



# COVID-19 Impact on the Banking Industry: Lag Between Recession and Bank Distress

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Economic recessions and financial crises can [cause distress in the banking industry](#). Typically, there is a lag between the onset of a recession and the peak of bank industry distress. The economic effects of the Coronavirus Disease 2019 (COVID-19) pandemic could similarly stress the banking industry, perhaps acutely, given the sudden and unprecedented nature of the [economic contraction](#). Even though this contraction is severe, a lag is expected, and certain provisions in the Coronavirus Aid, Relief, and Economic Recovery Act ([CARES Act](#); P.L. 116-136) may lengthen it.

## Typical Lags

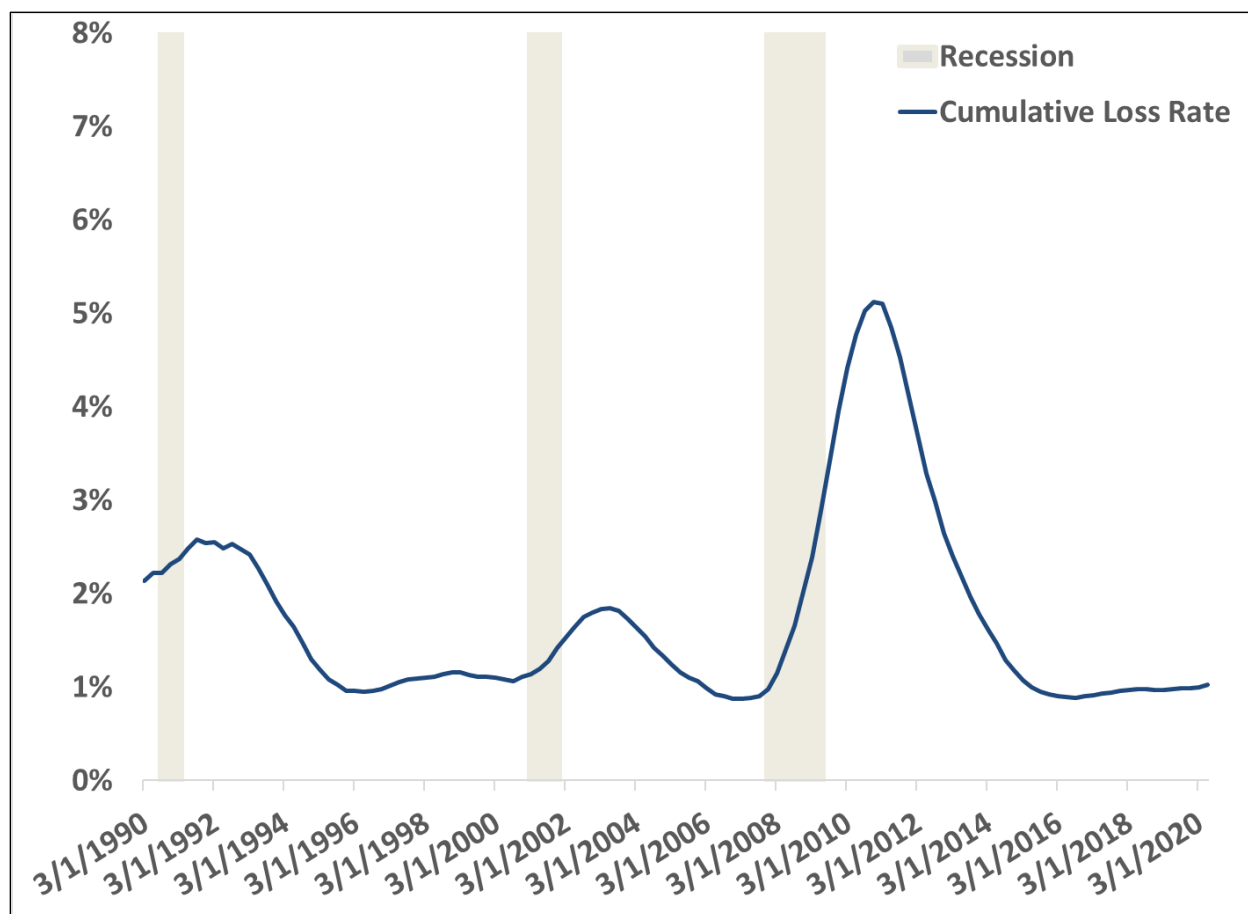
When people lose jobs or businesses revenue declines, many individuals and businesses have resources to continue making loan payments for a time. For example, U.S. [households and nonprofit organizations](#) held almost \$11.4 trillion in cash and bank accounts and another \$2.6 trillion in money market mutual funds (an instrument similar to a bank account) at the end of 2019. U.S. [nonfinancial businesses](#) held almost \$3.5 trillion in cash and bank accounts and \$808 billion in money market mutual funds. In addition, individuals who lose jobs are often eligible for [unemployment benefits](#). Reducing expenses and drawing on lines of credit (e.g., credit cards) to meet those expenses are other strategies that could allow borrowers to continue to make installment loan (e.g., mortgage) payments.

These resources can last for a time, but missed loan payments begin to grow at some point. Even then, banks have some time before they become distressed as a consequence. If a borrower were to miss a few payments, it would not necessarily mean the loan is a total loss. The borrower might find a new job, or business might start to pick back up. For this reason, a loan goes through a progression of [statuses](#) in bank records—30-89 days late, 90+ days late, nonaccrual—before the bank writes it off as a loss (called a *charge-off*). The bank tries to recover what value it can, such as through a foreclosure and sale of a property securing a mortgage. The *net charge-off* is the amount that is ultimately unrecoverable. Once losses start to accumulate, a bank may deplete its capital to a point that it is seriously impaired and in danger of failing. [Bank capital](#) can be considered the owner's investment in a bank, which includes the investment by the stockholders of bank stock, and an instrument that enables a bank to absorb losses on assets. As shown in [Figure 1](#), in the last three recessions, the two-year cumulative net charge-off rate does not peak until one to three years after the onset of a recession.

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**Figure I. Two-Year Cumulative Net Charge-Off Loss Rate, as % of Average Total Assets**

**Sources:** FDIC, *Quarterly Banking Profile: Second Quarter 2020*, at <https://www.fdic.gov/bank/analytical/qbp/>; CRS calculations.

**Note:** Two-year cumulative net charge-off rate is the sum of the most recent eight quarters of net charge-offs divided by average total assets over that period.

Given these factors, it is not surprising that the most recently available [bank data](#) does not yet show signals of bank distress.

## Potential CARES Act Effects

Certain CARES Act provisions provide funds to individuals and businesses and thus may improve their abilities to make loan payments. In addition, the CARES Act may affect how loans with missed payments progress from current to noncurrent to written off. (CARES Act [provisions and regulator actions](#) that provide regulatory relief to banks, as well as [Federal Reserve programs](#) that provide liquidity and support the macroeconomy, are beyond the scope of this Insight.)

Three large programs that provide such direct support to individuals and businesses are the [Paycheck Protection Program](#) (PPP), [Economic Impact Payments](#) (EIP), and the [expansion of unemployment insurance](#) (UI) payments. Details about eligibility criteria and other program features are available in the links in the previous sentence. Regarding the amount of funding these programs have provided,

- over 5.2 million PPP loans [totaling \\$525 billion](#) in value had been approved for businesses by the time the program expired on August 8, 2020;

- nearly 160 million EIPs totaling approximately [\\$270 billion](#) had been disbursed to eligible households by June 30, 2020; and
- people receiving UI payments received an extra \$600 per week until July 31, 2020, and these payments [reportedly totaled \\$250 billion](#) (some states have made additional UI benefits available after July 31, pursuant to an [executive order](#) issued by the President on August 8).

Another CARES Act provision requires that [certain mortgage servicers](#) grant, upon request from the borrower, a forbearance (i.e., permission to postpone payments) on certain home mortgages. Payments can be postponed for up to six months in the initial forbearance, and this can be extended an additional six months. Banks own many of the mortgages eligible for forbearance and may face challenges in accounting for nonperforming loans. As of August 10, [the number of mortgages in forbearance stands around 7.5%](#), according to one company tracking the industry. Further, numerous borrowers may exit the CARES Act forbearance period in a similar economic position in which they entered it. For example, [extended forbearances outnumbered resolved forbearances](#) two-to-one in July, suggesting a sizeable number of consumers are still struggling to make payments.

One particular concern centers on foreclosure. In normal times, when a mortgage falls 120 days behind, foreclosure proceedings can begin. ([Federal law prohibits foreclosures until after a borrower has become 120 days delinquent.](#)) From a bank's perspective, foreclosure is a process by which it can repossess a property where the borrower can no longer make payments and recover value from a nonperforming loan. During a forbearance, a borrower's status is paused; however, as the CARES Act forbearances start to expire over the next 6-12 months, mortgage servicers may be in a position of servicing a number of loans that have not been able to make payments for several months for up to 120 more days. If the concentration of borrowers exiting forbearance who are unable to continue making payments were to become significant, then banks may be facing conditions that would not be realized for several months, which could portend an increase in foreclosures.

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