Office of the Comptroller of the Currency

ON POINT

ECONOMIC AND POLICY INSIGHT FROM THE OCC

Pandemic Provisioning Reflects Economic Stress

The COVID-19 pandemic brought economic activity to a halt in the second quarter of 2020. Lockdowns affected all but the most essential businesses, causing unprecedented economic disruption, which persists in varying degrees today. Oil and gas and "high-touch" industries,[1] particularly leisure and hospitality, transportation, and retail, which were directly affected by social distancing measures, experienced more economic stress than other industries in which remote work and other accommodations mitigated the adverse pandemic effects. These stresses remain and are reflected in how small banks[2] are approaching credit loss provisioning for these industries.

Concentrations of High-Risk Sectors

The pandemic has not affected all types of economic activity in the same manner. To evaluate the pandemic's impacts, the OCC Economics Department adapted a Bank for International Settlements (BIS) methodology that identifies high-risk industries using local labor market information. In addition to high-touch industries, the BIS definition of high-risk industries includes energy-related sectors because of the massive reduction in transportation fuel demand that resulted from the pandemic lockdowns and heightened fears about air travel. This list is further supplemented with industries that experienced severe job losses in April of 2020. In total, 25 three-digit North American Industry Classification System (NAICS) industries[3] were identified as high risk. Counties are then considered high risk if at least 50 percent of their total employment is in these high-risk industries, and low risk if the share is no more than 25 percent of total employment in these industries. Figure 1 below illustrates the geographic distribution of counties of various risk levels.

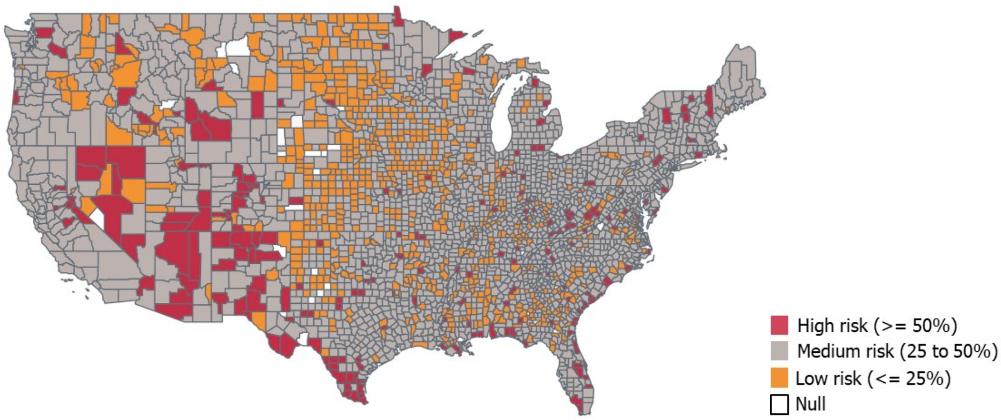
[1] High-touch industries are those that are most reliant on interpersonal customer interaction (as validated by data from Google trends). Refer to "Identifying regions at risk with Google Trends: the impact of Covid-19 on US Labour markets," https://www.bis.org/publ/bisbull08.htm

[2] Small banks are defined as banks with $5 billion or less in assets.

[3] The first two digits of a NAICS code designate the sector (e.g., Manufacturing), and the third indicates the subsector (e.g., Chemical Manufacturing).

As shown in figure 1, high-risk counties take a few forms. They include larger counties that have greater shares of leisure and hospitality, areas reliant on tourism and travel on the coasts and in other popular vacation spots, and energy-heavy areas in the Southwest.

Figure 1: Employment in High-Risk Industries as Percent of Total Employment



Sources: County Business Patterns, 2018 United States Census, OCC Economic and Policy Analysis calculations

Small Bank Credit Provisioning in High-Risk Areas

Credit provisioning by the banks serving these high-risk counties can be used to evaluate the effects of the pandemic. The focus is on banks with less than $5 billion in assets as they are most likely to be operating in a smaller geographic area and, therefore, more affected by local economic conditions..

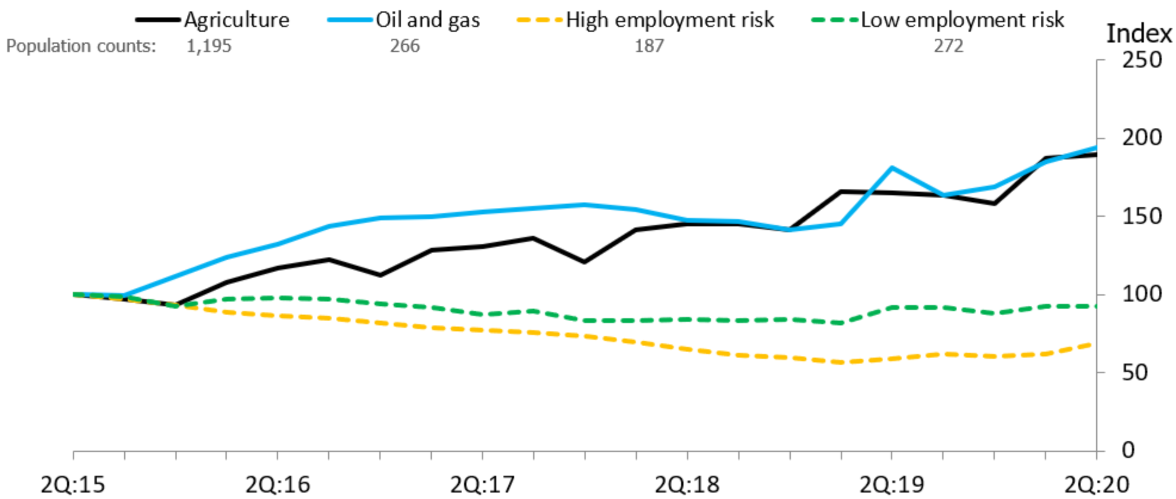
As a start, rates of nonperforming loans (NPL)[4] are explored across different groups of banks. Figure 2 shows these rates separately for four mutually exclusive categories of banks, defined as follows:

- Agriculture: Banks with loan concentrations of at least 25 percent in agricultural real estate or agricultural production
- Oil and gas: Banks located in counties with at least 3.5 percent of total employment in oil and gas industries, representing the top 25 percent of counties with the highest concentration of employment in this industry[5]
- “High employment risk:” Banks located in high-risk counties, as defined above
- “Low employment risk:” Banks located in low-risk counties

[4] Nonperforming loans include loans 90 days past due plus nonaccruals.

[5] Note that in figure 2 and the subsequent discussion, banks headquartered in oil and gas reliant counties are grouped as “oil and gas,” but employment in these industries is still included in the criteria for subsequently identifying banks in high-risk counties.

Figure 2: Total Nonperforming Loans Indexed From the Second Quarter of 2015 to the Second Quarter of 2020 by Lender-Risk Type

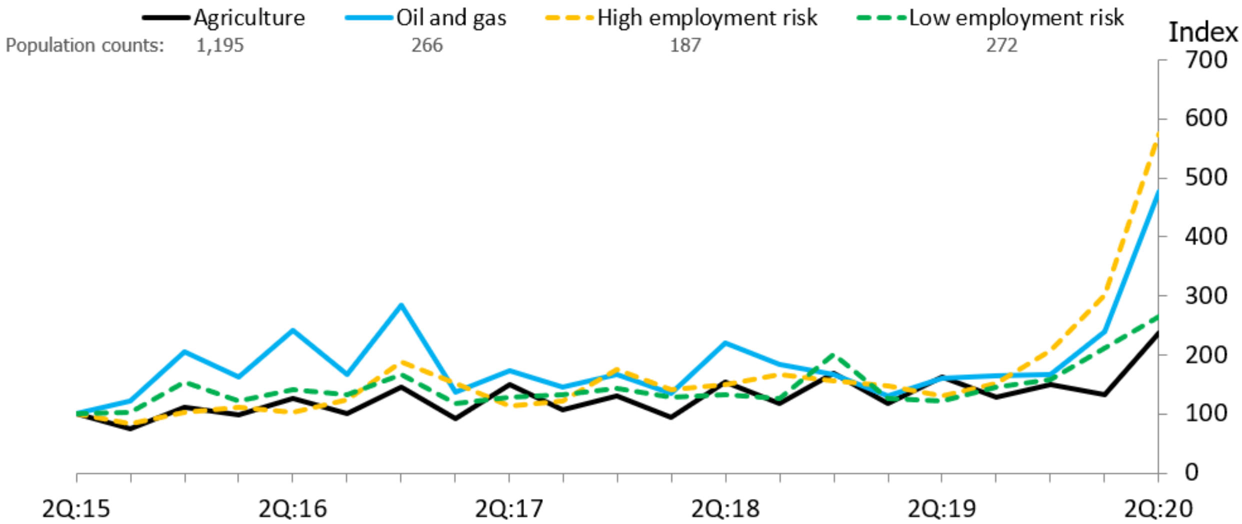


Sources: OCC Integrated Banking Information System, County Business Patterns, 2018 United States Census, OCC Economic and Policy Analysis calculations

Two key patterns emerge from figure 2. First, agricultural and oil and gas banks already experienced some stress prior to the pandemic given the increase in the rate of NPLs since 2015. Second, there has not yet been a marked increase this year in the rate of NPLs in any of these bank categories, despite the pandemic. Various forbearance programs have helped keep the number of NPLs in check. As these programs expire, banks could see increases in the rate of NPLs and, eventually, more defaults. For banks in the high-employment-risk group, however, NPLs had been declining for the past 4 years, before starting to edge up in the first quarter of this year—coming out of a relatively benign credit period. Keep in mind that the loans indexed in figure 2 are loans that were at least 90 days past due as of June 2020, reflecting loans that were already under stress before the pandemic.

Loan loss provisioning can provide a view into the extent to which banks are anticipating losses. Reserving for future losses requires banks to form an expectation of how their loans will perform in the future. A review of provisions can serve as a forward-looking indication of what banks are anticipating. A look at the loan loss provisioning for these four bank categories shows that banks in areas with significant exposure to the oil and gas sector, or to the high-risk industries significantly increased their loan loss provisioning in early 2020, as shown in figure 3 below.

Figure 3: Loan Loss Provisions Indexed From the Second Quarter of 2015 to the Second Quarter of 2020 by Lender-Risk Type



Sources: OCC Integrated Banking Information System, County Business Patterns, 2018 United States Census, OCC Economic and Policy Analysis calculations

In general, loan loss provisions stayed fairly stable from 2015 to 2019. But in the first two quarters of 2020, provisions increased substantially, particularly for banks operating in the riskiest local economies.

A caveat is in order here. Starting in 2020, most publicly traded financial institutions implemented a new accounting standard that required them to calculate loss reserves for the entire life of the loan, whereas under the previous standard, the horizon was typically shorter. Nonpublicly traded institutions will implement the new standard starting in 2023. As a result, many financial institutions saw their loan loss reserves increase in the beginning of 2020, before any effects from the pandemic were felt. However, most smaller banks (with less than $5 billion in assets) are 2023 adopters of the standard, so the change in the accounting standard is unlikely to have had a significant effect on 2020 provisioning at these banks. Therefore, the data suggest that the pandemic will likely affect different economic sectors to varying degrees, and that banks with larger exposures to riskier sectors will see more significant loan losses.

The Point?

Small banks are differentiating the potential of future credit losses across various industries in a way that seems highly logical given what is known so far about the pandemic's disparate (and most likely lingering) effects on economic activity.