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

September 10, 2020

The economic ramifications of the Coronavirus Disease 2019 (COVID-19) pandemic could cause borrowers to miss loan payments, potentially to the point of individual banks or the bank industry becoming distressed. How and to what degree banks will be affected is uncertain. Comprehensive bank data are collected and released quarterly and provide indicators of industry health. On August 25, 2020, the Federal Deposit Insurance Corporation (FDIC) released the Quarterly Banking Profile: Second Quarter 2020, which reports aggregate data from all 5,066 FDIC-insured institutions as of June 30, 2020. This Insight presents certain data that may indicate how the pandemic is affecting banks.

Background

The COVID-19 pandemic has caused millions of businesses to close or limit operations and cost tens of millions of people their jobs. Economic downturns can threaten banks because more businesses and households may miss loan repayments. Because most bank assets are these types of loans, the missed payments can reduce bank income and impose significant losses. Meanwhile, bank liabilities—the deposits they hold and the debt they owe—oblige banks to make funds available to depositors and creditors. If borrower repayments were to decline enough, a bank’s ability to meet those 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. If losses were sufficiently large, banks may nevertheless fail, reducing credit available to the economy and potentially destabilizing the financial system.

Certain effects and bank responses to economic downturns—such as reduced income and increased loan loss reserves (described below)—occur shortly after the onset of economic deterioration. Other effects—such as increased loan delinquency, incurred losses on assets, and reduced capital value—occur after a longer lag.
Income and Loss Reserves

In the second quarter of 2020, banking industry net income (i.e., profits) was $18.8 billion, a decline of nearly 70% from the $62.5 billion in the second quarter of 2019. This follows a similar decline in first quarter 2020 income.

In addition, banks increased the amount of credit loss reserves to absorb anticipated losses. (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.)

Before this Insight assesses the size of credit loss reserves, it notes an ongoing change in accounting method. In response to banks’ financial challenges resulting from the 2007-2009 financial crisis, the Financial Accounting Standards Board (FASB) promulgated a new credit loss standard—Current Expected Credit Loss (CECL)—in June 2016, and requirements to use the new standard have recently started to apply to certain banks. CECL requires earlier recognition of losses compared with the methodology it is replacing. Supporters of the new standard assert reserving for losses earlier would reduce the impact of downturns. Other observers assert the standard is excessively cautious, as a bank must reserve for all losses expected over the entire life of the loan when it first makes the loan.

Large publicly traded companies (including publicly traded banks) were required to issue financial statements that incorporated CECL for reporting periods beginning December 15, 2019. However, the March 2020 CARES Act mandated that no bank shall be required to use CECL methodology from the date of enactment until the earlier of (1) the date the public health emergency ends or (2) the end of 2020. Bank regulators gave banks the option to delay the use of CECL for two years followed by a three-year transition period. For more information on CECL, see CRS Report R45339, Banking: Current Expected Credit Loss (CECL), by Raj Gnanarajah.

Total provision for bank credit loss reserves was $61.9 billion, an increase of nearly $41.9 billion (or 382%) from $12.8 billion at the end of the second quarter of 2019. The 253 banks that used CECL methodology reported $56 billion in provision for credit loss reserves, and non-CECL adopters reported approximately $6 billion. This size disparity is due in large part to the fact that publicly traded banks tend to be much larger relative to other banks. Nevertheless, the disparity could raise concerns. If banks using the older methodology, which does not require losses to be recognized as quickly, do not make sufficient credit loss reserves to absorb the losses, then some of those banks might (1) need to consider consolidating with healthier banks, or (2) face failure.

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<th>Second Quarter of 2020</th>
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<tr>
<td>Net Income</td>
<td>$18.8 billion</td>
<td>$62.5 billion</td>
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<tr>
<td>Credit Loss Reserves</td>
<td>$61.9 billion</td>
<td>$12.8 billion</td>
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Source: FDIC, Quarterly Banking Profile: Second 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 loan nonperformance and loan charge-offs (what happens when a bank gives up on a loan and writes off the loan’s reported value from bank assets). However, the levels of these indicators have not reached unusually high levels. As of June 30, 2020, the noncurrent rate (i.e.,
percent of loans more than 90 days past due or in nonaccrual status) rose to 1.08%, up from 0.93% 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. The second quarter net charge-off rate was 0.57%, up from 0.50% a year ago. This rate had a recent peak of 3.00% in the fourth quarter of 2009.

Regarding capital, banks added $31.9 billion in bank equity capital in the second quarter, a 1.51% quarterly increase. This growth rate is down from a year ago, when banks added $38.6 billion in the second quarter—a 1.95% increase—but indicates the downturn has not yet hurt bank capital. In contrast, in the last crisis, bank equity capital decreased by $44.9 billion (3.3%) in the third quarter of 2008.

### Table 2. Loan Performance and Bank Equity Capital

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<tr>
<td><strong>Net Charge-Off Rate</strong></td>
<td>0.57%</td>
<td>0.50%</td>
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<tr>
<td><strong>Bank Equity Capital Change</strong></td>
<td>$31.9 billion, or 1.51%</td>
<td>$38.6 billion, or 1.95%</td>
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</table>

Source: FDIC, Quarterly Banking Profile: Second Quarter 2020.

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