How will financial institutions manage non-financial risks in a post-pandemic world?

Data-driven insights will be critical when accessing (re)insurance capital to mitigate volatility in a rapidly changing risk environment.

Concerns about the spread of the COVID-19 - declared a pandemic by the World Health Organization on 11th March 2020 - have prompted governments to take drastic action to help saves lives, protect health care systems and the global economy. The economic and social implications of these measures are significant. The rise of the pandemic and ensuing scramble for recovery has created immediate challenges for financial institutions (FIs) but the ongoing impacts of COVID-19 will add new pressures on global business for many years to come.

Aon's recently published decision making framework – Decision Making In Complex & Volatile Times: Keys to Managing COVID-19 – describes three distinct timeframes to an organisation's response to a crisis: react and respond; recover; and reshape. After the initial response to COVID-19, during which many financial institutions focused on remaining operational, most have moved through the *recover* stage (which relates to stabilising the business and looking at shifting to new operating models), and on to the *reshape* phase which acknowledges the new normal will demand leaders "to rebuild their vision, strategy and priorities for the future."

Business models are changing. Accelerated by the COVID-19 pandemic, FIs around the world continue to take urgent measures to remain operational. In moving forward, firms need to actively consider the financial, regulatory and risk implications, including the role of insurance and other risk transfer solutions to mitigate volatility.

How is the insurance market responding to the outbreak of COVID-19?

The potential impact of insured losses suffered by banks due to COVID-19 currently remains too early to fully quantify by the market. For FIs, lessons learned from the global financial crisis of 2008 are being used to engage with recovery measures, consider risk and regulatory implications and plan for the future. In exploring the relationship between non-financial risk losses and financial crises, a clear correlation can be identified between movements in equity indices caused by economic shocks, and losses in fraud, conduct and execution risks.

Research has shown a strong correlation in an upsurge in crime and liability (conduct and execution) losses in the years following a recession.

Which key operational and non-financial risks are likely to emerge and what are their implications for risk quantification?

<table>
<tr><th></th><th>Direct Financial Loss Sustained</th><th>Compensatory Damages to 3rd Parties</th><th>External Legal Fees</th><th>Regulatory Fines and Action</th><th>Remediation Costs
Hiring consultants, additional staff cost, ...</th><th>Losses Due to Business Interruption</th><th>Incident Response Support</th></tr>
<tr><td>Cyber</td><td>✓</td><td>✓</td><td>✓</td><td rowspan="5">Regulatory fines potentially covered under cyber and D&O for natural persons, but not under PI/E&O

Regulatory action covered under D&O and potentially under PI, where the regulator is acting on behalf of customers</td><td>✓</td><td>✓</td><td>✓</td></tr>
<tr><td>Conduct</td><td>N/A</td><td>✓</td><td>✓</td><td>X</td><td>X</td><td>X</td></tr>
<tr><td>Fraud</td><td>✓</td><td>✓</td><td>✓</td><td>✓</td><td>X</td><td>X</td></tr>
<tr><td>Execution</td><td>X</td><td>✓</td><td>✓</td><td>X</td><td>X</td><td>X</td></tr>
<tr><td>Outsourcing</td><td>X</td><td>✓</td><td>✓</td><td>X</td><td>X</td><td>X</td></tr>
</table>

Since 2014, insurance capacity, for crime and liability product lines (as well as for cyber), has been readily available for FIs. Premiums have remained competitive, with minimal internal challenge for budget approval in these products. In a post-COVID-19 world, this is likely to change.

Even for firms with robust risk management strategies in place, insurers are reducing capacity and increasing premiums significantly. For other firms, obtaining coverage on the existing basis will be a real challenge.

"Moving forward, it will be critical for firms to provide evidence of how they manage risks, the effectiveness of their risk control and governance frameworks, and to use robust risk data and information to articulate the underlying and insured risk profile."

Jonathan Humphries, Executive Director, Aon

The value of data: safety in numbers

Ensuring your risk management strategy evolves with the rapidly changing commercial environment is vital. By engaging in a structured process and demonstrating sound risk management, firms will be able to articulate their risk profile and demonstrate risk governance effectiveness to stakeholders – clients, regulators, shareholders and (re)insurers.

Historical loss experience, structured scenario analysis and modelling incorporating the calculation of insurance mitigation, provides a powerful source of information for articulating a firm's risk profile. This enables firms to:

- Evaluate options and identify desired risk coverage to mitigate volatility (and potential pillar 2 capital off-set) and minimise costs (retained losses and premiums)

- Select the most appropriate limit of cover and retention levels, for each policy being purchased, to align with appetite on an aggregate or single loss basis

- Use the data and insights derived to both help (re)insurers gain comfort in the underlying risk being insured, and to support negotiations

Working with a specialist risk advisor can enable firms to access sophisticated risk modelling tools, including operational and non-financial risk capital models. Bolstering these data-driven insights with the knowledge and experience of specialist risk advisory and broking teams enables firms to make informed decisions about risk management, building long-term resilience as the global business environment continues to change.

How can Aon help firms make informed decisions?

Aon's proprietary methodologies use broking expertise in conjunction with actuarial and engineering techniques, that are applicable even for firms without an internal capital model. For clients without sufficient internal loss data, Aon's OpBase provides 30 years of data history that can supplement scenario analysis to build a risk profile. Our research[1] demonstrates approaches to scale OpBase data into models that are proportionate for the organization.

For G-SIB/D-SIB banks, insurers, critical infrastructure providers and investment firms, Aon's experts are able to inform business decision-making around risk strategy, investment and financing, and support FIs in building operational and non-financial risk frameworks which meet regulatory expectations for pillar 2 (and pillar 1) capital and stress-testing purposes.

Our specialist team has built, validated and replicated over forty operational and non-financial risk capital models. By conducting scenario analysis and using external data, whether it be OpBase or consortia data, our experts support stakeholder engagement to build robust assessments of unexpected loss.
Bolstering data-driven insights with the knowledge and experience of our specialist risk advisory and broking teams enables firms to make informed decisions about risk management and build long-term resilience as the global business environment continues to change.

If you would like to discuss any of the issues raised in this paper, please contact our specialist team:

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[1] *Dimensional Analysis [see - Cohen (2016). An assessment of operational loss data and its implications for risk capital modelling. The Journal of Operational Risk 11(3), 71–95 (https://doi.org/10.21314/JOP.2016.178); and Cohen et al (2019). An investigation of cyber loss data and its links to operational risk. The Journal of Operational Risk 14(3), 1–25 (https://doi.org/10.21314/JOP.2019.228)]*