The FDIC Podcast – Looking Back on 2020

BRIAN SULLIVAN: Welcome back to the FDIC Podcast, a place where we talk about how our banks connect to our own lives. I'm Brian Sullivan at the Federal Deposit Insurance Corporation and today we're going to be talking about 2020…a year most of us would gladly say 'good riddance' to.

The global pandemic and its horrible health and economic consequences turned our lives upside down last year. But how did our banks fare and how did our banking system hold up?

The FDIC just came out with its latest *quarterly* report card on the health of our nation's banks. And *this* quarter, the folks in the FDIC research division took a deep look on the entire year of 2020.

Joining us to pour over the numbers and tell us what they mean is Pat Mitchell and Meg Hanrahan, two senior financial analysts who, along with a staff of others, produce the FDIC's Quarterly Banking Profile. Meg and Pat, welcome!

MEG HANRAHAN: Thank you, it's great to be here!

PAT MITCHELL: Thanks Brian, great to be here!

BRIAN SULLIVAN: Pat, let's start with you…2020, pretty bad for all the obvious reasons. Was it bad for our banks?

PAT MITCHELL: You know, Brian, I'll tell you 2020 was an extremely challenging year for everyone, including the banks. However, given how dire things seemed early on in the beginning of the year, the start of the pandemic, banks have really proven quite resilient and performed quite well.

Let me focus on net income for the banking industry, it's a key barometer for how banks fared in 2020. Overall, for the full-year 2020, income declined almost 36.5% compared to 2019. The primary driver of that was provisions and provisions are amounts that banks have to set aside for losses from loans, that is loans that are unable to ultimately pay. So, think of that as creating a rainy day fund, for things that might go bad in the future. And even there for 2020, I tell you it's been a tale of two halves of the year.

In the first half of the year, the pandemic to hold, governments issued shut down orders. And we saw the most dramatic declines in GDP and increases in unemployment that have been seen since the Great Depression. So, so pretty dramatic and pretty frankly little dire feeling...

BRIAN SULLIVAN: ..right, so banks naturally thought things could get worse, we're going to provision.

PAT MITCHELL: Absolutely. So as a result, banks reacted and they increased provisioning quickly in the first and second quarters to prepare for, you know, some of the worst potential outcomes. They had to prepare for the worst, set up their rainy day fund.

However, as things have gone on—as a result of many factors, including fiscal and monetary policy, which, which I think your listeners are probably very well aware of—the economy has rebounded stronger than, than probably almost anybody expected. It's really been very remarkable. You combine that with the quick deployment of a vaccine and also the ongoing rollout of that vaccine, and the economic outlook looks much brighter than anybody ever thought it would.

As a result, banks have pulled back and they've had to set aside less in their rainy day funds. In fact, it's the lowest level since 1995 for provisions, so it's quite remarkable. So net income has rebounded and it's been very strong in the last two quarters. So, it really is net income was low in the first two quarters and regained strength in the last two quarters.

BRIAN SULLIVAN: …still lower than it was in 2019 but certainly a lot higher than it was earlier in the year.

PAT MITCHELL: Well, even there, that's the interesting thing. For the last two quarters they've actually approached the pre-pandemic levels of total net income. And in fact, even in fourth quarter, it actually exceeded the 2019 level of income. So, it actually really has been quite strong.

BRIAN SULLIVAN: So now that banks aren't provisioning or saving for that rainy day as much as they did in the first half of 2020, does this suggest banks are more optimistic as the year went on?

PAT MITCHELL: Yeah, I think that's fair. I mean, definitely fair. The loan performance really has been better than anticipated. So, when you think of the non-current loans—and let's think again, non-current loans…those are loans that have fallen behind in their payments. Maybe you haven't paid, you're supposed to pay and you haven't paid. So those have increased since the pandemic, but very modestly, at much, much lower levels than anybody anticipated.

So, as a comparison the non-current loan rate, and that is the non-current loans as a percentage of total loans, was at 1.18% at the end of fourth quarter 2020. But let's compare that relative to previous stress times. So, if you look in 2009, it was well above 5%. So, this is, while it's been increasing, it's been very modest and it's still a relatively low level.

And overall, loans have performed remarkably well. Both consumer loans, real estate loans and corporate loans. And all of this really supports the banks' optimism. There is reason to be optimistic. Of course, there are areas of stress and areas where we've remained focused, both the

FDIC and the banks. And so, think of those as like travel-related and retail loans are some obvious ones. And so, we remain cautious on those sectors. So, there are still some uncertainty, some pockets that we remain concerned about. But overall, yes, there, you know, banks are much more optimistic.

BRIAN SULLIVAN: Well Meg…all of what Pat just said strikes me as fairly positive in the scheme of things. Certainly, the amount of provisioning earlier in the year suggests banks thought things would be worse than they ended up being. We hear a lot about something called Net Interest Margins being at historic lows…tell us what that means and why we should care.

MEG HANRAHAN: Well, Brian, the net interest margin actually measures the difference between what the bank earns on their loans and securities and what they pay out on deposits. The margin tells us what basically is left over to pay for the other expenses—salaries, rent, computer equipment, and even provisioning like Pat had just discussed.

Interest rates are very low right now. And many loans are being refinanced at lower rates. Great for the consumer, not so great for the banks. So, banks are making less money on their loans and while the banks are able to reduce their deposit costs. So, the rate you're earning on your deposits are probably very low right now and banks were able to reduce that. Loan interest rates are actually falling more rapidly. So, banks are seeing that the money available to pay all their other expenses is decreasing. And as you mentioned, net interest margin is at the lowest level that it has ever been in the history of the Quarterly Banking Profile. So, of a concern when it's at the lowest level we've ever seen.

Two key factors are actually affecting the net interest margin. One is the low interest rate environment that we're in. The Fed has reduced rates, they've stated that they do not intend on raising rates for the near future. The other is the change in the mix of what banks have on their balance sheets. So typically, they have a lot of loans on their balance sheet, but now they have more of a mix of cash, securities and loans. So that's also hurting their net interest margin. So, you know, our concern is, is it going to continue to shrink and will banks be able to cover their expenses? So, we'll be continuing to be monitoring that.

BRIAN SULLIVAN: Well, if this 'net interest margin' is at historic lows, and staying there…are banks still lending?

MEG HANRAHAN: Well, banks were very active in helping small businesses through the *Paycheck Protection Program* earlier in 2020. But other than government-sponsored programs, banks are not making many loans. Banks actually saw the amount of loans that they have on their books drop this quarter. This decline is partly due to tightening underwriting standards, so maybe requiring a little bit more information or a little bit more from borrowers, which typically happens during a recession. So that's not surprising, but it's also partly due to a lack of demand. People are paying their current loans. As Pat mentioned, we really haven't seen a huge increase in non-current loans. So, people are paying their loans, but they don't want to take on more debt.

BRIAN SULLIVAN: Right. So, people are saving more, borrowing less…is that a good thing or a bad thing?

MEG HANRAHAN: Yes. And I say that teasingly, but, but in all honesty, it is actually a good thing *and* a bad thing. Consumers are saving more than before the pandemic. They're paying down their debt and not borrowing. That's a good thing for banks. You know, many consumers are uncertain about their job, income…they're being prudent and saving. So that's good for banks. As Pat mentioned, we, we've not seen loans become delinquent and we've seen deposits grow.

But the bad part is for the overall economy. When we say we're not spending our money. So, those funds are not flowing through the economy. Consumers are not ordering the pizza, so the restaurant owner is not buying from their supplier, and the supplier isn't buying from the materials to make those supplies. So, it just goes on and on, but so that's why, you know, teasingly, but in truth…it's good *and* bad.

BRIAN SULLIVAN: Yeah, I can't tell you the last time I went to a movie…. Well, Pat, early on in this pandemic, consumers and businesses alike put their money into their banks. That sounds like we have confidence in our banking system, right? Help us to understand what's behind this historic growth in bank deposits and whether that gives you any cause for concern?

PAT MITCHELL: Yeah Brian. So, deposits have grown at a record rate. And, and again, similar, similar to what Meg was talking about. This is generally a good story for banks. Deposits are a cheap way, and the primary way, that most banks actually fund their loans. So, they actually take deposits, and they convert them into loans. So again, that is, that is net good.

The increase in deposits has been an outcome of a few things. So first, we've had monetary and fiscal policy took hold and a lot of these funds…this increased money…found their way into banking accounts. For example, think of the stimulus checks. So, the stimulus checks that were provided to individuals, those found their way into bank accounts and increased the amount of deposits in the banking system. And in fact, the other part of this that that's taken place and Meg mentioned this, is really the, the decline in spending. So, we've had record savings rates. Consumers have been saving that at or near record savings rates. Consumers, aren't traveling, they aren't eating at the pizza place, they aren't spending money at the movie theater, as you mentioned, all of these things contribute. So that results in savings and results in increased deposits.

So, with this, all this led to record positive growth, and that is good for the banks. As previously discussed, banks will ultimately need to take those deposits and they will have to eventually lend them to increase the amount that they, that they earn. But all in all, these are, these are all good things for the banking system…and for depositors.

BRIAN SULLIVAN: But as Meg said, they're tightening their lending standards…for obvious reasons. The demand for new loans is low. So, the money just stays in the bank.

PAT MITCHELL: It's transitory as way I would consider that. As we come out of the recession and we're starting to see parts of that, banks will end up having more confidence and borrowers will have end up having more confidence. So, then those deposits will, can get converted ultimately to loans.

BRIAN SULLIVAN: Meg, can you say anything about banks that are heavily invested in certain vulnerable sectors? Commercial real estate comes to mind.

MEG HANRAHAN: Yeah. As Pat mentioned, that is one of the areas that we have a little bit more concern about. Basically, what we're concerned about is like, you know, a lot of companies have employees working from home, so will they need that office space that they had before? Maybe not.

We also know a lot of people aren't traveling anymore. Hotels, other travel industries are having a hard time. If we're not staying in hotels, the owner of that hotel may not be able to meet their mortgage payment. So, these are areas that we're concerned as to, you know, are they going to get better? Both of these situations make it hard for, like I said, for the property owners to pay their mortgages. So, we haven't quite seen a huge rise in loan payment problems yet…though, commercial real estate is the one portfolio where we have seen a rise in more and more borrowers, not being able to make their mortgage payments. However, it's still at very low levels compared to let's say, when we had the Great Recession back in 2008, 2009, the level was much higher than it is today. So, nothing that we're, you know, too dramatic, but it's something that we're going to continue to watch, particularly now that we have the vaccine, the vaccine rollout seems to be getting better that maybe these, you know, by the second half of 2021, we may not be as concerned as we are today.

BRIAN SULLIVAN: So, we can all agree that 2020 was a year we'd rather forget? Pat, Meg…let me get your final observations about your look-back on last year. Seems our banks…our banking system…proved to be pretty resilient, right Pat?

PAT MITCHELL: It's been an, it's been a remarkable year on every level and the same has held true for the banking system. But overall, as you know, banks, and our economy, have proven incredibly resilient.

So, as I reflect and I look back and if you'd have told me in April that we'd be in the position we are today, I would have been highly skeptical that we'd be in as good a position today as we are, both from the banking system and the economy. And I would have been quite pleased. So, I would have been skeptical and pleased.

BRIAN SULLIVAN: You would have taken that…

PAT MITCHELL: Absolutely. And, you know, having noted that I don't want to dismiss or…certainly there are significant, tremendous challenges out there for individuals. For individuals, it's still a very difficult time and there are still challenges. We've talked about the banking challenges here and, no…we're not out of the woods yet. So there's still a lot of uncertainty, but yes, things have proven quite, banks have proven quite resilient and it really has been remarkable story and yes, I agree. I would care to forget it still.

BRIAN SULLIVAN: Right, right…Meg, do you sleep well at night or what keeps you up?

MEG HANRAHAN: I do sleep well at night. Partly because as Pat mentioned, we really have rebounded. Again, if this had been March or April last year…even May…I would have said something completely different and said, “no, I don't sleep at night.” But now we've seen banks have been resilient. And I think also that banks have shown that they're a safe place. As we mentioned, deposits have grown tremendously. Consumers realize that banks are a safe place to put their money while we're going through this crazy environment. And while there's still certainly some headwinds, some concerns about interest income, their net interest margin, and also some concerns about loan portfolios. Again, there's a lot of hope now that we're seeing the vaccine rollout now that we're seeing, you know, improvements in the economy, bankers are feeling confident in the economy. So, I'm feeling a lot better. Still, I'm a bank examiner at heart, so still have a little bit of concerns, but definitely feel banks have been really resilient throughout this pandemic.

BRIAN SULLIVAN: Well, Meg Hanrahan…Pat Mitchell…thank you both for joining us and walking back through 2020 and again, something we’d rather resign to the history books. But I do appreciate you both joining us.

MEG HANRAHAN: Thank you.

PAT MITCHELL: Thanks Brian.