Ask an Economist: Community banks and the Paycheck Protection Program

April 29, 2021

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Research by Kansas City Fed Senior Economist W. Blake Marsh and Economist Padma Sharma shows that community banks have played an outsized role in the Small Business Administration's (SBA) Paycheck Protection Program (PPP). Their findings, published in a December 2020 *Economic Bulletin*, show that these banks disbursed 37% of all PPP loans despite holding only 18% of outstanding bank loans. Further, although participation in the program boosted community banks' revenue, it appears to have lowered profitability—at least initially.

How have community banks benefitted from participation?

Loans through the PPP have helped community banks grow their balance sheets at a time when they might otherwise be driven to shrink them. These loans have accounted for a majority of net growth in community bank loans since the onset of the pandemic. In fact, loans at community banks grew at a substantial rate of 15% over the year ended in 2020. Without PPP loans, loan growth at these institutions was only 4.5%. The limited loan growth outside of the PPP underscores survey results reporting tightening bank standards and a lack of demand for other loan types at commercial banks.

How were profits affected?

Although the PPP has helped ease credit conditions, it also has affected profitability for community banks. Loans through the program carry a lower interest rate—1%—than many other types of loans, potentially lowering banks' profit margins. We found that banks with high PPP exposure experienced a larger decline in their net interest margins relative to banks with low PPP exposure. We categorized banks into groups of high and low exposure based on whether their share of PPP loans to total loans exceeded or fell under the median level of 7%. Before the pandemic, banks that would later have high PPP exposure were more profitable than their peers, as evidenced by their higher net interest margins. However, after the introduction of the PPP, net interest margins for the two groups of banks converged, suggesting that PPP loans were not particularly profitable assets for banks, at least initially.

What are the conclusions or forecasts?

Although the full effect of PPP lending on bank income is not yet known, our findings have implications for the near-term outlook of the banking industry and for the effects of the new round of PPP funding that became operational in January. First, as PPP loans become eligible for forgiveness, banks will need to identify alternative lending opportunities that are both sound and profitable to generate revenue. Second, the effects of PPP lending on bank profitability have not yet fully materialized, and will be determined by the pace and timing of ongoing loan forgiveness.

Banks receive a further boost to their revenues in the form of lump sum origination fees from the SBA once a loan is forgiven. Overall, a bank's decision to participate in the ongoing PPP funding round, or similar government-backed lending programs, is a function of the program's effects on the bank's long-term health and the near-term economic outlook.

Further resources

Read the full *Economic Bulletin* on this topic at *KansasCityFed.org/research*.
