EXECUTIVE PERSPECTIVES ON TOP RISKS

Financial institutions demonstrate resiliency in responding to COVID and start to look forward out to the horizon

Massive disruptions in the global supply chain. Challenges in attracting and retaining talent to address needs all across the enterprise. COVID-19 variants. Cyber attacks and ransomware. Wildfires and flooding. Geopolitical tensions in specific regions and shifts on issues related to climate change. Long-overdue shifts in expectations related to diversity, equity and inclusion. Political divisiveness and gridlock. Artificial intelligence (AI), automation and other rapidly developing digital technologies. More permanent shifts to hybrid and remote work environments. Shifting customer preferences and demographics. Big data analytics.

The global marketplace is dramatically impacted by these and a host of other notable risk drivers triggering significant levels of uncertainties that make it extremely difficult for an organisation's leaders to anticipate what risks may lie just over the horizon. Unanticipated events are unfolding at record pace, leading to massive challenges to identify the best next steps for organisations of all types and sizes, regardless of where they reside in the world. As no one is immune to uncertainty, C-suites and boards need to be vigilant in scanning the horizon for emerging issues. Because it is impossible to anticipate everything of significance that lies in the future, organisations must focus on building trust-based, resilient cultures that can pivot at the speed of change.

In this 10th annual survey, Protiviti and NC State University's ERM Initiative report on the top risks on the minds of global boards of directors and executives in 2022 and over the next 10 years, into 2031. Our respondent group, which includes 1,453 board members and C-suite executives from around the world, provided their perspectives about the potential impact over the next 12 months and next decade of 36 risk issues across these three dimensions:[1]

- **Macroeconomic risks** likely to affect their organisation's growth opportunities
- **Strategic risks** the organisation faces that may affect the validity of its strategy for pursuing growth opportunities
- **Operational risks** that might affect key operations of the organisation in executing its strategy

[1] Each respondent rated 36 individual risk issues using a 10-point scale, where a score of 1 reflects "No Impact at All" and a score of 10 reflects "Extensive Impact" to their organisation. For each of the 36 risk issues, we computed the average score reported by all respondents.

Commentary – Financial Services Industry Group

Last year, our survey focused on identifying the top risks in 2021 (conducted in the fourth quarter of 2020) reflected a financial services industry that was still consumed with responding to the most significant global pandemic in the past 100 years. Many of the areas of focus highlighted in last year's survey involved short-term operational challenges, including ongoing efforts to shift employees into work-from-home environments and develop new routines to serve clients remotely. These issues were coupled with broader economic concerns brought on by the pandemic, including an expected credit downturn caused by massive unemployment increases and business shutdowns, as well as profitability pressure from interest rates again being slashed down to or near 0% and investment portfolio losses caused by declining asset values.

A year later, the financial services industry (and the world at large) has very clearly not yet returned to a pre-COVID normal, but the situation has evolved and stabilised significantly. Our 2022 survey results demonstrate increasing confidence on the part of financial institutions that they will navigate the remaining stages of this crisis effectively wherever it leads. Industry leaders are now taking the time to refocus on the medium- and longer-term risks to their businesses that will remain as COVID reaches an endemic state and we transition into the evolving "new normal" that will follow.

Overview of top risks for 2022

1. The current interest rate environment may have a significant effect on the organisation's operations; and
2. Economic conditions (including inflationary pressures) in markets we currently serve may significantly restrict growth opportunities or impact margins for our organisation.

Even as financial and employment markets have staged a stunning comeback from the lows of 2020, most central banks around the world have kept extraordinarily accommodating monetary stimulus programs in place, putting pressure on financial institutions' margins and profit levels. However, there are signs this era may be coming to an end as concerns about inflation (which reached a 30-year high in Q4 2021)[2] start to outweigh lingering COVID-related economic challenges. The key question now is whether policymakers have waited too long to start tightening, and whether it's still possible to pull back support quickly enough to both deflate asset bubbles (by some measures, stocks are as expensive now as at the 1929 peak)[3] and tame inflation, but slowly enough to avoid triggering another recession.

3. The adoption of digital technologies (e.g., artificial intelligence, automation in all of its forms, natural language processing, visual recognition software, virtual reality simulations) in the marketplace and in our organisation may require new skills that either are in short supply in the market for talent or require significant efforts to upskill and reskill our existing employees; and
4. Our organisation's succession challenges and ability to attract and retain top talent in a tightening talent market may limit our ability to achieve operational targets.

Concerns about digital disruption have ranked at or near the top of our survey for the past several years, even in 2021 when the responses were otherwise dominated by COVID. At the onset of the pandemic, we predicted that legacy modernisation efforts might slow or be paused as organisations responded to immediate operational and

[2] www.wsj.com/articles/us-inflation-consumer-price-index-october-2021-11636491959.

[3] www.bloomberg.com/opinion/articles/2021-11-12/capm-redesign-still-shows-stocks-close-to-1929-valuation?srnd=premium&sref=lUrmNyXw.

health and safety challenges, but that medium- to long-term, COVID would actually accelerate the transition to a digital world.[4] This has played out even more quickly and definitively than we expected. What's new this year, and is likely to accelerate this trend even further, is the whiplash transition from the double-digit unemployment environment of 2020 to the Great Resignation of 2021. Competition for technologists and data scientists never really let up even during the darkest days of COVID layoffs last spring, and has only intensified since then. More surprising is the broader recovery in the labour market, and how difficult it has been for financial institutions to fill run-of-the-mill operational roles in addition to technology ones. If this trend persists and as the cost of labour suddenly surges after stagnating for decades in real terms, the ROI calculations in favour of automation solutions that reduce cycle times and the need for headcount will only get more compelling — in turn, creating even more demand for technology skills.

5. Regulatory changes and scrutiny may heighten, noticeably affecting the way our processes are designed and our products or services are produced or delivered.

Concerns about this risk were most pronounced among U.S. respondents. After benefiting from a somewhat more permissive, business-friendly regulatory environment under the Trump administration, President Biden's major regulatory agency leadership nominees have universally taken a harder line on consumer/investor protection and financial stability matters than their predecessors. The industry is already seeing the effect of this change in priorities in the form of a significant increase in pending regulatory investigations.

Notable changes in year-over-year results

- Uncertainty surrounding our organisation's core supply chain including the viability of key suppliers, scarcity of supplies, volatile shipping and delivery options, or stable prices in the supply chain ecosystem may make it difficult to deliver our products or services at acceptable margins.

This risk saw one of the largest year-over-year increases. We found this particularly interesting considering that the unique nature of financial services institutions' "inputs to production" means the industry is not as heavily reliant on the types of materials that are currently subject to the significant disruptions facing manufacturers, retailers and other industries. We presume this risk is nevertheless on FSI leaders' radars as a result of the chip shortage increasing technology costs, as well as the knock-on effect of supply challenges hurting the bottom lines — and financing needs — of financial institutions' clients.

- Performance shortfalls may trigger activist shareholders who seek significant changes to our organisation's strategic plan and vision.
- Growing focus on climate change policies, regulations and expanding disclosure requirements as well as expectations of key stakeholders about climate change, supply chain transparency, reward systems, and other governance and sustainability issues may require us to significantly alter our strategy and business model in ways that may be difficult for us to implement on a timely basis.
- Our organisation may not be able to adapt its business model to embrace the evolving "new normal" imposed on our business by the ongoing pandemic and emerging social change.
- Shifts in perspectives and expectations about social issues and priorities surrounding diversity, equity and inclusion are occurring faster than the pace at which our organisation is motivated and able to manage effectively (e.g., recruiting, retention, career advancement, reward systems, behavioural incentives,

[4] www.protiviti.com/US-en/insights/newsletter-bulletin-v7i7-finding-equilibrium-uncertain-times-part1.

shared values and culture), which may significantly impact our ability to attract/ retain talent and compete in the marketplace.

The four risks above were all among the biggest year-over-year gainers, reflecting an increasing focus on ESG scrutiny and objectives. In particular, we expect that climate disclosure and stress testing/scenario analysis requirements will take a big leap forward and require more resources starting in 2022.

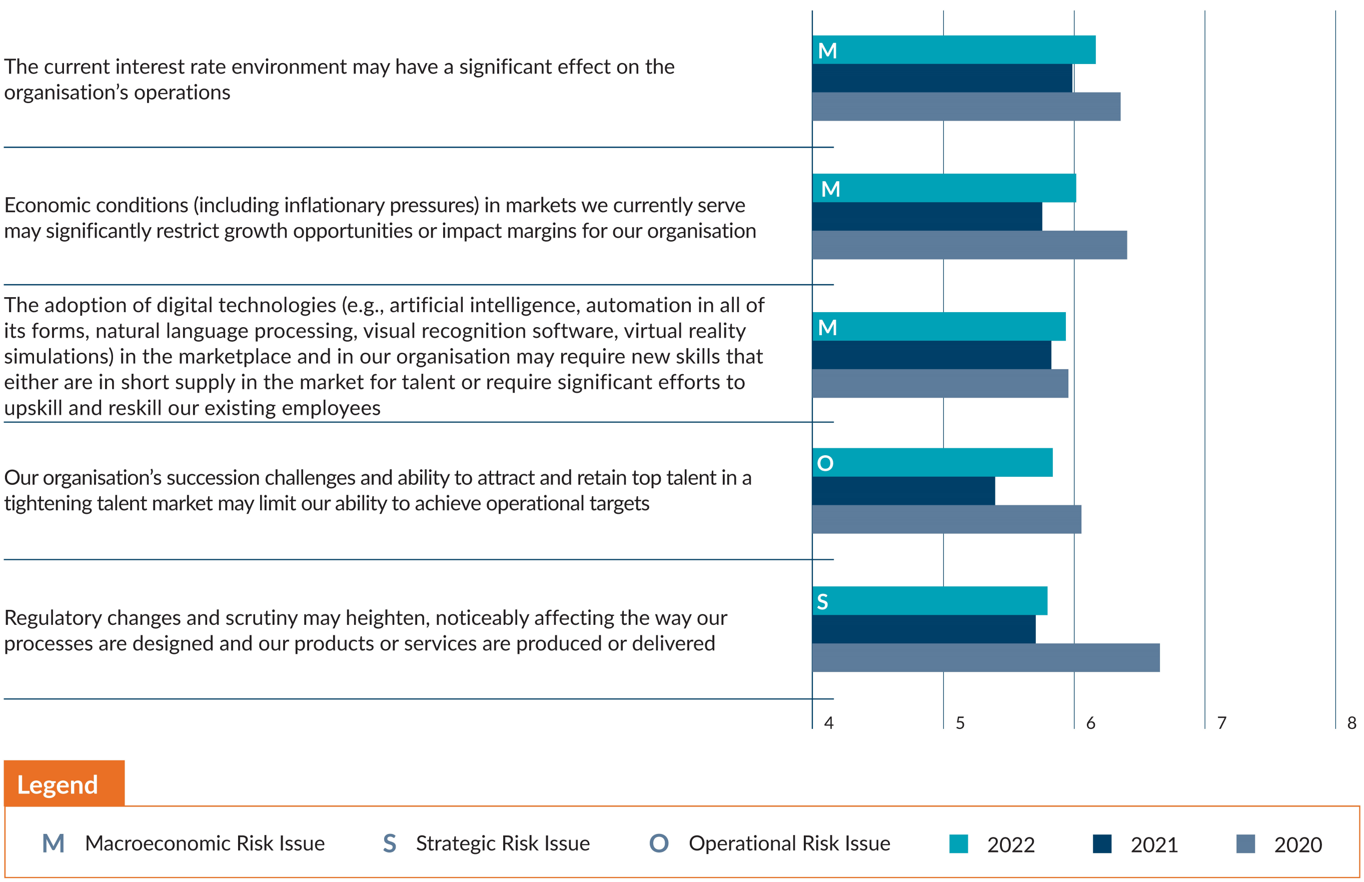
- Government policies surrounding public health practices, social distancing, return-to-work, crowd limits, and other pandemic-related regulations and protocols may significantly impact the performance of our business.

This risk showed the largest year-over-year decrease, while ...

- Our ability to meet expectations around protecting the health and safety of employees, customers, suppliers and the communities in which we operate may be insufficient to receive market permission to operate or encourage people to work for us or do business with us.

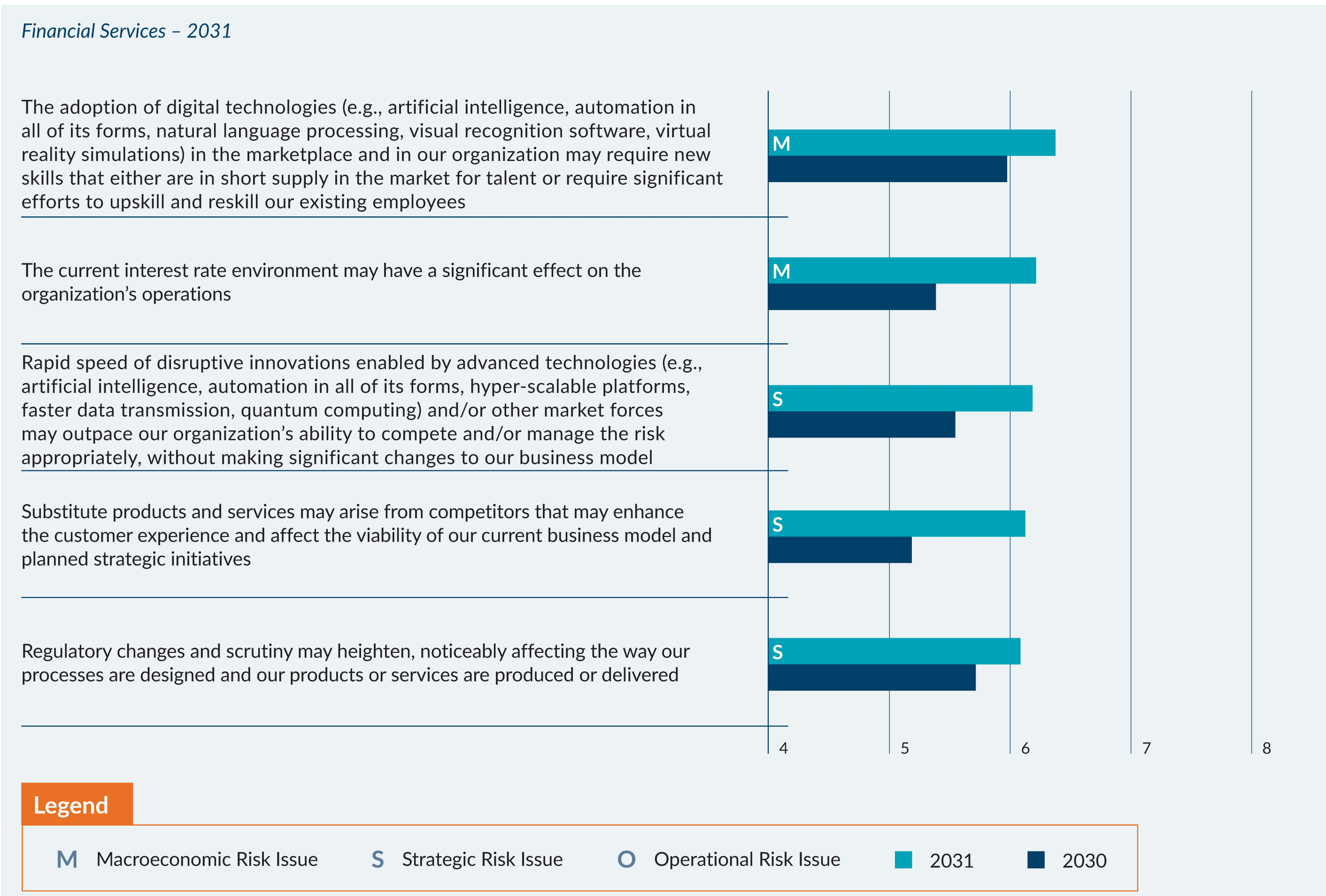
... was one of the risks with the largest year-over-year increases. We thought this was an interesting pair of results that, read together, neatly summarised the shift in perspectives regarding COVID within the industry, with last year's respondents primarily worried about another round of lockdowns contrasting with this year's focus on being able to return employees to the office safely — and being able to attract and retain employees generally.

Financial Services – 2022



Overview of top risks for 2031

A look at the results for the 10-year risk outlook among financial services industry organisations indicates that board members and senior executives view a notably riskier outlook for the next decade compared with the decade-out view from last year's survey. To illustrate, in our 2021 study, no risk issue for the Financial Services industry group was rated at the "Significant Impact" level for 2030. In this year survey, however, there are eight risk issues rated at the "Significant Impact" level for 2031. In addition, there are substantial increases in risk scores for numerous risk issues — among them, the possibility that economic conditions (including inflationary pressures) may restrict growth opportunities or impact margins, the interest rate environment, substitute products and services, and ease of entrance of new competitors into the industry and marketplace. Among other factors, these last two risk issues could be more top-of-mind due to emerging fintech and cryptocurrency organisations.



We believe the increased scores for 2031 risks largely reflect the trends we mentioned earlier about how financial institutions are feeling increasingly confident in their ability to manage the impacts of the acute pandemic phase of COVID, however much longer it will last. This has given executives the ability to start to focus on longer-term risks that carry much less certainty in how they will unfold or confidence in how their organisations should manage them. The impact that transitioning through COVID will have on macroeconomic conditions, inflation trends, and where and how financial institutions serve their customers (and in turn, who will provide those services and where and how those employees, contractors and robots work) is impossible to quantify yet, but almost certainly will be larger than that of any other event in our working lifetimes. We also expect that the longer the pandemic phase lasts and the greater the ongoing health and safety impacts are even when we start to "live with COVID," the greater the differences between the pre-COVID and post-COVID economies will be. In that context, heightened concerns about forward-looking risks seem justified.

"Financial institution executives are at once more confident in their ability to navigate the immediate challenges COVID-19 continues to present, while also less certain about and increasingly focused on the challenges that they'll face in the transformed economy that will follow the pandemic phase. Concerns about labour shortages and access to talent, the need to keep up with digital transformation trends, and fending off emerging competitors in a difficult interest rate environment are at the forefront of this year's results."

Michael Brauneis, Managing Director, Financial Services Industry Leader, Protiviti

Conclusions

The 2022 Top Risks Survey results reflect a resilient financial services industry that is nevertheless acutely sensitive and responsive to the growing long-term threats of disruption to its business model. Although COVID is not going away, the industry has made great strides in learning to operate effectively and profitably in spite of it. The economic collapse in demand and credit crisis that appeared quite possible 18 months ago is an increasingly distant memory. New ways of working created by the pandemic — classic examples of the old saying that necessity is the mother of invention — have unlocked client service delivery and workforce innovations that are likely here to stay for the long term.

At the same time, financial institutions face unrelenting pressure to invest in technology and fend off a growing threat from digital disruptors. How the industry responds to ESG demands — both with respect to its own operations directly as well as those of the clients that it lends to, invests in and insures — will become increasingly important. Finally, employees have gained power they haven’t had in decades and will be increasingly open to changing firms as a result. Compensation will remain a critical consideration and labour costs will increase as a result, but other factors including work-life balance, hybrid flexibility, and comfort level with the culture and values of the organisation will also become increasingly important retention drivers.

All in all, our 2022 survey results are significantly more optimistic than last year’s, but also demonstrate increasing awareness of the emerging risks that lie around the corner from COVID.

Contact

Michael Brauneis
Managing Director, Financial Services Industry Leader
+1.312.476.6327
michael.brauneis@protiviti.com