Addressing top-of-mind banking and capital markets issues

Growth and profitability

Increasing probability of recession has tempered growth hopes and expectations, with **increased focus on operating cost belt-tightening, proactive credit monitoring, and management** to safeguard profitability.

Small business remains a major battleground between high-scale national banks investing in digital value propositions and regional/community banks emphasizing high-touch service.

Banks are monitoring how to change deposit pricing strategy following the typical lag of raising deposit rates after the rise in interest rates.

Credit costs remain low, but there are some areas of concern (e.g., subprime auto and subprime mortgage), with **potential for deferred credit stress due to expiration of forbearance and stimulus programs.**

Potential actions to take include:

- **Specific growth opportunities** of interest include commercial treasury services, ESG and green-linked finance, and "deep vertical" plays integrating credit, liquidity, and treasury services aligned with specific vertical niche needs
- **Preserve capacity** for origination and servicing in the recovery—institutions that need to rehire/rebuild to meet eventual recovery demands risk missing out on 2 – 3 quarters' growth in 2023 – 2024
- Partner with and invest in complex fintech ecosystems as a means of "**insourcing" innovation** and expanding potential market reach
- Optimize business portfolios and strategies with a mix of higher-risk innovation "bets" designed to **drive long-term growth and more stable and predictable established businesses.**

Thought leadership:

- Profitability: Innovation for revenue and growth

Cost optimization

Although the banking industry has seen relatively few announcements of major cost reduction programs in recent months (versus the retail industry, for example), **planning for improved efficiency is a priority and the potential for more decisive steps this fall and winter is high.**

Due to inflation, pandemic, and geopolitical conflict, **upward pressure on human capital and procured cost bases have intensified**, further contributing to banks' current focus on managing down or deferring discretionary spend.

Banks appear to be **trimming spending for office leasing** due to an increased remote workforce, but also expect to **boost employee compensation** through 2023 to retain talent.

Potential actions to take:

- Institutions expecting a short and shallow recession should work to **preserve origination and processing capacity**, while managing costs, to ensure strong "out of the gate" performance in the recovery
- **Rethink location strategy**—aggressively optimize the branch distribution network to match evolving client behaviors and preferences, and office footprint requirements to match the evolving remote workplace
- Focus digitization efforts on **high-cost and high-value client servicing and middle office functions**
- Eliminate unnecessary costs and **transform underlying cost drivers** – enterprise and product architecture simplification initiatives, transformation of "institutional metabolism," and decision-making pace.

Thought leadership:

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

Credit

Increased corporate default rates have led to a wave of credit-rating downgrades on existing loans in bank portfolios. Defaults on leveraged loans totaled $6 billion in August, the highest since October 2020.

Banks are expecting the **commercial real estate slowdown to continue** into Q4 and 2023, but certain segments are performing better than others.

The future of the **office space real estate market remains highly uncertain** due to economic headwinds, limited demand, varying back to office work policies and a trend toward firms downsizing their real estate footprint.

While still below prepandemic levels, consumer loan **delinquency rates are starting to increase** and will likely reach the 2019 level in late 2023.

Potential actions to take:

- As banks manage the impact of inflation and an expected increase in credit costs on their business, use it as an opportunity to **provide more high-value financial advisory and financial infrastructure services to clients**
- Re-examine loan pricing models to ensure appropriate balance between expected credit costs and an increasingly competitive lending environment due to higher interest rates and slowing loan demand.

Thought leadership:

- Credit Markets Update Q2 2022

INSIGHTS

We surveyed 100 senior bank executives to ask for their insights on some of the most pressing risks and challenges facing the industry. View a summary of our findings below.

› 2022 Banking Industry Survey

Monitor trends and identify potential opportunities that could impact your strategic objectives in this economic environment, including credit and OTTI.

› Office of the Chief Economist

Resources to keep you updated on potential impacts of the Russia-Ukraine war.

› Insights to help navigate uncertainty

Addressing top-of-mind banking and capital markets issues (continued)

Cyber

As digital-first business strategies continue to be pushed to the forefront for financial services institutions, many have achieved extreme transformation velocities—**substantially decreasing exposed digital surface areas most vulnerable to cyberattacks**.

Concurrently, **a significant uptick in adversarial activity and an ever-changing threat landscape increases the risk of an event occurring**. Threat actors have invested in highly sophisticated attack tools, techniques, and procedures.

Key focus areas for CISOs include:

- **Aligning business with security:** Cyber teams must flex their priorities to support evolving business needs and technology strategies.
- **Digital trust:** Customer expectations around stewardship, data protection, and transparency are elevated by new and enhanced customer engagement methods.
- **Cloud transformation:** Cloud security teams must develop a cloud-first security strategy and approach including cloud-native controls, cyber resilience, cloud provider security assessment, and cloud security governance.
- **Evolving cybersecurity teams:** Address capacity gaps in critical skills areas through managed service providers, novel resourcing approaches, and investment in upskilling employees.

Thought leadership:

- Enhancing the cybersecurity risk framework
- Building customer trust through effective cyber security risk management
- The changing shape of ransomware
- Subscribe to Risk and Cyber Insights

ESG

The current SEC regulatory agenda and rulemaking calendar projects the **climate risk** disclosure rules to be finalized in October 2022. Also in October, the SEC expects to propose **human capital management** disclosure rules.

In the spring of 2023, the SEC expects to finalize the **cybersecurity risk management, governance, and incident** disclosure rules in March and issue proposed **corporate board diversity** rules in April.

There **could be some risk to the October finalization of the climate risk disclosure rules** given responses to the proposed rule, recent appointments of two new SEC commissioners and the volume of other activity ongoing at the SEC, including the various ESG-related rules.

Actions to take to in advance of these changes:

Regardless of the timing of the finalization of the SEC climate disclosure rules, financial services institutions should prepare to advance their ESG engagement and prepare for SEC and regulatory reporting:

- **Consider organizational structure**, including who is responsible for ESG reporting and whether there is sufficient collaboration from the controllership, SOX, IT, and internal audit groups
- Assess whether **sufficient levels of expertise or technology solutions for SEC reporting exist** within the company and/or if engagement with climate experts, third-party vendors, or upskilling internal resources are appropriate next steps
- **Evaluate current processes for collecting emissions data and calculating GHG emissions**, including how that data is collected and by who, and what controls are in place.

Thought leadership:

- Podcast: 'No Regrets' moves on ESG reporting
- SEC proposes climate reporting and assurance rules
- SEC proposes cybersecurity rules

Regulatory

There is **heightened focus on key areas of sanctions and digital assets** within fraud and financial crimes risk management; institutions must establish a robust program to **evaluate exposures, mitigate risks, and enhance compliance** as regulators and enforcement agencies prioritize efforts in these areas.

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 abated.

As part of public and private focus on "ESG" **regulators continue to shift attention to "S" factors, focusing on customer and investor protections**, looking for evidence that institutions are treating all customers/investors fairly and equally and are responsive to any customer/investor concerns.

Potential actions to take:

- **Expect increased regulatory focus on fee income** (including overdraft/insufficient funds), consumer complaints (responsiveness, equitable treatment), application of "fairness" broadly (UDAAP) such as in ML/AI applications
- **Anticipate increased coordination among regulators**, especially in areas such as CRA, third-party risk management, climate-related risk management, M&A activity, and the use of AI.

Thought leadership:

- Inclusion: Community Reinvestment Act Proposal
- Regulatory Scrutiny of Technology and Data
- Gearing up for evolving ESG regulations

Addressing top-of-mind banking and capital markets issues (continued)

Digital transformation

While an army of fintech start-ups, box stores, and alternative lenders raises competition by scaling up and moving steadily into the banking space, **a modern core infrastructure is what will allow banks to survive—**and thrive—despite these disruptive threats.

Banks have a great opportunity to respond to this challenge by modernizing their core infrastructure and thrive as a future-ready, customer-centric bank, unlocking things such as **product innovation, speed to delivery, and real-time processing**.

Potential actions to take:

- To efficiently unite front, middle, and back office and deliver consistent experiences, you must **establish the foundation of a modern core**
- Get the most out of interoperability standards by **separating operations like pricing away from debits and credits**
- **Provide the same level of excellent customer experience in every interaction** and over any channel they use to connect with their bank.

Thought leadership:

- The foundational elements of core modernization for banks
- Become the digital bank your customers need

Digital assets

Financial institutions continue to initiate digital asset pilot programs and product offerings in trading, wealth management, custody, clearing/settlement, and payments.

Ethereum successfully transitioned to a **proof-of-stake consensus mechanism**, where holders can earn staking rewards (akin to **interest**).

Regulatory agencies investigate and respond to high-profile collapses of certain tokens, as well as digital asset lenders and borrowers.

Evolving legal and regulatory landscape, SEC, CFTC, banking regulators, and others seeking expanded authorities.

Three things management could do:

- Develop a **capability assessment and risk compliance strategies**, and evaluate potential partners/vendors for digital asset initiatives
- **Design appropriate systems of internal control and compliance procedures**, and engage in ongoing dialogue with regulators prior to product launch
- **D**etermine whether **product and service offerings need to pursue additional licensing and registration**, including with SEC, CFTC, FinCEN, IRS, and/or state regulators.

Thought leadership:

- Crypto & Digital Assets: Treasury & DOJ Report Recommendations
- Assessing crypto and digital asset risks
- Crypto and digital assets: Regulatory challenges
- Crypto as an Asset Class

Tax

The Inflation Reduction Act (IRA), signed into law on August 16, 2022, introduces **tax provisions generally effective in 2023,** including:

- A corporate minimum tax generally equal to 15 percent of net income reported on financial statements (subject to adjustments) for corporations that have average net income in excess of $1 billion
- A 1 percent excise tax on stock repurchases (netted with stock issuances)
- Green energy tax credits and incentives (including transferability of certain tax credits).

There is an **increasing focus on tax credits** given the potential scope expansion of the proportional amortization method of accounting for tax credit investments, new tax credit rules in the IRA, and uncertain treatment of tax credits under OECD Pillar 2.

Bank tax departments can **gain efficiency and accuracy through leveraging bank technology transformation** (e.g., ERP conversions) to improve tax data and modernize tax processes and technology.

Potential actions to take:

- **Evaluate how tax provisions in the IRA impact the organization** (e.g., identifying whether a bank could be subject to the corporate minimum tax)
- **Analyze new tax credit opportunities and potential impacts** to tax equity investing and credit markets (i.e., pricing, demand, transferability) due to legislative and accounting changes for tax credits
- **Leverage bankwide digital transformations** to modernize tax processes and technologies, with focus on improving data accuracy and efficiency.

Thought leadership:

- Analysis and Observations: Tax law changes in the Inflation Reduction Act of 2022
- U.S. Tax Legislation: IRA and CHIPS

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