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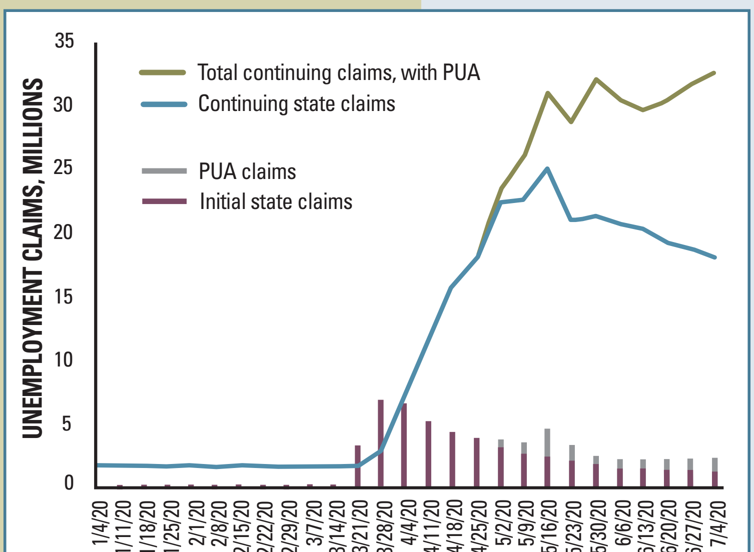
The State of Banking Amidst the Pandemic

> *The emergence of the COVID-19 crisis and the ensuing economic lockdowns produced record levels of unemployment, with 50 million state-level, first-time unemployment claims filed in the 16-week period beginning on March 21.*

With the COVID-19 pandemic dominating the societal and economic landscapes, and correspondingly the banking environment, this issue of *Bancology* focuses exclusively on the crisis, and its implications for the United States economy, financial institution balance sheets, and branch networks.

The State of the Economy

The emergence of the COVID-19 crisis and the ensuing economic lockdowns produced record levels of unemployment, with 50 million state-level, first-time unemployment claims filed in the 16-week period beginning on March 21. State-level claims still exceeded 1.3 million per week as of early July, or double the peak level during the financial crisis of 2008-09.[1] Although millions of those workers were recalled in May and June and some of the initial filings will reflect the same worker (furloughed, recalled, furloughed again), as of early July, 18 million workers remained under continuing state-level unemployment claims. In addition, 14 million independent contractors (i.e., the self-employed, delivery-service drivers, and other "gig economy" workers) remained under federal pandemic unemployment assistance program claims. Further, almost all of the nation's job growth in May and June resulted from the recall of temporarily furloughed employees, even as permanent job losses actually increased in each of those months.[2]



First-time and continuing unemployment claims

However, in contrast to 2008-09, several of the primary economic indicators, most notably housing sales, home prices, and consumer spending, remain seemingly unscathed. Across the nation, there has been little, if any, erosion in home prices, and consumer bankruptcy filings declined by 24% in the first six months of 2020 versus the same period one year prior, per the American Bankruptcy Institute. How is it that these key economic indicators, which cratered in the prior recession, have remained so resilient in this recession? Both the structure of the current recession and the legislative policy response have helped forestall the level of readily observable economic decay in the current crisis.

Most notably, the lockdown has disproportionately impacted the retail and services sectors, which rely on in-person visits for sales. But wage bases in those sectors skew lower; thus, the proportion of wages impacted by layoffs sits significantly below the proportion of workers so impacted. In a study using data from national payroll processor ADP, economists from the Federal Reserve Board and the University of Chicago found that at the trough of the COVID-induced layoffs, 35% of workers in the lowest-earning income

[1] In addition, claims under the federal Pandemic Unemployment Assistance (PUA) program hovered near one million per week in the first two reporting periods in July.

[2] Note also that while the Bureau of Labor Statistics' 'headline' U-3 unemployment level decreased to 11.1% in June, the more inclusive U-6 measure, which also counts those employed part-time but seeking full-time work, and those not actively searching for work (mostly due to pandemic lockdowns), remained at 18% of the labor force in June. And other measures, such as the sum of continuing state and PUA claims, show unemployment hovering near 19% with minimal improvement in May or June. In sum, a look beyond the headline statistics reveals an even more dire environment.

quintile had been furloughed, versus only 9% of workers in the highest-earning quintile. To date, this has remained largely a blue-collar recession, with higher-earning (and thus higher-spending) white-collar employees continuing at work, only from a home-versus office-based location.

Further, governmental programs of two types manifested immediate benefits. Direct transfer income-support payments in the form of one-time stimulus checks and expanded unemployment insurance yielded an increase in aggregate U.S. personal income of 10.5% in April versus March; and even after a 4% decline in May, aggregate personal income still remained above pre-pandemic levels. Concurrently, direct transfer grants (these grants are technically loans, but convert to grants so long as employers maintain pre-crisis payroll levels) under the Paycheck Protection Program of the federal CARES Act helped millions of businesses retain employees on payroll, preventing unemployment levels from soaring even further.

Beyond those direct payments to consumers and businesses, an array of federal mortgage forbearance programs and state / local eviction moratoria prevented immediate-term foreclosures and evictions of those who suffered income declines, protecting housing prices. Notably, a lack of inventory from homeowners reticent to enter the home-showing process in the midst of a pandemic has also helped keep home prices elevated. In addition, the housing market benefitted from lesser leverage today than in the 2008-09 crisis: home equity line and loan use has declined by nearly 50% since peaking at $610B in mid-2009,[3] and equity ratios have increased substantially. At the start of 2009 in the trough of the financial crisis, owners' equity represented 36% of aggregate U.S. home values (i.e., for every $1,000 a home was worth, consumers held $640 in mortgage debt and $360 in equity), and even in the pre-crisis year of 2007 the ratio hovered around 52%; but at the onset of the COVID crisis that ratio had grown to 65%.

With these support mechanisms able to bridge the gap for many consumers and businesses until lockdowns eased, the nation may have averted a depression; but numerous warning signs remain for a sustained recession. There have been countless articles debating the 'letter shape' of eventual recovery, with those letters referencing the general shape of a plot of some economic indicator (e.g., consumer spending, gross domestic product, employment rate, personal income). For example, the V-shaped recovery would occur with a quick and sharp bounce back to pre-pandemic levels; the U-shaped recovery would involve a more gradual ascent to prior levels; and a W-shaped recovery could experience some level of backsliding after an initial rebound, prior to full recovery.

However, a most likely and unfortunately troubling scenario may most closely resemble a distorted version of the square root symbol, with the 'long' and 'short' sides reversed. That is, we may see demand initially rebound in a shape indicative of a 'V', but then plateau at some level below pre-pandemic pace; and this would imply treacherous conditions over the next six months. Absent a COVID-19 vaccine, several factors will continue to create substantial headwinds for the economy.

Foremost, at some point the aforementioned support payments and forbearance / eviction-moratorium programs will winnow or expire completely. Though uncertain at present, an additional round of federal support may be forthcoming, but likely at a lesser income-replenishment level than in the initial wave of relief measures. Already there is some evidence of firms indicating layoffs immediately following exhaustion of Paycheck Protection Program funds. Note also, even as consumer bankruptcy filings declined in the first six months of the year, commercial bankruptcy filings increased by 26% in that same period, and any continuation of that trend will bring added layoffs, too.

Even as retail firms reopen, a sharp decline in oil prices – partially attributable to supply decisions by foreign producers and partly attributable to demand declines for driving in a work-at-home environment and for air travel – will continue to drag on employment and investment in the energy sector that contributes 8% of U.S. gross domestic product. Further, consumer reticence to travel and dine out will continue to impair the hospitality sector that employs 10% of U.S. workers, just as reticence to enter stores will burden the retail sector.

In concert, these economic hardships will ensure unemployment remains well above pre-pandemic levels; and coupled with the expiration of income-support and forbearance programs, will likely accelerate consumer defaults and erode home prices – two typical recession events that policy decisions have to date mitigated.

Continued economic slowdowns will bring second-order impacts, too. The downtown restaurant that loses traffic as some portion of the workforce remains on work-from-home status; the stores in a college town where only a proportion of students and faculty return to campus while others utilize online classrooms; the landlords who own shopping centers with vacated retail storefronts; the accounting firm with fewer clients as companies vanish…all will suffer revenue losses, sometimes at lethal levels. And notably, many of these second-order impacts will migrate up the wage ladder, bringing more permanent white-collar job losses, versus the sometimes-temporary, blue-collar service sector furloughs.

To conceptualize these impacts, consider the effect of anything less than full recovery; for example, if consumer spending revives to 90% of pre-pandemic levels. At first glance, 90% sounds encouraging; after all, it's an "A" grade on a test. But how many firms can withstand a 10% revenue loss? Consider a firm that sells $110 of product with expenses of $100, for a healthy 10% margin. But assume those $100 in expenses divide $50/$50 between fixed costs such as rent and insurance, and variable costs such as personnel and materials. If demand declines by 10%, revenues fall to $99. And the owner can reduce variable costs by a corresponding 10%, from $50 to $45.

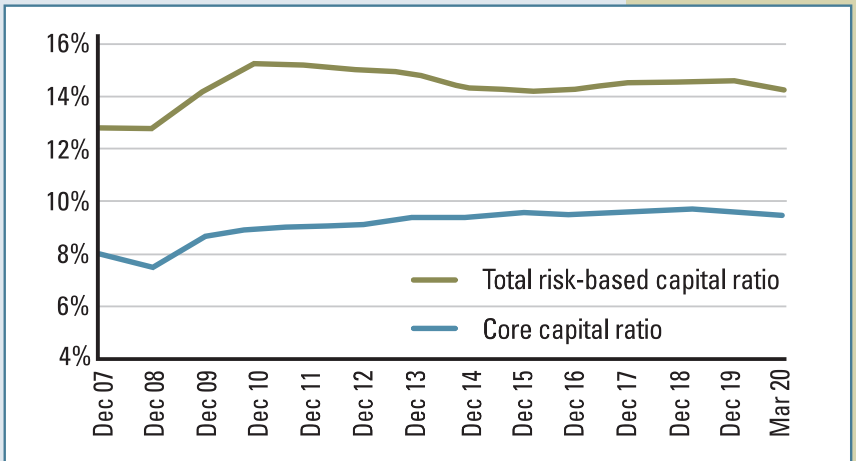
To date, this has remained largely a blue-collar recession, with higher-earning (and thus higher-spending) white-collar employees continuing at work

[3] Both the home equity line and loan statistics and the owners' equity data are from the Federal Reserve Board's Flow of Funds Accounts tables.

But the fixed costs are exactly that, remaining fixed at $50; bringing total expenses to $95 and reducing the firm's margin to 4%, a level that may not warrant continued operations. So, a 10% reduction in revenue created a 60% reduction in profits. Though simplistic, the example conveys the key points that a small decline in revenue can erode a significant proportion of profits; and that for many firms, it's only those last marginal sales that create profits sufficient to offset fixed costs. Accordingly, a real-world recovery to 90% of pre-pandemic level demand could prove catastrophic for numerous firms, and for the economy overall.

Finally, consider the 80/20 rule, the adage that at many businesses, 20% of customers account for 80% of revenues. Though the proportions vary by industry, the heuristic of a top-heavy customer base holds true at many businesses; and in the consumer sector, affluent individuals with greater discretionary spending power tend to form most of that 20%. Thus, as the second-order effects ensnare more higher-earning, white-collar employees, more businesses will suffer as even top-tier clients reduce visits, underscoring how little margin there is for even a modest decline in sales activity.

In considering the impact of unemployment, consumer spending, and similar statistics, it is critical to focus on levels rather than flows. Because the pandemic created such abrupt and severe disruption in the economy, numerous indicators will show meteoric percentage gains. For example, from the end of April to the end of June, TSA passenger counts at U.S. airports increased by 400% (yes, quadrupled!), seemingly good news. But those end-of-June totals reached only 25% of the levels of June 2019. Similarly, record-setting employment gains in May and June recouped only about one-third of total job losses of March and April; and even a recovery that brings unemployment to the 7% - 8% range would leave the economy at historically unsettling levels. In sum, a recovery in the 'distorted-square-root' shape described above would herald an acutely troubled economy.



The banking industry entered this recession with a much stronger capital position than the 2008-09 financial crisis

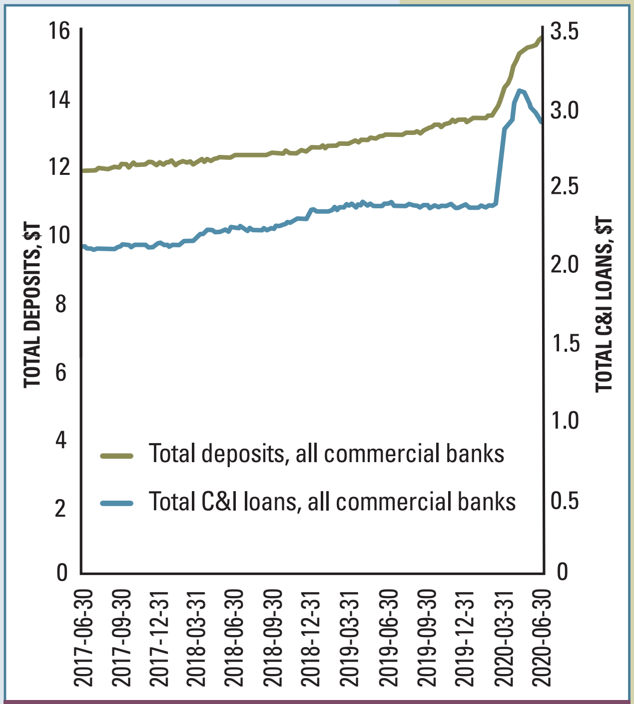
The State of Bank Balance Sheets [4]

Given the economic factors discussed in the prior section, where does this leave bank balance sheets? Much as with consumers' individual portfolios, in the early stages of the pandemic bank balance sheets remained robust and healthy, but fraught with harbingers of trouble ahead.

To the positive, the banking industry entered the COVID-19 crisis in a much stronger position than it entered the 2008-09 financial crisis. Due to a raft of regulatory actions that emerged from the 2008-09 crisis, banks and credit unions hold vastly stronger capital positions than at the onset of the last recession. Onerous as the new capital adequacy, stress test, and loan-reserve policies may seem, they likely prevented the COVID health and economic crisis from spiraling into a financial crisis, and for that we should all collectively thank our regulators.

In another positive, the industry enjoys ample liquidity with deposit balances soaring due to inflows from federal stimulus programs and consumers' reticence to spend in an uncertain economy. Between March 30 and June 15, total deposits in U.S. banks increased from $13.5T to $15.5T, as businesses deposited the proceeds of Paycheck Protection loans and consumers deposited stimulus checks and enhanced unemployment benefits. Many businesses obtained the PPP loans as a 'rainy-day' buffer in the event of a more severe or longer-than-expected downturn; but in the near term, with ample cash on hand, they simply parked the PPP proceeds in their checking accounts.

Similarly, many consumers saved rather than spent stimulus funds in anticipation of needing those funds as other benefits expired. Correspondingly, some consumers utilized mortgage forbearance or rent deferral programs even if not immediately needed, but in a risk-averse hedge against future needs. Finally, note both business and consumer spending declined not only because of economic uncertainty, but also for the simple reality of having fewer places to spend; e.g., a business not sending employees to a cancelled conference; a family delaying a vacation due to lockdowns. In sum, these business and consumer behaviors leave banks with record-level deposits.



The sharp upturn in deposits and loans reflect the arrival of PPP loans and other stimulus deposits

[4] *Unless noted otherwise, all statistics in this section are from the Federal Reserve Bank of St. Louis and include only commercial banks, but not credit unions. In that total assets in the industry divide 92% in banks versus 8% in credit unions, the bank-only data are highly indicative of the status of the industry overall.*

Bankers should prepare business cases for various points along the continuum spanning from "current depressed activity levels turn permanent" to "everything reverts to prior state." As long-term trends emerge, they can then pursue the appropriate tactics in reconfiguring branch networks.

Yet these deposits will inevitably erode as income support measures wane; and concurrently, troubles will heighten on the asset side of the balance sheet. On the commercial side, commercial and industrial loans showed a jump, mirroring the business deposit inflow, as PPP borrowings elevated aggregate bank C&I loans from $2.4T in mid-March to $3.1T in early-May. However, by the end of June, that total had regressed to $2.9T, likely reflecting the pay down of existing loans with limited replenishment in an economy with fewer firms seeking to borrow for immediate expansion or operations. (Note this contrasts with many of the largest firms, e.g., the "Fortune 1000" group, which have aggressively issued debt securities to secure long-term cash needs at minimal interest rates.) As the PPP loans convert to grants and roll off of banks' balance sheets, the lack of traditional C&I demand will threaten earnings levels.

Commercial real estate loan volumes showed modest increases in the early months of the pandemic, likely as in-process transactions closed; but balances appear to have plateaued in June. More concerning, delinquency rates in CRE loans had increased to 82 basis points at the end of the first quarter, after hovering near 68 bps in each of the prior three quarters, raising fears over what second-quarter reporting will show for that measure. For one indicator, bond-rating firm Fitch reported delinquencies within commercial-mortgage-backed securities instruments rising from 1.46% in May to 3.59% in June – the largest one-month increase on record – and the firm projects the delinquency rate to peak near 8.5% in the third quarter, a harrowing harbinger for banks' on-balance sheet CRE portfolios (and possibly for their investment portfolios).

On the consumer side, indicators remain similarly alarming. Consumer loan balances (a category that includes credit card, automobile, and most other non-mortgage borrowings) have declined by 6% since the onset of the COVID crisis. And though consumer real estate balances have remained stable, loss levels in those portfolios appear certain to increase. Data from the Census Bureau's Household Pulse Survey and mortgage-software provider Black Knight showed that as of early July, 8.5% of U.S. mortgage holders had enlisted in some type of forbearance program. As noted, some of those may have opted into the program preemptively, not because of immediate difficulty in meeting payments, but in case of future job loss. But of those loans in forbearance, 46% made a payment (partial or full) in April, but only 30% in May and 24% in June, suggesting increasing financial hardship as the lift from stimulus checks fades. Although most institutions sell forward the vast majority of mortgages they originate, many legacy thrifts and credit unions still carry sizable mortgage portfolios, and many other banks maintain some proportion of originated mortgages in portfolio.

A corollary on the rental side: according to the National Multifamily Housing Council, 77.4% of renters paid rents due at the start of July, versus 80.8% in June and 79.7% one year prior. These lapsed payments would affect the landlord's commercial mortgages, not consumer mortgages; but the trend in payment difficulty mirrors that of the homeowner segment.

The earliest crisis impacts may be reflected in an increase in nonperforming loans, which accelerated from a total of $83B across all U.S. banks as of December 31, 2019 to $88B as of March 31. But bankers clearly anticipate further challenges, as the industry's aggregate allowance for loan losses grew from $113B as of March 31 to $152B as of June 30.

In sum, absent an extension of fiscal stimuli or a marked, rapid recovery in the employment market, the expiration of income support, mortgage forbearance, and rent-deferral programs will tax consumer finances, not only accelerating credit losses but also hampering consumer spending to a degree that will further pressure business viability. Thus, we should anticipate reduced earnings; and though bankers can to some extent accelerate the recovery by keeping credit (prudently) available, in the near term the industry will remain constrained by macroeconomic trends.

The State of Branch Networks

Whenever banks and credit unions face earnings challenges, the branch network emerges as an obvious target for expense reduction. At typical retail-driven institutions, branch operations account for about two-thirds of total noninterest expenses. In that the forced closing of branch lobbies during the pandemic has driven consumers into other channels, it has correspondingly raised a question of whether institutions need to reopen all their branches.

In assessing this, first keep in mind the fundamental role of the branch is not as a transaction processer; that is simply a cost we absorb for the convenience of our account-holders. Rather, the branch exists to add new accounts, to recruit customers into the institution and to ensure bankers meet clients' continually evolving needs with the appropriate products and services throughout their lives. And in this role, the personal interaction that branches deliver can provide both value and differentiation, especially for smaller institutions.

Still, earnings constraints may demand cost reductions, and if so, the top consideration should be to consolidate around existing strongholds. This would include paring one-off forays into markets where the franchise lacks the critical mass to leverage the network effect – the phenomenon whereby larger branch networks capture a disproportionate share of balances as consumers seek omnipresent live/work/shop branch coverage.[5] Correspondingly, it also implies maintaining branch depth in areas where the institution already enjoys a strong incumbent position.

Further economies may lie in converting from a traditional operating model, where every branch functions essentially as a miniature bank unto itself; to a hub-and-spoke model, where only certain functions are delivered by on-site personnel

[5] *See Bancology Volume 62 for an in-depth discussion of the network effect at http://www.bancography.com/downloads/Bancology0417.pdf*

at every branch, while other functions migrate to centralized delivery. For example, in a cluster of four branches within a three-to-five mile span, one hub might maintain on-site personnel for all functions, but the three other branches would fulfill only basic requests such as checking, savings, and installment loan openings with on-site personnel; while addressing more complex requests such as business loans, mortgages, and wealth management services by appointment via officers domiciled at the hub.

The hub-and-spoke model can even be expanded to include management as a centralized function, wherein the manager of the hub of the branch cluster oversees all branches in the cluster in their sales agenda and operations, leaving a senior CSR (deemed the customer service manager) as the highest-ranking officer on site at the spoke branches.

If those actions cannot deliver sufficient expense reductions, an institution may need to consider in-market consolidations. And while incremental branch contraction represents the most risk-averse approach, any evidence that the pandemic has permanently shifted consumer preferences to remote channels could allow more radical configuration. If bankers believe consumers have adopted to reduced branch availability, that could allow migration to a model where electronic channels assume the role of spoke branches. Under this "hub-and-hub" model, institutions would retain only the highest-volume branches as flagships offering the full array of products and services, but shunt simple account openings and maintenance requests to online, call center, or interactive teller machine channels.

Inherent in this approach though, is that the surviving hubs, the flagships, become essential representations of the institution's brand; meriting investment in interior and exterior design and merchandising. With fewer outposts to create brand awareness, the flagships gain increased prominence as "financial superstores" presenting the full extent of the institution's offerings; and note also, visible evidence of investment in remaining facilities would mitigate the adverse perceptions of broad branch closures. Presented as part of a strategic shift that enhances the service experience at the surviving branches, the strategy can plausibly reduce noninterest expenses without risking attrition. However, if widespread branch closures occur without offsetting investment in surviving branches, consumers may (rightfully) perceive a distressed institution focused more on survival than client needs, accelerating the institution's decline.

Even with profitability challenges forcing an examination of expenses, stronger banks and credit unions may still want to consider expansion opportunistically. The commercial real estate issues discussed in the prior section should reduce land and lease prices for new branches (and also give bankers favorable leverage in renegotiating current leases). Further, given the long lead time between the decision to add a branch and actual opening, the branch you start pursuing today could open into a reviving economy in mid-2021.

Irrespective of long-term branching strategies, bankers must adopt several immediate changes to the branching model for the duration of the COVID crisis. First and most important, plan for the contingency of having to close branches due to customer and/or staff COVID infections. Don't wait until the first outbreak to develop a strategy, but have on retainer a vendor to clean and sanitize the facility; plans for contact tracing of the affected employees relative to others at the bank they may have visited; plans for how you will notify customer and regulators of temporary closures; and similar.

One strategy may involve grouping branches in geographic clusters; and then opening all but one, keeping the closed branch in reserve as a 'clean' facility, ready to bring online should an outbreak affect an entire community. Plan also for float and call center staff to backfill branch roles; keep in mind, a branch can be sanitized in a couple of days for reopening, but exposed staff may need to quarantine at home for two weeks.

The COVID-19 crisis has rendered drive-ins imperative, and every institution should consider how best to utilize those; for example, is there benefit in extending hours to offset closed lobbies? Even as lobbies reopen, social distancing requirements may be a catalyst for consumers to adopt interactive teller machines driven by remote-based representatives; and for bankers to initiate or accelerate the deployment of that technology.

Similarly, bankers should evaluate deployment of contactless ATMs, where the consumer places their cash order online or through a mobile device, receives a Quick Response (QR) code sent to their phone, and then waves the phone under a scanner on the ATM to receive the ordered cash. Though invented for speed and security, contactless ATMs would reduce the user touchpoint to only the actual cash dispensed, giving a safety-based predicate for consumers to select an institution.

The degree to which bankers pursue branch network reconfiguration and new technologies should reflect beliefs regarding the duration of the COVID crisis, and the extent to which branch activity levels will return post-crisis. Although there is a defensible viewpoint that the crisis will precipitate acute permanent declines in branch transaction levels, a counterargument could posit that the early adopters of electronic channels exited the branch channel long ago, and the remaining mixed-channel and branch-dependent users will drift back as lobby availability returns.

As such, bankers should prepare business cases for various points along the continuum spanning from "current depressed activity levels turn permanent" to "everything reverts to prior state." As long-term trends emerge, they can then pursue the appropriate tactics in reconfiguring branch networks. But in the immediate term, all bankers should be considering opportunities to increase branch network operating efficiency, to offset near certain declines in revenue and increases in credit losses as the recession drags onward.

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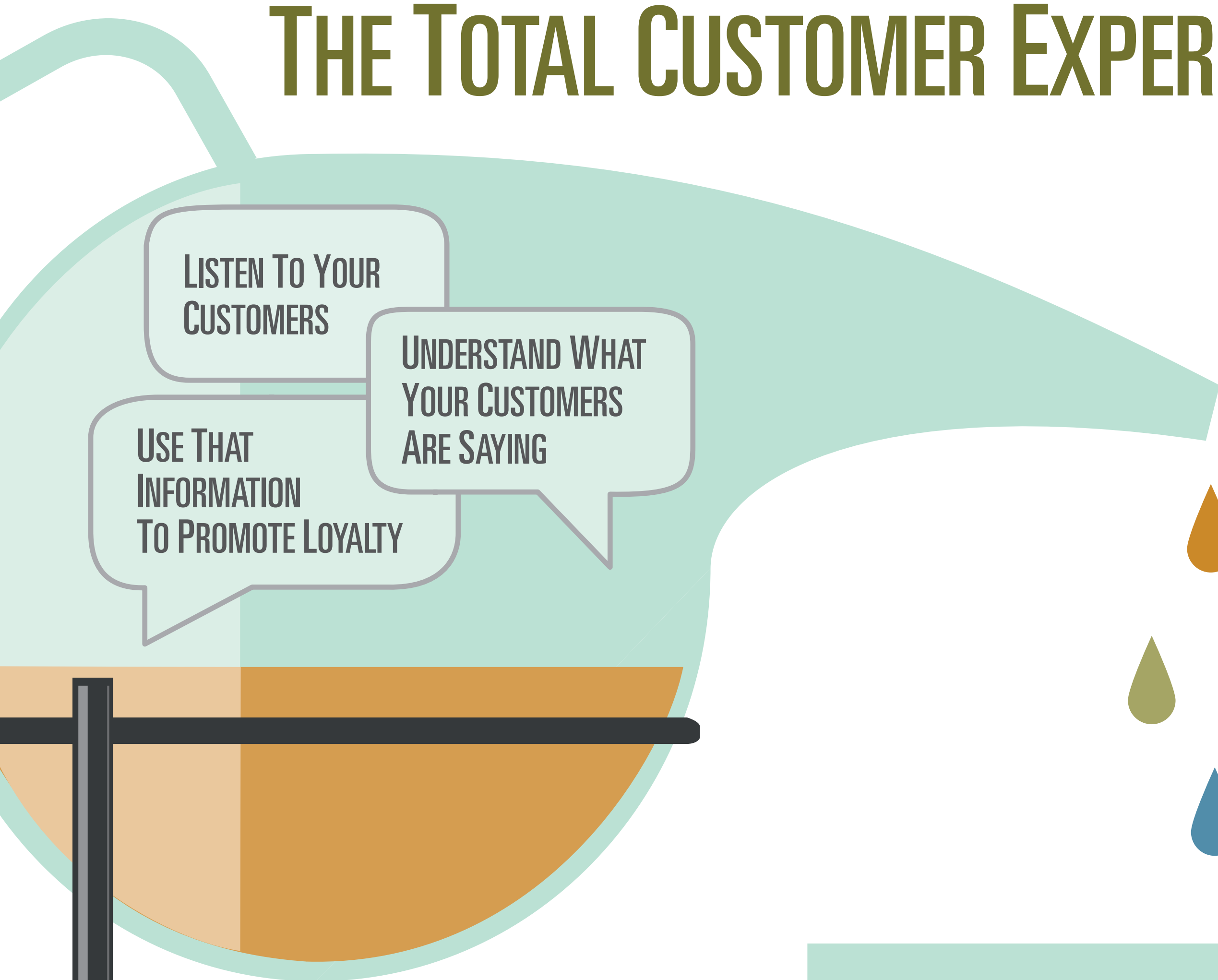

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