Financial Services Risk Trends

Covid | Compliance | Cyber | Culture | Climate Change | Claims

An Insurer's Perspective

Executive briefing

Allianz Global Corporate & Specialty

Covid, Cyber, Compliance and ESG top risk concerns for financial services sector: **Allianz**

- New AGCS report identifies key risks and loss trends for the financial services sector.
- Covid-19 may drive market corrections and insolvencies – which could impact financial institutions' balance sheets, increase exposures for directors and result in litigation.
- AGCS analysis of $1bn of insurance industry claims show cyber incidents, including crime, is the top cause of loss. Insurers see a rising number of losses from outages or privacy breaches with third-party service providers a potential weak link.
- Compliance issues are already one of the biggest drivers of claims - violations can be contributing factors in each of the top 10 causes of loss – and the burden is growing – particularly around ESG factors and climate change.

Financial institutions and their directors have to navigate a rapidly changing world, marked by new and emerging risks driven by cyber exposures based on the sector's reliance on technology, a growing burden of compliance, and the turbulence of Covid-19, according to a new report **Financial Services Risk Trends: An Insurer's Perspective** from Allianz Global Corporate & Specialty (AGCS).

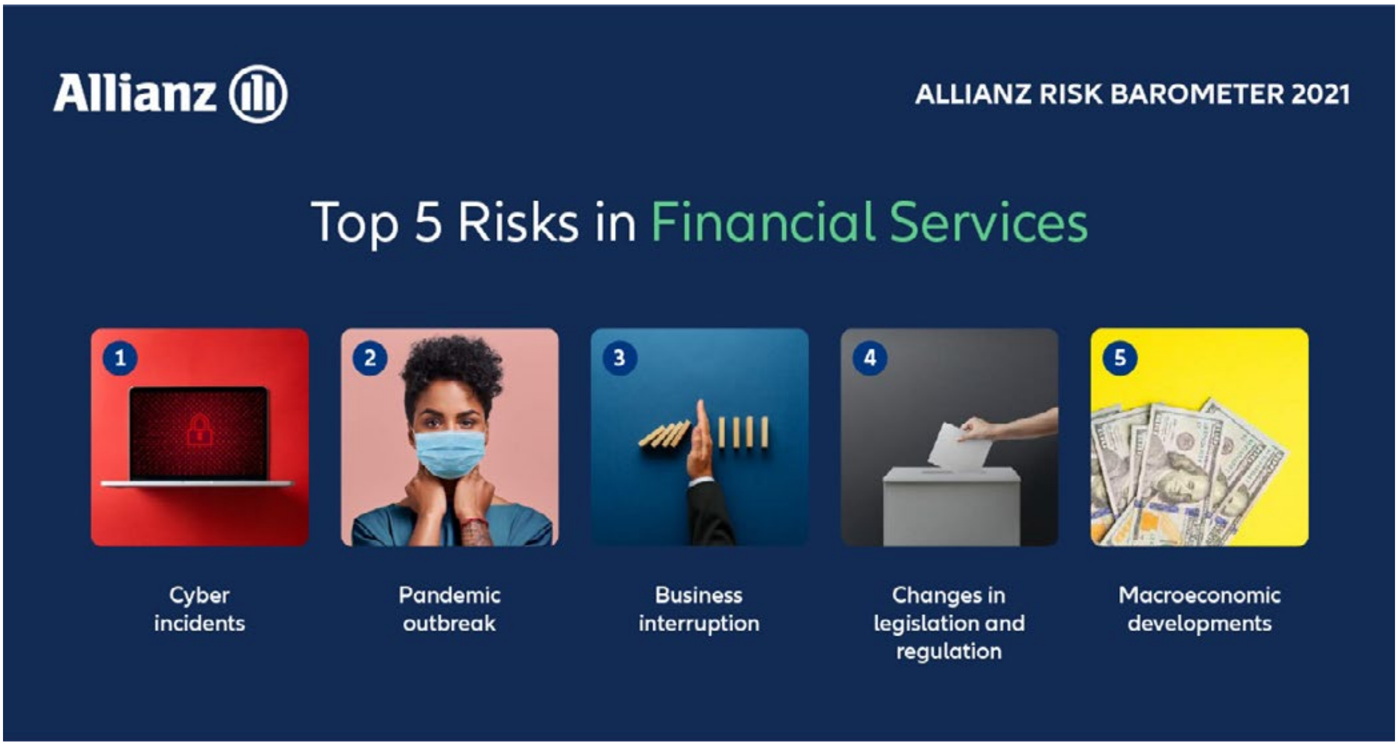
At the same time, the behavior and culture of financial institutions is under growing scrutiny from a wide range of stakeholders in areas such as sustainability, employment practices, diversity and inclusion and executive pay.

"The financial services sector faces a period of heightened risks. Covid-19 has caused one of the largest ever shocks to the global economy, triggering unprecedented economic and fiscal stimulus and record levels of government debt," says **Paul Schiavone, Global Industry Solutions Director Financial Services at AGCS**.

"Despite an improved economic outlook, considerable uncertainty remains. The threat of economic and market volatility still lies ahead while the sector is also increasingly having to focus on so-called 'non-financial' risks such as cyber resilience, management of third parties and supply chains, as well as the impact of climate change and other Environmental Social and Governance (ESG) trends."

The AGCS report highlights some of the most significant risk trends for banks, asset managers, private equity funds, insurers and other players in the financial services sector, as ranked in the **Allianz Risk Barometer 2021**, which surveyed over 900 industry respondents: Cyber incidents, Pandemic outbreak and Business interruption are the top three risks, followed by Changes in legislation and regulation – driven by ESG and climate change concerns in particular. Macroeconomic developments, such as rising credit risk and the ongoing low interest rate environment, ranked fifth.

The Allianz Risk Barometer findings are mirrored by an AGCS analysis of 7,654 insurance claims for the financial services segment over the past five years, worth approximately €870mn ($1.05bn). Cyber incidents, including crime, ranks as the top cause of loss by value. Other top loss drivers include negligence and shareholder derivative actions.



The top five risks for the financial services sector as voted for by over 900 sector respondents in the **Allianz Risk Barometer 2021**

Top covid concerns

Financial institutions are alive to the potential ramifications and unintended consequences of government and central bank responses to the pandemic, such as low interest rates, rising government debt and the winding down of support and grants and loans to businesses. Large corrections or adjustments in markets – such as in equities, bonds or credit – could result in potential litigation from investors and shareholders, while an increase in insolvencies could also put some institutions' own balance sheets under additional strain. Claims may be brought against directors and officers where there has been a perceived failure to foresee, disclose or manage Covid-19 related risks.

The Covid-19 environment is also providing fertile ground for criminals seeking to exploit the crisis. The rise in homeworking, fast adoption of new technologies and potentially weaker controls and oversight are making companies and customers more vulnerable to cyber-crime and potentially making it easier for rogue employees to commit market abuse or fraud.

Companies are also planning for a return to the workplace in coming months but with infection risks likely to persist for some time yet getting workers back into offices is a task without precedent. This is likely to be a huge source of uncertainty, raising difficult questions around Covid-19 infection liability, vaccinations and privacy issues with regards to the medical information of employees. Inadequate return to office plans could even see employers face liabilities related to employment practices and whistleblowing claims.

Cyber highly exposed despite high levels of security spend

Cyber security experts warned of a perfect storm for financial institutions as Covid-19 led to a rapid and largely unplanned increase in homeworking and electronic trading and this soon materialized. With attacks increasing by well over 200% globally at the start of the pandemic it is unsurprising that cyber risk ranks as the top concern in the Allianz Risk Barometer.

Despite one of the highest levels of cyber security spend, financial services companies are an attractive target and face a wide range of threats including business-email compromise attacks, ATM “jackpotting” - where criminals take control of cash machines through network servers - and extortion and ransomware attempts. One of the largest cyber-attacks of the past year, the **SolarWinds** incident, was a supply chain attack. Hackers accessed the software company’s network in order to target thousands of customers, including banks and agencies, demonstrating the potential vulnerabilities of the sector to attacks and outages via their reliance on third-party service providers. Most financial institutions are now making use of cloud services-run software which comes with a growing reliance on a relatively small number of providers. Institutions face sizable business interruption exposures, as well as third party liabilities, when things go wrong. Analysis of almost **2,000 cyber claims** (across all industry sectors) shows that business interruption costs drive the losses, accounting for 60% of the value of $800mn of claims.

How financial institutions manage risks presented by the cloud will be critical going forward. They are effectively offloading a significant portion of cyber security responsibilities to a third-party. However, by partnering with the right cloud service provider, companies can also leverage the cloud as a way to manage their overall cyber exposure.

This is likely to become an even bigger issue as regulators increasingly focus on business continuity, operational resilience and the management of third party risk following a number of major outages at banks and payment processing companies. Indeed the report notes that there has been a seismic shift in the regulatory view of privacy and cyber security in recent years with firms face a growing bank of regulation and requirements. The consequences of data breaches are far-reaching, with more aggressive enforcement, higher fines and regulatory costs, and growing third party liability, followed by litigation. Companies need to operationalize their response to regulation and privacy rights, not just look at cyber security.

Unintended consequences of new technology

Applications of new technologies such as Artificial Intelligence (AI), biometrics and virtual currencies will likely raise new risks and liabilities in future, in large part from compliance and regulation. With AI, there has already been regulatory investigations in the US related to the use of unconscious bias in algorithms for credit scoring. There have also been a number of lawsuits related to the collection and use of biometric data. The growing acceptance of digital or cryptocurrencies as an asset class will ultimately present operational and regulatory risks for financial institutions with uncertainty around potential asset bubbles and concerns about money laundering, ransomware attacks, the prospect of third party liabilities and even ESG issues as "mining" or creating cryptocurrencies uses large amounts of energy. Finally, the growth in stock market investment guided by social media raises mis-selling concerns – already one of the top causes of insurance claims.

ESG factors take center stage

Financial institutions and capital markets are seen as an important facilitator of the change needed to tackle climate change and encourage sustainability. Again, regulation is setting the pace. There have been over 170 ESG regulatory measures introduced globally since 2018, with Europe leading the way. The surge in regulation, in combination with inconsistent approaches across jurisdictions and a lack of data availability, represents significant operational and compliance challenges for financial services providers.

Financial services may be ahead of many other sectors when it comes to addressing this topic, but it will still be an important factor shaping risk. Social and environmental trends are increasingly sources of regulatory change and liability, while increased disclosure and reporting will make it much easier to hold companies and their boards to account.

At the same time, activist shareholders or stakeholders increasingly focus on ESG topics. Climate change litigation in particular is beginning to include financial institutions. Cases have tended to focus on the nature of investments, although more recently there has been an escalation in the use of litigation by activists and advocacy groups seeking to advance climate policies, drive behavioral shifts and force disclosure debate. Besides climate change, broader social responsibilities are coming under scrutiny, with board remuneration and diversity being particular hot topics, and regulatory issues. Companies that commit to addressing issue such as climate change and diversity and inclusion will need to follow through. For those that do not, it will come back to haunt them. Elevating and identifying ESG risks through a business' risk registers and committees and making sure it is understood how they will perform in and out of the boardroom, is crucial.

Claims trends and impact on insurance market

The AGCS report also highlights some of the major causes of claims insurers see from financial institutions. The fact that compliance risk is growing is concerning as compliance issues are already one of the biggest drivers of claims – violations can be contributing factors in each of the top 10 causes of loss, according to AGCS analysis. Keeping abreast of compliance in a rapidly-changing world is a tough task for companies and their directors and officers as the burden is enormous, accompanied by regulatory activism, legal action and litigation funding.

Cyber incidents already result in the most expensive claims and insurers are seeing a growing number of technology-related losses including claims made against directors following major privacy breaches. Other examples include sizable claims related to fraudulent payment instructions and business email compromise attacks. Such payments can be in the millions of dollars. AGCS has 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, and have made claims against policyholders for loss of opportunity. 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.

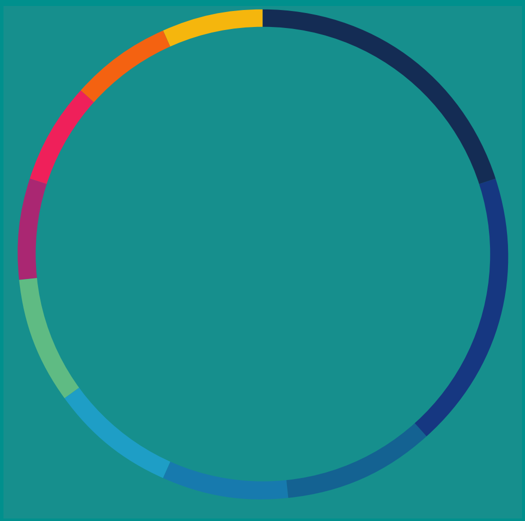
Claims against directors and officers arising out of underlying prosecutions of banks have become a significant severity driver of claims. Insurers have seen a number of large claims that have arisen out of investigations and prosecutions for sanctions breaches in the US. Mergers and acquisitions and initial public offerings have also generated large claims in recent years, as have money laundering, tax and accounting fraud, currency cartels and collusion, and large insolvencies. Increasing frequency and severity of derivative actions against directors and officers of financial institutions and consumer/customer class action claims is also concerning.

Recent loss activity, compounded by Covid-19 uncertainty, have contributed to a recasting of the insurance market for financial institutions, characterized by adjusted pricing and greater risk selection by insurers but also a growing interest in alternative risk transfer solutions in addition to traditional insurance.

Insurance is increasingly an important part of the capital stack of financial institutions and a growing number are partnering with insurers to manage risk and regulatory capital requirements or utilizing captive insurers to compensate for changes in the insurance markets or finance more difficult to place risks. Providing capital relief to banks on their loan and credit line portfolios is an area of growing interest.

At AGCS, we are committed to engaging with financial institutions to help them mitigate their exposures and develop adequate risk transfer solutions for a sector that is embarking on a major transformation, driven by fast-paced technology adoption and growing ESG issues, while having to master the impacts of the Covid-19 pandemic.

Claims analysis



Top 10 causes of loss by value

Computer System/Network Security Error, Violation or Breach or Crime	**12%**
Negligence	**11%**
Company/Insured v Insured (e.g. board v board)*	**6%**
Employee Dishonesty	**5%**
Shareholder Derivative Action	**5%**
Fraud/Embezzlement/Intentional Misconduct	**5%**
Government Claim or Investigation	**4%**
M&A Warranty Breach (e.g. seller/buyer merger and acquisition dispute)	**4%**
Breach of Trust or Duty	**4%**
Mis-selling	**4%**

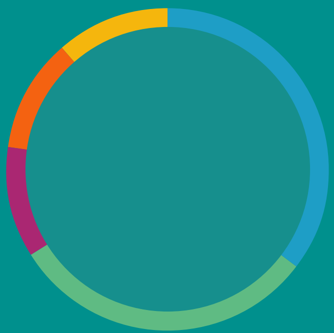
Based on the analysis of 7,654 claims worth approximately €870mn ($1.05bn) reported from January 1, 2015 to March 31, 2021. Total includes the share of other insurers involved in the claim in addition to AGCS. Percentage shares are rounded up or down accordingly. Graphic shows breakdown of top 10 causes of loss only. Other causes of losses were also identified in the data analysis.

*Driven by historical loss experience

Source: Allianz Global Corporate & Specialty

Top 5 causes of loss by value by selected policies

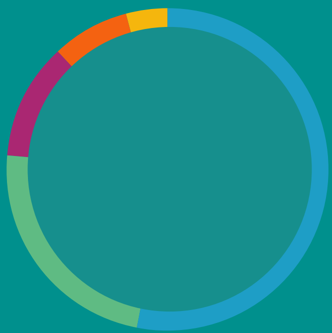
Directors and Officers



1	Company/Insured v Insured*	**22%**
2	Shareholder Derivative Action	**19%**
3	Securities Violations/ Shareholders Disputes (direct)	**7%**
4	Class Action (customers)	**7%**
5	Governmental Claim or Investigation	**7%**

Based on the analysis of 3,349 claims worth approximately €225.7mn reported from January 1, 2015 to March 31, 2021. Total includes the share of other insurers involved in the claim in addition to AGCS. Percentage shares are rounded up or down accordingly.

Crime



1	Employee Dishonesty	**41%**
2	Fraud/Embezzlement/ Intentional Misconduct	**18%**
3	Non-Compliance with Laws and Regulations	**9%**
4	Computer System or Network Security Error, Violation or Breach or Crime	**6%**
5	ATM Loss	**3%**

Based on the analysis of 894 claims worth approximately €106.4mn reported from January 1, 2015 to March 31, 2021. Total includes the share of other insurers involved in the claim in addition to AGCS. Percentage shares are rounded up or down accordingly.

Professional indemnity

1	Negligence	**19%**
2	Computer System/Network Security Error, Violation or Breach or Crime	**16%**
3	Mis-selling	**7%**
4	Breach of Trust or Duty	**7%**
5	Fraud/Embezzlement/ Intentional Misconduct	**5%**

Based on the analysis of 2,921 claims worth approximately €485.4mn reported from January 1, 2015 to March 31, 2021. Total includes the share of other insurers involved in the claim in addition to AGCS. Percentage shares are rounded up or down accordingly.

* driven by historical loss experience

Source: Allianz Global Corporate & Specialty. Graphics show breakdown of top five causes of loss only. Other causes of losses were identified in the data analysis.

Download **Financial Services Risk Trends: An Insurer's Perspective**

For more information:

Martin Zschech
Global Head of Industry Solutions & Client Management
Global Industry Solutions Director for Financial Services
martin.zschech@allianz.com

Allianz Global Corporate & Specialty SE
Dieselstr. 8, 85774 Unterfoehring, Munich, Germany

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