

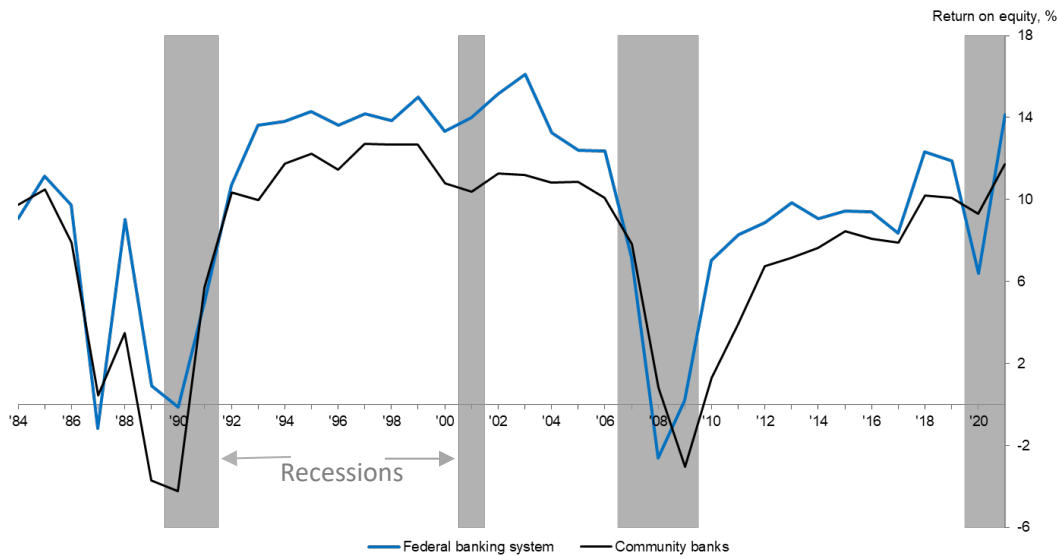
ON POINT

ECONOMIC AND POLICY INSIGHT FROM THE OCC

Sustaining Bank Profitability a Near-Term Challenge

The federal banking system (system) survived a turbulent 2020 as the COVID-19 pandemic caused great uncertainty and put pressure on earnings in the first half of the year. By the end of 2020, however, bank profitability not only normalized but excelled, in large part due to unprecedented fiscal and monetary stimulus including the Payroll Protection Program (PPP),¹ a key part of the Coronavirus Aid, Relief, and Economic Security (CARES) Act. Indeed, the first quarter of 2021 saw banks register returns on equity at levels not seen since before the global financial crisis of 2008, as shown in figure 1.

Figure 1: Bank Profitability Rebounds After COVID-19 Stress, Helped By PPP



Source: OCC Integrated Banking Information System

Note: FDIC-insured federal banking system annual data 1984-2020. The 2008 figures are the sum of quarterly net income and include estimates to restore income eliminated due to purchase accounting treatment of Countrywide (2Q 2008); Washington Mutual (3Q 2008); and Wachovia, National City, and Downey (4Q 2008). Community banks have less than \$5 billion in assets and exclude specialist institutions such as credit card and trust institutions.

¹ See [“PPP Lending Provides Boost to Metro Area Small Banks and Businesses.”](#) April 6, 2021.

This improvement in system profitability was evident from the largest megabanks to community banks with less than \$5 billion in assets.²

But there are several nonrecurring factors related to the pandemic response and its winding down that are not expected to continue. Thus, the bank profitability outlook will increasingly rely on a return to core banking tenets such as prudent loan growth and managing headwinds from persistent net interest margin (NIM) compression in a low-interest-rate world.

Nonrecurring Factors Fueled Recent Earnings Strength

Several factors boosting earnings in the first quarter of 2021 are expected to wane or disappear entirely over the next year. Two of the most prominent are:

- Negative provisions; and
- Lingering beneficial effects of the PPP on loan growth and income.

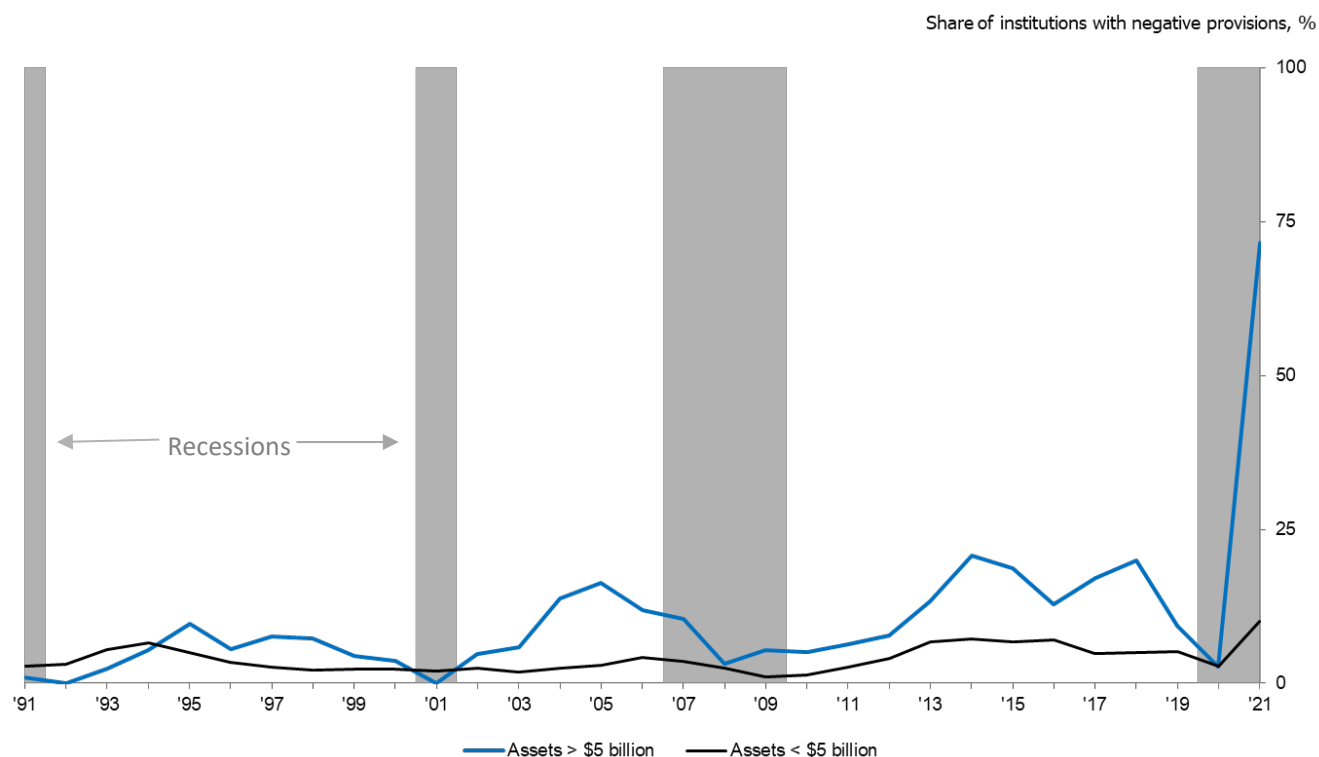
The uncertainty that existed in the early days of the pandemic about the depth and duration of the downturn—unlike any other in the past century—led many banks to increase provisions significantly in an effort to build an adequate reserve for future losses.³ So the release of those reserves now that the economy has improved is not unexpected nor unwarranted. Releasing reserves via negative provisions boosts income.

Figure 2 shows the share of banks above and below \$5 billion in assets that recorded negative provisions for the first quarter of each year dating back to 1991. Clearly the share of larger banks reporting negative provisions spiked well beyond all historical levels to nearly 75 percent in the first quarter of 2021. But even 10 percent of banks under \$5 billion reported negative provisions, exceeding the percentage in the mid-1990s. The effect on profitability from this rare occurrence was significant. For context, system provisions were \$10 billion in the first quarter of 2019, before jumping to \$40 billion in the first quarter of 2020 as banks sought to build reserves in anticipation of the adverse COVID-19 economic impact. System provisions then dropped to negative \$13 billion in the first quarter of 2021 as banks released reserves. So the swing in provisioning and resultant boost to profits are atypical. If banks were required to provision at the same rate as in the pre-pandemic first quarter of 2019, return on equity (ROE) would have been just 3.8 percent instead of 14.2 percent in the first quarter of 2021.

² Throughout this article “community banks” refers to Federal Deposit Insurance Corporation (FDIC)-insured institutions in the federal banking system with less than \$5 billion in assets, excluding specialist institutions such as credit card and trust banks.

³ March 2021 was also the first quarter in which some of the largest banks implemented the current expected credit losses (CECL) standard, which requires the allowance for loan losses to reflect expected losses over the life of the loans rather than incurred losses.

Figure 2: An Unprecedented Three in Four Larger Banks Register Negative Provisions in First Quarter 2021



Source: OCC Integrated Banking Information System

Note: Data for FDIC-insured federal banking system as of first quarter of each year. Banks with assets under \$5 billion exclude specialist institutions such as credit card and trust institutions.

PPP loans boosted both loan growth and net interest income growth, driving recent high profitability despite NIM compression. Figure 3 shows how NIM and loan volume interact to affect net interest income (NII), which accounts for 60 percent to 70 percent of most banks' total revenue.

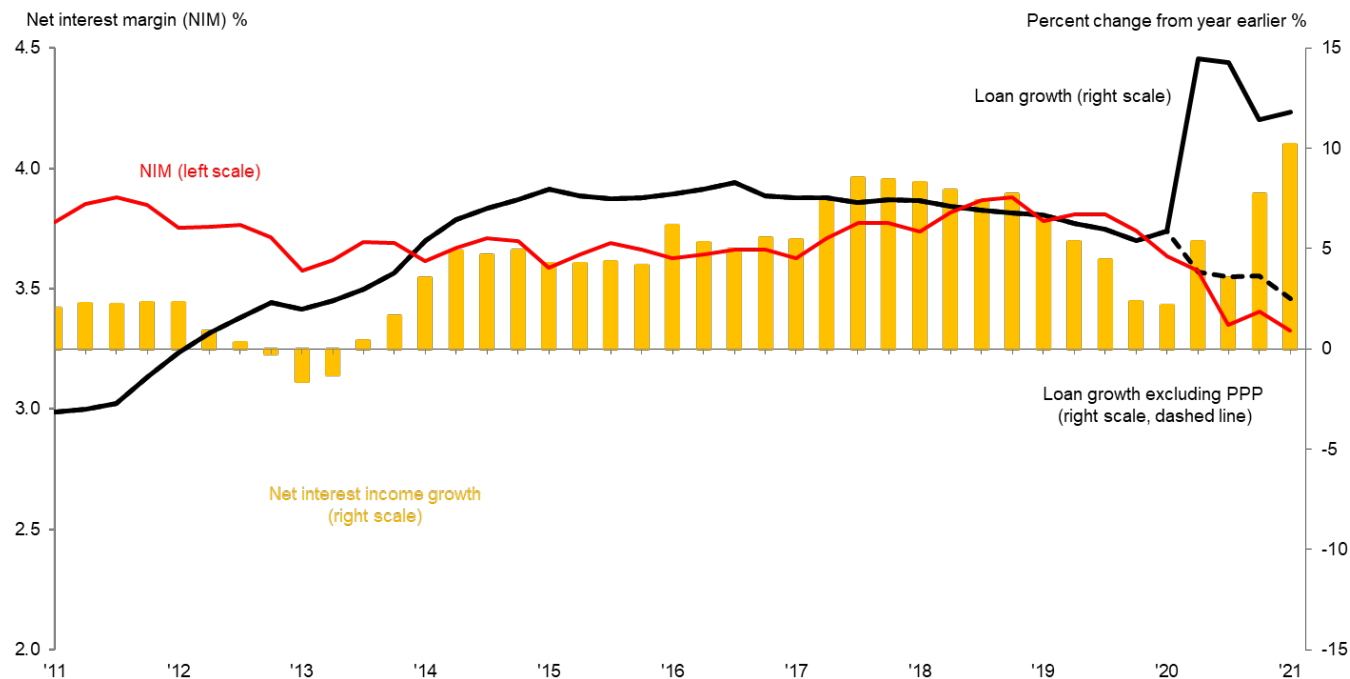
Roughly, net interest income reflects both a “price” (NIM) and “quantity” (mostly loan growth) effect. Examining the quantity effect by showing loan growth both with and without PPP loans is essential to accurately interpret the loan growth trend—especially for community banks, which have an outsized share of PPP loans. Total loan growth over the past year was very robust for this cohort of banks, though commercial and industrial (C&I) lending, which makes up about one-fifth of overall loan volume on balance sheet, was almost exclusively PPP-driven. Absent PPP loans, there would have been a clear deceleration in the pace of community bank loan growth starting in early 2020. Without PPP loans, total loan growth at community banks would have slowed to a rate not seen since the early part of the economic recovery from the global financial crisis over a decade ago; that, in turn, was the slowest lending recovery since World War II.⁴ PPP lending also has a noticeable positive effect on the income statement, with origination fees recorded as interest income as these loans are paid back or forgiven. Clearly

⁴ The material effect of PPP lending on bank balance sheets and income statements is discussed in a previous “On Point” article, [“PPP Lending Provides Boost to Metro Area Small Banks and Businesses”](#) April 6, 2021.

then, sustaining and increasing lending would be beneficial for net interest income as banks wind down PPP lending.

As to the “price” effect on NIM, the influence of overall interest rate levels and term spreads is less obvious over prior economic cycles for the overall system. However, community bank NIMs historically have benefited when short-term interest rates rise.⁵ Assuming that historical relationship holds, NIM would not be expected to improve significantly for community banks in the near term given that the current Blue Chip consensus expects short-term rates to remain low and flat through 2022.

Figure 3: PPP Drives Loan Growth and NII at Community Banks as NIM Remains Low



Source: OCC Integrated Banking Information System

Note: FDIC-insured federal banking system institutions under \$5 billion in assets excludes specialist banks such as credit card and trust institutions.

Community Banks With NIM Pressures Exited the Industry at a Faster Rate

Because NII is a dominant share of revenues for community banks, and small changes in NIM can be very influential, NIM pressures can have severe implications for banks in a weaker financial position. While industry consolidation has been omnipresent since the 1980s, data suggest that banks under the most NIM pressure have slightly higher industry exit rates in economic expansions, and even more pronounced exit rates during recessions as failures accelerate.

⁵ Angela Hinton and Chester Polson, “[The Historic Relationship Between Bank Net Interest Margins And Short-Term Interest Rates](#),” FDIC Quarterly 2021, volume 15-2, article 1.

Figure 4 shows, for each year, the three-year *forward* bank industry exit rate for those banks that were in the top and bottom quartiles of NIM performance during the *prior* two years. For example, for the 2004 vintage, the ratio of NIM in 2004 over NIM in 2002 is used to rank the banks and create the top and bottom quartile NIM performance groups—the NIM ranking process is repeated for every year. Each vintage is tracked over the following three years to determine exit rates. Bank exits can occur for multiple reasons, most often a merger.⁶ The time period shown includes both economic expansions and recessions.

Figure 4 Banks With Weak NIM Exit the Industry at a Higher Rate



Source: OCC Integrated Banking Information System
 Note: FDIC-insured commercial banks with assets under \$5 billion exclude specialist banks such as credit card and trust banks.

Without exception, banks in the bottom (worst) quartile for NIM change are more likely to exit the industry. Moreover, when the evaluation is limited to recessionary periods, 75 percent of the exits for banks in the bottom quartile of NIM performance are failures; for banks in the top quartile this percentage is less than 50 percent. When the economy is weak, failure rates spike for banks struggling with NIM pressures.

The Point?

Banks will struggle to maintain high profitability as they transition from post-pandemic tailwinds and encounter headwinds from low short-term interest rates and subdued loan growth.

⁶ Bank exits take the following forms: absorption, consolidation, merger, liquidation, payoffs, resolution of conservatorships, and other closings. Failures are defined here as any FDIC-assisted exit.