Section I: Executive Summary

After a prolonged period of relative stability, economic conditions deteriorated sharply in March 2020 following the onset of the COVID-19 pandemic and closure of several key industries. The consumer, business, and banking sectors overall had entered 2020 in relative strength. Although corporate debt fundamentals raised concern, smaller businesses were growing and consumer balance sheets were strong. Many sectors of the economy were challenged as the pandemic unfolded, but federal programs provided timely and important support to affected industries and consumers throughout the year. The banking industry remained resilient entering 2021 despite the extraordinary challenges of the pandemic. Strong liquidity and capital levels at the start of 2021 should help to mitigate potential asset quality deterioration across loan portfolios.

The economy entered the deepest recession in modern history in 2020 as millions of individuals lost their jobs and many small businesses closed. The unemployment rate rose to a record high and an unprecedented number of people filed for unemployment insurance.[2] Extensive fiscal and monetary policy helped limit the impact of the crisis and prevent mass business bankruptcies and consumer defaults. Conditions remain weak for many service industries including restaurants, retail, entertainment, travel and tourism, and other discretionary services that do not allow for remote work. The economic environment poses a significant source of risk for the banking industry as the pandemic continues into 2021. Even after vaccinations are dispensed broadly across the population, the recovery for some of the most affected industries remains uncertain.

Financial market conditions deteriorated sharply with heightened stress in early 2020, but most markets have since recovered. In March 2020, the onset of the pandemic severely disrupted financial markets, and equity and corporate bond markets saw sharp selloffs. Market conditions improved with the help of unprecedented federal support programs. Most markets fully recovered throughout the rest of 2020, and some exceeded pre-pandemic levels.

The banking sector, though challenged by economic and financial market conditions, remained relatively resilient in 2020 and was a source of stability to the economy. The banking sector was helped by strong capital and liquidity levels as well as various government programs that enabled banks to extend loan forbearance and to provide support for consumers and businesses. Industry balance sheets remained sound through 2020, but banking income declined substantially. FDIC-insured institutions reported a 36.5 percent decline in income between 2019 and 2020, which was primarily driven by a sharp increase in provision expense during the first half of the year. Bank liquidity was supported in 2020 by a record increase in deposits. Deposits surged 22.6 percent between 2019 and 2020. The banking industry loan portfolio increased in 2020, primarily because of growth in commercial and industrial loans, including those made through the Small Business Administration (SBA) Paycheck Protection Program (PPP). Asset quality indicators deteriorated modestly but remained considerably better than those reported during prior recessions, partly because of government support extended during the year.

[2] The unemployment rate as measured by the Bureau of Labor Statistics based on the Current Population Survey reached the highest level since record collection began in 1948.

Key Risks to Banks

FDIC-insured institutions faced a challenging landscape in 2020. Federal support programs cushioned the nation's economy and muted the effects of the pandemic on the banking industry, but close monitoring of key risks remains essential. The discussion of risks in this report is organized by topic and ordered alphabetically, not by level of risk.

Credit Risk: Banks are exposed to an array of credit risks. In 2020, these risks intensified as the economic contraction unfolded. Banks remained relatively resilient partly because of government support extended to businesses and consumers most affected by the recession. However, institutions with elevated levels of credit exposure to affected sectors are potentially more vulnerable to market disruptions and could present risk management challenges.

- **Agriculture: The agriculture industry withstood the volatile 2020 marketplace with the help of record levels of government assistance and a rebound in commodity prices.** As a result, agriculture bank conditions were sound as 2020 came to a close. Strong farmland equity has enabled farmers to restructure loans to manage operating losses and replenish working capital. Asset quality at farm banks remains favorable. Net farm income in 2021 is expected to decline from last year but remain higher than historical levels.

- **Commercial Real Estate: The pandemic challenged commercial real estate (CRE) market conditions in 2020.** Conditions weakened sharply in lodging and retail sectors at the pandemic's onset, and other property sectors face uncertainty. Increased use of remote work and potential shifts in behavior and preferences could influence the CRE outlook. The volume of CRE loans held by FDIC-insured institutions reached a record high at year-end 2020. Acquisition, development, and construction loans—historically, a riskier category of CRE loans—grew slightly in 2020 but were nearly 40 percent below the 2008 peak. Among FDIC-insured institutions, CRE loan performance metrics remain at manageable levels as loan accommodations have become part of the lending landscape.

- **Consumer Debt: Conditions for consumers deteriorated with the onset of the pandemic as business closures contributed to double-digit unemployment.** Government programs have helped support household balance sheets and consumer loan performance during the pandemic. Consumer loan volumes fell in 2020 as households pulled back on spending and used savings to reduce outstanding loan balances. While government support and improving economic conditions have helped consumers stay current on their loans, the outlook for consumer asset quality remains uncertain. An improving economy may result in stronger consumer loan performance and increased consumer lending opportunities.

- **Energy: The energy market deteriorated sharply in 2020, but banks with exposure to lending in this sector remain resilient.** Energy demand declined worldwide with the onset of the pandemic, causing energy prices to plunge. The market had already experienced substantial oversupply from a production policy impasse within the OPEC+ coalition and near-record U.S. production. After falling in early 2020, oil prices improved during the second half of the year as supply and demand imbalances improved. Oil and gas producers continue to face many challenges. Poor operational performance and escalating environmental, social, and governmental risks contributed to capital scarcity for producers. Banks with significant exposure to the energy market have shown resilience to these challenges.

- **Housing: Housing activity recovered strongly in 2020.** After housing sales and starts deteriorated immediately after the onset of the pandemic, conditions recovered strongly during the rest of 2020. Low interest rates, increased demand to accommodate remote work, and a limited supply of homes contributed to record home price increases in 2020. Banks have benefited from increased housing market activity with slightly higher lending volumes and strong refinancing activity, although loan performance metrics of 1–4 family residential mortgages at FDIC-insured institutions weakened slightly in 2020.

- **Leveraged Lending and Corporate Debt: Corporate debt markets experienced disruptions early in the pandemic, but Federal Reserve actions helped to restore stability to bond and leveraged loan markets.** Corporate debt levels were elevated before the pandemic and increased further in 2020 as bond issuance surged, pushing corporate debt-to-GDP to an all-time high as the level of corporate debt rose and GDP declined. Banks remain exposed to risks in corporate debt markets through direct loans and lines of credit to corporations, holdings of collateralized loan obligations, and participation in the arranging of leveraged loans and corporate bonds, as well as indirect macroeconomic effects of corporate debt distress on other loan portfolios. Banks with concentrations in loans to firms in especially hard-hit industries could face elevated credit losses as those firms struggle to recover from the pandemic.

- **Nonbank Financial Institution Lending: Bank exposure to nonbank lenders increased significantly in 2020, particularly in mortgage lending.** Nonbank financial institutions relied on bank lending amid the uncertainty at the onset of the pandemic. Most of the lending to nonbank financial institutions occurs at the largest banks, but some community banks are a source of lending to nonbank mortgage lenders. The growth in banking sector exposure to nonbank financial institutions in 2020 increased the industry's vulnerability to risks from nonbanks and their lending activities.

- **Small Business Lending: Small business conditions weakened significantly at the onset of the pandemic as stay-at-home orders and changing consumer behavior reduced economic activity.** However, small business lending increased in 2020 primarily because of bank participation in the PPP. Further, small business closures and bankruptcies did not translate into credit deterioration in 2020. While asset quality remains at manageable levels, the long-term effect of the pandemic on small business asset quality is uncertain and remains an important source of credit risk for banks.

Market Risk: The low interest rate environment presents earnings challenges to banks. However, bank liquidity positions remain strong as deposits grew rapidly in 2020. Uncertainty in the economy, coupled with a sudden rise in deposits, led many community banks to allocate a higher percentage of assets to readily available liquidity sources. Community bank reliance on wholesale funding decreased as deposits rose.

- **Interest Rate Risk and Net Interest Margin: The low interest rate environment continues to pressure banking sector profitability.** The net interest margin reached a record low as asset yields declined more than funding costs. The ratio of loans to total assets also declined for community and noncommunity banks in 2020, as strong deposit inflows exceeded loan demand. Community banks face interest rate risk challenges in a low interest rate and tepid loan environment.

- **Liquidity and Deposits: Banks entered 2020 with strong liquidity, and deposit growth during the year further increased liquidity levels.** Deposits surged during the pandemic, as consumers and businesses responded to uncertainty by stockpiling cash. Federal programs created to mitigate economic stress contributed to unprecedented deposit growth. Increased on-balance sheet liquidity reduced many community banks' reliance on wholesale funding. While industry liquidity improved last year, sudden changes in depositor behavior as pandemic conditions evolve warrant monitoring.