2019 Outlook for Financial Institutions

Global volatility is a key theme for financial institutions as we begin 2019. In the U.S., the government shutdown, questions about future monetary policy (to tighten or not to tighten) and speculation about reaching the end of an extended corporate growth cycle has translated into market volatility after a period of relative calm. In Europe, uncertainty around Brexit and the prospective relationship between the UK and EU has businesses confounded about operating in the real economy. Regulators who may have regional variance continue to exert influence over the way financial institutions operate.

Of course, the confluence of such a wide range of issues impacting the operations and performance of financial institutions ultimately impacts their insurability. That in conjunction with insurer performance cycles leads us to highlight the following short list of critical themes relevant to the financial lines markets that we'll need to pay close attention to in 2019:

Insurance Pricing in the Financial Lines Markets is Firming

In the US and UK financial lines markets we are experiencing a firming rate environment at the start of 2019. Broadly, insurers are pressing for increased premium and/or retention levels on a risk by risk basis. According to Aon's D&O Pricing Index, in Q3 2018, only 8% of primary renewals experienced a premium decrease. This is the lowest percentage of premium decreases since Q2 2013. Primary policies experienced a premium increase of 3.2% in Q3 and there have been primary pricing increases for seven consecutive months.

"we began to see some signs of dislocation on the margin in the market as some carriers curbed their appetite for certain lines of business by reduced line sizes or exiting from markets altogether. That's another marker of a firming or market correction. In North America, the positive pricing trends in the third quarter continued, in fact improved in several areas, particularly in our major accounts, retail and E&S wholesale divisions. Overall, rates in North America were up about 2.5%, the same as last quarter, while renewal price change, which includes exposure, was up 4%...In major accounts in specialty which doesn't include agriculture, premiums were up 5%. Rates for major accounts were up over 3% with risk management at rates of less than 1%, while excess casualty rates were up 10%, property was up 12% and public D&O was up 8.5%."

- Chubb Q4'18 earnings call

In order to effectively navigate this firming marketplace, Aon recommends: 1) starting the process early; 2) working with your Aon broker to understand the marketplace for your specific risks; 3) clearly defining your renewal goals; 4) determining what levers you can pull to achieve best in class results; and 5) having options.

Isn't There Abundant Insurance Capacity?

In 2018 we experienced another significant year of natural catastrophe activity including Hurricanes Michael and Florence and the California wild fires. While the hit to the insurance industry did not exceed the high-water mark set in 2017 (~$150bn), 2018 still produced natural catastrophe insured losses in excess of $85bn (exceeding the last 10-year annual average). Despite all of this, overall insurance market capacity remains at historically high levels. Aon estimates that global reinsurer capital stood at $595bn at September 30, 2018, down 2% relative to the end of 2017. This calculation is a broad measure of the capital available for which insurers can trade risk. Traditional capital fell by USD20 billion to $496 bn (-4%), while alternative capital rose by $10 bn to $99 bn (+11%). Further, recent M&A among insurers, such as AXA and XL, has had no material

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If you have questions about your specific coverage or want more information, please contact your Aon broker.

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impact on overall capacity levels. As we progress through 2019, we'll have to pay close attention to whether pockets of the insurance market will attract additional opportunistic capital despite already high levels of overall capitalization.

So, why are rates firming? Record levels of litigation, underperformance of portfolio and heightened exposures

After a prolonged soft market, record levels of Securities Class Actions (SCA) are contributing to a firming marketplace for financial lines coverages. In 2018 there were 403 total SCAs which is on par with the record levels of 2017. M&A litigation accounted for 185 filings, or 46%. Two hundred and eighteen filings were "traditional filings". The number of 2018 traditional filings – those that allege violations of Rule 10b-5, Section 11, and/or Section 12 - was the highest amount since 2008. The SCA litigation rate for U.S. exchange listed defendants is 8.7%, the highest on record.

One notable case in 2018 was *Cyan*, which has certified that under the Securities Act of 1933, Section 11 claims can be brought in both federal and state court, further expanding the number of jurisdictions for Section 11 claims to be brought. This has resulted in an increase in class actions, particularly against companies having initial public offerings, but the state data is more difficult to track than at the federal level.

The percentage of cases alleging regulatory violations across multiple industries, many of which would be considered event-driven cases, accounted for about 17% of filings, down 26% from last year. ICO's (Initial Coin Offerings) also contributed to the uptick in federal securities class actions, accounting for at least nine suits in 2018.

In addition to the D&O claims above, financial institutions professional liability (E&O) continues to see heightened frequency of claims, including those related to sales practices, lending and regulatory investigations. In tandem with an increase in frequency, companies insuring financial institutions have experienced an increase in claim severity with recent nine-figure insurable losses in D&O (Side A), E&O and Fidelity Bond. Many of the insured losses have largely been borne by the handful of insurers willing to take a leadership position on complex risks - several insurers had limits of $50mm (some over $100mm) per risk - and, as these insurers recalibrate, "new capacity" is not anxious to step in to these risks. The large losses have been particularly impactful pricing for excess limits. While primary layer D&O pricing has decreased approximately 2% over the past five years, pricing for excess limits has decreased 28% in this time, according to Aon's data. Insurers have responded to their profitability challenges not only by seeking rate increases but also by managing (reducing) their overall limits, adjusting attachment levels, imposing coverage restrictions (such as proprietary funds exclusions in Fiduciary Liability policies) and walking away from deals deemed inadequately priced. As a result, "less attractive" risks, such as large D&O and E&O programs, are becoming increasingly difficult and more time consuming to place.

Across the pond in London, Lloyds conducted a market performance review in the second half of 2018 of all syndicate business plans for 2019. Focusing on consistently underperforming syndicates, the Lloyds Performance Director instructed underperforming syndicates to undertake remedial action in order to return their businesses to profitability. Of the "Decile 10", or the 10% worst performing classes of business, professional indemnity (E&O) was identified as the second worst performing class in the market.

Cyber as a Risk Driver

Financial statement impact of breaches has shifted to business disruption due to technology failures or outages (i.e. business interruption, contingent business interruption and systems failure). Trading, brokerage and asset management operations, all underpinned by technology and connectivity to third party networks, can present significant business continuity and profit and loss exposure to banks. Aon's cyber insurance solutions contemplate meaningful first party capacity for expense and P&L loss resulting from a breach of security at either your firm or your critical vendors' and suppliers' (e.g. exchanges) or from a simple failure of your (or your vendors') trading/technology platforms. Coverage may attach at fixed dollar retentions (rather than after waiting period deductibles) and is supported by a claims preparation and advocacy partnership between Aon's Cyber Solutions and Property Claims Practices.

Unauthorized Transfer or Theft of Client or Proprietary Assets (i.e. fraud loss)
Banks continue to develop new retail capabilities and invest in digital asset and blockchain technologies. However, regulatory and monetary loss exposure only continues to increase as bad actors, criminals or nation-states initiate misappropriation of firm financial

assets (e.g. money and securities) or client financial assets in the firm's care custody and control through phishing, malware, email hijacking and other tactics. Aon's unique solutions for these exposures include integrated cyber and crime programs; cryptocurrency crime insurance and 401k theft insurance.

Information / data leakage (i.e. privacy liability)

In a post-financial crises and General Data Protection Regulation (GDPR) world, where banks are still adapting to new regulations and secular changes to trading and capital markets businesses - and thus pivoting to more personal-record intense lending and retail activities - privacy and non-public information exposure is at an all-time high. Aon's knowledge and experience can assist clients in accelerating time to compliance and Aon's GDPR Protect Solution can help banks transfer the financial, regulatory, and legal risks associated with privacy liability and related regulation.

Digital Assets and Cryptocurrencies

We entered 2018 in the midst of a surge in the valuation of cryptocurrencies and a deluge of Initial Coin Offerings (ICOs). This quickly transitioned to a vast regulatory crackdown and a plummet in the prices of cryptocurrencies (down approx. 90%). While the euphoria has died down, many believe that digital assets will have a meaningful role in financial services. The flow of ICOs has subsided and we have seen the emergence of STOs (Securities Token Offerings) and efforts to comply with regulations. In 2018, traditional financial institutions continued to invest in and launch digital asset platforms – a trend to keep an eye on in 2019.

Companies have prudently been seeking insurance solutions to address their crypto exposures. Established financial institutions should consider whether their current insurance policies (including Crime, Cyber and E&O) are covering these exposures. A traditional crime policy or fidelity bond is often inadequate, making it critical to tailor policy wording to address a company's unique exposures. This is a challenging segment, but Aon has been a leader in placing insurance for various crypto and digital asset businesses.

Employment Practices Liability (EPL), Wage & Hour and UK Gender Pay Gap

Workplace harassment allegations are front page news and, while first and foremost are devastating to the individuals involved, can have a significant adverse business impact, such as damage to a company's reputation or strained relationships with investors, and may mandate change in the c-suite. These events are not only an EPL risk, but also a D&O risk.

Wage and Hour concerns remain high as certain jurisdictions, such as California, institute new regulations that increase exposure for employers such as "unrestricted breaks" and an "ABC test" related to independent contractor classification. Defense costs alone can lead to significant losses.

In the UK, regulations requiring large employers to disclose their gender pay gap came into effect April 2017 with first reports due April 2018. Reports must include hourly and bonus pay gaps, bonus pay proportion, and the proportion of women and men at each hourly pay quartile. Firms must publish within 12 months of the April 5th snapshot date each year. It must be published on the employer's own website and remain there for at least three years from the date of publication, in English and accessible to all its employees and the public.

Noncompliance or failure to report is "an unlawful act" falling within the enforcement powers of the UK's Equality and Human Rights Commission and could attract "unlimited fines." The Commission could open an investigation if they suspect a considerable pay gap is being hidden by employers. Reputational risks are also a consideration if employers fail to comply with the regulations.

The data reported could provide fodder for existing or future lawsuits under the U.K.'s 2010 Equality Act, a codification of earlier laws, which gives women and men the right to equal pay for equal work, and provides a framework for comparing jobs by effort, skill or decision making.

Fiduciary Liability – proprietary funds

As 36(b) excessive fee cases are winding down, ERISA suits for excessive fees of proprietary funds in sponsored retirement plans are growing. From 2011 to the present, the plaintiff's bar has initiated at least twenty-five "proprietary funds" cases with all but three of these initiated over the past three years. Several new cases were filed in 2018. Many Fiduciary Liability insurers have responded by attaching exclusionary language, increasing retentions and/or pricing and seeking the completion of related questionnaires at renewal.

Fintech, Blockchain and Big Data

Financial institutions continue to invest heavily in technology as it is an integral part of their client offering and ongoing pursuit of operating efficiencies. Blockchain, a "distributed ledger technology" (DLT), is "live" and being actively utilized by several large financial institutions. One of the largest banking institutions in the world by total assets reported $250 bn in settled transactions in 2018 using the blockchain technology. Risks will vary depending on the structure and features of the blockchain – for example, is it "public" or "permissioned"? As financial institutions increase their reliance on technology, Aon recommends an in-depth review of professional liability (E&O), cyber liability policies and fidelity bond (crime) to avoid potentially significant gaps in coverage.

Regulatory trends to watch and consider

- Privacy regulations: Following in the footsteps of GDPR, California has promulgated the California Consumer Protection Act (CCPA) and more states are expected to take similar actions. The SEC has a heightened focus on cybersecurity.
- Operational Risk: 1) As conduct risk converges with operational risk, big banks continue to struggle with bad actors circumventing compliance and control frameworks; regulators globally are looking to drive better controls, governance, oversight, accountability, and capital adequacy to manage losses flowing from bad actors. Human resource mechanisms pertaining to rewards and compensation continue to have a role in attempting to deter bad behavior/and improve performance; 2) As we progress towards adoption of the Standardized Measurement Approach (SMA) for calculating regulatory capital in 2022, are banks preparing for the claims recovery data and documentation burden that will be required under the SMA to allow insurance recoveries to positively impact operational risk capital?
- M&A: As the Dodd Frank roll back raises the "enhanced prudential supervision threshold" for bank holding companies from $50 bn to $250 bn in total consolidated assets - will this lead to increased M&A in the banking sector?
- Bank Failures: While no banks were taken over by the Federal Deposit Insurance Company (FDIC) in 2018, this will likely change if we enter an economic slowdown in 2019.
- Cryptocurrency and Digital Assets: In the wake of the regulatory crackdown in 2018, will there be increased focus on regulation and compliance as these businesses seek broader acceptance?
- Climate Change: Aon's Weather, Climate & Catastrophe Insight: 2018 Annual Report shows how the last two years' natural disasters have been the costliest on record. Of the $225 billion in economic losses in 2018, only $85 bn (or 38%) was insured, leaving a global protection - or capital efficiency - gap of some $135 bn. With increased investor and regulatory scrutiny, climate-related risks are increasingly becoming C-suite priorities.
- Cannabis: in the U.S., several states have, or are considering, legalization of forms of cannabis. It remains illegal, however, at the federal level. As these businesses and their service providers expand, they are in need of banking solutions, but banks are cautious not to run afoul of federal regulations. Will federal regulations change as more states legalize cannabis?
- New Leadership at several key regulators and committees: House Finance Committee (now under Democrat control); Consumer Financial Protection Bureau (CFPB); New York Department of Financial Services; FDIC.

About Aon's Financial Services Group

The Financial Services Group (FSG) is Aon's dedicated global management liability insurance specialty practice. This team is comprised of 550 insurance professionals worldwide, all of whom are dedicated to serving the needs of our clients. FSG globally includes a 67 person legal and claims team to assist clients with claims counseling and avoidance. Aon is the market leader in management liability with approximately $4.4B in premium placed annually across the globe. Our accumulated experience from placing this volume translates into a keen awareness of insurer capabilities and emerging international litigation issues. It also offers us an opportunity to impact insurer behavior regarding pricing, coverage, and the claims resolution process.

About Aon's Financial Institutions Industry Practice

The Financial Institution (FI) Industry Practice is Aon's global specialty practice focused on lensing the broad range of capabilities and solutions across Aon's business segments (Risk, Reinsurance, Health, Retirement and Data/Analytics) for the risk management and growth enabling needs of our FI clients.