Addressing top-of-mind banking and capital markets issues

Content

Insights

As we reflect on the regulatory year that was and that is coming, KPMG Regulatory Insights offers a unique view across the KPMG Ten Key Regulatory Challenges.

Ten Key Regulatory Challenges of 2023: Mid-year Look Forward

Learn more about the top drivers for innovation and growth.

2023 Banking top 10

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

KPMG Economics

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Risk and regulatory

There is a renewed focus on **key foundational elements of governance, accountability, and transparency** and how those are applied to traditional offerings as well as new asset categories and technologies. Traditional "**safety and soundness**" infrastructure components are front and center (e.g., capital, liquidity, risk management/credit risk, and oversight/governance).

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 fully 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 or complaints.

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

Potential actions to take include:

- **Anticipate increased scrutiny from the regulators in light of recent market events**, especially in areas such as enterprise risk management, liquidity and concentrations, third-party risk management and operational resiliency, timeliness of MRA remediation, and new products and technologies.
- **In this interest rate environment, expect increased regulatory focus on stability/composition of earnings**, access to credit, consumer fraud/complaints/claims, adequacy of disclosures, and application of "fairness" broadly (i.e., UDAAP), including the use of models, algorithms, and AI applications.

Thought leadership:

- Ten Key Regulatory Challenges of 2023: Mid-year Look Forward
- Bank Supervision: OCC "Persistent Weaknesses"
- The 'Empowerment' of State Law and Regulation

Credit

The Federal Reserve is currently prioritizing efforts to address the **delayed effects of interest rates** on the broader macroeconomic landscape.

The delinquency rate for securitized office commercial real estate (CRE) loans rose from 2.77% in April to 4.02% in May 2023. There is an **increase of borrowers handing over properties to lenders** to avoid bankruptcy costs.

As banks prepare for a potential increase in defaults, they are **bracing for a subsequent rise in other real estate owned inventories**. The decline in collateral value, particularly in the office, hotel, and certain retail CRE segments, will make it more challenging to recover losses.

Within the next three years, CRE loans totaling $1.5 trillion are set to mature. Due to **tightened lending standards for CRE, financing options are becoming increasingly limited** for borrowers. According to Co-Star, an estimated 83% of outstanding office CRE loans are unlikely to be refinanced.

The combination of **declining collateral values** and a **10% increase in CRE loan delinquencies** from the previous quarter has created an expectation among banks of all sizes for significant increases in the allowance for credit losses (ACL).

Potential actions to take include:

- Thoroughly **evaluate the framework and processes for developing the ACL estimate** to ensure it incorporates current and forecasted trends and conditions.
- Proactively **analyze existing CRE exposure** to identify and mitigate emerging maturity, refinance, and collateral value risks.
- **Considerations should be applied to property type**, such as office, as well as to geographic locations, such as downtown urban
- Temporary **reallocation of operational resources may be required** to navigate the next 12 months. It may be prudent to proactively plan and cross-train professionals for CRE, workout, and other real estate owned (OREO) management.

Thought leadership:

- CECL Pulse check Q2 2023
- Credit Markets Update Q1 2023

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Growth and profitability

With the increased probability of a recession, companies continue to focus on **reducing costs of operations, and monitoring credit and management** to safeguard profitability.

The **adoption of alternative business models**, including embedded finance, API-led open banking, and banking-as-a-service (BaaS), historically the domain of challenger banks and nontraditional competitors, are becoming more mainstream and may drive earnings growth at "heritage" banks in 2023 and beyond—but expect heightened regulatory scrutiny of BaaS and embedded finance strategies that rely on partner networks for origination and distribution.

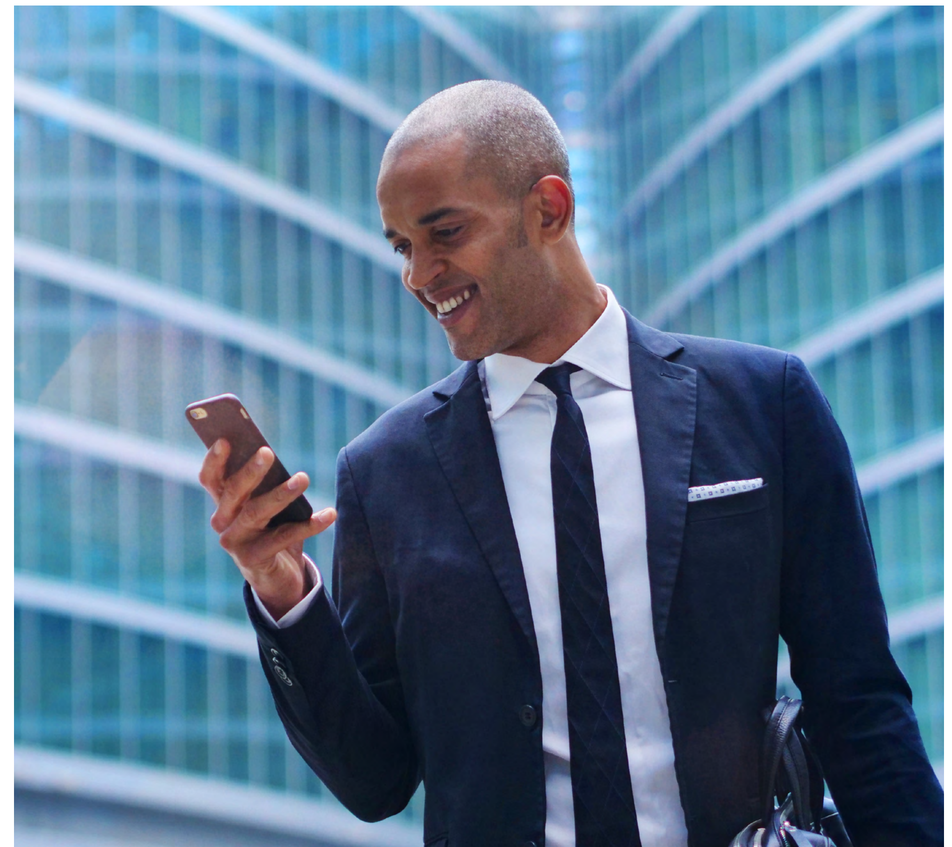
Many companies are evaluating existing product lines with an **increased focus on funding requirements and offering additional financial products to existing customers**, in addition to top-line revenue.

Potential actions to take include:

- Focus on specific growth opportunities, including **commercial treasury services, ESG and green-linked finance, and "deep vertical"** niche.
- During the recovery, **preserve capacity for origination and servicing**—institutions that need to rehire/rebuild to meet eventual recovery demands risk missing out on two to three quarters' growth in 2024.
- To "**insource**" **innovation and expand market reach**, partner with and invest in complex fintech ecosystems.
- Improve business portfolios and strategies with higher-risk innovation "bets" designed to **drive long-term growth and more stable and predictable established businesses**.

Thought leadership:

- Pulse of Fintech—KPMG Global
- Profitability: Innovation for revenue and growth



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Cost optimization

As macroeconomic warning signs continue to emerge, the emphasis on reducing costs and improving efficiency is growing stronger.

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 enhance efficiency and scalability; 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**.

Common themes in cost-reduction efforts include **continued digitization and automation of complex processes** (e.g., onboarding, and underwriting); **outsourcing of high variable volume processes** (KYC, AML monitoring, and investigations); **locational strategies** (e.g., offshoring of select corporate functions and analytics centers, and domestic hybrid work location strategies); and **strategic business reconfiguration** (servicing channel migration strategies, self-service portal development, account service-level realignment, and branch network optimization).

Potential actions to take include:

- **Re-assess capacity needs and levels** – Even after recent "spans and layers" reviews to account changing business conditions and expectations.
- **Optimize funding costs** – Invest in deposit analytics, pricing tools, and value propositions to optimize funding costs during high or volatile rate environments, as inexpensive deposit funding is no longer widely available
- **Examine procured cost bases** – Explore alternative vendors, contract renegotiation, and demand management.
- **Develop core transformation strategy** – Compare cloud-based alternative cores with the latest traditional provider offers and plan migration strategies (e.g., parallel implementations) as contracts age out.
- **Transform underlying cost drivers** – Simplify enterprise and product architecture, account service-level realignment, transformation of "institutional metabolism," and decision-making pace.

Thought leadership:

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

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Capital management

Concurrent with their focus on cost reduction and efficiency improvement, **banks are also re-examining the efficiency and effectiveness of their management of financial resources, including capital**. The transition to Basel IV capital standards, with greater emphasis on operational risk capitalization and greater constraints placed on internal model-based capitalization approaches, is also expected to drive significant changes in capital measurement and management.

Potential actions to take include:

- **Basel IV regulatory capital modeling** – Revisit capital and liquidity modeling and analytics infrastructure in light of the most recent Basel IV guidance, including implementation timelines.
- **Lending portfolio optimization** – Assess capital efficiency at segment and product levels to identify capital release or capital appetite arbitrage opportunities.
- **M&A/business portfolio optimization** – Implement a more aggressive approach to 'zero-based' optimization of marginal capital allocation, which includes (a) feed/starve segmentation of business activities with sub-hurdle rate returns and no clear, credible path to competitive differentiation and return improvement, and (b) identifying potential divestiture candidates.
- **Dividend and share buyback strategy** – While buybacks are a politically sensitive topic, some traditional portions of the banking industry are mature and likely to generate excess capital relative to the scale of attractive internal investment opportunities. Where these dynamics exist, and where shareholders are able to redeploy capital to higher-growth and higher-return activities elsewhere, expanded capital return strategies, including both dividends and buybacks, may be appropriate.

Thought leadership:

- The big reversal—M&A trends in financial services

Artificial intelligence

In today's highly competitive business landscape, companies are increasingly turning to AI-powered solutions to improve their operations and provide better customer service. However, for these solutions to be effective, it is essential to **prioritize engineering of prompt writing for large language models** (LLMs).

To leverage the power of LLMs effectively, companies must focus on prompt writing, which involves **creating high-quality training data and designing effective prompts** that can guide the model's behavior. Without a focus on prompt writing, LLMs may generate inaccurate or irrelevant responses, leading to poor customer service and business performance.

Generative AI is becoming another powerful technique in an organization's toolbox of advanced analytics and AI. However, with this growing set of capabilities comes the need to **develop literacy and governance to ensure the use of generative AI builds trust in the outcomes it creates and is done in line with the organization's standards** while considering business and customer impacts. Companies must develop a set of frameworks, controls, processes, and tools to ensure AI systems are being designed and deployed in a trustworthy and ethical manner so that companies can accelerate value.

Potential actions to take include:

- **Invest in high-quality training data** that accurately reflects the intended use of the AI system and identifying and addressing any potential biases in the data.
- **Design effective prompts** that understand the intended use and can guide the model's behavior and ensure that the AI system generates accurate and relevant responses.
- **Conduct regular risk assessments** to identify potential risks associated with the use of AI-powered solutions and developing strategies to mitigate those risks.

Thought leadership:

- Generative AI in the modern workplace—KPMG Global (3/31)
- KPMG Generative AI Survey
- Generative AI has an increasing effect on the workforce and productivity—KPMG survey

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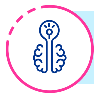
Cyber

Generative AI, such as ChatGPT, is becoming increasingly prevalent, and organizations must prioritize controls around these tools. **Cybersecurity should be considered during their development** to ensure adequate protection. A survey conducted by Microsoft found that **89% of surveyed companies do not have tools in place to secure its AI systems**. Impending regulations, such as EU's AI Act, will require organizations to ensure security and trustworthiness of their high-risk AI systems.

While cloud adoption provides benefits such as resilience and security, it also poses several risks, particularly within the banking sector. A heavy reliance on a few cloud service providers (CSPs) increases exposure of the financial industry significantly. Therefore, **the Treasury developed best practices to mitigate risks of cloud adoption frameworks and cloud contracts**, including reducing dependence on a few CSPs.

Regulators are pursuing "weak links" in cyber programs and coverage. In 2023, regulatory agencies will continue executing their extensive agendas. All financial system participants must implement risk mitigation and resilience measures against regulatory requirements. **Scrutiny will intensify as regulatory agencies focus more on trust in the banking sector**.



Key focus areas for CISOs include:

- **Establish guardrails to maximize the benefits of AI**: Set expectations, pre-preestablish internal process, and implement controls throughout the development of these tools.
- **Preemptive regulatory response**: Cyber teams must flex their priorities to support evolving business needs while maintaining pace with threat actors and regulatory requirements.
- **Evolving cybersecurity teams**: Utilizing managed service providers, creative resourcing strategies, and investments in employee upskilling will help close capacity gaps in key skill areas.

Thought leadership:

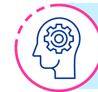
- Building trust in AI is a shared responsibility
- AI Security Framework Design
- Focus on Tech: Cloud, AI, Personal Data

Digital transformation

Transformation at many organizations is technology focused, but controllers and CAOs are finding that much more needs to change. While technology is an enabler of transformation, its impact depends greatly on the **people and processes surrounding it, making governance, culture, and change management** key considerations.

The pressure to transform also does not preclude the need for strong business cases—with many technologies promising the world but delivering far less, leaders must **clearly demonstrate the value of initiatives to secure appropriate buy-in and investment**.

Return on investment (ROI) on new technologies, particularly automation, often has a long timeline given the high up-front costs or is difficult to quantify in terms that will convince decision makers. Nevertheless, with new technologies steadily gaining traction and leaders increasingly recognizing the need to transform to stay competitive, controllers are poised to radically alter their organizations in the coming years.



Potential actions to consider:

- Approach transformation with a **broader, function-wide or organization-wide mindset** in terms of both the change itself and the intended benefits.
- Change management is necessary to **ensure that organizational structures align with new technologies**, and that sufficient adoption occurs.
- Examine close processes to **identify inefficiencies and reduce complexity** to make it easier for teams to handle in the short term, while also preparing their organizations for future automation implementations.

Thought leadership:

- Corporate Controller & CAO Hot Topics: Digital Transformation Spotlight
- Empowering banks to be future-ready
- Core Modernization: Fortify the foundation Podcast

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ESG

In December 2022, the Federal Reserve Board (Federal Reserve) issued instructions for the six large U.S. banks participating in its pilot climate scenario exercise announced in September 2022. The exercise **expects all financial institutions, regardless of size, to strengthen quantitative climate analysis** (physical and transitional) and highlights the resources needed by risk and credit management to prepare and execute it. The six large banks must submit their results by July 31st and the Federal Reserve plans to publish aggregated insights reflecting what has been learned about climate risk management practices by the end of 2023.

This spring, media reported the SEC was considering **softening its final climate rule** due to **pushback received from companies and investors**. The final climate rule is expected by fall 2023, but uncertainty around its scope makes it challenging for institutions to determine optimal steps forward on their ESG journey. Despite the delay, there are ESG accelerators financial institutions can consider, including certain opportunities and initiatives.

Steps to take to progress on an ESG journey:

- **Build out the institution's green financing product set**, with products aimed at unlocking hidden commercial demand such as clean energy, clean fleet and commercial real estate upgrades.
- **Enhance coverage of emerging green segments** with dedicated coverage teams, tailored understanding to account for growth characteristics and specialized pricing and securitization capabilities.
- **Take the next step in identifying and calculating greenhouse gas emissions**, considering how the data is collected and by who, and what controls are in place.

Thought leadership:

- ESG for Banks Share Forum
- Climate Risk: FRB's Pilot Scenario Analysis and Risk Management Practices
- KPMG Climate Scenario Analysis for US-based Banks webcast

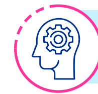
Tax

Banks are **assessing the impact that rising interest rates** have on the balance sheet and the associated tax methodologies.

- Certain transactions may **generate large losses that could be subject to reporting requirements** unless certain exceptions are met.
- **Large changes in valuations combined with potentially punitive rules for misidentification** of securities 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.

Provisions in the **Inflation Reduction Act (IRA)** could impact banks in 2023.

- If a corporation's financial statement income (subject to adjustments) exceeds an annual average of $1 billion over three years, the corporation is generally subject to a **Corporate Alternative Minimum Tax (CAMT) of 15%** on adjusted financial statement income starting in 2023. Additionally, the CAMT contains a credit carryforward mechanism that may **need to be factored into regulatory capital calculations**.
- A 1**% excise tax is generally imposed on repurchases of stock** (net of stock issuances) by certain publicly traded corporations for repurchases occurring after December 31, 2022.



Potential actions to take include:

- **Review and update mark-to-market tax ID statement** to confirm it is capturing securities appropriately.
- Determine whether loss transactions **could be subject to reportable transaction rules**.
- **Evaluate impact of provisions in the IRA** to determine additional liabilities, opportunities, regulatory capital considerations, and/or filing requirements.

Thought leadership:

- Tax provisions in IRA relevant to the banking industry
- Analysis and Observations: Tax law changes in the Inflation Reduction Act of 2022
- Accounting for tax provisions in the IRA and CHIPS legislation

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T+1 settlement cycle

On February 15, 2023, the Securities and Exchange Commission (SEC) adopted a final rule for the **move to a T+1 settlement for transactions in U.S. cash equities, corporate debt, and unit investment trusts** with a May 28, 2024, required compliance date. The SEC believes that further shortening the settlement cycle to T+1 will reduce market participants' exposure to credit, market, and liquidity risk arising from unsettled transactions and yield numerous benefits, including reduced costs and increased market efficiency as investors will have quicker access to funds.

Strong project management and organizational leadership, coupled with timely communication and coordination among industry participants will be vital to a successful migration from T+2 to T+1.

Potential actions to take:

- **Establish a committee** to identify actions, establish timelines, and monitor progress to ensure timely compliance with T+1 settlement.
- **Consider the operational impacts** to existing trade processing and identify enhancements required to automated systems and processes including:
  - **Internal and industry testing** with depositories, counterparties, custodians, vendors, and other market participants to ensure market and operational readiness. Testing should begin at least three months in advance of March 2024, industry-wide testing is set to begin Q3 2023.
  - **Evaluating geographical location strategies** to expand operational capacity required for exception monitoring to regions outside of the U.S.
  - **Vendor readiness** by coordinating with third-party vendors to make appropriate system and service-level changes as a result of the shortened settlement cycle.
  - Assessing the need to **update** legal and/or service level agreements with relevant third-parties and internal written policies and procedures.
- The SEC will continue to assess the feasibility of an eventual future shift to a "same-day settlement" (T+0), and organizations should be mindful of the action steps that they take today with the eventual move to T+0.

Thought leadership:

- SEC final rule for T+1 settlement cycle
- Ready for the T+1 Accelerated Settlement transition?

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