FEDERAL RESERVE BANK OF KANSAS CITY | JUNE 28, 2022

Community Banking BULLETIN: Feature

Providing insights on community banking

Effects of pandemic unlike previous financial crisis

By Justin Reuter

While the COVID-19 pandemic brought uncertainty across the financial sector, community banks have fared better than in the previous financial crisis. Credit uncertainty early in the pandemic did not materialize into heightened problem asset levels, and earnings have remained relatively unchanged. However, community bank balance sheets have grown at unprecedented rates causing various financial measures to demonstrate volatility in excess of changes seen during the previous financial crisis.

In March 2020, uncertainty created by the COVID-19 pandemic pulled the U.S. economy into a recession for the first time since 2008. Government response efforts included encouraging banks to prudently work with borrowers affected by COVID-19, implementing various economic stimulus programs, and installing several federally supported lending facilities.

The COVID-19 pandemic created disruptions in financial markets not experienced since the financial crisis. In order to compare how community banking organization[1] (CBO) financials evolved through the pandemic relative to the previous financial crisis, changes in various metrics were charted utilizing the quarter preceding each stress event as the starting period. Changes in the metrics during the quarters of stress are measured in relation to the starting period, as follows:

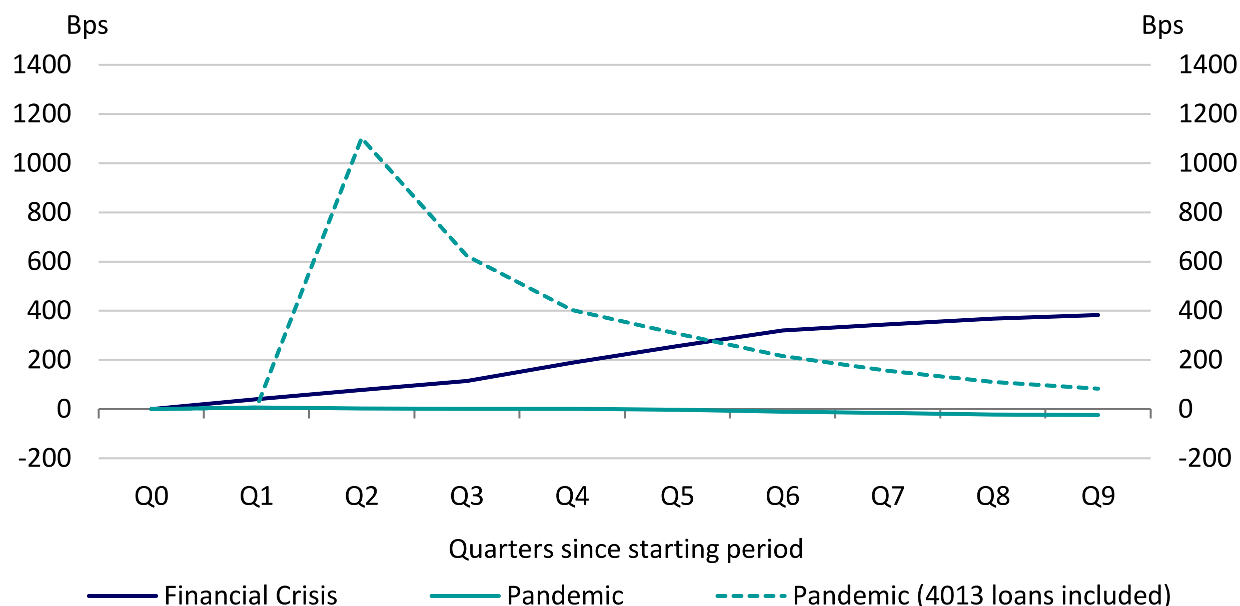
- Financial crisis related volatility was measured from December 2007, just prior to the financial stress in the banking sector in 2008, which is quarter zero for “Financial Crisis” on subsequent charts.
- Pandemic related volatility was measured from December 2019, just prior to the pandemic in 2020, which is quarter zero for “Pandemic” on subsequent charts.

For each quarter after the starting period, the value at quarter zero is subtracted from the current period in order to analyze the metrics’ change relative to the beginning of each stressed period.

At the onset of the pandemic, CBOs increased provision expense to bolster allowances for loan and lease losses given the potential for credit deterioration in loan portfolios. Additionally, CBOs began modifying loans for borrowers adversely affected by the pandemic in accordance with Section 4013 of the CARES Act, which granted banks temporary relief from reporting the loans as troubled debt restructurings. This led to heightened credit quality related ambiguity given the true credit quality of these loans was unknown during the forbearance period. To better understand potential credit problems, these loans were added to traditional problem assets during the pandemic which resulted in an increase in “problem assets” of over 1,100 basis points (bps) two quarters into the pandemic; however, Section 4013 loan modifications have declined significantly since that time (see Chart 1).

Modification activity helped prevent a decline in loan quality, as loans past due over 90 days or on nonaccrual and other real estate owned have remained at or below pre-pandemic levels. In contrast, credit quality issues were recognized as experienced during the financial crisis without a similar forbearance policy. Thus, problem assets steadily increased and were up 383 bps nine quarters into the financial crisis, compared to being down 24 bps nine quarters into the pandemic.

Chart 1. Problem Asset Level* Migration

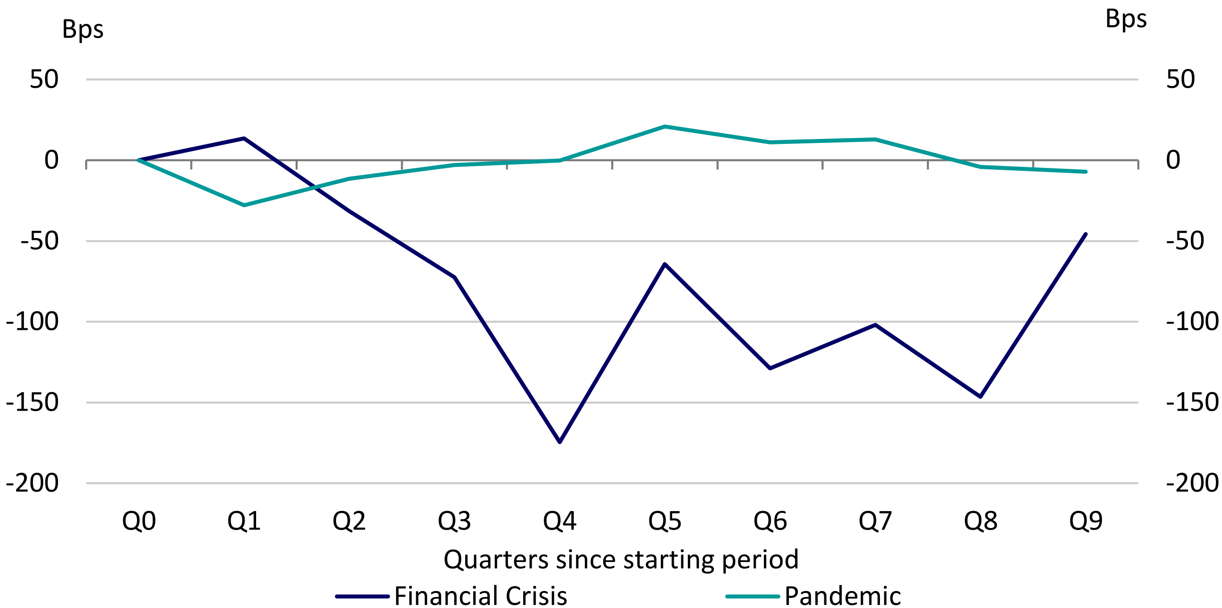


*Loans past-due 90+ days, on nonaccrual, or other real estate as a percentage of total loans and other real estate
Source: Reports of Condition and Income, inflation-adjusted

Return on average assets (ROAA) at CBOs has remained strong and near pre-pandemic levels despite the need to increase provision expense early in the pandemic and pressures on asset yields from ballooning balance sheets and a persistently low-interest rate environment (see Chart 2). As credit issues have remained muted through the pandemic, CBOs have been able to reduce and maintain lower levels of provision expense, helping to offset profitability pressure caused by lower average yields on earning assets. In addition, fee income generated from the Paycheck Protection Program helped boost bottom lines for CBOs during the pandemic. In fact, while ROAA fell by 28 bps the first quarter following the onset of the pandemic, it began converging toward pre-pandemic levels afterwards, and in the fifth quarter ROAA actually exceeded pre-pandemic levels by 21 bps.

In contrast, CBOs experienced substantial earnings declines during the previous financial crisis. Significant asset quality issues resulted in a need to continuously increase provision expense, and four quarters after the start of the financial crisis ROAA had fallen by 175 bps. ROAA remained low for many of the following quarters, not returning to pre-crisis levels for over 3 years.

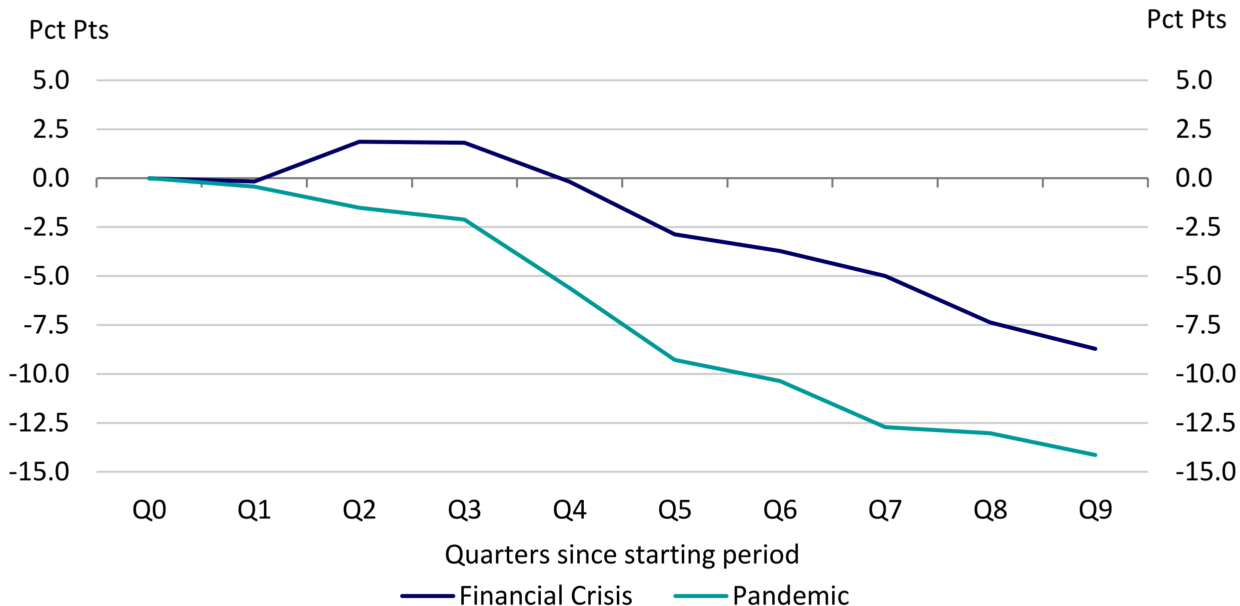
Chart 2. Return on Average Assets Migration



Source: Reports of Condition and Income, inflation-adjusted

While CBOs have been able to avoid meaningful credit deterioration and declines in bottom-line earnings, deposit-driven balance sheet growth from economic stimulus programs changed balance sheets much faster during the pandemic than the previous financial crisis. Despite programs such as the paycheck protection program, loans as a percentage of deposits dropped quickly during the pandemic (see Chart 3). Just over two years into the pandemic, the loans-to-deposits ratio is 14 percentage points below 2019 levels, falling much lower and faster than during the financial crisis.

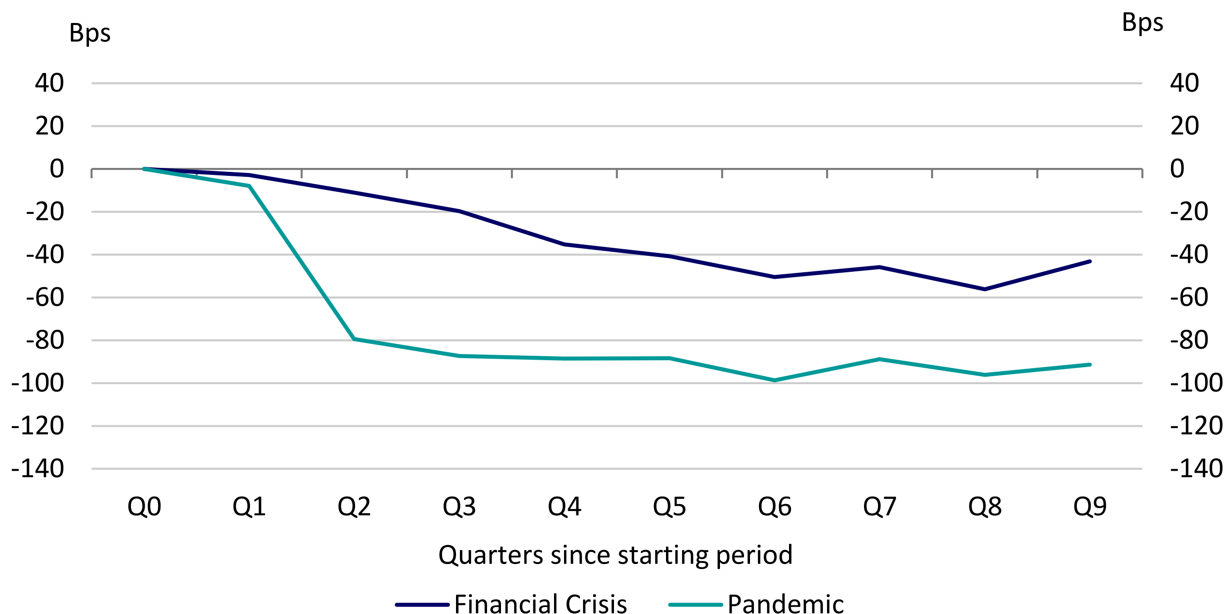
Chart 3. Loans-to-Deposits Migration



Source: Reports of Condition and Income, inflation-adjusted

The sudden growth in deposits with limited corresponding opportunities to deploy the funds caused a rise in liquid, low-yielding assets. This rapid balance sheet growth, outpacing capital augmentation, has placed downward pressure on the tier one leverage ratio, and just two quarters into the pandemic the tier one leverage ratio had fallen by 79 bps (see Chart 4). In contrast, it was credit-related losses during the financial crisis that caused the tier one leverage ratio to decline, falling by a high of 56 bps eight quarters into the financial crisis.

Chart 4. Tier 1 Leverage Ratio Migration



Source: Reports of Condition and Income, inflation-adjusted

While uncertainty was high early in the pandemic, credit issues have not materialized in the same ways they did during the previous financial crisis, and banks have been able to maintain pre-pandemic profitability. However, the expansion of CBO balance sheets and the resultant change in the composition of assets is likely a longer-term impact and challenge facing community banks. While community banks fared well through the pandemic compared to the previous financial crisis, how they respond to and manage the challenges of an unprecedented balance sheet structure and a potentially volatile interest rate environment will need to be closely monitored over the coming years.

Questions or comments? Please contact KC.SRM.SRA.CommunityBankingBulletin@kc.frb.org

---

[1] Community banking organizations are defined as having $10 billion or less in total assets

Justin Reuter is an advanced risk specialist at the Federal Reserve Bank of Kansas City. The views expressed are those of the author and do not necessarily reflect the positions of the Federal Reserve Bank of Kansas City or the Federal Reserve System.