

# Managing volatility in financial services

Approaching the future with greater  
confidence



# Creating a brighter future for financial services

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# Introduction

## In brief

- ▶ Volatility has become an ever-present challenge for business leaders
- ▶ Companies face a current “trilemma” of rising inflation, energy transition and insecurity, and disrupted supply chains
- ▶ Financial services organizations need to assess their preparedness for medium-term geopolitical scenarios while envisioning longer-term megatrends

The saying “the only constant is change” - attributed to the Greek philosopher Heraclitus - has never been truer than today.

Keeping up with macroeconomic, geopolitical and technological developments can feel like a full-time job. And there’s little sign of a respite.

Volatility casts a huge cloud of uncertainty over current and future strategy and operations. For leaders across financial services, coping with the now and planning for the future has become highly complex.

It’s not enough to know about the various forces of change; decision-makers need to understand how different phenomena affect each other in an interconnected, interdependent world. Only then can they formulate strategies and contingencies that will enable their organizations to thrive - whatever the scenario.

You can’t always predict the future. But you can be better prepared for it. This paper takes a three-stage approach of “now”, “next” and “beyond” and delves deeper into each to come up with a framework that’s flexible enough to adapt to the many challenges and opportunities that will emerge.

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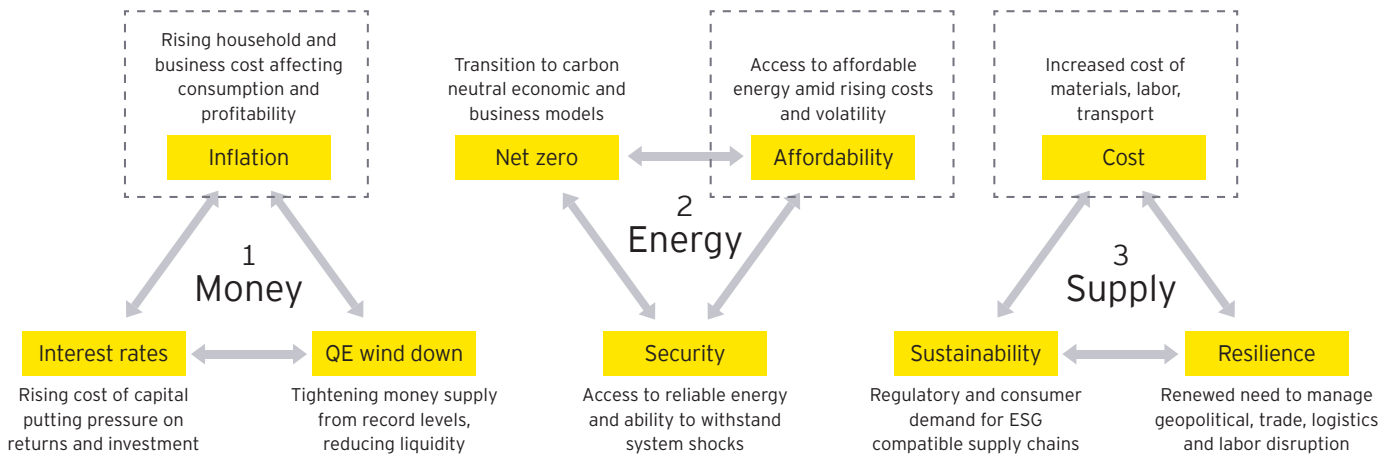
# Address the “now”

# The three “trilemmas”

First, consider the macro challenges affecting the financial services market. We have grouped these into three sets of “trilemmas”: money, energy and supply.

Individually, each of these would be a big cause for concern, but together, they are putting a huge strain on revenue, margins, operations and risk management.

Inflation, overwhelmingly driven by supply side costs, will materially affect businesses now and in the coming years



## Money

Inflation remains rampant, with rising costs reducing consumer spend and business profitability. Elevated interest rates will also be a key risk for highly indebted governments, particularly those with a large proportion of US-dollar-denominated debt. Governments will likely need to raise tax revenue to meet higher debt repayments. Even so, sovereign defaults and economic crises are likely in 2023. The rising cost of capital will put further pressure on returns and investment while liquidity shrinks as central banks pull back on quantitative easing.

## Energy

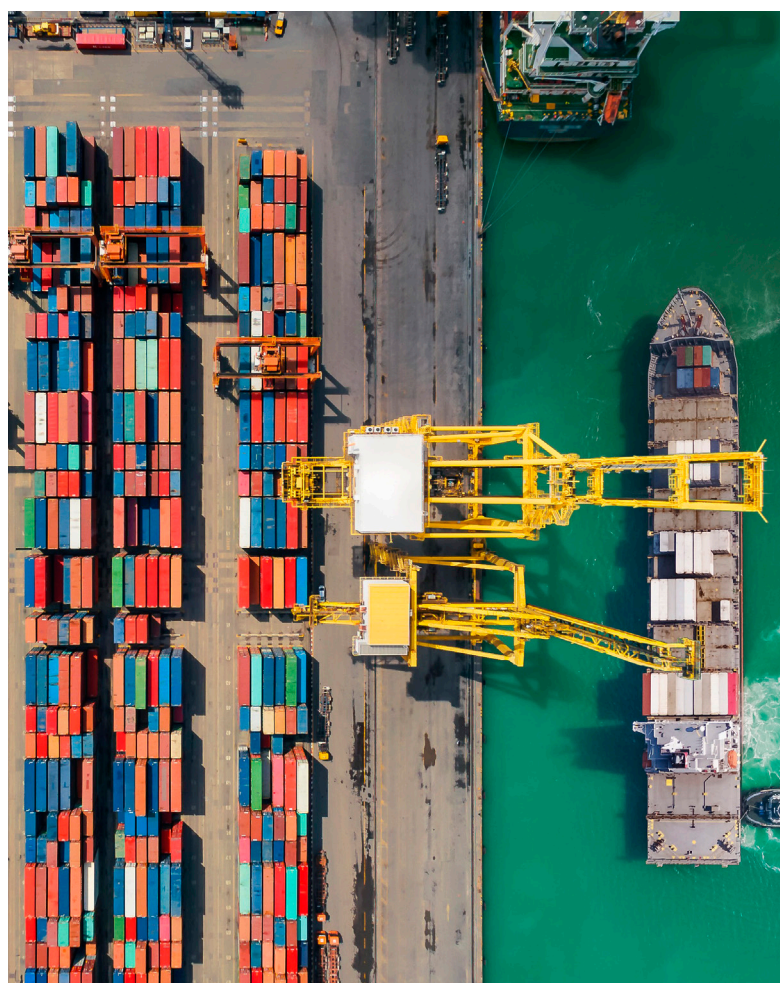
Affordable and available energy can no longer be taken for granted. Investment in renewables is unavoidable as businesses race to achieve net zero. Governments and companies are pursuing multiple, sometimes incompatible, energy security goals simultaneously: transition to carbon neutral models, reliability of supply, and affordability for households and businesses. Government price caps are expected to reduce inflation in the medium term.

## Supply chains

Supply chains have been under strain as a result of increased costs of materials, labor and transport, along with continued disruption from COVID-19 pandemic, conflicts and civil unrest, trade wars, and resource and labor shortages. Supply chains are also transitioning to become more sustainable, meet regulatory and consumer ESG demands.

These phenomena are contributing to high inflation that threatens to send many parts of the world into recession. Few had predicted the current levels, suggesting a lack of understanding of the interaction between the three forces of money, energy and supply. In the UK, for instance, the main measure of inflation, the CPI (Consumer Price Index), confounded economic forecasters by hitting a 40-year high of 11.1% in Oct 2022. In the eurozone, the headline inflation rate is forecasted to fall in 2023 from 10% at the end of 2022. Nevertheless, businesses should remain fully prepared by stress-testing for even higher rates of inflation.

Scenarios should also consider the ongoing impact of wage increases, with as many as 30 million workers in the eurozone set to re-negotiate their wages based on inflation.



## What does this mean for financial services?

- ▶ The consequences of the trilemmas of money, energy and supply are higher operating costs, reduced consumer disposable income, a slowdown in M&A opportunities, higher funding costs and a greater probability of loan defaults. However, the impact on different financial services subsectors is likely to vary.
- ▶ Retail and commercial banks should experience an increase in profitability due to rising interest rates but may be dragged by underperforming or non-performing portfolios, and possible regulatory intervention to support businesses and assure financial stability.
- ▶ Challenger banks and digital lenders are expected to see more intense competition for deposit funding, increased customer activity, pressure on underperforming players (who may become M&A targets), increased regulatory focus on protecting vulnerable customers, plus higher demand for capital.
- ▶ For investment banks, there are openings for potential transactions due to the rising cost of credit and reduced appetite for IPOs, as well as falling interbank fee revenue that could lead to job losses. While capital and liquidity buffers may also be stressed, heightened volatility may lead to increased trading returns.
- ▶ Life insurers should benefit from rising rates and inflation, increasing their solvency, although credit defaults and downgrades puts their capital positions at risk and could lead to distress. Higher interest rates are also likely to have a positive impact on annuities, while inflationary pressure on the cost base could drive further consolidation.
- ▶ Non-life insurers may see inflation affect portfolio value and returns, together with reserves and cost of settling claims, with possible divestment of non-core portfolios and/or businesses.
- ▶ Finally, rising risk aversion amongst investors and markets may force asset managers into widespread selloffs in equity and bond markets. Assets under management could decline, which, along with headwinds to wealth and savings, is set to put pressure on revenues. This, along with high inflation, is increasing cost-to-income ratios, and higher interest rates and macro trends may impact growth of private/alternative assets.



## Immediate considerations

Volatility is forcing financial institutions into a series of compromises as they grapple with rising costs, inflation and ESG demands. For example, decarbonization suddenly takes on greater importance as traditional fossil fuel energy supplies are cut off. Yet, with profitability falling, where will the investment funds come from? In this difficult moment, banks, insurers and asset managers may be forced into difficult trade-offs across the following areas:

### Strategy

As recession kicks in, valuations of potential M&A targets are likely to fall, with a greater possibility of distressed businesses open to takeover, widening the scope for acquiring scale and/or new capabilities. Strategic planning teams should be awake to these expanding opportunities. Within the organization, the uncertain environment may mean business units or portfolios are candidates for disposal or wind-down, requiring brave and decisive action. The rise in loan delinquency also begs questions over accelerating the sale of non-performing exposures.

### Financial management

Fluctuating and unpredictable economic conditions call for an agile response - especially regarding rising interest rates, with a recession likely to change counterparty credit risk. It's important to measure asset sensitivity to determine the impact on the balance sheet, as well as review and recalibrate models and assumptions about customers. Coping with inflation and increased utility costs requires further tightening of cost controls across functions, and organizations should look for ways to offset increased third-party spend as these providers are also forced to raise prices.

### Propositions


One of the biggest business challenges is whether to launch new products and services to cater for recession-specific customer demands - as well as rationalizing or simplifying existing products. There may be opportunities to pass higher cost-to-serve onto customers. Mitigating revenue leakage is another priority.

### People

Given the financial stress that recession can place on customers, financial institutions will have to ensure their workforces can provide an empathetic front-line experience, while also supporting the launch of new products and services to meet these challenging circumstances. With escalating labor costs and a talent shortage, it's vital to rethink the employer value proposition to attract and retain the best people.

### Operating model

In a tough economic climate, financial institutions are under pressure to get an adequate return on current investments and projects, eliminate waste in critical business processes, and optimize costs through outsourcing, offshoring or automation. In the cost-optimization journey, some front-line teams, processes and systems may struggle to scale and could need additional support.



Prepare for  
the “next”

## Adapting to four potential global scenarios

Geopolitics has shifted dramatically and the outlook for the global operating environment is increasingly uncertain. Over the past few decades, the world has become accustomed to trading through global supply chains, along with low interest rates and low inflation. But more recently, forces like COVID-19 pandemic, Brexit, and climate change have shifted the narrative and reminded us how quickly circumstances can change.

Among the potential developments are a loosening of alliances and the formation of more distinct trading blocs, and a shift from internationalist liberalism to more nationalist statism. Energy security and elevated inflation may also push governments in different countries to diverge in their trade-off choices, further complicating the operating environment for international companies.

EY teams' analysis\* revealed two key uncertainties that will be the primary drivers of the future global operating environment:

### The shifting trajectory of globalization

#### Primary

- ▶ Geopolitical relations (loose alliances to distinct blocs)
- ▶ Economy policy stance (internationalist liberalism to nationalist statism)

#### Secondary

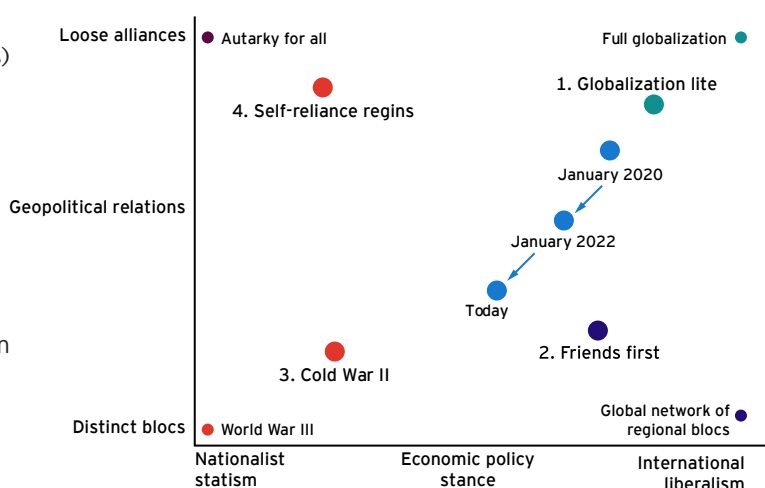
- ▶ China's geopolitical positioning
- ▶ Outcome of the war in Ukraine
- ▶ Climate change impacts
- ▶ Evolution of COVID-19 pandemic
- ▶ Transatlantic relations
- ▶ Strength of economic growth/inflation (globally and in key countries/regions)
- ▶ Cyber attacks and disinformation campaigns
- ▶ Strength and activism of middle powers
- ▶ Global food security and unrest
- ▶ Election outcomes/leadership transitions in key countries
- ▶ Presence of local/regional military conflicts

### Will the geopolitical environment be defined by loose alliances or distinct blocs?

This will be driven by the outcome of the war in Ukraine and China's geopolitical positioning. The policies of the US and EU will also play a crucial role, including the strength and cohesiveness of transatlantic relations. The foreign policies of various middle powers - including India, Australia, Turkey and Brazil - will also help shape future geopolitical relations.

### Will countries continue to favor nationalist competition or shift toward more internationalist liberalization?

This will be determined by how much governments embrace industrial policies and expand the number of sectors they deem nationally strategic. These decisions will, in turn, be driven by the evolution of the COVID-19 pandemic, global food security, energy security, climate change impacts and the strength of economic growth.



\*[www.ey.com/en\\_uk/geostrategy/future-of-globalization](http://www.ey.com/en_uk/geostrategy/future-of-globalization)

## Here are four potential scenarios resulting from these forces:

### 1. Globalization lite - loose alliances and low inflation

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In this scenario, a return to the pre-pandemic status quo sees an easing of international tensions, dynamic GDP growth and low inflation across a relatively liberalized and globalized operating environment. With global economic growth rebounding, alliances fade in relevance, and policy constraints on globalization recede - except for strategically important sectors such as defense and telecommunications, which are confined to domestic or allied markets. Some pariah countries remain isolated.

### 2. Friends first - distinct blocs and moderate inflation

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A shifting of global trade alliances leads to various economic blocs, where supply chains, trade and investment shift to "friendly" countries, exemplified by "friendshoring" of key operations and supplies. Trade flows are particularly restricted in strategic sectors, with a gradual divergence of the liberalized West and China. GDP growth remains positive but modest, with inflation higher than previous decades but still moderate.

### 3. Cold War II - distinct blocs and high inflation

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A more extreme economic and financial decoupling between China and the West with an intensified confrontation between these blocs. The hardening of alliances and ideological competition creates a "stand-off" similar to a Cold War and a third group of non-aligned countries. With trade restricted to certain nations, economic growth slows and inflation remains high, although some sectors continue to thrive.

### 4. Self-reliance reigns - loose alliances and high inflation

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A radically alternative scenario where nations retreat from globalization and international cooperation and turn inward, as last seen in the 1930s. Faced with loose, decaying alliances, governments promote domestic production and seek ever-greater self-sufficiency. Global trade and capital flows diminish as supply chains and strategic sectors are onshored, further weakening economic growth and creating inflationary pressures.

## Impact on the financial services sector - and response

Organizations need to understand how these scenarios may affect growth potential and inflation, as well as access to markets, customers, investment and talent. Certain outcomes could mean higher costs of capital and lower growth, possibly undermining the viability of some cross-border business models.

If the global monetary and payments systems were to fragment, for example, this could affect the ease of doing business, with a further impact on transaction volumes and

margins. We could even see other global currencies emerge as an alternative to the dollar, as well as digital currencies to rival fiat currencies.

If geopolitical fragmentation were to accelerate, the collective focus on sustainability may slacken, which could exacerbate climate change. And if a closing of borders restricts the flow of people, then the war for talent could get even more fierce, with a need to rethink HR strategies.



# Adapting to uncertainty

Scenario planning is critical to indicate the risks ahead. Leaders need to build the capabilities and confidence to adapt swiftly once the direction of change becomes clearer. There are three important imperatives to address:

## **1. Resilience - de-risk the business and check for unforeseen exposures**

Reducing the vulnerability of the business and operating model can provide a more stable foundation for future growth. This involves quantifying exposure to shocks and market developments and making contingency plans for different outcomes. The business portfolio may require reshaping to be ready for a tougher operating environment. Senior leaders should re-evaluate the risk/reward trade-offs around big strategic decisions - especially growth investments - and review the organization's overall footprint to adapt to potential shifts in location, while also taking advantage of remote working opportunities.

## **2. Agility - adapt business models to succeed despite uncertainty**

In uncertain times, the ability to change course quickly and smoothly can help organizations stay on top of change and ahead of competitors. Business and strategic

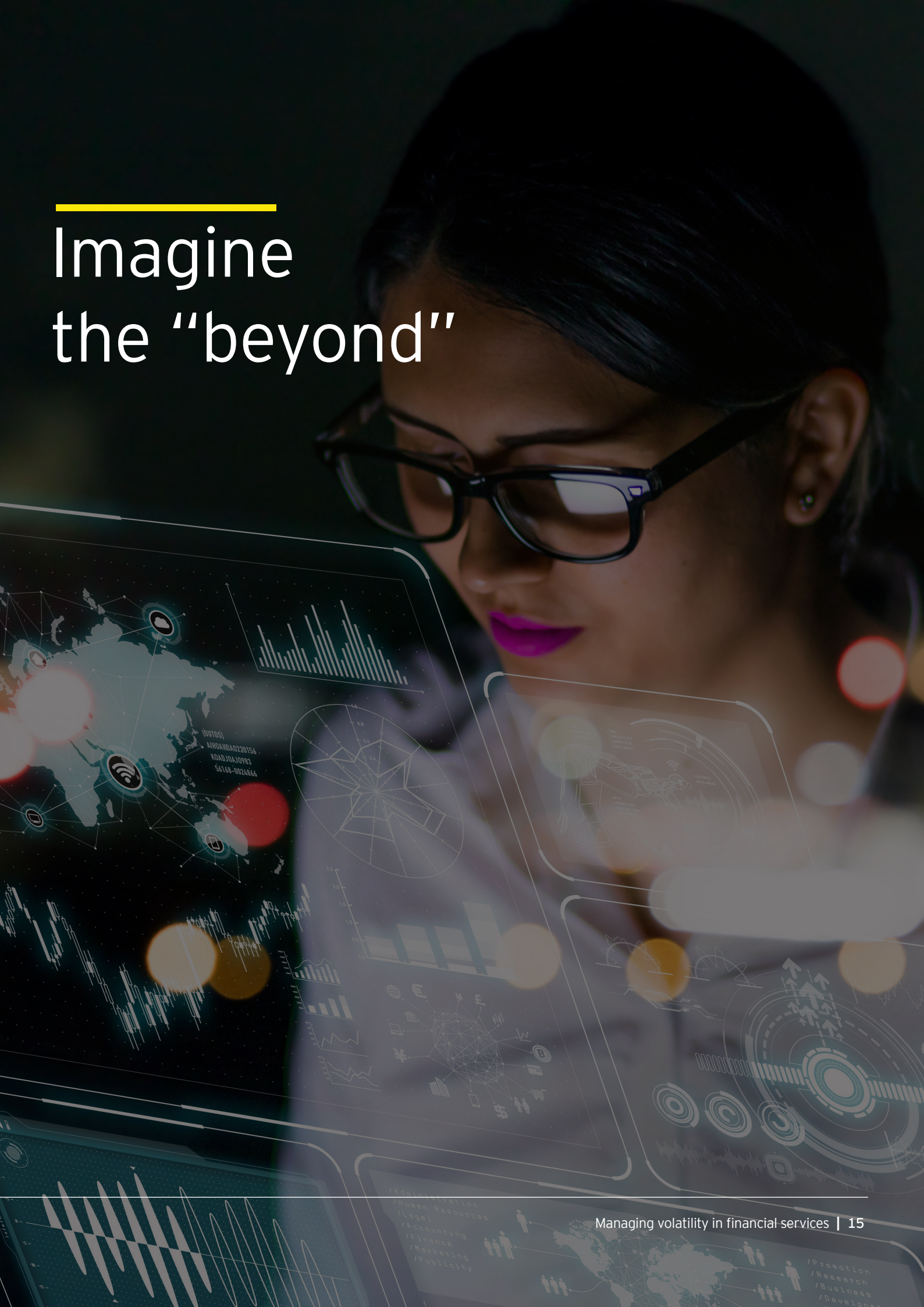
planning should be revamped to become more adaptable to sudden and emerging events - effectively transitioning from a static to a dynamic activity. Management of financial resources like capital, liquidity and funding needs similar flexibility, and it's helpful to seize any opportunities to reduce business complexity. In their efforts to enhance their capabilities, financial institutions may look to ecosystem partners to access know-how and human resources.

## **3. Growth - pursue scale and consolidation in target segments**

With business models under threat, organizations that have clear competitive advantages like scale or specialization will be well-positioned for growth. Regular portfolio reviews can identify segments with higher risk-adjusted profit opportunities, augmented by M&A in both core and FinTech markets, taking advantage of lower valuations. As possible trading blocs emerge, deeper relationships with clients brings greater certainty. Along with localized supply chains and financing and circular business models, this can help drive sustainability and ultimately, shareholder value.

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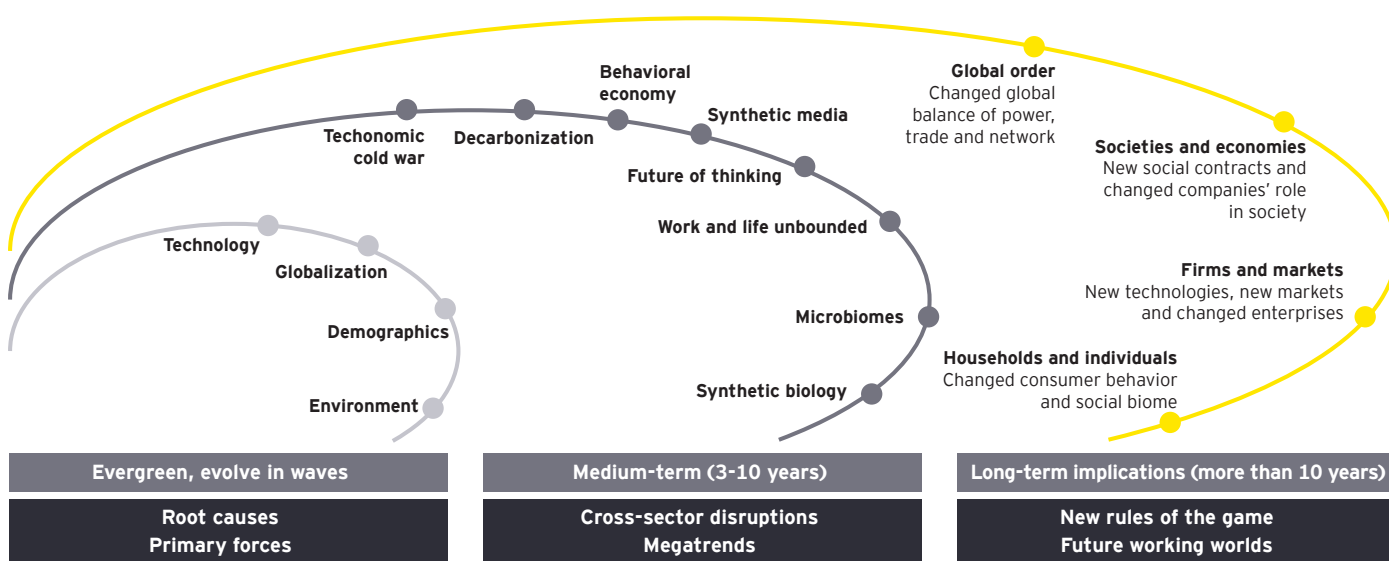
# Imagine the “beyond”



# Keeping an eye on the long-term

## Megatrends: the framework

EY teams' framework for understanding where disruption comes from, where it's headed and what it means to you...



## Tomorrow's megatrends should inform today's thinking

Our future is set to be shaped by primary, evergreen forces of technology, demographics, environment and globalization. But even though the timeframes are longer (5-10 years) and the projections less certain, financial services companies still need to think about how these megatrends might impact societies, economies and the wider global order.

The current macro and political frictions may not go away but are likely to be surpassed in importance by technological trends and fundamental changes in attitudes. Here are some of the key medium-term (3-10 years) megatrends that could influence the financial services industry:



## Microbiomes

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Found in bacteria, plankton and fungi, these have exciting potential for addressing healthcare challenges and decarbonization. Financial institutions should assess investment opportunities in this sector and the impacts on products. E.g., longer life expectancy should influence personal financial products like pensions and long-term care plans.

## Behavioral economy

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Connected devices are generating huge amounts of data that can be used to influence our decisions and behavior. Financial institutions will have to consider the ethics of AI and risk modeling.

## Synthetic media

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Deepfake impersonations are increasing the risk of theft from organizations and individuals, as well as fake insurance claims using doctored photos. This has spawned a new industry of digital forensics, watermarking, and digital assets, with implications for payment controls and digital asset strategy.

## Work/life unbounded

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Boundaries between education, work, leisure, and retirement are becoming blurred, with technology enabling remote access to work and education. Financial institutions need to assess how this affects the employee value proposition and retirement planning.

## Future of thinking

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The increasing dependency on smartphones is causing mental health problems, polarized views, and decreased critical thinking. Financial institutions may need to pay more attention to providing mental health support and delivering advice-based services.

You can read more about these megatrends at [www.ey.com/megatrends](http://www.ey.com/megatrends)

## Key takeaways

Financial services organizations have ample experience of weathering previous volatility. Yet the current and future operating environment will be much more challenging, given the sheer diversity of the volatility they face, in the short-, medium- and long-term.

### Review business model

Organizations should review the current volatility to assess what changes are needed to strategy, financial management, propositions, people and operating models. How prepared is the institution to adapt to the four potential mid-term scenarios and does longer-term strategic planning include the impact of megatrends?

### Ability to transform

Being able to transform will be key to responding to the uncertainty today and ahead. Institutions need to ensure existing transformation, such as around strategic cost and digital and customer experience, take into account this increased volatility. This is also true for changing products such as mortgages, investment options, insurance, and even embedded finance for non-FS clients.

## Conclusion

You can't always predict the future. But you can be better prepared for it. It's not enough to know about the various forces of change; decision-makers need to understand how different phenomena affect each other in an interconnected, interdependent world.

In adapting to current and future volatility, FS institutions need to constantly assess themselves what changes are required to their strategy, financial management, propositions, people and operating models. Only then

### Sustainable finance

There are significant potential impacts on sustainable finance. Firms will need to carefully calibrate their sustainable finance strategy. This could include changing their modeling in light of energy pressures and responding to any geopolitical changes to sustainability targets.

### People first

The pandemic and the pivot to remote working was a good demonstration of the importance of people and how FS firms can quickly respond to volatility. Going forward, organizations will need to consider the impact of change on future skills and learning, migration and mobility.

### The prudential impact

Higher volatility requires firms to be ever more vigilant around their prudential strength. Leaders will need to ensure adequate levels of stress testing and risk modeling around new risks and indicators as well as rapid re-forecasting and reporting tools.

can they formulate strategies and contingencies that will enable their organization to thrive - whatever the scenario.

Corporate leaders need to tap into immediate, medium- and longer-term scenarios and megatrends that will shape the world and create adaptive, resilient organizations that can manage volatility, minimize disruption, and maintain growth.

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Over 84,000 EY professionals are dedicated to financial services, serving the banking and capital markets, insurance, and wealth and asset management sectors. We share a single focus – to build a better financial services industry, one that is stronger, fairer and more sustainable.

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