Regulatory Alert

Financial Services Regulatory Insights

December 2019

2020 Federal supervisory priorities

Key points

— The FRB, OCC, and FSOC have each released reports outlining risk areas they expect will impact the financial services industry in 2020; supervisory and regulatory priorities will align with these risk areas. Similar reports from the SEC and FINRA are anticipated in early 2020.

— The identified risks are generally consistent among the agencies' reports, including cybersecurity threats, credit risk, operational resilience, capital and liquidity, BSA/AML and sanctions compliance, technology transformation, nonbank competition, data governance, regulatory fragmentation/divergent regulation, and LIBOR transition.

KPMG's Regulatory Insights recently issued the fifth edition of its annual Financial Services Ten Key Regulatory Challenges. In the paper, we evaluate how, in 2020, five business imperatives – technology transformation, customer interaction, payments modernization, market expansion, and cost efficiencies – will force new and differing risk and regulatory concerns across ten areas of regulatory challenge. The "Key Ten" include: geopolitical change, divergent regulation, data protection and governance, operational resilience, credit quality, capital and liquidity shifts, compliance agility, financial crimes, customer trust, and ethical conduct. KPMG has great depth in each of these areas and we would welcome the opportunity to discuss them with you in more detail.

The Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), and the Financial Stability Oversight Council (FSOC) each released reports outlining the areas of risk they will focus upon going forward into 2020. Highlights of each of these reports follow.

FRB Reports

The FRB's Supervision and Regulation Report highlights:

— Continued nonfinancial, governance, and risk management weaknesses in areas such as compliance, internal controls, model risk management, operational risk management, data and IT infrastructure, Bank Secrecy Act, and anti-money laundering (BSA/AML) compliance

— Supervisory priorities for large and foreign banking organizations, including:
  - **Capital**: stressed forecasting, underwriting standards, credit risk management, current expected credit losses (CECL)
  - **Liquidity**: stress testing assumptions, liquidity position, risk management and governance over liquidity data, liquidity risk management monitoring, compliance with liquidity regulations
  - **Governance and controls**: operational resilience of critical systems, IT and cyber-related risks, compliance risk management, internal audit, BSA/AML and sanctions compliance, third-party risk management, and LIBOR (London Inter-bank Offered Rate) preparedness
  - **Recovery and resolution planning**

- Supervisory priorities for regional and community banking organizations, including:
  - **Credit risk**: concentrations of credit (commercial real estate, construction and land development), highly leveraged commercial and industrial credits, agricultural lending, credit administration
  - **Operational risk**: mergers and acquisition, IT and cybersecurity, and fintech
  - **Other**: BSA/AML and sanctions compliance, liquidity risk, LIBOR preparedness, and CECL implementation

The FRB's Financial Stability Report is intended to outline the agency's assessment of the resilience in the U.S. financial system across four broad categories. The report states that the level of vulnerabilities has remained generally consistent since May 2019 and highlights current vulnerabilities:

- **Asset valuations** remain elevated in some markets relative to income streams, including leveraged loans, commercial real estate, and agriculture loans
- **Borrowing by businesses** is historically high relative to Gross Domestic Product with the most rapid increases concentrated among the riskiest firms amid weak credit standards; debt owned **by households** remains at a model level relative to incomes
- **Current debt levels** point to financial-sector resilience, U.S. banks remain strongly capitalized, and the leverage of broker-dealers is at historically low levels.
- **Funding risk**, including liabilities issued by nonbanks, remains modest; short-term wholesale funding continue to be low compared with other liabilities and high-quality liquid assets to total assets remains high.

OCC Semiannual Risk Perspective: Fall 2019

The OCC Report highlights the key issues facing the federal banking system, focusing on those issues that pose threats to safety and soundness and compliance with applicable laws and regulations. Key risk themes include:

- **Operational risk**: drivers include:
  - The need to adapt and evolve current technology systems for ongoing cybersecurity threats
  - The ability to understand, implement, and control technology advances and innovation
  - Increased use of third-party service providers and related ongoing oversight and fraud risk
  - The need for effective controls and operational resilience to mitigate potential disruptions
- **Credit risk**: preparation for inevitable cyclical change is needed:
  - Identify borrowers vulnerable to declining cash flow
  - Evaluate the bank's vulnerability to indirect credit risk
  - Maintain robust credit control functions (credit review, problem loan identification, workout, collections, and collateral management)
- **Interest rate risk**: volatility in market rates and recent yield curve inversions are placing pressure on net interest margins and net interest income
- **Strategic risk**: derived from:
  - Non-depository financial institutions, especially in bank lending
  - Innovative and evolving technology applications and expanding data analysis capabilities (artificial intelligence, machine learning)
  - Utilities-sharing, particularly for BAS/AML and sanctions compliance
- **LIBOR transition/benchmark pricing**: examiners will evaluate whether bank have begun to assess their exposure to LIBOR in assets and liabilities to determine potential impacts and develop risk management strategies
- **Emerging risk**: agricultural credit balances, CECL implementation, and cyber threat changes (and related control deficiencies including patch management, network configuration, access management)

FSOC 2019 Annual Report

The FSOC's 2019 Annual Report highlights developments in the financial markets and regulation, emerging threats, and recommendations to promote U.S. financial stability.

The emerging threat areas and related recommendations include:

- **Cybersecurity:** Continued investment in and greater reliance on IT across a broadening array of interconnected platforms is increasing the risk of a cybersecurity event. The FSOC recommends regulatory agencies ensure a robust and consistent standard of cybersecurity monitoring and examinations, including oversight of third-party service providers, and harmonize cybersecurity supervision and regulation giving consideration to how emerging technologies will be addressed.

- **Market factors:** The FSOC suggests that the following issues could pose potential threats to U.S. financial stability: risk-taking in large, complex, interconnected financial institutions; concentrations of activities and exposures in central counterparties (CCPs); reliance on short-term wholesale funding markets; liquidity and redemption risks at investment funds; financial innovation; and data gaps and challenges. In response, the FSOC recommends:
  - **Large, interconnected institutions** maintain sufficient capital and liquidity to reduce their vulnerability to economic and financial shocks.
  - The CFTC, Federal Reserve, and SEC coordinate on supervision of all systemically important **CCPs**, evaluate the robustness of existing rules and standards including stress testing, and promote further recovery and resolution planning.
  - Regulators continue to monitor the liquidity of **repurchase agreement markets** as well as assess potential financial stability risks from other types of cash management vehicles.
  - The SEC monitor the implementation and effectiveness of rules to reduce **liquidity and redemption risk in investment funds**.
  - Financial regulators continue to monitor and evaluate the impact of changes, such as the increasing role of non-traditional market participants, concentration of liquidity providers, fragmentation of execution venues, importance and availability of data, and market interdependencies, for adverse effects on **market integrity and liquidity.**
  - Regulators and market participants continue to improve the scope, quality, and accessibility of **financial data**, including adoption of the Legal Entity Identifier and Universal Loan Identifier, and harmonize domestic and global derivative data for aggregation and reporting.
- **LIBOR transition to alternative reference rates**: Market participants should formulate and execute transition plans prior to year-end 2021, including evaluation of fallback provisions in existing contracts. Regulators should use supervisory authority to understand the status of regulated entities' transition from LIBOR, including legacy LIBOR exposure and plans to address it.
- **Prolonged credit expansion:** The FSOC notes that nonfinancial business leverage is at the upper end of historical ranges. It recommends the regulatory agencies monitor levels of nonfinancial business leverage, trends in asset valuations, and the ability of regulated entities to manage severe, simultaneous losses.
- **Nonbank mortgage origination and servicing:** Federal and state regulators should coordinate closely.
- **Financial innovation:** The FSOC encourages regulators to consider appropriate approaches to reduce regulatory fragmentation while supporting innovation and continuing to examine risks of digital assets, including stablecoins.
- **Housing finance:** The FSOC reaffirms its view that housing financial reform is urgently needed to address the conservatorships, codify existing reforms, and implement a durable and vibrant housing financial system.

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