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INSIGHT

COVID-19 Impact on the Banking Industry: Conditions in the Third Quarter of 2020

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The economic ramifications of the Coronavirus Disease 2019 (COVID-19) pandemic could include borrowers missing loan payments, potentially causing distress for banks. Bank regulators release comprehensive data on bank condition and income every quarter. On December 1, 2020, the Federal Deposit Insurance Corporation (FDIC) released the *Quarterly Banking Profile: Third Quarter 2020*, which reports aggregate data from all 5,033 FDIC-insured institutions as of September 30, 2020. This Insight presents certain statistics about how the pandemic is affecting banks.

Background

The pandemic has caused businesses to close or limit operations and millions of job losses. Economic downturns threaten bank profitability because more borrowers might miss loan repayments, which can reduce bank income and impose losses. Meanwhile, bank liabilities—the deposits they hold and the debt they owe—obligate banks to make funds available to depositors and creditors. If borrower repayments decline enough, a bank's ability to meet its obligations could become impaired, potentially causing it to fail. In contrast, bank capital—largely equity stock and retained profits from earlier periods—enables a bank to absorb a certain amount of losses without failing. For this reason, bank regulators require banks hold certain amounts of capital (in addition to subjecting them to a variety of safety and soundness regulations) in order to avoid failures. However, if losses are sufficiently large, banks may nevertheless fail, reducing credit available to the economy and potentially destabilizing the financial system.

Certain effects of, and bank responses to, economic downturns—such as reduced income and increased credit loss reserves—occur shortly after the onset of economic deterioration. Other effects—such as increased loan delinquency, incurred losses, and reduced capital value—occur after a longer lag (see CRS Insight IN11501, *COVID-19 Impact on the Banking Industry: Lag Between Recession and Bank Distress*). Thus far the bank industry is holding up well, but as the pandemic continues to affect the economy, signs of stress may start to emerge.

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Income and Loss Reserves

In the third quarter of 2020, banking industry profits were $51.2 billion, a decline of nearly 11% from the $57.4 billion in the third quarter of 2019 but an increase from second quarter 2020 profits of $18.8 billion.

Profits rose in part because of a decline in provisions for credit losses from the second quarter, when credit loss reserves spiked. Credit loss reserves were $14.4 billion in the third quarter of 2020 and $61.9 billion in the second (see **Error! Reference source not found.**). The spike and subsequent decline could be a response to the pandemic, a change to accounting methodology, or both.

Credit loss reserves offset the overstatement of income on loans and other assets by adjusting for potential future losses on related loans and other assets. In June 2016, the Financial Accounting Standards Board promulgated a new credit loss standard—Current Expected Credit Loss (CECL)—which requires earlier recognition of losses. Large publicly traded companies (including publicly traded banks) were required to issue financial statements that incorporated CECL for reporting periods beginning December 15, 2019. Although the CARES Act mandated that regulators cannot require banks to use CECL until the earlier of the end of the public health emergency or the end of 2020 (and the bank regulators gave banks the option to delay the use of CECL for two years followed by a three-year transition period), 254 banks nevertheless made the transition by the third quarter. Reportedly, most of the largest banks that collectively hold nearly 80% of the industry's assets are among those that made the transition. This makes it difficult to determine to what extent the recent changes in loss reserve statistics are the result of the pandemic. For more information on CECL, see CRS Report R45339, *Banking: Current Expected Credit Loss (CECL)*.

Table 1. Income and Loss Reserves

	3rd quarter 2020	2nd quarter 2020	3rd quarter 2019
Net income	$51.2 billion	$18.8 billion	$57.4 billion
Credit loss reserves	$14.4 billion	$61.9 billion	$13.9 billion

Source: FDIC, *Quarterly Banking Profile: Third Quarter 2020*.

Loan Performance and Capital

Two indicators of bank health that deteriorate after a time lag are loan performance and capital levels, and these have yet to be significantly affected by the pandemic.

The most recent data showed an uptick of the noncurrent loan rate, although the level has not reached unusually high levels (see **Error! Reference source not found.**). The third quarter noncurrent rate (i.e., percent of loans more than 90 days past due or in nonaccrual status) rose to 1.17%, up from 0.92% a year earlier. For context, in the aftermath of the 2007-2009 financial crisis, the rate reached a peak of 5.46% in the first quarter of 2010. As part of the exception allowed under the CARES Act, banks are not yet reporting loans that are in forbearance as noncurrent, however.

Loan *charge-offs* (what happens when a bank gives up on a loan and writes off the loan's reported value from bank assets) ticked down from the second quarter and a year ago. The third quarter net charge-off rate was 0.46%, down from 0.51% a year ago. This rate had a recent peak of 3.00% in the fourth quarter of 2009.

Regarding capital, banks added $36.3 billion in bank equity capital, a 1.7% quarterly increase. This growth rate is up from a year ago, when banks added $3.5 billion in the third quarter, a 0.2% increase. (In the last crisis, bank equity capital decreased by $44.9 billion, or 3.3%, in the third quarter of 2008.) The increase in capital was almost entirely due to retained earnings—that is, profits that were not distributed to shareholders as dividends—which were 270% greater than a year earlier. This may be due, at least in part, to regulator limits on capital distributions imposed during the pandemic. It may also indicate that banks are building up their capital reserves to be flexible to respond to future adverse conditions.

Table 2. Loan Performance and Capital

	3rd quarter 2020	2nd quarter 2020	3rd quarter 2019
Noncurrent rate	1.17%	1.08%	0.92%
Net charge-off rate	0.46%	0.57%	0.51%
Bank equity capital (BEC)	$2,185.8 billion	$2,149.5 billion	$2,101.4 billion
BEC quarterly change	$36.3 billion, or 1.7%	$31.9 billion, or 1.5%	$3.5 billion, or 0.2%

Source: FDIC, *Quarterly Banking Profile: Third Quarter 2020*.

The number of banks on the FDIC's "Problem Bank" list may also indicate that the industry has yet to experience widespread stress, as recent quarters have seen a slight uptick to 56 banks in the third quarter from 51 at the end of 2019.

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