Allianz Global Corporate & Specialty

Global Industry Solutions Outlook Q&A

Financial services

Risk trends and future opportunities

Trends Q&A

Martin Zschech, Global Head of Industry Solutions and Client Management at Allianz Global Corporate & Specialty (AGCS) and Global Industry Solutions Director for Financial Services assesses the outlook and challenges for the sector and discusses some of the main factors and loss trends behind the industry's top risks, as ranked by **Allianz Risk Barometer** respondents.

How do you view the outlook for the financial services sector? What are some of the challenges and opportunities AGCS sees for it today and in the years to come?

Recent years have seen the financial services (FS) industry have to navigate the unprecedented levels of uncertainty caused by the Covid-19 pandemic. Banks, asset managers, insurers, capital markets, together with other FS organizations around the globe, all played their part in helping to ride out the storm.

Of course, many clouds remain. FS companies are not immune to the challenges facing other sectors such as geopolitical tensions including the war in Ukraine, inflation and rising interest rates, supply chain disruptions, the prospect of regional or global recession, the heightened cyber risk landscape and increasing competition from Big Tech companies providing more financial offerings. Then March 2023 saw problems surface in the banking sector with the collapse of Silicon Valley Bank (SVB), which specialized in lending to start-ups, including fintechs, and Signature Bank, sparking investor fears, lawsuits, falling share prices and US government intervention. Meanwhile, in Europe, the Swiss government enabled a takeover of Credit Suisse by UBS amid fears that a failure to protect depositors would trigger a new global banking crisis.

Many analysts consider systemic risk to the sector to be low as large lenders are much stronger financially than they were before the financial crisis in 2008.[1] Others have said that more shutdowns and seizures in the US are possible.[2] In the wake of SVB's failure, banks will become even more conservative in their lending, according to Allianz Research. What is also certain is that regulators are going to be watching for signs of more instability across the sector very carefully.

Looking a little further ahead, and on a more positive note, agreements such as the United Nations' 2030 Agenda for Sustainable Development, which has 17 Sustainable Development Goals (SDGs)[3] at its heart, and provides a shared blueprint for peace and prosperity for people and the planet, represents a huge opportunity for the FS sector as significant private investment will be required to achieve these goals. However, established principles for sustainable investment/insurance will need to be followed.

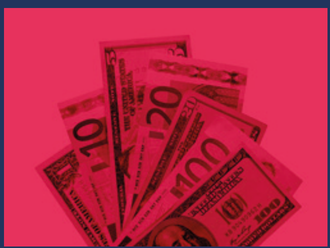
1 The Times. What is happening to banks and why are people talking about a crisis? March 16, 2023
2 The Guardian, SVB collapse may be start of 'slow-rolling crisis', warns BlackRock boss, March 15, 2023
3 United Nations, Department of Economic and Social Affairs, Sustainable Development, The 17 Goals

Top 5 risks for financial services companies 2023

1
42%
→
2022: 1

Cyber incidents
(e.g. cyber crime, malware/ransomware causing system downtime, data breaches, fines and penalties)

2
34%
↑
NEW

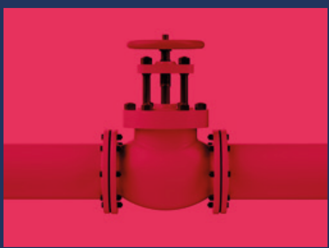


Macroeconomic developments
(e.g. inflation, deflation, monetary policies, austerity programs)

3
26%
→
2022: 3

Changes in legislation and regulation
(e.g. trade wars and tariffs, economic sanctions, protectionism, Euro-zone disintegration)

4
21%
↑
NEW



Energy crisis[1]
(e.g. supply shortage/outage, price fluctuations)

5
21%
↓
2022: 2

Business interruption
(incl. supply chain disruption)

Source: Allianz Global Corporate & Specialty

The top five risks for the financial services sector as voted for by 865 respondents in the **Allianz Risk Barometer 2023**

1 Energy crisis ranks higher than business interruption based on the actual number of responses

Cyber ranks as the top risk for FS companies in the **Allianz Risk Barometer**. What are the main threats criminals pose and how are their tactics evolving? How can companies best prepare?

Despite investing in significant levels of cyber security spend each year, respondents view the FS industry as highly-exposed– a fact mirrored by a Boston Consulting Group report which stated that cyber threats are 300 times as likely to target this sector than others.[4] The main threat for financial institutions is the attempt to repossess the assets they hold (be it in clients' accounts or proprietary). This can be achieved in multiple ways – for example, through impersonation, cyber-attack or falsified electronic correspondence. Moreover, entities in this segment can also be prone to more 'standard' attack mechanisms, such as extraction of personal data of the client or holding the IT system hostage via ransomware attacks. The banking industry experienced a 1,318% increase in ransomware attacks in 2021 according to reports.[5]

Attacks methods evolve quickly. For example, open source artificial intelligence (AI) tools can be used to craft highly personalized spear phishing attacks. At the same time the growing reliance of banks on third-party providers, such as cloud computing services, means they could be vulnerable to cyber-attacks that have a knock-on effect across the financial system. The European Central Bank is to ask all major lenders to detail by next year[6] how the sector would respond to a serious breach of its cyber defenses given current threat levels.

Cyber-attacks can often include a human element, where employees, contractors or customers are unwittingly complicit in incidents. Just one click on a link or a download can lead to a costly ransomware attack or data breach. Training and technology can help minimize human error. Employees are the first line of security and therefore should be regarded as part of the cyber security team with a corresponding investment in their education.

Those who are well trained can significantly reduce the impact of a breach or even prevent it from happening. The same applies to top management, who should periodically rehearse scenarios in order to prepare and respond to a major cyber incident – building resilience and business continuity planning is absolutely key to reducing the impact. In addition, companies need to operationalize their response to regulation and privacy rights in relevant jurisdictions.

4 Business Insider, Cyberattacks are 300 times as likely to hit financial firms than other companies. A sweeping new report finds they're not prepared, June 20, 2019
5 Security Magazine, Banking industry see 1318% increase in ransomware attacks in 2021, September 20, 2021
6 Financial Times, ECB tells banks to run cyber stress tests after rise in hacker attacks, March 9, 2023

Macroeconomic developments, such as inflation and monetary policies, and changes in legislation and regulation also rank as top risks for the sector in the **Allianz Risk Barometer**. Could you highlight some of the ways in which these are impacting FS companies?

A number of surveys of FS companies – such as from the Bank of England[7] – have revealed that many believe inflation is still likely to be one of the most challenging risks to manage over the next year. A damaging consequence of inflation is the long-term impact it can have. Even after the economy seemingly recovers, investments may take a while to regain value, proving just how susceptible assets can be to fluctuations. And while inflation triggers higher interest rates, which increases net interest income, on the other hand it likely slows down loan demand and brings a higher risk of loan default. The Silicon Valley Bank failure also highlights banks' general macro-financial challenges from restrictive monetary policy, which essentially removes diversification, according to **Allianz Research**. Negative returns from bonds and equity put pressure on assets while quantitative tightening has led to a contraction of money supply, resulting in greater competition for deposits (as banks lend less).

Compliance is one of the biggest challenges for FS companies with legislation and regulation around digitalization, climate change and environmental, social, and governance (ESG) issues, to name but a few examples, constantly evolving. The compliance burden for financial institutions has increased significantly over the past decade. Regulatory enforcement has intensified as banks and senior management are more readily held to account by lawmakers, prosecutors and shareholders. At the same time, increases in sanctions, such as in response to Russia's invasion of Ukraine, also bring unprecedented challenges.

Ultimately, the multiple regulatory and reporting challenges facing financial institutions require them to improve the effectiveness and efficiency of their compliance activities and put data and technology to clever use.

> "Multiple challenges require financial institutions to improve the effectiveness of their compliance activities and put data and technology to clever use

7 Bank of England, Systemic Risk Survey Results – 2022 H2, October 12, 2022

Financial services loss trends: top causes of claims

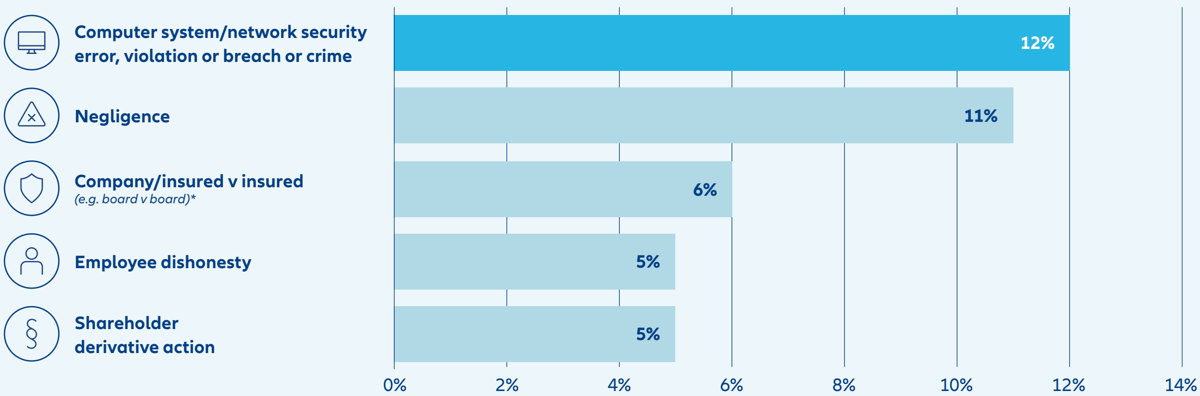
In recent years, insurers have continued to see large claims relating to compliance and increased regulatory activity. Violations can be contributing factors to each of the top causes of loss by severity. The compliance burden for financial institutions has increased significantly with companies subject to a growing bank of rules and regulations including sanctions, whistle blowing, data protection and cyber security laws, as well as environmental, social, and governance (ESG) requirements.

Cyber incidents, including crime, have resulted in some of the most expensive claims in the analyzed dataset below. In recent years insurers have seen a growing number of technology-related losses including claims made against directors following major privacy breaches. Sizable losses have come from fraudulent payment instructions and "fake president" scams. Insurers have also handled a number of liability claims arising from technical problems with exchanges and electronic processing systems where systems have gone down and clients have not been able to execute trades. There have also been claims where a system failure has caused damages to a third party; one financial institution suffered a significant loss after a trading system crashed causing processing failures for customers.

AGCS regularly engages in open dialogues with the financial services segments to discuss risk trends and challenges. Whether it is providing traditional **directors and officers insurance** coverage or alternative risk transfer solutions such as **'virtual captives'** at AGCS we are investing heavily in our network and expertise in underwriting, claims and operations, so we can best respond to the needs of our customers and contribute to a better management of risks in a complex environment that is constantly evolving.

The analysis was conducted on 7,654 claims worth approximately €870mn reported from January 1, 2015 to March 31, 2021. The claims includes the share of other insurers as well as AGCS.

Top 5 causes of claims by value for FS companies



*Driven by historical loss experience

Source: Allianz Global Corporate & Specialty

What are some of the most important ESG issues and challenges the FS sector is dealing with?

The growing focus on environmental, social, and governance (ESG) topics offers the opportunity for many FS companies to step up and lead when it comes to investing in people and the planet. Although the FS sector may be ahead of others when it comes to addressing ESG, regulations and guidance will still be a driver of risk going forward. Challenges are ongoing, whether it is FS companies having to assess and mitigate environmental risk in their own portfolios or when it comes to supporting others on their own net-zero journeys.

Increasing scrutiny from regulators puts more pressure on financial institutions to disclose ESG practices and risk management, which can bring reputational risk. At the same time, a lack of consistent standards and reporting frameworks makes ESG knowledge gathering, training and certification difficult and drives up costs. This will change in time.

Risks such as climate change and diversity, equality and inclusion have become central concerns for organizations, but businesses and insurers are also starting to pay closer attention to other ESG-related issues such as biodiversity for example. Again, financial institutions may face financial, market, reputational and legal risks if they invest in economic activities that cause adverse effects on biodiversity or are highly dependent on natural capital. On the other hand, protecting biodiversity provides huge opportunities for investments. The financing gap to restore biodiversity until 2030 is estimated at US $711bn per year according to **Allianz Research**.

Ultimately, integrating ESG considerations across all aspects of business is becoming a key performance indicator of a company's financial health and its ability to meet increasing stakeholder expectations to support the transition to a green economy, access capital, raise financing, meet heightened regulatory and compliance requirements, and attract and retain talent.

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The UN's Sustainable Development Goals represent a huge opportunity for the FS sector

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- ↗ Global Industry Solutions | AGCS (allianz.com)
- ↗ Financial Services Insurance | Allianz
- ↗ Allianz Risk Barometer | AGCS
- ↗ D&O Insurance Insights 2023 | AGCS (allianz.com)

About AGCS

Allianz Global Corporate & Specialty (AGCS) is a leading global corporate insurance carrier and a key business unit of Allianz Group. We provide risk consultancy, Property-Casualty insurance solutions and alternative risk transfer for a wide spectrum of commercial, corporate and specialty risks across nine dedicated lines of business and six regional hubs.

Our customers are as diverse as business can be, ranging from Fortune Global 500 companies to small businesses. Among them are not only the world's largest consumer brands, financial institutions, tech companies, and the global aviation and shipping industry, but also floating wind parks or Hollywood film productions. They all look to AGCS for smart solutions to, and global programs for, their largest and most complex risks in a dynamic, multinational business environment and trust us to deliver an outstanding claims experience.

Worldwide, AGCS operates with its own teams in more than 30 countries and through the Allianz Group network and partners in over 200 countries and territories, employing more than 4,200 people. As one of the largest Property-Casualty units of Allianz Group, we are backed by strong and stable financial ratings. In 2022, AGCS generated a total of €11.2bn gross premium globally.

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