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2024 banking
regulatory outlook

Center for
**Regulatory
Strategy**
US

A message from the Deloitte Center for Regulatory Strategy

The 2023 failures of three large regional banks and the required support needed to rescue a global systemically important bank (G-SIB) had a significant impact on public discussions about the appropriate approach to regulation and supervision for banks based on their size, risk profile, and business model. For regulators, 2023 was a call to action to enhance their supervisory toolkit (including new regulations), further develop analytical and monitoring practices, and ultimately increase the speed and force of their actions when it is necessary to take them.

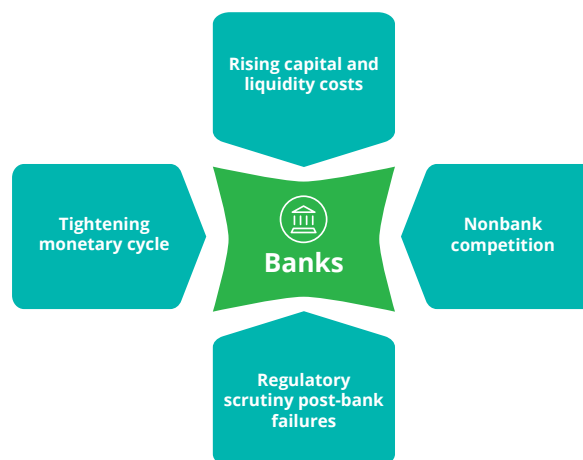
For banks, these supervisory and regulatory changes and other outside pressures (Figure 1) will further necessitate building scalable capabilities to self-identify issues, enhance information and analytics, and monitor and control the level of risk. Banks will need to have effective governance, risk management, risk mitigation, and an effective control framework.

For our banking regulatory outlook this year, we've identified four key themes affecting the industry:

- Regulatory scrutiny of risk management and governance intensifies
- Shifts in regulatory frameworks and consumer safeguards create expanding challenges
- Financial risk takes center stage again
- Growing digitization and innovation require more investment

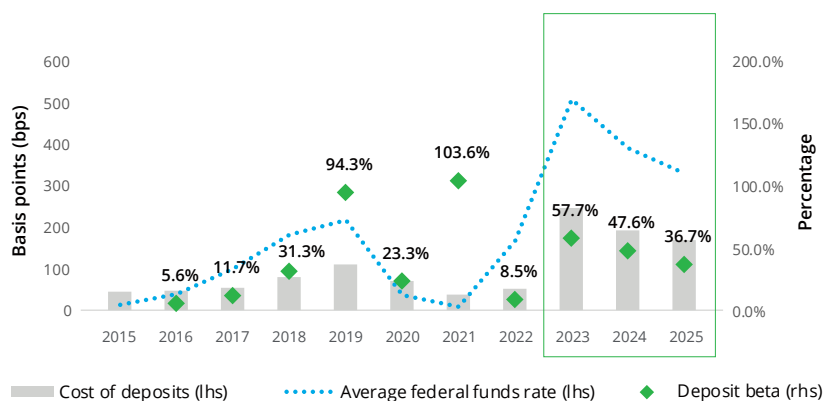
The scale and public nature of recent risk management and control failures puts the industry on notice. Now, more than ever, is the time to ensure foundational risk management and governance expectations are implemented and operational.

Figure 1: Banks are being pressured across multiple fronts



Risk aversion from regulators is growing at a time where a tremendous amount of innovation is disrupting the banking industry and prompting a re-think of regulatory frameworks, particularly around artificial intelligence (AI) and digital assets. Coupled with significant pressures from nonbank competitors, banks will face greater challenges in launching new products and engaging in novel financial services. Challenges are not limited to the regulatory perimeter, but foundational aspects of banking. Banks will incur increasingly higher costs to retain deposits (Figure 2).

Figure 2: Average deposit cost for the US banking industry



Source: Deloitte Center for Financial Services analysis on S&P Market Intelligence database

In our *2024 banking regulatory outlook*, we provide our assessment of the regulatory and supervisory changes—and pressures—that banks may face in the coming year, the importance of each area to the organization, and practical considerations to address vulnerabilities to better position banks for challenges ahead.

We hope that you find in our outlook a North Star amid the constellation of regulatory topics. We are here to help you set the course.

Sincerely,



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Regulatory scrutiny of risk management and governance intensifies

Federal banking regulators have signaled that supervisory scrutiny of financial institutions' risk management and governance capabilities is expected to increase materially for large financial institutions and banks, particularly for those that are globally active, foreign or regional in nature.¹ In the United States, the failures of three large regional banks earlier in 2023 exposed shortcomings in the current supervisory framework and have put considerable public pressure on banking authorities to reevaluate their supervisory and examination programs.² Going forward, examiners are expected to be more assertive in identifying supervisory concerns and to be empowered to escalate supervisory findings and act more quickly.

Closely linked with increased supervisory attention on safety and soundness, regulators will be focused on addressing untimely remediation of supervisory findings by banks. At the beginning of 2023, Acting Comptroller of the Currency Michael J. Hsu shared his views on "too-big-to-manage," whereby banking organizations scale to a size and complexity that makes them challenging to effectively manage and results in recurring control failures, risk management breakdowns, and other negative surprises.³ As regulators increase their focus on prompt remediation of supervisory findings, the scale and complexity of banking organizations—and their manageability—will come under greater scrutiny as well. This will be particularly true for regional banking organizations that have struggled to resolve outstanding supervisory matters in a timely manner or have experienced sizable growth in recent years.

Regulatory and supervisory pendulum is swinging to a more restrictive stance

Regulatory and supervisory expectations

As we approach the 10th anniversary of the Board of Governors of the Federal Reserve System's (FRB) Regulation YY-Enhanced Prudential Standards (EPS) and Office of the Comptroller of the Currency's (OCC) Heightened Standards (HS) rulemakings borne from the global financial crisis (GFC), banks and supervisors have outlined increased requirements for governance, risk management, compliance, capital planning and stress testing, and liquidity planning and stress testing.⁴

However, many financial institutions still have work to do to accomplish the original intent of the regulatory reforms laid out 10 years ago, particularly in the face of exposed difficulties as a result of a rising rate environment and material weaknesses in governance, risk management, and reliance on wholesale or nontraditional funding sources.

At present, supervisors are responding to the regulatory agencies' tone at the top in a post lessons learned environment. Supervisors are now much less likely to give an organization the benefit of the doubt when making their supervisory evaluations.⁵ There is now less leniency for prolonged or missed deadlines or subpar remediation and a quicker trigger to issue supervisory actions (Figure 3).

Why banks should take notice

The more aggressive and less accommodating supervisory environment will create significant pressures on banking organizations to accelerate remediation efforts and operate within a much narrower margin for error or future mishaps. Regaining or further building credibility with regulators will be of paramount importance. Moreover, regaining depositor and broader marketplace confidence will also be challenging and underscores the need for institutions to build *resilient* risk management capabilities well ahead of rapid growth in size, business model innovations, or mergers and acquisitions (M&A).⁶ Significantly, this recent hit to confidence underscores that time is of the essence in addressing past and present issues, as there may be no warning as to when depositors and other critical counterparties may once again suddenly lose confidence and cut off the funding that is the life blood to an organization's viability.⁷ To help mitigate financial stability concerns, supervisors are also proposing higher capital standards that provide a greater margin for safety in bank risk management and supervisory effectiveness.

Given this swinging pendulum and the ongoing risk management challenges of an ever changing, complex financial system, institutions should seek to work even harder than before to build trust. That goal of course cannot be accomplished overnight but can come by establishing a more consistent track record of excellence in governance, risk management, and compliance over time.

Figure 3: Since 2021, outstanding supervisory findings have been rising, particularly for RBOs



Source: FRB, “[Supervision and regulation report](#),” November 8, 2023. Note: Values prior to 2023 are as of year-end. The 2023 value is as of the end of Q2 2023. The findings’ count data is subject to revisions as issues are reviewed, updated, and finalized; this could result in minor historical count fluctuations.

Being proactive and demonstrating a culture of “taking the highest ground possible” that is demonstrated through substance and “show me” vs. “tell me” will be critical.

How should banks respond?

Banks can take concrete actions to build trust with regulators by engaging more proactively and focusing on the basics, which include the following steps:

- **Align strategy and engagement to meet regulatory focus:** Position longer-term business and regulatory strategies to better align with emerging regulatory attention, including assessing those business models that are narrowly focused and engaging early and proactively with supervisors.
- **Focus on the core foundational elements:** Drive core safety and soundness tenets into the business and operating model. Pursue a simplification of the organizational structure, business processes, and products to reduce execution risk and gain a clear line of sight into vulnerabilities.
- **Address legacy issues before going on the offensive:** Address legacy risk management issues before launching aggressive and competitive growth and profit strategies such as mergers, new business lines or adding significant operational capacity.

Key legacy issues include lack of proactive risk management and regulatory readiness, weak deposit strategy and balance sheet risk management, and mediocre or weak capital and liquidity positions.

Too big to manage?

Regulatory and supervisory expectations

Regulators have raised the question as to whether some organizations can become too big or too complex to manage. Some organizations have been slow to fix risk management deficiencies with complex remediation efforts being bogged down with manual operations, unclear roles and responsibilities, and insufficient monitoring and oversight on an end-to-end basis for execution risks. These developments have led regulators to focus on the largest and most complex banks—those with more than \$250 billion in total assets. Regulators’ increased supervisory scrutiny has also been supplemented with a number of long-awaited, proposed rulemakings that have been released for industry comment.

Why banks should take notice

Many banks have recognized these weaknesses, but some have had very uneven success in effectively addressing them. For some banks, many of these issues were on the radar of management; however, the money and time to reach more sustainable solutions was in scarce supply. Solutions tended to be designed to accomplish only just enough compliance to satisfy regulators in the moment, but in many cases fell woefully short of sustainable, strategic solutions.

An unfortunate side effect of adopting suboptimal tactical solutions is that resources have been stretched handling business as usual, organic growth, and remediation. Operational failures, combined with the failure of remediation programs to address the underlying issues, erodes trust with supervisors over time. Ultimately, the regulatory cost is higher over time.

These weaknesses can significantly hinder banks' fight to maintain market share at time when the pace of innovation is increasing. Both bank and nonbank financial company (NBFC) competitors are driving innovation through the adoption of sophisticated technologies like AI and are updating their core infrastructure to leave behind antiquated end-of-life mainframe core systems.

How should banks respond?

Banks can respond by further investing in their core risk and regulatory infrastructure and take the following steps:

- **Recapture the high ground:** Invest in strong and sustainable organizational and infrastructure adjustments to produce consistent returns without chronic, nagging problems. Develop risk, regulatory, and compliance areas into leading-class functions (dealing with fewer issues means you can focus more on the business).
- **Grow the proper way:** Plan to address key aspects of EPS and HS implementation before you reach critical regulatory thresholds. Sustainable, less burdensome compliance dividends can be a major goal of growth plans.

- **Anticipate expectations:** To maintain trust with regulators, anticipate their regulatory expectations when evaluating new technology that aims to improve business processes. This may require hiring specialized risk and compliance staff.

Related content: Regulatory scrutiny of risk management and governance intensifies

Regulatory and supervisory pendulum is swinging to a more restrictive stance

- October 2023: [FDIC focuses on bank boards for governance and risk enhancements](#)
- May 2023: [Prepare for more stringent regulation and agile supervision after bank failures](#)

Too big to manage?

- September 2023: [Federal banking agencies propose new resolution planning requirements](#)
- September 2023: [Federal banking agencies propose new long-term debt requirement](#)
- April 2023: [Mid- to large-size banks expect greater scrutiny on their upcoming resolution plans](#)
- April 2023: [Legal entity and booking model optimization](#)



Shifts in regulatory frameworks and consumer safeguards create expanding challenges

With the rise of fintech companies and other NBFCs, including the continued entrance of big technology companies into the financial services space, financial regulators are increasingly focused on ensuring their regulatory and supervisory programs are suited for the changing market landscape. In 2024, regulators are expected to continue staking out the regulatory perimeter of the banking system, using consumer protection as a channel for doing so.

Cascading obligations and expanding the regulatory perimeter

Regulatory and supervisory expectations

As regulators' demands and expectations roll downhill from the largest banks to smaller banks, we expect that they will cascade regulatory obligations to smaller institutions and slowly expand their regulatory perimeter to systemically important non-banking institutions, fintechs, payment companies, and big tech firms that are increasingly offering financial products and services.

Some of this activity will be driven by market forces, including expected consolidation among community and smaller regional banks and scaling up at the mid-size regional level to meet enhanced regulatory requirements.

We see the following impacts by size, risk, and business model:

- *\$250B + G-SIBs*: Some of the largest US banks face more intensive supervisory focus, more public enforcement actions, and pressure from both ends of the US political spectrum.
- *Large and mid-size regionals (\$10B–\$250B)*: Regional banks face a very real possibility that proposed liquidity, debt and capital requirements, currently applicable only to banks greater than \$250 billion in assets, will apply to them on a phased-in basis over the next several years. Additionally, new prescriptive

and enforceable corporate governance and risk management guidance has been proposed that would extend to mid-sized regional banks.⁹

- *De novo banks*: De novo banks seeking new bank charters continues to be a challenging proposition, requiring the commitment of substantial time and resources, with no guarantee of success.
- *Nonbanks*: We expect regulators to broaden the regulatory perimeter by examining nonbank relationships, with many nonbanks likely being forced to reckon with enhanced supervision.

Why banks should take notice

Recent developments signal a change from both policymakers and agencies alike with an emphasis on modernizing their supervisory approaches. In November 2023, the Financial Stability Oversight Council (FSOC) approved two key documents: (1) the FSOC finalized a new analytical framework for identifying, assessing, and responding to potential risks to US financial stability which included attention to NBFCs and payment, clearing, and settlement designations; and (2) the FSOC amended its guidance on designating NBFCs as systemically important by rolling back some prerequisites that were previously included in prior guidance.¹⁰ Additionally, that same month, the Consumer Financial Protection Bureau (CFPB) issued a proposal that would allow it to supervise digital wallet and consumer payment applications.¹¹ These actions are important steps that evidence a shifting and potentially more aggressive regulatory approach.

We expect that implementation of the finalized proposals may lead to relevant financial regulators conducting more financial stability reviews and ultimately more company designations. These designations would effectively pull NBFCs into the federal regulatory perimeter, imposing federal supervision, examination, enforcement, and other requirements all of which would increase regulatory scrutiny and obligations.

How should banks respond?

The inevitability of more regulatory focus and regulatory change has placed the imperative upon both banks and NBFCs to define how they will adapt to thrive within the evolving regulatory perimeter. Consider the following:

For banks:

- **Enhance due diligence and intensify oversight:** Banks will need to enhance the rigor with which they conduct due diligence on potential NBFC collaboration. Once collaboration begins, they will need to intensify their oversight of NBFC relationships and conduct effective ongoing monitoring as well as comprehensive risk management assessments accordingly.

For NBFCs:

- **If seeking a charter, understand the material time and resources required:** Applicants with non-traditional models should come to the table with significant resources, well-defined business plans, thoughtful governance and risk management plans commensurate with the risks inherent in the proposed business model, and a realistic assessment of the time and resources necessary to stay the application course.
- **Reassess risk management in light of scrutiny:** NBFC engagement with products and services that have been traditionally relegated to the banking industry will likely prompt regulators to extend consumer protection efforts (e.g., fair lending, privacy, and fraud) as well as broaden the scope of safety and soundness expectations.
- **Upgrade to bank-like risk management:** Build bank-like risk management functions and capabilities (e.g., a three-lines independent control structure, a formal risk appetite statement aligned with the business strategy, and enhanced risk-control governance) adjusted based upon business profile, operational interconnectedness, and client base.

For both banks and NBFCs:

- **Protect customers during tail-risk events:** Revisit business continuity planning to make sure that customers are protected in case of unprecedented circumstances.

Consumer protection

Regulatory and supervisory expectations

In 2024, we expect regulators to further scrutinize the potential for harmful effects resulting from banks' use of innovative products, services, and technology on consumers.

We expect the CFPB, as well as the federal banking regulators, to focus their consumer examinations on product lines that have not received recent exam scrutiny (such as deposits), the use of AI on loan decision-making, and banks' and fintech companies' payment systems. Unfair, Deceptive, or Abusive Acts or Practices (UDAAP) will continue to be the principal statute accounting for the vast majority of citations in both supervisory activity and enforcement actions.¹²

Regulators will likely also finalize and modernize several regulations in 2024, including Section 1033 (Open Banking).¹³

Why banks and nonbanks should take notice

Payment systems

Payment companies' expansion into peer-to-peer (P2P) payments in particular has drawn the attention of the regulators. In November 2023, the CFPB issued a proposal that would allow it to supervise digital wallet and consumer payment app providers.¹⁴ If finalized, the agency estimates the rule would cover approximately 88% of nonbank digital consumer payment transactions.¹⁵ While the CFPB has direct authority to examine or investigate these technology companies and other service providers, innovative arrangements between banks and these entities mean that federal banking regulators may further assert their authority under the Bank Service Company Act (BSCA).¹⁶

Redlining

The expanding use of AI requires particular attention to ensure the tool is not trained on biased data, thereby perpetuating and potentially magnifying discriminatory outcomes.¹⁷ Real estate appraisals have shown disparities in valuations based on borrower characteristics.¹⁸

TPRM

Banks' third-party risk management (TPRM) programs will be a main area of emphasis to reduce the inherent contagion risk of entities operating outside the regulatory perimeter.¹⁹ The OCC's 2023 to 2027 strategic priorities mentioned TPRM under "Consumer Compliance" five times, more than any other section.²⁰ Innovative products and services and novel arrangements between banks and tech companies are an important driver of this focus.

CRA and 1071

The interagency Final Rule for the CRA will require major shifts in the way a bank operates and how it reports its efforts for related activities.²¹ The implementation period will be challenging to meet despite the fact it will span several years.

While small business lending data collection has been challenged in the courts, small business lenders not party to the lawsuit should be proceeding with their efforts and not rely on relief from the Supreme Court decision that is expected mid-2024. This new data source will be a cornerstone in the final CRA rule and the information generated will provide useful insights for fair lending activity as well.

1033

The CFPB proposed rule on consumer-authorized financial data-sharing will alter how such consumer financial data is managed and shared across the industry.²² The release of this new rule will create major disruptions, opportunities, and potential shifts in the relationships between banks and tech companies. The ability of consumers to control their data may

further solidify the new regulatory perimeter where tech companies are expected to maintain the same attention to the three lines as banks do. The degree of impact will depend on how far the final rule goes in pushing the statutory mandate's limiting conditions for standard setting.²³

How should banks and nonbanks respond?

Consumer protection-related regulatory changes will have significant impacts on banks of all sizes and may extend to certain nonbanks. Banks and nonbanks can take the following steps to better prepare:

- 1. Enter partnerships with caution, deliberation and care:** Fear of missing out may continue to entice rapid deployment of new partnerships, innovative products, and services; however, regulators' heightened focus in this area will continue to drive greater attention to sound risk management. If partnerships are necessary, the relationships need to be clearly understood and documented.
- 2. First, do no harm:** When deploying new technology, such as AI, be aware of unintended consequences and guard against creating or magnifying consumer harm. Even basic IT risk management will see an increased consumer harm focus, with CFPB now examining for elements supporting sound cybersecurity.²⁴ Consider implementing enhanced controls, including those using AI.
- 3. Level up:** Technology companies in particular will need to level up their compliance management systems. The CFPB's information gathering under Section 1022 of the Consumer Financial Protection Act (CFPA), its investigation authority, and its exigent supervisory authority bring combined pressure.

Related content: Shifts in regulatory frameworks and consumer safeguards create expanding challenges

Cascading obligations and expanding the regulatory perimeter

- February 2023: [Pushing the boundaries of the banking regulatory perimeter](#)

Consumer protection

- November 2023: [Federal oversight of big tech companies and other providers of digital wallets and payment apps 5x5](#)
- November 2023: [Agencies modernize the Community Reinvestment Act \(CRA\)](#)
- October 2023: [CFPB proposed open banking rule “accelerates the shift”](#)
- September 2023: [Intersection of Section 1071 and proposed Community Reinvestment Act \(CRA\) modernization data collection and reporting requirements](#)
- July 2023: [Dark patterns: Considerations for Unfair, Deceptive, or Abusive Acts or Practices \(UDAAP\) programs](#)
- April 2023: [CFPB’s 1071 Final Rule mandates small business lending data](#)

We expect the CFPB, as well as the federal banking regulators, to focus their consumer examinations on product lines that have not received recent exam scrutiny (such as deposits), the use of AI on loan decision-making, and banks’ and fintech companies’ payment systems.



Financial risk takes center stage again

The COVID-19 pandemic and accompanying supply chain shocks, along with changes in monetary policy, have transformed the macroeconomic environment faced by banks. While the banking system has broadly weathered these changes with strength and resilience, the failure of three large regional banks earlier 2023 exposed underlying fragilities potentially faced by some institutions. In particular, rising interest rates and reduced liquidity have raised the financial risk environment for banks and garnered the attention of regulators.

Over the summer 2023, federal banking agencies proposed significant reforms to bank capital standards to improve the safety of the banking sector, including the finalization of Basel III international standards (“Endgame”) and new long-term debt requirements for insured depository institutions over \$100 billion.²⁵ These changes will disproportionately impact large regional banks (i.e., those between \$100 billion and \$250 billion in assets) and require significant maturation of governance and risk management frameworks. Institutions will need to invest in second- and third-line capabilities to meet new regulatory expectations.

Furthermore, the financial costs of these proposed reforms will put additional pressure on banks’ net interest margins, which have been declining modestly since 2022.²⁶ Changes to capital calculations and risk weightings will require banks to reevaluate their business models and consider changes to their strategic planning and operations. At the same time, higher-for-longer interest rates and tighter liquidity will also need to be incorporated into strategic planning and risk management processes (e.g., new scenarios analysis and regular testing). Collectively, changes to the macroeconomic environment and regulatory reforms will keep financial risks at the center of banks’ and regulators’ attention for the foreseeable future.

Basel III: Capital

Regulatory and supervisory expectations

Since the Basel III Endgame notice of proposed rulemaking was released, there has been a significant amount of analysis, technical summaries, and opinions

published over various public media.²⁷ The initial reaction from the banking industry has been less than favorable due to differences in the newly proposed requirements relative to those in other jurisdictions, overall cost implications and the disproportionate impact across banks.²⁸ There was also some hesitation from members of the FRB and the Board of Directors of the Federal Deposit Insurance Corporation (FDIC), neither of which unanimously approved the proposed rule.²⁹ However, the chance for material revisions appears uncertain, so institutions should start understanding the potential impact and planning for implementation. This is especially true for Category III and IV banks (Figure 4).³⁰

The proposal sets out the most significant changes to the capital rules since the original Basel III reforms were implemented in the United States in 2013. As a result, capital requirements will significantly increase, with agencies estimating an aggregate increase in capital and risk-weighted assets of 16% and 20%, respectively.³¹ While the proposal’s impacts are broad, the biggest effects will be on Category III and Category IV banking organizations, as the changes would undo many of the tailoring privileges established in 2019.³²

In addition to Basel III Endgame, new long-term debt (LTD) obligations are expected to be finalized in 2024.³³ The impact to the Deposit Insurance Fund (DIF) caused by the recent bank failures highlighted the need for large regional banks to be able to absorb losses and provide more options for resolution, similar to how total loss-absorbing capacity (TLAC) has been used to support G-SIBs.³⁴ The LTD proposal would establish new requirements for insured depository institutions (IDIs) with at least \$100 billion in total assets to maintain outstanding eligible LTD in the amount no less than the greater of (i) 6% of risk-weighted assets; (ii) 2.5% of total leverage exposure; or (iii) 3.5% of average total consolidated assets. As most regional IDIs tend to be majority deposit funded, some IDIs may need to replace relatively cheaper deposit funding with more expensive longer-term debt funding. This impact, along with other proposed rules, needs to be understood both in terms of cost, and the potential competitive impact relative to other regulated banks and non-regulated institutions.

Figure 4: Basel III Endgame scope and applicability across large banking organizations

Capital regulations		Category I	Category II	Category III	Category IV
		US G-SIBs	≥\$700B total assets or ≥\$75B cross jurisdictional activity	≥\$250B total assets or ≥\$75B in nonbank assets, wSTWF or OBS exposure*	\$100B to \$250B total assets
Risk-based requirements	Market risk	Green	Green	Green	Green
	Operational risk	Green	Green	Blue	Blue
	Credit risk	Green	Green	Green	Green
	CVA risk	Green	Green	Blue	Blue
	Regulatory capital	Light Blue	Light Blue	Green	Green
	G-SIB surcharge	Green	Grey	Grey	Grey
	CCyB	Light Blue	Light Blue	Light Blue	Blue
Leverage capital	SLR	(Enhanced)	Light Blue	Light Blue	Blue

Legend: Light Blue: Currently applicable with no changes; Green: Currently applicable with changes to methodology; Blue: Newly applicable; * wSTWF: Weighted short-term wholesale funding; OBS: Off-balance sheet

Source: Deloitte, "US Basel III Endgame: Key changes, impacts and where to begin," August 2, 2023.

Why banks should take notice

The proposal will result in significant effort and resources to achieve compliance, especially for Category III and IV banks, even with a three-year implementation period.³⁵ This will take place with the potential implementation of other proposed rules regarding resolution planning and long-term-debt, leading to an inordinate amount of work for Category II-IV institutions.³⁶ Additionally, the Endgame proposal is more constraining, in some respects, from the Basel III implementation in other jurisdictions, such as the United Kingdom and European Union. Therefore, more internationally active Category I banks (e.g., G-SIBs) may face higher cost of compliance than their foreign-based counterparts due to these differing international requirements.

Banks need to understand the cost to change existing processes, or in the case of Category III and IV institutions, implementing new processes. This will need to include both understanding the level of resources needed and timing of implementation. Furthermore, business model profitability needs to be assessed as certain activities will become more capital-intensive than others. For example, banks can expect higher risk weighting for loans, residential real estate, and retail exposures which could adversely affect banks' lending and consumer businesses. Meanwhile, new operational risk capital calculations will impose greater costs on banks' noninterest and fee-based income. Banks that have greater concentration in these areas could face significantly higher costs and experience reduced valuations.

The rule will bring previously unimpacted banks under the rule requirements, even before the impact of other proposals like the proposed long-term debt rule. This makes the \$100 billion cutoff more significant as well as the focus on certain business activities. It also makes the implementation effort fall more heavily on those banks that have not been subject to these requirements in the past. This uneven impact could result in competitive disadvantages for banks depending on their business model and ability to compete with non-regulated and foreign entities. As a result, the industry may experience the potential need for more consolidation, resulting in fewer and larger banks that are less disadvantaged by concentrations in activities that carry a heavier capital impact.

While the rule is not final, it is coming and it is important for banks to understand the impact in terms of implementation resources, the ongoing operating costs, and how they should be allocated, and the competitive implications. Starting early to reduce the risk of falling behind is important as the agencies are being more aggressive on enforcing compliance.

How should banks respond?

Beyond the immediate priority of reviewing the proposal, banks can also benefit by mobilizing on certain activities to jump-start their Basel readiness efforts:

- **Quantitative impact study:** Conduct an individualized impact assessment to understand how changes in capital risk weighting and methodologies will impact business lines and incorporate into strategic planning.
- **Data collection:** Once available, banks should seek to appropriately understand the data collection templates furnished by the federal banking agencies so that internal data is both (1) appropriately provisioned, rationalized, and cleansed and (2) subsequently mapped into the regulatory templates as intended.
- **Implementation planning:** Mobilize resources to define and document requirements and conduct gap analysis to identify incremental “build” and engage in high-level implementation planning.

Macro-economic impacts including the interest rate environment

Regulatory and supervisory expectations

Banking regulators have recently focused more attention on the impact of rising rates on financial institutions, with business models more susceptible to a rising rate environment receiving more scrutiny. Banks that have experienced high growth and larger investment securities portfolios with significant funding by uninsured deposits have been particularly vulnerable. Regulatory attention has focused on size, type, and term of investment securities portfolios; the amount in available for sale versus held for investment; the level of uninsured deposit funding sources; and the sufficiency of liquidity and ability to support operations under stress. Regulators are also looking at investment strategies and how these and liquidity needs are tied together. With respect to credit, examiners will be evaluating the effectiveness of banks' actions to identify and manage credit risk given the significant changes in market conditions.³⁷

Why banks should take notice

Rising interest rates during the past two years have been challenging for banks to adjust their funding and investment strategies in a rising interest rate environment. Many have been challenged with anticipating and adjusting to what appears to be a higher-for-longer interest rate environment.³⁸

Rising interest rates have particularly affected institutions with larger securities portfolios. Some of this was the result of the influx of deposits over the past couple of years, many of which were uninsured, combined with the inability to deploy those funds to underwrite loans. Complicating this further was the fact that these depositors tended to be more rate sensitive. The degree to which these portfolios are funded by more volatile liabilities has increased the need to be able to access investment securities for liquidity purposes under stress, including when these portfolios are experiencing significant depreciation.

The bank failures from 2023 reflect situations where investment decisions did not adequately align with the volatility of funding sources and the ability to be used under stress. This has revealed how critical it is that an institution maintain an investment strategy that also considers funding needs under stress.

As higher interest rates place headwinds on the economy and borrowers, banks have become more cautious in their lending and are evaluating and preparing for potential fallout from the new environment. For example, in the third quarter of 2023, banks reported tightening lending standards to both businesses and consumers across commercial and industrial lending, residential real estate lending (including home equity lines of credit), credit cards, consumer loans, and auto loans.³⁹

How should banks respond?

Banks can help offset their vulnerabilities by truly understanding their exposure and take the following steps:

- **Document your strategy:** Banks need to be aware of their vulnerability to rate changes and document their strategies and procedures to mitigate their exposure under stress.
- **Model expected interest rate impact on loan performance under stress:** Identify loan types whose payment sources are vulnerable to higher rates and factor the impact in performance assumptions used in stress testing models.
- **Maintain a robust risk assessment process and credit review plan:** Use the recurring portfolio review process as a data input for the credit risk review's annual plan.
- **Align exposure with appetite:** Take steps to match the bank's exposure to a changing rate environment to the appetite for risk ensuring investment and funding strategies are in alignment.

Liquidity

Regulatory and supervisory expectations

Liquidity risk management has become a primary area of attention for regulators. While liquidity reporting and stress testing has been in place in various forms for Category I–IV banks, the level of attention to this area has increased substantially. Assumptions applied to liquidity stress and capabilities to raise funding have not always reflected the speed with which deposits can be withdrawn and contingent funding sources accessed.

One area of focus for regulators is on uninsured deposits, given how quickly these deposits ran during the 2023 bank failures. For most IDIs, the treatment of uninsured deposits has been a lower priority with rough estimates used for purposes of Call Report and blanket assumptions for liquidity. With higher levels of uninsured deposits in many IDIs, they are also getting the investors' and the public's attention.

Regulators will be keen to know whether uninsured deposits are retail or wholesale. For wholesale deposits, they will need to know whether they are operational or nonoperational, and the extent of concentrations among businesses and industries.

Why banks should take notice

A bank's ability to support stress assumptions and quickly raise funds, as well as the ability to report liquidity to regulators on a timely and ad-hoc basis, can be expected to continue to have regulators' attention. In some cases, banks have been asked to provide more frequent liquidity reporting (daily as opposed to monthly), even though this is not a formal requirement.

For many banks, understanding the levels and attributes of insured and uninsured deposits (and the pass-through depositors who have claims on them) can support the bank's goal of having more accurate reporting, disclosures, assumptions (especially under stress), and recovery and resolution planning. While too much liquidity comes at a financial cost, too little will also attract regulator attention.

Large IDIs greater than \$100 billion in total assets are already subject to the requirements of FDIC Part 370, “Recordkeeping for Timely Deposit Insurance Determination,” which means there is the expectation of identifying internally held uninsured deposit amounts. However, even these IDIs may be challenged with determining the uninsured level in deposits externally held under a single custodian account where the deposit insurance passes through to the individual depositor, such as with deposit brokers.

Understanding deposit relationships can help with the segmentation of depositors based on their attributes. Inter-affiliate deposits, and government deposits where the uninsured portion is collateralized, while still uninsured, are less prone to run under stress.

Depositor access and the ability to withdraw funds has dramatically changed over the last several years. With real-time payments (FedNow), it will likely only increase.⁴⁰ Together, with the impact of social media, the potential for deposits to be withdrawn is far faster than many IDIs are prepared to respond.

How should banks respond?

Banks can prepare to respond to regulators’ increased interest in liquidity and the underlying nature of deposits. For many banks, the increase in level of effort will be significant. Steps banks can take include:

- **Test sensitivity:** To appropriately assess the adequacy of liquidity levels, include an analysis of the sensitivity to stress that results in the need for increases in the level of liquid assets and contingency funding sources needed relative to the impact on business-as-usual operating costs. The magnitude of the impact will vary depending on the institution’s business model.⁴¹
- **Monitor surge deposits:** Banks should appropriately monitor and manage the volume of surge deposits given their less stable nature and characteristics that differ from deposits gathered in normal conditions. Banks should identify uninsured depositor attributes with regard to their business segment,

size, source, purpose and historical trends. Using this segmentation, potential concentrations should be identified and used to understand the expected volatility level under stressful conditions.

- **Understand the information highway:** Seek to understand how depositors get information (accurate and inaccurate), especially under stress. Banks with high uninsured deposit levels need to be prepared for the herd to move quickly.

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Growing digitization and innovation require more investment

The pace of digitization has transformed the banking industry as banks continue to face competitive pressures to adapt to the changing financial realities and incorporate digital innovations into their operations, services, and product lines. At the same time, regulators have increasingly responded by developing more guidance and clear expectations for banks' technology capabilities. Among the most impactful for banks will likely be modernizing data capabilities and incorporating innovative financial technology applications into their strategic planning and governance frameworks.

Given increased regulatory expectations for data collection and reporting, along with continued scrutiny over innovative financial technology applications, banks will need to continue investing in their technology infrastructure and processes.

2024 is expected to be a particularly active year for regulatory changes with many upcoming rules focused on increased data reporting and granularity requirements. Furthermore, supervisors are expected to increase their scrutiny over financial technology applications—particularly those applications involving digital assets, distributed ledger technology, and AI.

Advancing data capabilities to meet growing data demands

Regulatory and supervisory expectations

Banks' data capabilities are of prime importance to regulators, boards of directors, and bank senior management, each of whom rely on this data to identify and manage risks as they emerge. Expanding data capabilities are needed to ensure data quality and accessibility for risk management, regulatory compliance, and financial reporting.

Regulators continue to stress the importance of end-to-end processes to ensure high-quality data. A bank's ability to assess and evidence the effectiveness of data controls and the maturity of quality assurance programs is critical to meeting regulators' expectations. Second-

and third-line testing programs are essential in assessing the progress and effectiveness of data programs. These programs often face difficulties in determining the correct scope and scale of their plans and testing.

In 2024, banks should consider preparing for the complex rules and regulations slated for finalization, such as Basel III Endgame and calculation revisions to the G-SIB capital surcharge,⁴² as several are data dependent. Many banks will find that 2024 is another stop on their journey to change the data culture and create sustainable, effective data programs. For others, it will be a promising year to start.

Why banks should take notice

The heightened supervisory pressures require banks to more clearly demonstrate substantive progress in closing supervisory issues or risk facing more severe supervisory consequences. Banks may align their efforts with regulatory focus by implementing data governance frameworks, enhancing data-quality programs, developing efficient data infrastructures, and modernizing technology solutions.

Most large firms have ongoing data remediation or strategic data programs underway. As banks progress with the maturation of their data programs, they will need to have meaningful measures of success, including data validation and control testing.

A growing challenge firms are facing is "interpretation risk." That is, the risk that an interpretation of a data requirement will result in incorrect data or incorrect regulatory calculation (e.g., risk-based capital ratios). As data requirements become more complex, this risk increases.

How should banks respond?

The continued need for complex data access across the firm requires banks to mature their data programs, advance automation, and build new capabilities. To effectively manage risk, inform business decisions, and meet regulatory expectations, banks can take the following steps:

- **Advance capabilities:** Utilize new capabilities such as AI/machine learning (ML) to improve data quality and create more efficient workflows. These new capabilities can be applied to data profiling, supporting data testing, and identifying data sources.
- **Create enterprise-wide data governance:** Develop independent data testing (e.g., transaction, control, conformance), data traceability (back to the origin of the data), and effective accountability policies.
- **Assess current effectiveness and maturity:** Develop risk-based assessments for annual planning. Based on these assessments and plans, banks are staffing these areas to support the testing activities.
- **Protect against interpretation risk:** Develop processes and controls within governance frameworks to validate these interpretations.
- **Review the data roadmap:** Review data roadmaps on a regular cadence, prioritizing efforts by risk, adjusting plans as appropriate. When plans, timelines, and deliverables change, communicate promptly with your regulator.

Responding to forces of innovation: Novel activities/crypto

Regulatory and supervisory expectations

The bar has been set very high for crypto and fintech-related activities. Even before the failure of certain crypto-focused banks, regulators had their concerns about this activity.⁴³ As the year progressed, the FRB announced a new supervision program focused on “novel activities,” specifically those related to (i) crypto-assets and distributed ledger technology (DLT) and (ii) complex, technology-driven partnerships with NBFCs to deliver financial services to customers.⁴⁴

2023 solidified regulators’ high degree of skepticism for crypto activities.⁴⁵ Banks with strategies and concentrated exposures should expect enhanced examination and supervision in 2024.

We do not expect the bar to be lowered in 2024. Banks should anticipate scrutiny when proposing or engaging in DLT activities, or when having concentrated exposure to crypto or fintech businesses (including partnerships).

Why banks should take notice

Blockchain and DLT are not going away. Banks and financial industry consortia continue to develop DLT use cases, including successfully deploying tokenized value transfers on their internal, ring-fenced networks.⁴⁶ Many of these use cases have potential applications for traditional banking services offered today by banking organizations, such as enhancing operational efficiency, eliminating intermediaries, enhancing security, improving transparency, leveraging smart contracts, and automating required record keeping.

The Bank for International Settlements’ (BIS) June 2023 Blueprint for the future monetary system unambiguously aspires to the longer-term viability of a shared, permissioned network (a unified ledger) with central bank digital currency (CBDC); tokenized bank deposits; and tokenized real-world financial assets. According to the BIS’s assessment, crypto and decentralized finance (DeFi) have offered a glimpse of tokenization’s promise, but remain a flawed system that cannot usurp the future of money.⁴⁷ Therefore, CBDC and commercial bank money should reinvent themselves with new technology; the two-tiered banking system, supported by regulation and supervision, preserves the singleness of money. The BIS offers no compromise on the highest standards of data security, operational cyber resilience, privacy, anti-money laundering (AML) safeguards, etc., and US regulators will expect the same.

At the US sector level, banks are encouraged to join innovation fora supported by BIS's vision, such as the Regulated Liability Network (RLN), even if regulators themselves prefer to remain low-key.⁴⁸ US regulators historically prefer to allow "safe and sound" private-sector innovation, conservatively engaging only later when concepts have matured and are better proven.

Outside of bank regulatory constraints, a few fintech companies have deployed customer-focused models and innovative tools that have produced rates of growth and customer acceptance that outstrip those of their "traditional bank" rivals. These innovations place greater pressure on banks to innovate within their regulatory environment.

Significant regulatory headwinds and hurdles remain. But banks would be foolish to ignore the competitive threats of novel products or services. Their usefulness and uptake are unmistakably gaining traction and slowly but surely changing the game.

How should banks respond?

While we would caution against any banking organization adopting a business strategy presenting concentrated risks relating to DLT or fintech partnerships, banks with appropriate scale and bandwidth can take several steps including:

- **Be a risk-aware banker:** Run any potential innovation initiatives through robust new-product processes, and enhance the risk governance framework (strategic plans, layered controls, risk appetite statements, compliance management systems, and internal audit processes) to include new products and services.
- **Be careful with whom you partner:** Apply the highest level of diligence and TPRM when entering DLT or fintech partnerships and maintain this diligence during the relationship.
- **Be mindful of your supervisors:** Bring your federal and state banking supervisors along for the journey, demonstrating your knowledge of what you are getting into, the related risks, and the appropriateness of your controls (top to bottom, front to back).

- **Remain actively 'crypto curious':** Identify select staff to become a team of internal "subject-matter experts" who review relevant media and regulatory updates, participate in banking trade group learning sessions, are aware of significant new product or platform developments (including those in test phase), and report to senior management on a regular cadence.

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The road ahead

While the banking industry remained resilient in 2023, changing macroeconomic conditions and market turmoil have helped set the upcoming regulatory agenda for heightened supervisory scrutiny and more stringent regulation. Supervisors are raising their expectations for governance, risk management, and compliance, and—at the same time—demonstrating their preparedness to escalate untimely remediated supervisory findings more quickly. Furthermore, regulators are focusing their attention on redefining the regulatory perimeter with an emphasis on consumer protection—for both banks and NBFCs alike. Effective risk management and control frameworks will, therefore, be critical now more than ever.

Compounding these changes in supervisory approach is a series of regulatory proposals aimed at improving financial resiliency within the system. Regulators are expected to finalize the Basel III international capital standards, which will significantly raise capital costs and reconstitute regulatory requirements for large banks with at least \$100 billion in assets. Moreover, new long-term debt requirements and expanded resolution plan regulations are expected to be finalized. Together, these regulatory developments along with others are set to make 2024 among the most impactful regulatory years for the banking system in more than a decade. It will be essential for bank leaders and decision-makers to remain focused on the basics of risk management and corporate governance as these changes head their way.

Regulators are focusing their attention on redefining the regulatory perimeter with an emphasis on consumer protection—for both banks and NBFCs alike.

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