include:

- **Consider the tax implications of any portfolio rebalancing transactions.**
- **Be ready to comply with the payment and filing requirements associated with the stock buyback excise tax** that are due for the first time on October 31, 2024.
- **Consider CAMT uncertainties and upcoming filing requirements and determine whether Form 2220 should be filed** to attain penalty relief associated with estimated income taxes and CAMT.

Thought leadership

- Decoding Bad Debt: Navigating the Proposed Regulations
- KPMG report: Reporting and paying the stock repurchase excise tax
- Corporations subject to CAMT must file Form 2220 to qualify for estimated tax penalty relief
- Rev. Proc. 2024-30: Procedures for obtaining auto consent to change method of accounting to the Allowance Charge-off Method

For more information around tax issues, contact Liz L'Hommedieu, National Tax Industry deputy.

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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 U.S. 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.

Since the California climate disclosure laws were originally signed in Q4 2023, there have been several rounds of proposed amendments. In June 2024, the California governor's administration proposed amendments to both the greenhouse gas (GHG) emissions law and the climate risks law to most notably defer the effective dates by two years to 2028. In late August, a new proposal was introduced and passed the California House and Senate that counters certain of the proposals made by the administration and would maintain the 2026 effective date for GHG emissions and climate risks.

As European companies begin reporting under the Corporate Sustainability Reporting Directive (CSRD), there are certain learnings for US companies in scope of CSRD, one of which is the EU Taxonomy Regulation that non-EU companies in the scope of CSRD are required to report. The EU Taxonomy Regulation establishes a classification system that helps companies and investors identify environmentally sustainable economic activities, classified under six environmental objectives defined by the EU. Various challenges companies may encounter in reporting include linking financial key performance indicators with the highly technical requirements, the high complexity of the regulation, and the interdependencies with other EU regulations.

While the SEC's climate rules are argued in the courts and the California climate bills are being debated in the state's government, banks may be pushed for more climate-related disclosure from various sources, including CSRD requirements (if applicable), 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 GHG emissions data, or enhancing risk management and internal control structure over such data.

Thought leadership

- Oversight of climate disclosures: SEC stay shouldn't mean stop
- Hot Topic: Climate in the US–Proposed amendments to California climate laws
- Avoiding the blind spot: EU Taxonomy reporting for US companies

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

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Payments

Banks need to deliver well on multiple changes when it comes to regulations and payment options for customers. The move to ISO 20022 as the common global business language for financial messaging is a significant change to payments platforms and the broader ecosystem. The 2025 mandates for Fedwire and SWIFT cross-border payments are key priorities. Banks will need the right set of capabilities to operate in a high-availability environment.

With these changes, banks also have more opportunities. Organizations can use the incremental data from ISO 20022 to **offer enhanced payment experiences and value-added solutions** to drive new value for customers and differentiate themselves.

Customers currently face challenges managing multiple accounts across various platforms, leading to inconsistent data, security concerns, and difficulties with payment confirmations and personal information updates. Banks can reclaim this space by **enhancing digital banking awareness and offering a consolidated user experience.**

Potential actions

- **Review your bank's payment systems** to align with the global ISO 20022 mandate and make necessary changes.
- **Identify ways to use additional data** from ISO 20022 for innovation, customer value addition, and operational efficiencies.
- **Work on innovations** like managing multiple 'pay from' accounts and personalized financial wellness advice.
- Acknowledge and strategize against the risk of losing market share to standalone biller apps and other digital platforms by **enhancing the appeal and functionality of online banking offerings.**

Thought leadership

- 2024 U.S. Banking Industry Outlook Survey
- Payments in the banking industry
- How banks can simplify digital payments

For more information about payments, contact Courtney Trimble, Principal, Advisory, Financial Services Solutions.

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