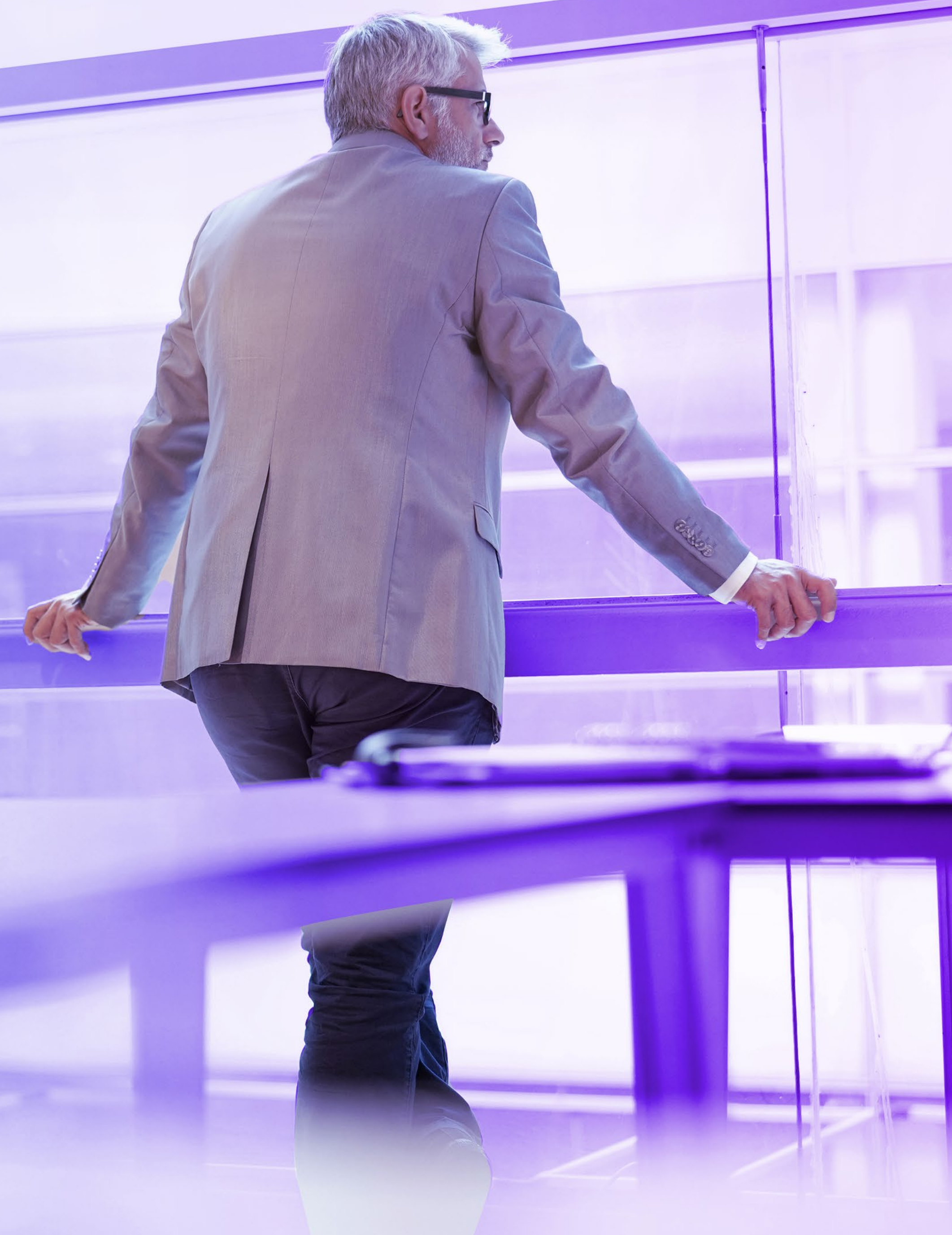
Addressing top-of-mind banking and capital markets issues



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 10 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

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

KPMG Banking and Capital Markets Insights

Risk and regulatory

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

Traditional **"safety and soundness"** infrastructure components are front and center for the regulators following recent market events (e.g., capital, liquidity, risk management/credit risk, and oversight/governance). Those 1Q23 events have resulted in regulatory updates and proposals on capital (Basel III Endgame), long-term debt holdings, and resolution planning.

And given the continued inflationary 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 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 considering recent market events**, especially in areas such as enterprise risk management, capital, liquidity and concentrations, 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 consumer "fairness" broadly (i.e., UDAAP), including the use of models, algorithms, and AI applications.

Thought leadership:

- Regulatory Intensity
- Resolution & Living Wills: FDIC and Joint (FDIC/FRB) proposals
- Capital Requirements: Proposed "Basel III Endgame" & GSIB Capital Surcharges
- Long-Term Debt Requirements: Interagency Proposed Rule

Credit

The Federal Reserve reports that **banks are tightening lending standards across both commercial and industrial (C&I) as well as commercial real estate (CRE)** portfolios, returning to the credit basis by increasing spreads, adding premiums on "risky" loans, and requiring lower collateral ratios along with higher repayment capacity. Commercial delinquency rates have seen a slight decrease over the past two quarters, but this is partially attributed to a consistent rise in charge-offs since the start of 2023. Early-stage delinquency (0-30 days) has been declining during the first half of 2023, suggesting a potential reduction in future volumes.

The Green Street Commercial Property Price Index indicates a **persistent decline in commercial real estate values**. Office properties have lost approximately 31 percent of their value since the Federal Reserve started increasing interest rates, attributed to ongoing remote and hybrid work arrangements, as well as higher investor return requirements. Multifamily properties are facing challenges driven by a supply and demand imbalance, leading to rising vacancies and slower rent growth.

The rapid accumulation of personal savings during the COVID stimulus period has now experienced a reversal, unlike previous recessions that typically witnessed only a slight increase in personal savings. As a result, **delinquencies for auto and credit card loans are inching closer to pre-pandemic levels**.

Potential actions to take include:

- Conduct a **comprehensive assessment of the framework and processes used to develop the ACL estimate** to help 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.
- Temporary **operational resource reallocations and proactive cross-training of professionals** for CRE, workout, and other real estate-owned (OREO) management may be required to navigate the next 12 months effectively.
- **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 2023
- Credit Markets Update Q2 2023

ESG

In July 2023, the Securities and Exchange Commission (SEC) finalized its cybersecurity disclosure rules. **Public companies are now required to disclose material cybersecurity events** on Form 8-K and disclose on Form 10-K the process to identify, and manage material risks from cybersecurity threats, including board oversight.

The SEC's final climate disclosure rule and proposed human capital management disclosures are expected as early as October. The SEC's proposed corporate board diversity disclosures are expected April '24.

In July 2023, the European Commission published the final text of the first 12 European Sustainability Reporting Standards (ESRSs). For years beginning January 1, 2024, certain companies will need to apply the ESRSs, which require the **disclosure of comprehensive information on an entity's performance** regarding sustainability topics and how they are managed. US companies may be subject to certain reporting requirements if listed on any EU exchange or if have substantial activity and a presence in the EU.

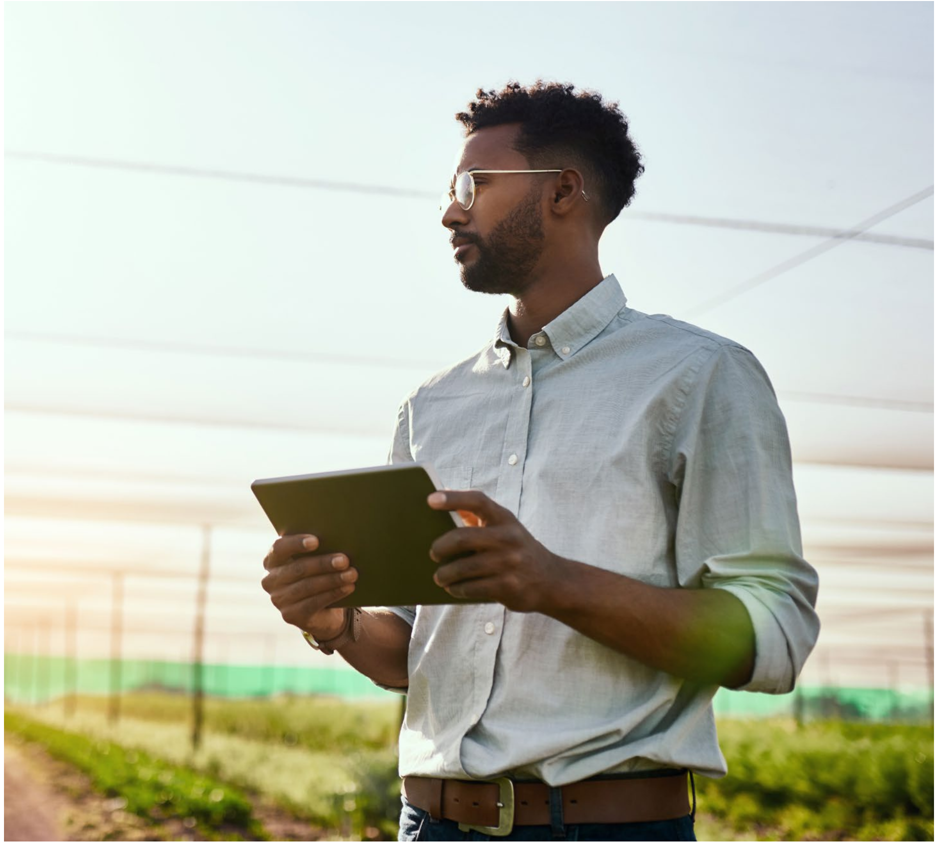
In mid-September, California Bill SB 352 passed the California Assembly and was sent to Governor Newsom for signing. The Bill, which applies to companies with greater than $1 billion of annual revenues doing business in California, requires reporting of a company's scope 1, 2 and 3 emissions beginning in FY 2025. The Bill would require limited assurance of scope 1 and 2 emissions beginning in 2026 rising to reasonable assurance in 2030. Other states, including New York, are progressing their own climate related bills, although none are as far along as the CA Bill.

Insights from recent ESG survey of large financial institutions:

- The majority of large banks have a **chief sustainability officer** responsible for overall ESG strategy and half of large banks have a **dedicated ESG controller** overseeing ESG disclosures.
- Large banks are investing in **climate data infrastructure** and in **technology** to enhance ESG disclosure and reporting capabilities.
- Large banks are **prioritizing data management** by standing up data governance structures, implementing processes and controls for data collection through disclosure, and contracting with external data management vendors.

Thought leadership:

- SEC finalizes cybersecurity rules
- Banking sector leans into ESG



Cost optimization

As the market stabilizes and a full-blown recession appears less likely, 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:

- **Reassess capacity needs and levels** – Even after recent "spans and layers" reviews to account for 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** – Leveraging the new and advancing technologies, cloud, digital, and generative AI.
- **Transform underlying cost drivers** – Simplify enterprise and product architecture, account service-level realignment, transformation of "institutional metabolism," and decision-making pace.

Thought leadership:

- Cost optimization: Drive profitability and efficiency

Growth and profitability

With the probability of a recession appearing to have receded, companies continue to focus on **reducing the 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, is 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. Also, look at nonfinancial services activity to support growth—airline card cobrands/lounges, etc.
- 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

Capital management

Concurrent with their focus on cost reduction and efficiency improvement, banks are also **reexamining the efficiency and effectiveness of their management of financial resources**, including capital.

Over the past quarter, banks have focused on liquidity and capital management.

The **transition to the proposed Basel III Endgame 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 III Endgame regulatory capital modeling** – Revisit capital and liquidity modeling and analytics infrastructure considering the most recent Basel III Endgame 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** – This is in line with the new capital requirements and managing liquidity review business portfolios and optimize through acquisitions or divestments to manage capital allocations.
- **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 can redeploy capital to higher-growth and higher-return activities elsewhere, expanded capital return strategies, including both dividends and buybacks, may be appropriate. Activist shareholders are also focusing on returning capital to shareholders.

Thought leadership:

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

Artificial intelligence

Organizations are increasingly adopting AI-driven solutions to enhance their operations and deliver better customer service. However, to help ensure the effectiveness of these solutions, it is crucial to **prioritize engineering of prompt writing for large language models** (LLMs).

To harness the true power of LLMs, organizations must focus on prompt writing. This involves **creating high-quality training data and crafting effective prompts** that can guide the model's behavior. Neglecting prompt writing can result in LLMs generating inaccurate or irrelevant responses, which can negatively impact customer service and overall business performance.

Generative AI is emerging as a valuable technique in organizations' toolbox of advanced analytics and AI. However, as these capabilities expand, it becomes **imperative to establish literacy and governance to instill trust in the outcomes generated by generative AI**. This should align with the organization's standards while considering the business and customer impacts. Companies must develop frameworks, controls, processes, and tools to help ensure the trustworthy and ethical design and deployment of AI systems. This enables companies to accelerate value while maintaining integrity.

Potential actions to take include:

- **Invest in high-quality training data** that precisely aligns with the intended application of the AI system and identify and address any potential biases in the data.
- **Create well-crafted prompts** that understand the intended use and can direct the model's behavior, ensuring that the AI system generates accurate and relevant responses.
- **Perform periodic risk assessments** to identify potential risks related to the utilization of AI-powered solutions and develop strategies to mitigate those risks.

Thought leadership:

- Generative AI in the modern workplace – KPMG Global
- 2023 KPMG Generative AI Survey
- KPMG generative AI survey report: Financial services

Cyber

The **SEC** approved a new rule related to cybersecurity risk management and disclosure requirements for public companies. Meeting these regulations requires action and input from multiple groups within the organization. Registrants are required to report material cybersecurity incidents on **new Item 1.05 of Form 8-K** within four business days after the registrant determines that the incident is material.

These new rules will significantly expand registrants' annual disclosures and provide more standardized and specific details regarding material cybersecurity incidents. Organizations need to begin scrutinizing their existing systems, processes, and controls to meet these **new requirements coming in December** of this year.

Additionally, **FSIs** are continuing to rapidly adopt **artificial intelligence**, particularly for **fraud prevention**. Organizations have been utilizing anomaly detection techniques and are now augmenting these strategies with new AI technologies to enhance their capabilities to detect and deter instances of fraud.

Key focus areas for CISOs include:

- **Proactive compliance with SEC requirements** – Organizations must prioritize and proactively respond to regulatory requirements by involving all relevant teams in order to ensure compliance with the upcoming response requirements from the SEC. This collaborative approach will aid in meeting deadlines and maintaining transparency when addressing cybersecurity concerns.
- **Scrutinize current processes to leverage automation** – Financial institutions should assess their existing processes and pinpoint problem areas to determine where automation and AI can be employed to more effectively allocate limited cyber resources.
- **Establish guardrails to maximize the benefits of AI** – To help ensure the effective and responsible use of AI in combating cybersecurity threats and addressing regulatory requirements, establish expectations, define internal processes beforehand, and implement controls throughout the development of these tools.

Thought leadership:

- SEC finalizes cybersecurity rules
- AI security framework design
- Building trust in AI is a shared responsibility

Digital transformation

Digital transformation is crucial for banks to thrive amid disruptive threats and evolving customer expectations. This **transformation goes beyond technology, impacting the entire enterprise from strategy to culture**. By fortifying foundations and building integrated ecosystems, banks can deliver consistent customer experiences and streamline processes.

Banks must **modernize their core operations, digitizing processes such as deposits, payments, and lending** to drive digital transformation. By leveraging advanced technologies such as cloud computing and AI, banks can innovate, accelerate processes, and enable real-time processing. This modernization is essential for banks to stay competitive, improve efficiency, and meet the demands of today's digital-first customers.

Successful digital transformation requires more than technology. It necessitates a **focus on governance, culture, and change management**. Leaders must demonstrate value, align organizational structures with new technologies, and ensure adoption.

Potential actions to consider:

- Prioritize **strengthening their foundational elements**, including strategy, people, and culture.
- Focus on **establishing an integrated ecosystem** that fosters collaboration and delivers consistent experiences across channels.
- Embark on core modernization efforts, **digitizing operations such as deposits, payments, and lending**. This modernization is crucial for banks to stay competitive, enhance efficiency, and meet the ever-evolving demands of a digital-first marketplace.

Thought leadership:

- Digital transformation in banking
- Corporate Controller & CAO Hot Topics: Digital Transformation Spotlight
- Empowering banks to be future-ready
- Future of commercial banking

Tax

Tax departments of large banks are **assessing the impact that proposed Basel III Endgame regulations** could have on the tax aspects of regulatory capital. The proposed changes that could impact the tax aspects of regulatory capital are summarized below. These changes would only apply **to Categories III and IV banks (banks with total assets between $100 billion and $700 billion and less than $75 billion of cross-jurisdictional activity)**.

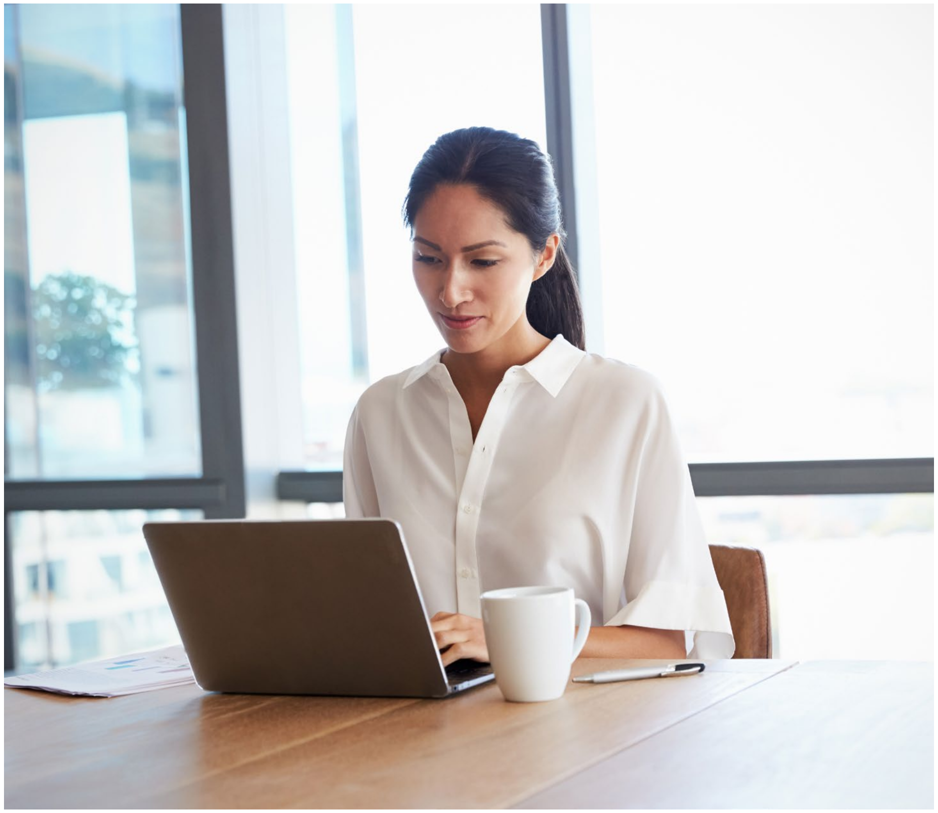
- Banking organizations in Categories III and IV **would be required to include most elements of accumulated other comprehensive income (AOCI)** (and related deferred tax asset (DTA)/deferred tax liability (DTL)) in regulatory capital in the same way that Categories I and II banks currently need to.
- Banking organizations in Categories III and IV **would be subject to the lower threshold percentages** for threshold items (which includes temporary DTAs) that currently apply to Categories I and II banks. Specifically, the current threshold percentage of 25 percent would be lowered to 10 percent and an additional adjustment would be made to capital if remaining aggregate threshold items exceed 15 percent of capital.
- The above proposed changes could have an **adverse impact on regulatory capital** as they could result in a greater amount of DTAs being disallowed from capital and/or a greater amount of risk weighted DTAs to consider in the capital ratio. The proposed Basel III Endgame regulations, if finalized, would be effective starting in July 2025 and would have a **three-year transition period** for certain items.

Potential actions to take include:

- **Conduct a current-state assessment** and look to establish centralized coordination to drive the various transition efforts to comply with the proposed rules.
- **Evaluate impact of proposed Basel III Endgame regulations** to determine the potential impact and possible planning opportunities.

Thought leadership:

- In the Vault with KPMG podcast discussing the proposed regulations and potential impact to bank tax departments
- Capital Requirements: Proposed "Basel III Endgame" & GSIB Capital Surcharges



Broker-dealer daily reserve requirement amendments

On July 12, 2023, the SEC proposed amendments to SEA Rule 15c3-3. These changes would require broker-dealers with average total credits of $250 million or more to **compute their net cash owed to customers and other broker-dealers daily instead of weekly**. The amendments aim to reduce the time gap between computations and ensure a timely matching of cash owed to segregated cash/qualified securities in reserve bank account(s).

Broker-dealer community feedback:

Although the comment period has ended, the SEC received feedback from broker-dealers focusing on the following themes:

- Switching to daily computations will **necessitate hiring/training staff and revamping IT systems**, resulting in additional expenses.
- Including amounts in the daily computations may not be feasible, **leading to increased liquidity tied up as a "cushion"** and limiting the broker-dealer's ability to provide customer financing. Availability issues may arise as financial market utilities, banks, and/or third-party data providers may be closed on or the day prior to a particular holiday.
- SEA Rule 15c3-3 typically mandates broker-dealers to decrease their reserve formula debit balance by 3 percent. **Requiring daily reserve computations along with the 3 percent reduction requirement is seen as redundant** and likely to raise reserve requirements.
- Certain broker-dealer activities do not pose a significant mismatch risk. Despite having average total credits of $250 million or more, their **debits largely or entirely offset these credits**, resulting in an unnecessary burden for them to perform daily computations.
- Considering the **substantial effort required for the transition to daily computations**, coupled with the simultaneous need to comply with other upcoming initiatives (e.g., T+1, FINRA Rule 4210), the implementation timeline should be commensurate with the level of effort.

Potential actions to take include:

- **Establish a committee or internal group** to oversee compliance with proposed amendments, set timelines, and monitor progress.
- **Assess current weekly reserve computations** and evaluate potential changes required to operationally complete daily computations, including:
  - **Automate IT system feeds or calculations** to streamline inputs for daily computations, collaborating with IT to estimate effort, resourcing, and timeline.
  - **Coordinate with upstream business processes** to align timing of feeds or manual processes affecting computations and updating service-level agreements accordingly.
  - **Review timing of information from third parties** and coordinate with them if adjustments are needed for timely execution of daily computations.
  - **Determine required headcount** to execute daily computations and timely satisfy deposit requirements.
- Evaluate broker-dealer's **liquidity management and funding** to accommodate daily changes in reserve deposit requirements.

kpmg.com/socialmedia

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.