KPMG

Addressing top of mind banking and capital market issues

January 2025

Content

Insights

Ten Key Regulatory Challenges of 2025

A guide to the anticipated regulatory shifts in areas like technology, data risks, and consumer/investor protections.

2024 SIFMA Conference on the Securities Industry

Highlights from the 2024 SIFMA FMS and AICPA & CIMA National Conference on the Securities Industry event.

KPMG Economics

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

KPMG Banking and Capital Markets Insights

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

Turning Points: 2025 Annual Outlook

The US economy is navigating a challenging landscape with slowing GDP growth, ongoing inflation battles, and significant policy risks that could impact various sectors and overall stability.

Risk and regulatory

With a new administration and shifting regulatory and enforcement priorities likely, **speculation continues about the future direction and intensity of financial regulation**.

Changes in regulatory agency leadership may lead to a variety of shifts, notably an increased focus on bolstering cryptocurrency/digital assets markets; lessening the intensity of supervision/enforcement (over time); expanding role of private equity in dealmaking and capital raising; and pullback of certain proposals impacting asset managers.

The impact of potential early efforts to lessen regulatory intensity through Congressional Review Act activity may be limited as few final rules were approved within the relevant lookback period (approximately back to August 1, 2024). This may be coupled with proposal/reproposal and/or final rulemakings that are currently in process or subject to legal stay and therefore unlikely to advance. **Financial services will continue to be a heavily regulated industry given its critical role to the economy.** Key areas of potential change in focus will also include expansion of AI applications and consumer/retail investor protections.

Potential actions:

- In the near term, **anticipate continued attention from the regulators**, especially in foundational areas such as ERM, cybersecurity, liquidity and concentrations, AML, timeliness of MRA remediation, issues management (including consumer complaints), and governance around new products and technologies.
- Any lessening of regulatory scrutiny and enforcement over time may include **diminished engagement with international standard setters.** Additionally, **increased divergence between federal and state laws and regulations** could also occur. That said, with the use of technology and AI becoming prevalent in financial services globally, and the likelihood of even more "disruptor" firms entering the market, continued regulatory focus on AI and cybersecurity is likely.

Thought leadership

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

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Credit

The 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 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. Disclosures are coming into focus, as the Securities and Exchange Commission (SEC) has indicated an expectation for more granular disclosure of components of the ACL methodology and drivers of changes in the ACL.

Property values are down 19 percent from their 2022 peak. The "maturity wall" concern persists, as 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 may drive increases in nonperforming assets. Non-owner-occupied CRE may present higher risk. However, the CRE market is showing some signs of improvement, with modest increases in asset values and deal volume. Significant capital remains on the sidelines waiting to be deployed.

Delinquencies and charge-offs are increasing for most consumer loan types, with the effect on credit card and auto loan portfolios exceeding historical levels. Institutions with higher exposure to subprime auto, credit card, and student lending portfolios will likely experience the most significant pressure on asset quality metrics.

Potential actions:

- Conduct a **comprehensive assessment of the framework and processes used to develop the ACL estimate and disclosures** to 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 Q4 2024
- Credit Markets Update Q3 2024

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Digital transformation

Banking and capital markets entities face a challenging growth environment due to geopolitical instability, uncertainty around regulations, and an economy with lingering (albeit lower) inflation. Even so, digital modernization efforts span multiple years, so this investment will continue unabated.

Significant investments are being made in areas such as AI, generative AI (genAI), data analytics, and cybersecurity. These technologies are essential for improving operational efficiency, enhancing security, and providing enhanced customer experiences such as mobile banking and digital wallets. Many institutions struggle with outdated legacy systems, which lack flexibility, scalability, and the ability to support digital transformation. However, new technologies are working to unbundle core legacy systems and create an ecosystem that is flexible and capable yet features the latest in security protocols.

Digital modernization is significantly influenced by partnerships. Collaborations with tech companies are crucial for financial institutions to stay current and reach customers. These partnerships help institutions integrate advanced technologies and innovative solutions to stay competitive. The steps made toward modernization enhance an institution's appeal to tech companies or M&A opportunities.

Potential actions:

- Review and assess IT infrastructure projects based on budget, timeline, and project outcomes
- Consider the potential benefits of partnership and M&A opportunities in the year ahead
- Prioritize investments in back-office processing and customer-facing applications
- Reskill and upskill the workforce with GenAI knowledge and skills.

Thought leadership

- 2024 U.S. Banking Industry Outlook Survey
- 2024 Banking trends

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Cost optimization

Cost optimization continues to be one of several key initiatives for all organizations, and as banks address their growth strategies going forward, this will be key to ensure they realize their long-term aims and goals.

As banks enter 2025, with falling interest rates, and potentially a more relaxed regulatory atmosphere, cost optimization will remain a key focus as banks look to continue to take advantage of previous cost optimization initiatives.

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. But it does come with challenges.

AI and GenAI continue to evolve, and use cases mature as banks continue to develop their understanding and application of AI. There is not yet a “silver bullet” use case that radically alters the cost dynamic, but high-impact use cases are expected to emerge over time.

Potential actions:

- **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 resulted in some banks reconsidering their offshore strategies and looking for onshore or nearshore alternatives)
- **Resegmenting clients** (e.g., ensuring clients meet the right criteria for their service offerings).

Thought leadership

- 2024 U.S. Banking Industry Outlook Survey

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Growth and profitability

In 2025, KPMG believes focus will return in the deal market as many organizations will look towards undertaking a transaction to support their overall growth ambitions. It is anticipated that the focus will be much more on sustainable growth and profitability, as opposed to just size and scale. Additionally, many banks may experience revenue headwinds from the recent CFPB rule limiting overdraft fees.

The deal market will likely be supported by a falling interest rate environment, plus a perceived change in the regulatory environment as the new administration takes control. These assumptions will likely be put to the test through existing transactions waiting for approval, as well as when the first several new transactions come forward for approval.

As banks consider their growth strategies, it is worth restating the following findings from the most recent KPMG Banking Industry Outlook Survey:

- Sixty-six percent of banks are confident of their growth prospects.
- Fifty-nine percent of banks believe profitability will grow inorganically.
- Twenty-nine percent of banks are considering spin-offs or divestures in order to strengthen balance sheets.
- Thirty-eight percent of banks see acquiring another bank as a growth strategy, with focus on consolidating the marketplace for banks with less than $150 billion of assets.

Potential actions:

- Leveraging partnerships with private equity/securitization to release capital to help grow high-margin and -revenue products or segments
- Managing product ranges to focus on growth areas to leverage falling interest rates and inflation, for example, mortgages and home equity loans
- Re-evaluate deposit product mix and pricing strategies in light of expected decreases in interest rate environment.
- Leveraging third-party firms that are “best in market” in client service, AI, or other specialties to increase speed to market
- Critically assessing market presence and locations to maximize cost savings and growth potential

Thought leadership

- 2024 U.S. Banking Industry Outlook Survey

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Capital deployment

Capital management remains front of mind for many organizations—short term interest rates declined with Fed Fund rate cuts, but debate over the number and timing of remaining cuts remains; longer term rates declined from earlier highs but are up from September lows and post-election and geopolitical uncertainty contribute to volatility.

Vice chair for supervision Fed Governor Barr announced in September that the **Basel III Endgame capital standards** would undergo reproposal.

Significant changes announced in Barr's speech were provided.

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

However, significant uncertainty exists about the ultimate outlook for the proposed standards and regulatory appetite for change in light of the upcoming administration change.

Potential actions:

- Monitor developments in the Basel III Endgame reproposal 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 capital releases or capital arbitrage opportunities, including capital reduction transaction/credit risk transfer.
- Align with the new capital requirements and liquidity management by reviewing business portfolios and optimizing through acquisitions or divestments for better capital allocation.
- Explore competitive advantages based on category classification (or identify products where capital constraints create a disadvantage).

Thought leadership

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

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GenAI

Our 2024 U.S. Banking Industry Outlook Survey delivered several key findings. Sixty-percent of financial institutions plan to use GenAI to bridge talent gaps and automate up to twenty percent of daily tasks. Financial services leaders also anticipate increasing their investment in GenAI with 84 percent planning to extend the emerging technology's application and introduce new functions.

Financial institutions eager to adopt GenAI face challenges with transparency, explainability, and data security. Trust is a significant concern, with data privacy and security risks being top priorities. To address these concerns, it's wise to consider establishing a robust governance framework that includes a steering committee and charter. Both are essential for managing GenAI risks and aligning with regulatory requirements.

There is no question that GenAI holds the promise of revolutionizing financial services. In these early days of the technology, GenAI is finding a foothold in various departments, including risk management, compliance, customer service, and innovation. Use cases showing promise include improving risk assessments, enhancing customer interactions, automating routine processes, and driving innovation in product offerings.

Potential actions:

- A GenAI center of excellence can drive cultural alignment, education, and adoption of GenAI, helping organizations manage risks and speed up implementation.
- Identify target opportunities in departments and functions for implementing GenAI that could result in sizable productivity gains.
- 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 takes into consideration other development projects and resource requirements

Thought leadership

- Financial services firms embrace Generative AI
- Building trust in GenAI for financial services
- KPMG AI Trust Framework

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Cyber

In the dynamic landscape of the banking and financial services sector, cybersecurity has emerged as a critical focus area, with major attention on zero trust architecture (ZTA) and Cloud Security. These trends necessitate proactive and sustainable security measures to address evolving challenges.

Financial institutions are increasingly adopting ZTA principles, moving away from traditional perimeter-based security to the "never trust, always verify" model. This approach emphasizes identity-centric security, data protection, and microsegmentation. Regulatory bodies have highlighted issues such as inadequate identity management and secure data access, worsened by rapid digital transformations and rising cyber threats.

Simultaneously, the accelerated adoption of cloud technologies calls for enhanced security to protect multicloud environments and cloud-native applications. chief information security officers are rethinking their security monitoring and automation strategies for security operations centers with a focus on cloud data protection and access management controls. Common challenges identified by regulatory bodies include inconsistent security policies and insufficient monitoring mechanisms across multicloud ecosystems.

Potential actions:

- **Identity-centric security:** Implementing robust identity verification and authentication to ensure that only authorized users access sensitive systems and data.
- **Data protection:** Enhancing strategies to safeguard information against unauthorized access and breaches, particularly in cloud and zero trust environments.
- **Micro-segmentation:** Minimizing attack surfaces and limiting the lateral movement of threats within networks by isolating workloads and resources.
- **Multi-cloud security:** Establishing consistent security policies, controls, and monitoring mechanisms across multi-cloud environments to protect cloud-native applications and data.

Thought leadership

- Cybersecurity considerations 2024 - KPMG Global
- SEC doubles down on cyber risk management accountability
- The Leadership Guide to Securing AI

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CIO's agenda

Quantum computing is on the brink of revolutionizing the Financial Services industry. Understanding quantum computing, the associated risks and its potential applications is a critical step in preparing for this disruptive technology. Quantum extends beyond classical computing by leveraging the principles of superposition, entanglement, and quantum interference. While classical computers process information in bits (0s and 1s), quantum computers utilize quantum bits (qubits), which can represent and store data in multiple states simultaneously. This exponential growth in computational power opens doors to unprecedented processing capabilities.

Understand quantum potential – Early adoption of quantum computing will provide a competitive edge, enabling advanced analytics and optimization capabilities, leading to more informed decision-making and superior risk management. Being a first mover also allows organizations to shape industry standards and capitalize on new market opportunities before competitors. Areas where quantum advantages are being researched are:

- Portfolio optimization: efficient asset allocation
- Fraud detection: advanced anomaly identification
- Pricing derivatives: accurate financial evaluation
- Market forecasting: predictive market analysis
- Transaction security: quantum-resistant encryption

Quantum risk – Quantum computers capable of breaking traditional encryption algorithms (such as RSA and ECC) pose significant security threats to financial services organizations. Entities should consider implementing a quantum strategy group responsible for monitoring and implementing post-quantum cryptography (PQC) standards.

PQC – Encompasses cryptographic algorithms designed to be secure against the capabilities of quantum computers, leveraging mathematical structures that are believed to be quantum resistant. As quantum computers advance, transitioning to PQC is crucial for maintaining the integrity and security of sensitive financial data and communications. Organizations should begin assessing their current cryptographic infrastructure to identify vulnerabilities that quantum computing could exploit, prioritizing critical data and systems that require enhanced protection.

Potential actions:

- Assess your organization's current understanding of emerging quantum computing technology, and inventory potential security risks
- Consider implementing a quantum security group

Thought leadership

- Are You Ready For a Quantum Leap?
- Preparing for the Quantum Leap.

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Payments

Institutions are now less than one year away from the industry mandate, ISO 20022 (effective November 2025). Even sooner, US banks are focused on meeting the March 2025 industry mandate for Fedwire (the Federal Reserve's US network for high-value wire payments).

Many banks have already modernized their payments system and are achieving the benefits from real-time payment capabilities. The benefit of ISO 20022 is the incremental data and the speed of SWIFT for cross-border payments. ISO 20022's incremental data provides banks with new revenue opportunities. According to a *Forbes* article, with SWIFT, 50 percent of GPI payments are credited to end beneficiaries within 30 minutes, 40 percent in less than 5 minutes, and nearly 100 percent within 24 hours.

In our last survey, 79 percent of banks surveyed said they are looking to modernize multiple payment types. Many banks and credit unions of all sizes have signed up for FedNow, an instant payment structure that enables individuals and businesses to send instant payments through their depository institution accounts.

Potential actions:

- Review your bank's progress toward real-time payment systems and alignment with the global ISO 20022 mandate.
- Identify products and services that could be offered using the incremental data from ISO 20022.
- Consider the business potential from marketing SWIFT for cross-border payments.
- Strategize against stand-alone biller apps and other digital platforms by enhancing the appeal and functionality from online banking offerings and the advantages from instant payments.

Thought leadership

- How banks can simplify digital payments
- 2024 U.S. Banking Industry Outlook Survey

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Tax

Several expiring tax provisions make 2025 a year that tax legislation needs to be addressed. Republican control of the House, Senate and White House increases the likelihood of more sweeping tax changes.

ASU 2023-09, *Improvements to Income Tax Disclosures*, expands annual income tax disclosures to address investor requests for more information about how the tax risks, tax planning, and operational opportunities in an entity's worldwide operations affect the effective tax rate and future cash flows, generally effective for banks for annual periods beginning after December 15, 2024.

The November 2024 issue of KPMG Hot Topic summarizes the guidance in the ASU on a topic-by-topic basis and provides KPMG observations related to implementing the guidance based on our current understanding of the ASU. Items that banks are currently working on include:

1. Adoption–Considering whether to adopt retrospectively or prospectively
2. Methodology–Deciding on optional methods for determining the states that make up the "majority" of state tax expense for the qualitative disclosure
3. Tax credit presentation–Deciding whether to include proportional amortization method and K1 deductions in the tax credit category or in a different category
4. UTPs–Deciding whether to elect to disclose the current-year accruals in the uncertain tax position (UTP) category or in the category for which the UTP relates (state, tax credits, etc.)
5. RTP adjustments–Considering whether the return to provision (RTP) should be broken out to categories the RTP relates to or recorded in other.

Recently **released IRS Office of Chief Counsel memorandum AM 2024-003**[1] concludes that the deductibility of FDIC special assessments imposed in November 2023, to recover the loss to the Deposit Insurance Fund arising from the protection of certain uninsured depositors, is not subject to the limitations for deductibility under section 162(r) and is not subject to capitalization under section 263(a).

The IRS further concluded that the liability to pay the FDIC special assessments was fixed under the all-events test for tax purposes in 2023, and the amount of the liability was determined with reasonable accuracy. However economic performance for the special assessment liability will generally not occur until the liability is paid. Therefore, **the IRS concluded the special assessment should be deductible in the year of payment.**

Potential actions:

- Confirm treatment for tax deductibility for FDIC special assessments.
- Start data gathering for ASU 2023-09 income tax disclosures and understanding related optionality.

Thought leadership

- Hot Topic November 2024: Income tax disclosures
- TaxNewsFlash: Deductibility of FDIC Special Assessments

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[1] Office of Chief Counsel Internal Revenue Service, "Deductibility of Federal Deposit Insurance Corporation (FDIC) Special Assessments" (September 11, 2024)

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