the CREDIT PULSE

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THE U.S. FINANCIAL SERVICES INDUSTRY CONFRONTS A NEW ENVIRONMENT

In this issue of the Credit Pulse, *we provide a look at the credit risk implications of the banking and capital markets oversight environment under the Biden administration, highlight post-stimulus commercial and consumer credit risks, and examine the pressing climate change-related risks affecting financial institutions and their lending portfolios.*

Throughout the first part of 2021, there have been continuing interest and questions among many organizations and industries, including financial services institutions, regarding the short- and long-term economic impacts of government stimulus programs, including the latest $1.9 trillion relief package signed into law in March. While providing welcome relief for individuals and business owners on many fronts, there are significant implications for the financial services industry that institutions must address, particularly related to their lending portfolios.

There also are significant developments on the regulatory front for financial institutions to consider, including but not limited to climate change-related policies and regulations. In December 2020, the Federal Reserve Board joined the Network for Greening the Financial System, a network of central banks to help mobilize the transition to a green economy. In early 2021, the Biden administration signaled that the long-term challenge of addressing climate change would require near-term actions.

President Biden's January 27 executive order calls for the United States to achieve net-zero emissions, economy-wide, "by no later than 2050" and a carbon pollution-free power sector by 2035. The link between the environment and the financial services industry has long been decoupled, and there are initiatives underway to begin addressing climate risk as a financial risk.

Under the Biden administration, banks and other financial services institutions should expect a range of ESG-targeted policy and regulatory changes to materialize sooner rather than later. These developments are not unexpected — in fact, most financial institutions now recognize they have an important role to play not only in helping to mitigate climate change-related effects on the environment, but also to mitigate their risk of losses from being exposed to these areas within their portfolios.

These and other challenges are materializing as ongoing pandemic-driven uncertainty, the start of a new presidential administration and a new U.S. Congress — each introducing decidedly complex dynamics on their own — also factor into the credit risks that resource-stretched portfolio management teams are striving to address.

Financial institution leaders would like to increase lending activity after a year in which many loan books shrunk, which for large U.S. lenders was the first time in over a decade. The pandemic-related shutdowns resulted in companies not turning to banks to initiate growth, and some lenders tightened underwriting standards.[1] In addition, credit portfolio managers are contending with soaring workloads, more opacity within their portfolios and fewer resources. Other complicating factors also loom large. Many of these circumstances relate

Key Credit Metrics

	2/28/2021	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Delinquency rates [2]	Not available	1.63%	1.58%	1.51%	1.52%
Leveraged loan default rate [3]	3.23%	3.83%	4.17%	3.23%	1.84%
U.S. Bureau of Labor Statistics unemployment rate [4]	6.20%	6.70%	7.80%	11.10%	4.40%
The Conference Board Leading Economic Index® (LEI) [5]	110.5	109.7	107.2	102.0	104.2
The Conference Board Consumer Confidence Index® [6]	91.3	88.6	101.3	85.2	120.0
CBOE Volatility Index® (VIX® Index) [7]	18.88 (3/22/21)	22.75	26.37	30.43	53.54
S&P 500 [8]	3,940.59 (3/22/21)	3,756.07	3,363.00	3,100.29	2,584.59

1 "America Went on a Borrowing Binge, but Banks Were Left Out," Ben Eisen, *The Wall Street Journal*, Feb. 10, 2021: www.wsj.com/articles/america-went-on-a-borrowing-binge-but-banks-were-left-out-11612953008.

2 Delinquency rates, Board of Governors of the Federal Reserve System: www.federalreserve.gov/releases/chargeoff/delallnsa.htm.

3 S&P Global Market Intelligence: www.spglobal.com/marketintelligence/en/campaigns/leveraged-loan.

4 U.S. Bureau of Labor Statistics: www.bls.gov/charts/employment-situation/civilian-unemployment-rate.htm.

5 The Conference Board: https://conference-board.org/data/bcicountry.cfm?cid=1.

6 The Conference Board: https://conference-board.org/data/consumerconfidence.cfm.

7 Cboe Global Markets, Inc.: www.cboe.com/tradable_products/vix/.

8 S&P Dow Jones Indices: www.spglobal.com/spdji/en/indices/equity/sp-500/#overview.

to the pandemic, the duration of which, along with its continuing potential to trigger additional containment actions, hinges on the speed and efficacy of global vaccinations and the vexing possibility of COVID-19 variants reducing the benefits of those shots.

The SBA continues to issue and update procedural guidance on PPP 1.0 and PPP 2.0 in response to ongoing challenges lenders have experienced, while adjusting processes and supporting technology to manage their loan underwriting and forgiveness surges. As the new stimulus package was being finalized earlier this year, the terms surrounding the previous stimulus programs continued to be adjusted. In late February, for example, the Biden administration made changes to the PPP loan application process and how eligible loan amounts are calculated for some borrowers to direct more funding to sole proprietors, the self-employed and firms with fewer than 20 employees.

Other side effects create direct challenges for credit portfolio managers, including new questions about the accuracy of credit scores of some consumers who have received COVID relief. Numerous harder hit industry sectors, such as commercial real estate, oil and gas, and leisure and hospitality, among others, continue to experience a protracted downturn from the pandemic conditions despite stimulus efforts.

While challenges remain, the trend in bank reserve levels reflects overall optimism, with the Allowance for Credit Losses beginning to decrease slightly for many banks as of year-end 12/31/2020 after a build-up of reserves through the second quarter of 2020. While overall reserve levels are still nearly double pre-pandemic levels, the more recent leveling off of, and in some cases minor decreases in, reserves is driven mainly by underlying credit portfolios performing better than expected, realized economic relief from government fiscal stimulus packages, and prospects of economic recovery appearing more likely with the rollout of COVID-19 vaccines.

Commercial and consumer credit updates

Amid fresh signs that economic growth is primed for a post-pandemic surge, financial institution leaders continue to seek new ways to sharpen visibility into their commercial and consumer loan portfolios. There are concerns about the viability of credit quality assessments, given the impacts — those that are known as well as those that remain less certain — of the more than $4 trillion worth of government stimulus injected into the markets over the past year.

In many instances, the traditional commercial portfolio management approach of periodically examining financial statements to determine whether they meet loan covenants has become less meaningful in the post-stimulus environment. While the operations of many small business borrowers suffered severe blows in the past 12 months, government relief may mask those negative impacts. As a result, traditional sources of financial

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viability — e.g., tax returns, recent financial statements — may not be the most useful tools to monitor the current condition of loan portfolios. On the consumer side, while there are indicators that the job market is moving more rapidly, similar dynamics and questions surrounding the timing of government relief potentially masking reliability of credit scores, in addition to industries that may not bounce back as quickly (e.g., airlines, fitness, retail), also pose challenges.[9]

Reducing this portfolio opacity requires drilling down into individual loan levels at a point when institutional resources are stretched thin. Managing a loan portfolio in 2021 requires significantly more time and effort than it did prior to the pandemic and a need to reinvent credit monitoring methods. PPP activities siphoned resources normally dedicated to monitoring and managing existing loan portfolios; plus, teams continue to invest time making ongoing adjustments to remote work processes and supporting technologies.

Commercial credit risk: Preparing for post-pandemic navigation

While reserves increased significantly over the last year, commercial credit risk managers continue to zero in on loans that lack reliable information about the borrower's current credit risk. In recent months, financial institutions have sliced and diced their portfolios to identify specific industries and portfolio segments bearing the brunt of the COVID recession. As the post-COVID-19 market and the long-term impacts of the pandemic continue to materialize, more institutions are seeking to deepen their analyses at the individual borrower level.

Specifically, financial institutions are working to determine which borrowers are unable to fully restore their operations to pre-pandemic levels of activity and assess the ability of these borrowers to service debt. These institutions are discovering precisely how granular their portfolio management visibility can be while seeking ways to adjust scorecards to clarify risk assessments. Credit risk managers continue to communicate more frequently with borrowers while scrutinizing their deposits, performance projections and other information that provides a more accurate assessment of their financial viability.

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Credit risk managers are supplementing and/or reinventing common credit risk monitoring methods, as traditional forms, such as 2020 covenant performance, are proving less effective given COVID-related impacts. In their drive to gain a more complete picture of credit quality, credit risk managers are:

- Reengineering ways to use existing credit data at the portfolio level by re-evaluating systems/tools used to aggregate information.
- Revisiting credit risk appetite KPIs/KRIs to incorporate emerging risk indicators (pre- and post-COVID thresholds/targets), as well as thresholds tied to trending rather than just point-in-time metrics. For example,

[9] "The 10 Industries That Have Been Impacted the Most by COVID-19," Jordan Rosenfeld, Yahoo! Finance, Mar. 17, 2021: finance.yahoo.com/news/10-industries-impacted-most-covid-110042511.html.

with a need to grow, lending book policy exceptions may be more prevalent and trend analysis can be used to understand where underwriting standards are loosening.

- Segmenting portfolios in different ways and performing scenario analyses to monitor changing risk profiles (e.g., government-sponsored/backed relationships, borrowers with operations that continue to operate below capacity due to government restrictions, borrowers benefiting from extended relief, etc.) and proactively manage anticipated future weaknesses.
- Exploring high frequency and behavioral analytics (e.g., weekly restaurant reservation bookings) at the relationship level to supplement traditional reporting and identify outliers that point toward inherent risks.
- Performing nuanced scrutiny of borrowers' financials to determine the impact of government support on performance and on covenants.
- Implementing increased monitoring in place of annual credit reviews, requesting more frequent performance projections and considering whether to modify requirements when evaluating covenant waivers.
- Challenging and/or deepening analysis on the viability of projections and ultimate repayment likelihood.
- Reevaluating risk ratings to maintain consistency in grading with comparable characteristics across loan types while factoring in forbearance arrangements and other loan accommodations.
- Reviewing practices for charge-off, accrual and TDR status to ensure alignment with Section 4013 of the CARES Act and interagency guidance as well as consistency in approach when evaluating individual credit.
- Expanding work-out staff and beginning engagement with work-out personnel early on in anticipation of increased defaults once government support tapers.

Consumer credit risk: The knowns and unknowns

On the surface, the consumer credit horizon looks promising. The $900 billion stimulus signed into law at the end of 2020 helped juice household income by a near-record 10% in January, and those households increased monthly spending levels (by 2.4%) for the first time in three months. And of course, this does not include the recently enacted $1.9 trillion COVID relief package containing a broad range of benefits for consumers and businesses. The current personal savings rate is also high, more than twice that of a year ago. The S&P/Case-Shiller Home Price Index for the first month of 2021 reported at 11.2% — its strongest year-over-year growth in almost five years and eighth straight month of accelerating home prices.[10] Despite these rosy metrics, troubling questions lurk concerning the potential fallout when payment modifications subside, the possibility of permanent job loss in some sectors, and the efficacy of relying on credit scores as an indicator of creditworthiness in the wake of these arrangements and economic stimulus programs.

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[10] "Home Prices Surge 11.2%: Case-Shiller," Mark Vickery, Zacks (via Nasdaq), Mar. 30, 2021: www.nasdaq.com/articles/home-prices-surge-11.2%3A-case-shiller-2021-03-30.

Other developments also may be hindering credit scoring accuracy. The use of buy now pay later (BNPL) services, in which buyers can complete purchases — usually in the $100-$300 price range — via a series of interest-free payments over weeks or months, is soaring and could be offsetting a rise in credit card debt.[11] These payment methods have become readily available on the checkout screens of e-commerce sites as well as via apps to use in physical stores, offered by fintech companies like Affirm, Klarna and Afterpay. Bank of America projects that the BNPL market will grow by a factor of 10 to 25 within the next four years, ultimately processing up to $1 trillion in transactions by 2025.[12]

BNPL service providers generally do not run credit reports, nor do they share on-time payment information with the credit bureaus. Some BNPL providers do report late payments to the bureaus. Missed payments also trigger significant late fees and interest charges, although fewer than one in four BNPL users understand their terms and conditions.[13] If borrowers who have relied on BNPL loans begin to default on those loans, their credit profile, while still showing a relatively higher credit score, not inclusive of that default due to timing, could deteriorate rapidly with the knock-on effect of struggling to pay the BNPL along with other bills.

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In addition, consumers are expressing confusion and frustration about their credit reports: The CFPB received more than 280,000 complaints concerning credit-reporting issues in 2020, double the number of similar complaints the bureau received in 2019. Similar accuracy matters challenge consumer credit portfolio managers, who are taking note of the credit bureaus' recent efforts to use alternative metrics (e.g., enhanced debt-to-income scores and other resiliency-focused measures) to assess default and bankruptcy risks. Some financial institutions now use occupation, industry and employer data to help identify borrowers with higher job-loss risks, including those sectors facing potential sustained losses such as hospitality, food service and entertainment.

Recognizing that traditional predictive measures such as payment history and FICO and VantageScores may not reflect credit risk in the pandemic environment accurately, consumer credit risk managers are taking other steps, such as:

- Increasing existing credit score minimums at underwriting and for portfolio monitoring purposes, while weighing percentage changes in scores more heavily.
- Correlating credit risk data with behavioral analytics (e.g., job changes, tuition payments, utility payments, social media connections).
- Developing and leveraging flag indicators to highlight signs of financial distress for individual borrowers.

[11] "Study: Buy Now, Pay Later Services Continue Explosive Growth," The Ascent, Mar. 22, 2021: www.fool.com/the-ascent/research/buy-now-pay-later-statistics/.

[12] "Investors Seek Growth Now in Paying Later," Telis Demos, *The Wall Street Journal*, Dec. 4, 2020: www.wsj.com/articles/investors-seek-growth-now-in-paying-later-11607077800.

[13] "Study: Buy Now, Pay Later Services Continue Explosive Growth": www.fool.com/the-ascent/research/buy-now-pay-later-statistics/.

- Applying differently weighted flags to significant drops in deposits, deposits relative to loan balances, or deposits dropping below a defined dollar minimum threshold.
- Highlighting credit line utilizations or sudden card use after a long dormant period.
- Leveraging FICO soft pull data to identify recent limit decreases from other lenders or delinquencies on accounts lower down the debt prioritization scale by segment (e.g., mortgage lenders might look for defaults on card or auto loans as an early warning indicator for their borrowers).
- Leveraging an institution's knowledge of commercial borrowers and probability of default as a predictor of jobless claims impacting the consumer portfolio.

One silver lining: Revising methods used to predict consumer repayment behaviors not only can be used as a measure of risk, but also may, in the long run, expand credit accessibility to underserved communities. Where there is risk, there may be reward.

The climate train has left the station

Count climate change among the trends in which interest and progress accelerated during the past year. COVID-19 opened more eyes to the impact of carbon emissions as well as to the steep price of confronting a pressing global crisis with insufficient preparation and coordination.

Widely shared photos of crystal-clear skies in Mumbai, Los Angeles, Beijing and other cities that routinely endure poor air quality showed the beneficial environmental impact of a reduction in greenhouse gas emissions by a whopping 9% in 2020. While that emissions reduction will fade as COVID shutdowns end, a steadily growing collection of nations, business groups, standards-setters, regulatory agencies and others are developing a more precise picture of the nature of risks associated with climate change as well as the opportunities associated with addressing the global challenge.

Financial institutions are awakening to the realization that they are deeply exposed to climate risk that, without action, could lead to considerable losses as banks transition from single event-type risks the industry is accustomed to managing, as well as the need to price for more permanent and systemic risks that existing business models may not yet address. The financial implications of environmental de-risking of portfolios, capital allocation decisions and new governmental policies worldwide, including those focused on carbon pricing, require expertise and input if they are to be worked out in an effective manner. Moreover, innovations and momentum in areas such as renewable energy, carbon sequestration, clean cement manufacturing and much more will need capital.

Recognizing the risk that climate change poses to financial stability, supervisory agencies are beginning to formalize guidance. As an example, the European Central Bank (ECB) issued a guide on climate-related and environmental risks, outlining supervisory expectations for areas such as strategy, governance, risk appetite, risk management, scenario analysis and disclosures.[14] In late March 2021, the Federal Reserve Board created

[14] *Guide on Climate-Related and Environmental Risks*, European Central Bank, November 2020: www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.202011finalguideonclimate-relatedandenvironmentalrisks~58213f6564.en.pdf.

a panel, the Financial Stability Climate Committee, that will evaluate climate-related risks.[15] Similar to the ECB guide, it is expected that this regulatory framework will include scenario analysis, disclosures and risk management expectations.

In a speech delivered at the "Transform Tomorrow Today" Ceres 2021 Conference, Federal Reserve Governor Lael Brainard stated:

> *Financial market participants that do not put in place frameworks to assess and address climate-related risks could face significant losses on climate-sensitive assets caused by environmental shifts, by a disorderly transition, or both. Conversely, robust risk management; scenario analysis; consistent, comparable disclosures; and forward plans can help ensure the financial system is resilient to climate-related risks and well positioned to support the transition to a sustainable economy.*[16]

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Given these types of developments, it is becoming critical for banks to develop a comprehensive understanding of climate and ESG-related risks within their portfolios. Key activities banks should begin undertaking not only to get ahead of any regulatory guidance, but also to begin recognizing and acting upon these risks, include:

- **Assess climate and other impacts at the borrower level during underwriting and throughout the life of the relationship** — This involves assessing climate and environmental risks in the business model and throughout the borrower's supply chains, applying various climate risk scenarios as part of underwriting, incorporating relevant ESG ratings and data into decisioning, incorporating risk into loan pricing, and adding provisions for climate risk and ESG responsibility to relevant legal agreements and covenants. Additionally, this includes ongoing monitoring of these risks and tracking green transition progress throughout the relationship with the borrower.
- **Assess the portfolio impacts of climate and other ESG risks and incorporate into strategy, risk appetite and governance** — To incorporate climate and ESG management, banks are isolating and quantifying highly variable climate, environmental and other related risks; applying various scenarios, segmentations and assessments; and using those granular insights to inform broader strategy and governance. Banks should begin developing strategy, risk appetite and governance around climate risk by establishing an internal task force to begin conversations and building out a plan to execute in accordance with these areas. Each should be informed by portfolio assessment and scenario analyses to develop a clear understanding of exposure of risk. These improvements will help institutions monitor, govern and reduce their financial risk exposure to transitional and physical climate and environmental risks.
- **Stay in tune with climate/ESG reporting standards** — To date, climate reporting has essentially been voluntary. Last summer, the Governance & Accountability Institute found that 90% of S&P 500 companies now voluntarily publish a

[15] "Financial Stability Implications of Climate Change," speech by Federal Reserve Governor Lael Brainard, Mar. 23, 2021: www.federalreserve.gov/newsevents/speech/brainard20210323a.htm.

[16] Ibid.

sustainability report on environmental matters — up from approximately 20% in 2011. Corporate ESG reporting has become a front-burner issue for more boards and executive teams. Companies typically use one of a handful of climate/ESG-reporting standards and frameworks — such as those developed by the Sustainability Accounting Standards Board (SASB) or the recommendations developed by the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD).[17] The ECB's *Guide on Climate-Related and Environmental Risks* specifically incorporates recommendations from the TCFD, which some financial institutions are piloting.

- **Identify data limitations —** Taking on climate risk will require robust data, both internal and external. Banks need to work proactively to address internal data limitations. In addition, they need to understand available external sources and data for performing various analyses and assessments and establish relevant partnerships.
- **Build climate and environmental risk literacy —** Banks should educate their lending units to bolster literacy of environmental issues and, where needed, add specialists to the team with deeper knowledge in areas such as climate risk and policy.

Climate change can inflict costly damage. Inversely, climate-related investments can drive massive value.

- **Identify sources of growth and opportunity to offset —** Climate change can inflict costly damage. Inversely, climate-related investments can drive massive value. For example, mangrove forests planted in Mexico to bolster storm protection have helped fisheries and eco-tourism there thrive, delivering an estimated $70 billion in economic benefits.[18] Moreover, there is significant momentum in new technologies and innovative business applications that support environmental regeneration and community improvement, while also generating revenue from competitive services or products. The growth in these companies is expected to be significant in the coming years and ripe with opportunities for banks to make meaningful investments while achieving a net-zero portfolio and establishing themselves as a key part of the climate change solution.
- **Assess environmental risks on an ongoing basis —** Many climate change impacts center on geographic regions (e.g., coastal areas and river valleys prone to flooding or forested areas prone to wildfires), as well as industries (e.g., natural resource extraction, power generation, transportation, etc.). In addition to those physical risks, an effective assessment also examines transitional risks, which will arise with greater frequency and magnitude as industries and economies adopt greener policies, rules and practices. "Such transitions could mean that some sectors of the economy face big shifts in asset values or higher costs of doing business," according to a Bank of England report. "It's not that

[17] For additional information, listen to Protiviti's podcast, "ESG and Financial Reporting Trends": www.protiviti.com/US-en/insights/podcast-esg-and-financial-reporting-trends.

[18] "Climate change: why it matters to the Bank of England," Bank of England: www.bankofengland.co.uk/knowledgebank/climate-change-why-it-matters-to-the-bank-of-england.

policies stemming from deals like the Paris Climate Agreement are bad for our economy — in fact, the risk of delaying action altogether would be far worse. Rather, it's about the speed of transition to a greener economy — and how this affects certain sectors and financial stability."[19] Transition risks may manifest in higher costs of doing business in certain sectors, which translates to declines in creditworthiness among companies in those sectors. Additionally, momentum continues to build to incorporate biodiversity loss as a source of financial risk that threatens the availability of ecosystem services into ESG frameworks. As noted in *Final Report - The Economics of Biodiversity: The Dasgupta Review*, commissioned by the UK Treasury and published in February 2021, "Physical, transition and litigation risks [related to biodiversity] affect real economic activities, which in turn affect financial institutions. These impacts can occur directly, for example lower profitability or the devaluation of assets, or indirectly through macro-financial changes. These risk factors are drivers of prudential financial risk, in particular credit risk, market risk, and operational risk."[20]

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- **Monitor rules, laws, consumer sentiment and enforcement trends —** In addition to new laws and regulatory compliance requirements, financial institutions should keep an eye on smaller changes and attitude shifts among standard-setting bodies, regulatory agencies and consumers. Climate-related pronouncements from industry groups also may provide useful information that can strengthen risk assessments and capital allocation decisions. For example, in February 2021 the U.S. Climate Finance Working Group — a council of 11 financial services industry trade associations, including the American Bankers Association — published 10 principles laying out a pragmatic approach to the transition to a sustainable low-carbon economy. Among other appeals, these guidelines call for climate regulation that is risk-based, fosters innovation in financial services and sets a carbon price that leverages the power of markets. "To drive capital investment, we support the use of market-based mechanisms, including a price on carbon that supports long-term decision-making," the principles document states. "Carbon pricing can also spur development of risks, and can inform and help scale key initiatives like voluntary carbon markets."[21] Monitoring activities should extend to credit rating agencies, which are adding new metrics and data to their credit analysis frameworks and tools to help institutions identify and assess relevant climate risks.

These activities and knowledge areas will help financial institutions incorporate climate change and broader environmental considerations into their credit risk management programs.

[19] "Climate change: what are the risks to financial stability?" Bank of England, 2021: www.bankofengland.co.uk/knowledgebank/climate-change-what-are-the-risks-to-financial-stability.

[20] *Final Report - The Economics of Biodiversity: The Dasgupta Review*, HM Treasury, Feb. 2, 2021: www.gov.uk/government/publications/final-report-the-economics-of-biodiversity-the-dasgupta-review.

[21] *Financing a U.S. Transition to a Sustainable Low-Carbon Economy*, U.S. Climate Finance Working Group, Feb. 17, 2021: www.isda.org/a/qXITE/Financing-a-US-Transition-to-a-Sustainable-Low-carbon- Economy.pdf.

In closing

As the effectiveness of global vaccination programs, the threat of COVID-19 variants and the impacts of the most recent round of economic stimulus all become better understood, financial institution leaders will be able to assess the resulting opportunities for growth and risk to their portfolios more accurately. Additionally, sharpened focus and additional resources will likely need to be brought to bear on consumer lending equity and enforcement as well as climate change-related activities as they relate to lending activity and managing credit exposures going forward.

CONTACTS

Bill Byrnes
Managing Director
+1.312.476.6387
bill.byrnes@protiviti.com

Matthew Moore
Managing Director
+1.704.972.9615
matthew.moore@protiviti.com

Michael Brauneis
Managing Director
+1.312.476.6327
michael.brauneis@protiviti.com

Ariste Reno
Managing Director
+1.312.476.6398
ariste.reno@protiviti.com

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