



Southwest Economy



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PLUS

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President's Perspective

Rob Kaplan, president and CEO of the Dallas Fed, regularly speaks and writes on the factors that affect economic growth in the nation and Eleventh District. Here are some of his recent thoughts on key issues:

On the Need for Economic Inclusivity and the COVID-19 Crisis

“For years, blacks and Hispanics have had an elevated level of unemployment versus whites. That started to improve dramatically in the last few years. We’ve now taken a step back as a result of this crisis. But a more inclusive economy where everyone has opportunity will mean faster workforce growth, faster productivity growth, and we’ll grow faster.”

Interview on Face the Nation—June 14, 2020

On the Outlook for Fed Policy

“We’ll have to run, obviously, a very accommodative monetary policy for some extended period of time, and that’s going to have to be combined with fiscal policy in order to help the economy grow faster. You should expect the Fed will do what it needs to do in terms of accommodation.”

Interview with Yahoo Finance—May 6, 2020

On COVID-19 Testing

“I think at this stage, to recover faster, the health care policies are central. And what do I mean by that? Ubiquitous testing, contact tracing, good procedures ... I think we could spend a fraction of what we are spending on stimulus on testing and, I’ve said before, why not spend billions to avoid spending trillions.”

Interview on Bloomberg TV—May 20, 2020

On Negative Interest Rates

“We should not go to negative rates. The big reason is it’s been tried in other parts of the world. I think it’s very questionable to me whether it’s been helpful. We have a big money market industry, we have a big financial intermediary industry. Negative rates, I think, could do great damage to both of those. So I think there are other tools that we should be using, not negative rates.”

Interview on KERA-TV—May 14, 2020



Small Business Hardships Highlight Relationship with Lenders in COVID-19 Era

By Wenhua Di, Nathaniel Pattison and Chloe Smith

ABSTRACT: The COVID-19 crisis has disrupted normal small business operations and will likely limit the ability of many enterprises to stay financially afloat. Although lenders have become better equipped to evaluate risks and serve small businesses, the supply of credit tends to shrink during economic downturns.

The COVID-19 outbreak has drastically disrupted small businesses and their lenders. Millions of small enterprises are simultaneously confronting health risks, reduced demand and supply chain issues. Many were ordered closed or told they could only partially operate, creating additional financial strain.

The most vulnerable—restaurants, nonessential retailers and personal services—are in sectors that typically maintain low cash buffers.¹ Within days of public health officials calling for social distancing, less than two-thirds of American businesses remained open.²

Small businesses have struggled to arrange short-term funding to meet expenses, while their lenders have responded cautiously. Federal government stimulus programs have offered a measure of relief.

Some lenders, attempting to navigate an uncertain environment, tightened underwriting criteria.³ Still others paused making loans not backed by the federal government.

Recessions over the past two decades provide some guidance on the funding challenges small businesses face.

Economic Activity Generators

Small businesses—those with fewer than 500 employees, according to the Small Business Administration (SBA)—accounted for 99.9 percent of U.S. firms and 99.8 percent of Texas firms in 2017.⁴ Texas small businesses boast a larger share of exporters and minority-owned-business employees than their counterparts in the nation as a whole.⁵

As a vital part of the economy, these small businesses generate almost two-thirds of net new jobs nationally,

account for nearly half of private sector employees and produce one-third of exports. These companies tend to be more productive than big businesses in terms of contribution to gross domestic product (GDP) per payroll dollar.⁶

More than 90 percent of small businesses have fewer than five employees. Nonemployer firms—often the self-employed—account for about four-fifths of small businesses. Although most are profitable, their margins aren't necessarily predictive of survival.⁷ Businesses with sufficient cash or liquidity, regular cash flow and access to affordable loans are more likely to survive volatile times.

Loan Program Lifeline

Reacting to the COVID-19 crisis, the federal government and the Federal Reserve collectively responded with fiscal stimulus, lending programs and monetary policy to bring relief, including programs to support employee retention through guaranteed loans or grants.⁸

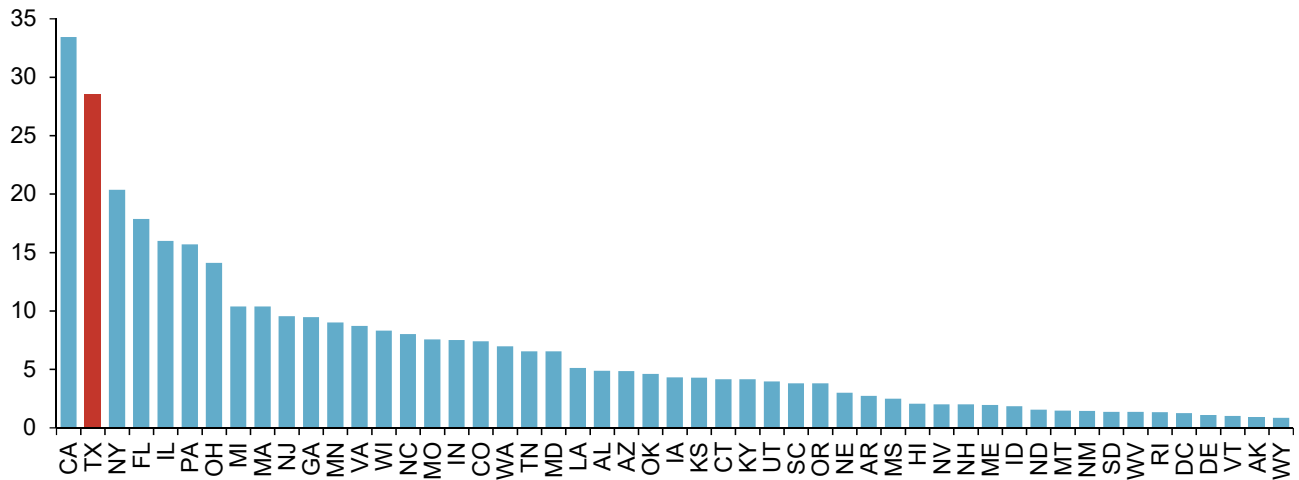
In addition to payment waivers for existing SBA borrowers and direct Economic Injury Disaster Loans with a forgivable loan advance of \$10,000, the Coronavirus Aid, Relief, and Economic Security (CARES) Act provided \$349 billion in aid (with another \$310 billion on April 24) and authorized the SBA to create a platform for the Paycheck Protection Program (PPP).

The program provides small businesses low-interest, partially forgivable, two-year loans to maintain payrolls and pay other expenses.⁹ PPP funding is largely distributed through banks and other private channels and aims to quickly inject hundreds of billions of dollars in liquidity into small businesses.

CHART 1

Texas Second Nationally in Total Paycheck Protection Program Borrowing

Approved loans (billions of dollars)



NOTE: Data show dollars approved in loans from the Paycheck Protection Program through April 16.
SOURCE: U.S. Small Business Administration.

To protect lenders against liquidity risk, the Federal Reserve established a lending facility to depository institutions on April 9. The Fed expanded eligibility to all PPP lenders, taking PPP loans as collateral on April 30. The Federal Reserve also established the Main Street Expanded Loan Facility to offer more liquidity to small and medium-sized enterprises as a supplement to the PPP program.¹⁰ These measures were intended to provide more assurance to lenders and boost available funds.

Take-up of the PPP was rapid. The program ran through its initial \$349 billion in two weeks. In this first wave, the SBA made 1.7 million loans totaling about \$342 billion through 4,975 lenders. Seventy-four percent of loans were for \$150,000 or less. Texas was No. 2 among the states in PPP dollars borrowed (\$28 billion) through April 16, behind only California, according to the SBA (*Chart 1*).

However, the amount borrowed relative to state GDP placed Texas 40th among states (1.5 percent of state GDP), with less-populous states such as Maine, Vermont and Montana in the lead at close to 3 percent.

By industry, construction borrowed the most nationally, followed by professional, scientific and technical services; manufacturing; and health care and social assistance (*Chart 2*). Accommodation and food services was in fifth place, and retail trade was sixth.

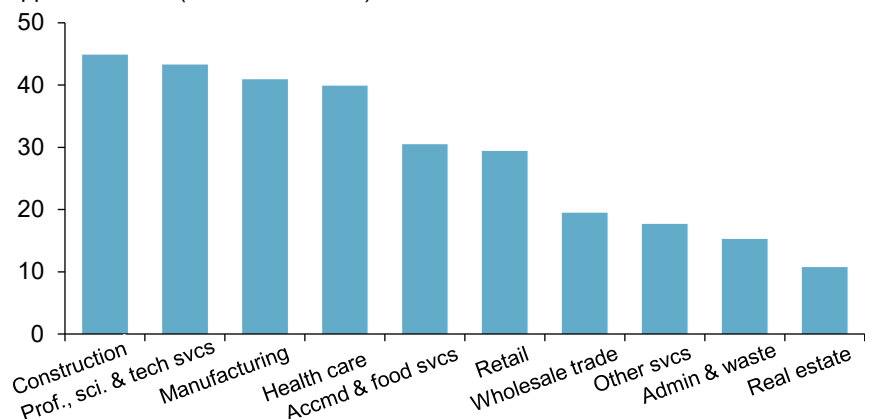
The PPP loan effort drew on the infrastructure of the SBA's flagship 7(a) loan program, which provides partial guarantees to small businesses annu-

ally during normal times. The program typically accounts for less than 5 percent of the total small business lending market. PPP loans are 100 percent guaranteed by the SBA and 20 times larger than SBA 7(a) funding. Eligibility is broadened from for-profit businesses to include all businesses with 500 or fewer employees.¹¹ Compared with the usual underwriting criteria for SBA 7(a) loans, PPP loans waived

CHART 2

Construction Gets the Most Funding in First Wave of Loan Program

Approved loans (billions of dollars)



NOTE: Data show dollars approved in loans from the Paycheck Protection Program through April 16.
SOURCE: U.S. Small Business Administration.

the collateral requirements and only asked lenders to conduct a minimal credit check.

To quickly disburse funds, the PPP program worked with more institutions. Usually, only certified lenders—typically banks and a small number of non-banks and credit unions—can make SBA 7(a) loans. Under PPP, all federally insured depository institutions and credit unions, and Farm Credit System institutions can participate.¹²

The Treasury, seeking to further boost the number of outlets disbursing funds, released a new application for nonbank program lenders on April 9.

Many smaller banks moved faster than some large banks to process applications. Moreover, a substantial number of initial loans occurred between borrowers and lenders with an existing relationship.¹³

The first-wave PPP did not entirely align with the areas most affected by COVID-19. Lender participation played an important role. The 21 largest banks made 14.4 percent of initial PPP loans, a much smaller share of small business lending than prior to COVID-19 (59 percent).¹⁴ Small banks filled the gap by making about 41 percent of PPP loans, as of May 16.¹⁵

Small Business Funding

Running a small business involves substantial uncertainty. Hundreds of thousands of small businesses fail each year. Only about half of startups survive more than five years, and just one-third last beyond 10 years.¹⁶ The median small business has enough cash on hand to cover 27 days of cash outflows, and retained earnings are usually insufficient to operate or expand.¹⁷

Small business lenders are generally cautious, often charging relatively high interest rates to offset credit risk. Thus, many business owners draw on personal funds, borrow from friends and families, take out home equity, use a personal or business credit card, or borrow from business partners before seeking commercial loans.

The Federal Reserve Banks' 2019 Small Business Credit Surveys showed that in more-normal times, while the

TABLE 1 Small Businesses Generally Credit Constrained

	Nonemployer firms	Employer firms
Have financial shortfalls (%)	61	54
Applied for external credit (%)	26	43
Received some/all if applied (%)	62	47
Have outstanding debt (%)	46	70
Debt averse (%)	23	14
Discouraged to apply (%)	13	9

NOTES: Nonemployer firms have no paid employees and are usually self-employed individuals. The survey had 6,614 responses from small employer firms and 5,841 responses from nonemployer firms.

SOURCE: Federal Reserve Banks' Small Business Credit Surveys, 2019.

majority of small firms experienced financing shortfalls, only 26 percent of nonemployer firms (usually the self-employed) and 43 percent of employer firms applied for external credit (*Table 1*).¹⁸

Many cited debt aversion or being discouraged to apply as reasons for not seeking loans. Among those that applied, many failed to receive funding. According to employer firms that attempted to get credit, about 57 percent sought \$100,000 or less, 35 percent applied for \$100,000 to \$1 million and 8 percent asked for \$1 million or more.

Among all loan-seeking businesses—which often look to borrow at several institutions—about 49 percent applied to large banks (assets exceeding \$10 billion), 44 percent to small banks, 35 percent to online nonbanks and 14 percent to credit unions or community development financial institutions. Small banks were more likely than large banks to approve loans.

Challenges for Lenders

Two main factors contribute to small businesses' unmet credit needs. Small business loans aren't as profitable to lenders as other types of loans. Origination and servicing costs for small loans are comparable to larger loans, but interest revenue is much less.

The other challenge is accurately assessing small businesses' credit risk. While traditional credit scoring models can effectively predict repayment patterns for consumer loans—mortgages, auto loans and credit cards—these models less ably assess business prospects

and the repayment capacity of small firms, especially newer enterprises.

Historically, community banks have specialized in small business lending because lenders in physical proximity can conveniently learn more about prospective borrowers through personal relationships and face-to-face interactions and collect more “soft” information to assist underwriting. Loans made from distant locations tend to be riskier.

These challenges nevertheless provide opportunities for lending innovations. “Fintechs,” a class of banks and nonbanks that use new technologies to make loans, have developed rapidly in the past decade. Advanced data integration technology and analytical tools allow lenders to efficiently process a broad range of borrower information. Data once gathered informally through personal contact have become quantifiable and easily transferrable for automated, online underwriting.

Fintech lending is in an early stage of development and hasn't been rigorously tested, leaving the majority of small business loans still locally originated. Nonbank fintech companies accounted for \$6.5 billion in loans with a small business focus in 2017.¹⁹ This represented less than 2 percent of the small business lending market, although it was the fastest-growing segment in fintech lending relative to student loan refinance and personal loans.

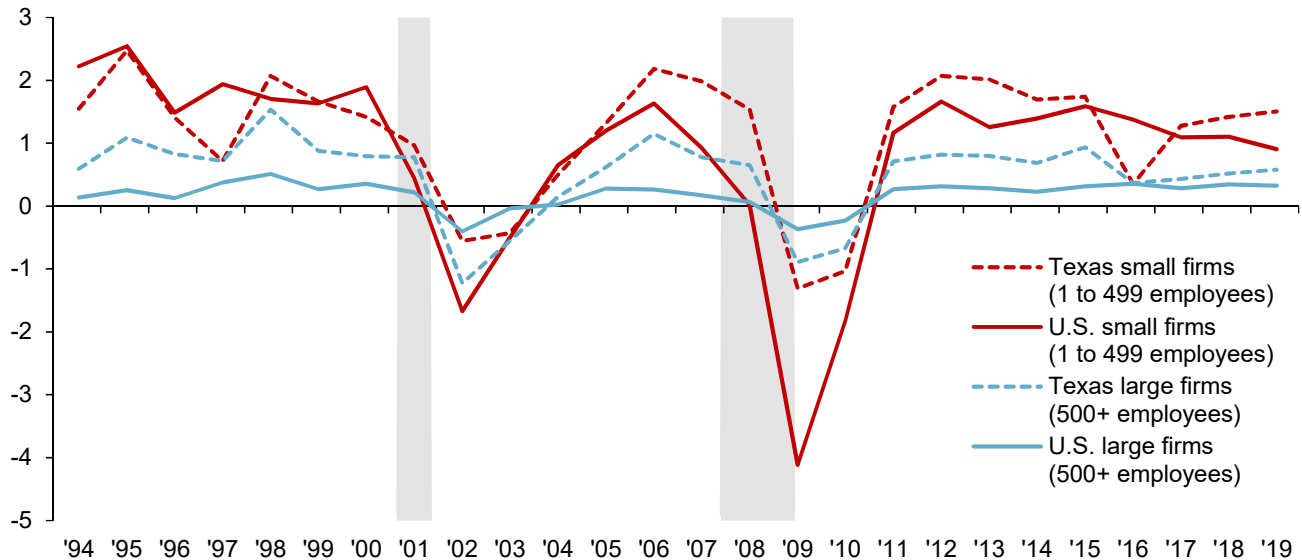
Lending During Downturns

Small businesses are less resilient in economic downturns and suffered more job losses than larger companies

CHART
3

Small Businesses Lose More Jobs in Recessions than Big Firms

Job gains/losses as a percent of employment



NOTE: Gray bars indicate U.S. recessions.

SOURCES: Bureau of Labor Statistics; National Bureau of Economic Research.

in the previous two recessions in the 2000s (*Chart 3*). Small businesses also subsequently rebounded with greater job gains.

Small businesses in Texas contracted more than larger firms during the Great Recession, a pattern that repeated itself nationwide. They were not as affected following the earlier dot-com bust. State and national trends suggest that small businesses may experience greater weakness during a credit crunch arising from a financial crisis.

When the downturn is systemic and businesses need liquidity the most, lenders are often also especially constrained. Small business lending—measured by the number and amount of Community Reinvestment Act (CRA) loans relative to the levels in 2005—rose before the Great Recession, declined sharply afterward, and during the gradual recovery remained below prerecession levels (*Chart 4*).²⁰

Another indicator of lending risk, the median physical distance between borrowers and lenders, follows a similar trend. During periods of stress, lenders from outside a market typically do not continue to service firms

with which they do not have a longer-term relationship.

With businesses and lenders confronting financial challenges arising from COVID-19, the SBA's fully guaranteed PPP loans help bridge the liquidity gap. In many cases, businesses initially sought PPP funding through community banks and large banks with local branches.

The lack of a longstanding relationship likely stymied many PPP applications, and an overwhelmed system derailed others. Online, nonbank fintech lenders provided an alternative if they were previously certified SBA lenders or had been quickly approved for program participation.²¹

Public-Private Partnership

Small businesses—key contributors to the economy—require credit access, especially during difficult times. Social distancing mandates to contain the COVID-19 spread and protect public health have damped demand for the services and products of small businesses. This poses an unprecedented threat. Small businesses need rapid financing or cash assistance to survive.

Loan programs in the COVID-19 federal fiscal package provide funding to help small businesses cope with the economic upheaval. Traditional banks and fintech lenders are dealing with the challenges to keep small businesses alive until those enterprises can more fully reopen. The crisis will test the capacity of the public-private partnership in small business lending.

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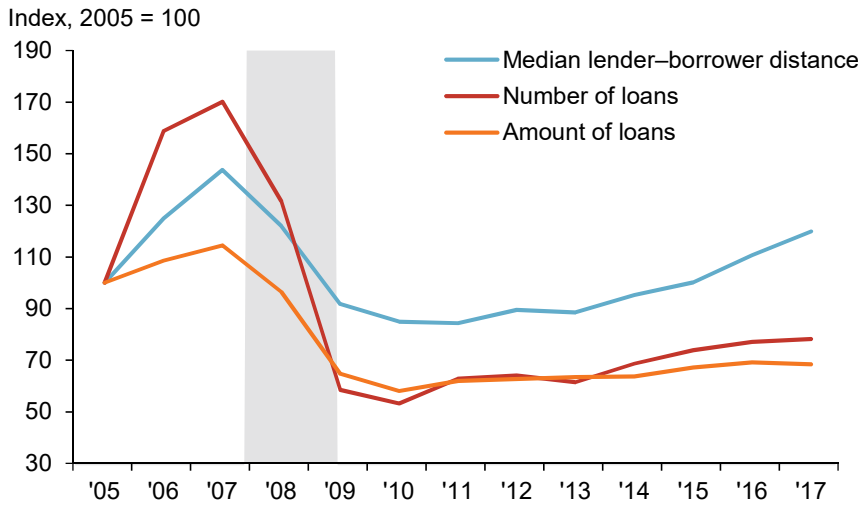
Notes

¹ "Place Matters: Small Business Financial Health in Urban Communities," by Carlos Grandet, Chris Wheat and Diana Farrell, JPMorgan Chase Institute, September 2019, <https://institute.jpmorganchase.com/institute/research/small-business/place-matters-small-business-financial-health-in-urban-communities>.

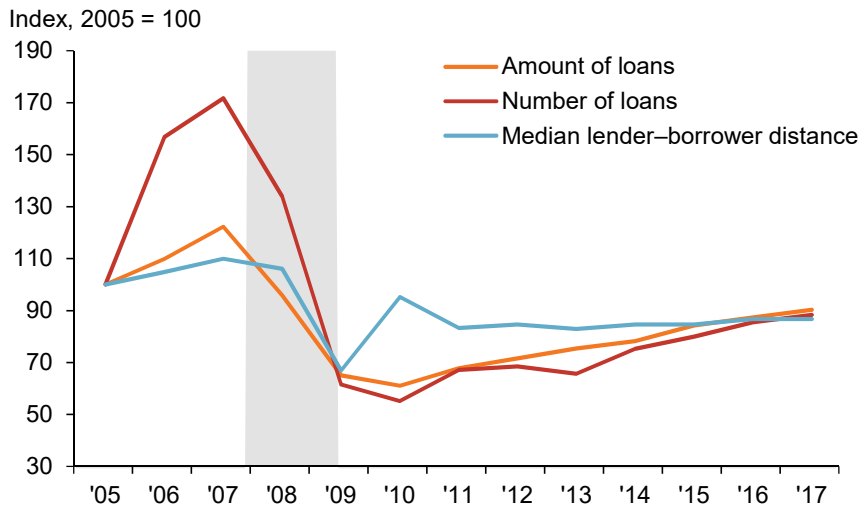
**CHART
4**

Small Business Lending Declines in the Great Recession

A. CRA Loans in the U.S.



B. CRA Loans in Texas



NOTES: The Community Reinvestment Act (CRA) loan amount is in real dollars. The gray bar indicates U.S. recession.

SOURCES: Federal Financial Institutions Examination Council; National Bureau of Economic Research.

² Data are from Homebase's survey of over 60,000 businesses and 1 million hourly employees active in the U.S. in January 2020, <https://joinhomebase.com/data/> (accessed May 11, 2020).

³ "People Need Loans as Coronavirus Spreads. Lenders Are Making Them Tougher to Get," by AnnaMaria Andriotis and Peter Rudegeair, *Wall Street Journal*, March 28, 2020.

⁴ Data are from the Census Bureau, Statistics of U.S. Businesses, www.census.gov/data/tables/2017/econ/subsb/2017-susb-annual.html (accessed April 27, 2020).

⁵ For more information, see "2019 Small Business

Profiles for the States and Territories," Small Business Administration (SBA) Office of Advocacy, April 2019.

⁶ For more information, see "Small Business GDP 1998–2014," by Kathryn Kobe and Richard Schwinn, SBA Office of Advocacy, December 2018.

⁷ See note 1.

⁸ The Coronavirus Preparedness and Response Supplemental Appropriations Act, Families First Coronavirus Response Act, and Coronavirus Aid, Relief, and Economic Security (CARES) Act were signed into law in March 2020.

⁹ Although the SBA has waived its "no credit elsewhere"

test, the SBA and Treasury still require borrowers to certify in good faith that their PPP loan request was necessary under the current circumstances.

¹⁰ Main Street Lending Program, Board of Governors of the Federal Reserve System, accessed May 11, 2020, www.federalreserve.gov/monetarypolicy/mainstreetlending.htm.

¹¹ Businesses in the hotel and food services industries (NAICS code 72) or franchises in the SBA's franchise directory that receive financial assistance from small business investment companies licensed by the SBA can have more than 500 employees if they meet applicable SBA employee-based size standards for those industries.

¹² "The CARES Act Works for All Americans," U.S. Department of the Treasury, accessed May 11, 2020, <https://home.treasury.gov/policy-issues/cares>.

¹³ "Giant U.S. Lenders Outpaced by Rivals in Small Business Rescue," by Hannah Levitt, Bloomberg, April 17, 2020.

¹⁴ "Did the Paycheck Protection Program Hit the Target?" by Joao Granja, Christos Makridis, Constantine Yannelis and Eric Zwick, University of Chicago, Becker Friedman Institute for Economics Working Paper no. 2020-52, May 2020.

¹⁵ "Paycheck Protection Program (PPP) Report, Approvals Through 05/16/2020," Small Business Administration, accessed May 27, 2020, www.sba.gov/sites/default/files/2020-05/PPP_Report_Net_200518.pdf.

¹⁶ For more information, see "Small Business Facts," SBA Office of Advocacy, June 2012.

¹⁷ For more information, see "Cash is King: Flows, Balances, and Buffer Days: Evidence from 600,000 Small Businesses," by Diana Farrell and Chris Wheat, JPMorgan Chase Institute, September 2016.

¹⁸ Data are from the Small Business Credit Survey, Federal Reserve Banks, www.fedsmallbusiness.org/ (accessed May 11, 2020).

¹⁹ For more information, see "2018 U.S. Digital Lending Market Report," by Nimay Dixit, S&P Global Market Intelligence, November 2018.

²⁰ About \$265.4 billion in loans were originated or purchased in 2017, according to Community Reinvestment Act (CRA) data. The CRA requires all banks and bank holding companies with total assets exceeding \$1 billion (2005 dollars) to report loans; it is estimated to represent 70 percent of all small business bank lending.

²¹ As a measure of online lending activity, in 2017, 16 percent of SBA loans were originated with more than 100 miles between borrower and branch, and 4 percent of loans were originated by an institution other than a bank or credit union. See "Remote Competition and Small Business Loans: Evidence from SBA Lending," by Wenhua Di and Nathaniel Pattison, Federal Reserve Bank of Dallas Working Paper no. 2003, January 2020.

A Conversation with Janie Barrera

LiftFund's Microlending Helps Small Businesses Battle to Survive COVID-19

Janie Barrera is the founding president and chief executive officer of San Antonio-based LiftFund. Created in 1994, LiftFund has one of the nation's largest microlending portfolios. The nonprofit provides loans and management training to very small enterprises in Texas and seven other states.

Q. What kind of companies do you work with? Are small businesses in Texas different from those elsewhere?

At LiftFund, we work with small business owners who are unable to access capital from traditional financial institutions. We serve the moms and pops of our communities, like the neighborhood retail shops, restaurants, beauty salons, and cleaning and maintenance service businesses. Although the economic climate, top industries and regulations differ across states, small businesses share more similarities than differences.

A good example of a LiftFund customer is Kela Neighbors. Her daughter struggled with severe eczema. In an effort to help her, Kela researched the healing components of natural ingredients and learned how to mix them to make organic bath and beauty products. Once her daughter started using Kela's homemade body mousse and soap, she noticed a significant improvement.

Inspired by this, Kela and her husband launched Organically Bath and Beauty in San Antonio. The Neighbors received a microloan from LiftFund to expand their business from a farmer's market to their own storefront.

Q. What is your definition of a small business, and what is the environment for these businesses in Texas during the era of COVID-19?

LiftFund defines a small business as having 10 employees or fewer and annual revenues of less than \$2 million. These businesses tend to have cash reserves of about eight weeks, so they have less of a cushion to weather a significant downturn than larger businesses.

Most small businesses are struggling. The good news is that besides the efforts of the federal and state governments, many municipalities have stepped up to provide grants and low-interest loans. Several large financial institutions have also partnered with LiftFund to provide grants and low-interest loans.

The majority of the funds issued by LiftFund have gone to low- to moderate-income individuals. We are reaching the least served.

Q. With so much economic weakness and uncertainty, what steps can a small business take to improve its chances of surviving?

Have patience and don't give up. They [small businesses] may have to stream-

line what they do. I encourage them to take seminars that are online right now to learn how to navigate this crisis and to find out what resources are available.

Learn best practices from others who are going through the same things. For example, there are a lot of gyms that are shifting workout programs online and getting customers to pay for the online experience. Learning to use online technology is crucial.

Q. What has been the impact of the federal government's Paycheck Protection Program (PPP) providing forgivable loans for small businesses to help them retain employees and fund operations?

In most cases, this program has had a very positive impact. In the first-round allocation of \$454 billion, community development financial institutions were brought into the mix too late in the game. At first, only banks could issue the loans. After community development financial institutions complained, those that had already been participating in loan programs with the Small Business Administration were allowed to participate.

In the second round of the program, \$30 billion of \$310 billion [in federal PPP funding] was allocated to community development financial institutions, credit unions and community banks with assets less than \$10 billion. While some have complained that the \$10 billion threshold was too high in that it includes 97 percent of all banks, the allocation in the second round has allowed community development financial institutions to be much more active and to have greater success getting the money to small businesses.

The biggest issue with the PPP program has been that many small restaurants have been unable to qualify for the conditions of the loan forgiveness. Because of this, even some that received funds are holding on to the money because they are afraid that if they don't



Photo credit: Carlos Javier Sanchez

► *In the long term, entrepreneurs are entrepreneurs, and they will continue to innovate and invest in new companies. They have a mindset that will keep them going.*

qualify for the forgiveness, they might be unable to make future loan repayments.

Q. How has LiftFund been involved in the PPP and other recent programs for small businesses? Has LiftFund made PPP loans to noncustomers?

Due to the late ruling [allowing community development financial institutions to issue loans] and the rapid depletion of the funds, LiftFund was only able to make nine loans of about \$800,000 in the first round of funding. With the \$30 billion allocation to community development financial institutions in the second round, LiftFund has been able to issue 450 loans for a total of \$16 million, with most under \$40,000. This is a large increase in the amount of funds that we typically distribute. In a typical year, we make about 1,000 loans for a total of \$29–\$30 million. In the last eight weeks, we have disbursed over \$33 million.

We offered PPP loans to all small businesses—regardless if we had done business with them before. One reason why banks had trouble disbursing to businesses that were not their customers is “know your customer” regulations that require paperwork on borrowers in an effort to reduce money laundering and other illegal activity.

Existing customers have already filled out this paperwork and, thus, can be processed for PPP loans more quickly. LiftFund has a process that we follow, which is similar to banks, so that existing customers can be processed more quickly. But even given that, more than half of the PPP loans that we distributed were to new customers.

One problem is that many small businesses don’t know about community

development financial institutions, including LiftFund. But fortunately, Gov. [Greg] Abbott held a press conference that was aired all across Texas to announce a program that we partnered on with Goldman Sachs, and that publicity has helped us attract new customers.

Q. LiftFund has historically had a 96 percent repayment rate from small businesses. How is this pandemic going to affect your customers and potentially the LiftFund repayment rate and LiftFund’s ability to serve your constituents?

We are expecting a higher default rate, and we let all of our funders know this. Since we are not a bank, we rely on investments and grants. Due to our strong underwriting standards, we were able to get a very high repayment rate.

The COVID-19 loans have some of that rigid underwriting, but not all of it. The funders are telling us that we should be more flexible; they know people are hurting, and we need to get the money to them quickly, and they understand that this will increase the risk of loss.

Because most of the funding is coming with no recourse, LiftFund’s loan-loss reserve does not have to be as robust as in the past. After Hurricane Harvey, we projected losses of 15 to 20 percent, but they came in under 10 percent. But this will likely be worse—this is much deeper and longer. This is like eight weeks of a hurricane.

I don’t know when LiftFund will return to doing traditional LiftFund loans in terms of the strict underwriting and coaching of new businesses. It may be this year; it may be next year. Now we

are focused on keeping businesses alive rather than helping them to start up.

Q. What else should be done to help small businesses?

There should be a third round of PPP funding from the federal government—this time for small businesses that have not been helped. We’ve done 454 loans to small businesses statewide, but this is just a drop in the bucket. There are many more out there that need help. In the third round, they should allocate a significant portion to women- and minority-owned businesses to ensure that the funding gets to them. We also need a grassroots campaign to reach out to these businesses to teach them how to qualify and apply for these loans.

Q. What type of long-term impacts will this pandemic have on small businesses and the economy in general?

In the long term, entrepreneurs are entrepreneurs, and they will continue to innovate and invest in new companies. They have a mindset that will keep them going. They will find a way to rebuild and to raise wealth within their families. Being in this field for 26 years, I can tell you people are so resilient and creative. I wish I had a crystal ball and could tell you what they will come up with, but I can’t. All I can say is that they will come up with a plan that I never thought imaginable.

COVID-19, Oil Price Collapse to Challenge Banks in 2020

By Amy Chapel and Kory Killgo

ABSTRACT: Eleventh District banks face challenges from instability in the energy sector and economic fallout from the COVID-19 pandemic. While district banks finished 2019 on solid footing, and regulatory and monetary interventions will buffer some of the headwinds, we expect profitability, credit quality and bank capital to decline in 2020.

Weakened business finances, soaring unemployment and cuts to the federal funds target rate—products of the COVID-19 pandemic—have diminished the outlook for banks nationwide and in the Eleventh Federal Reserve District. In addition, lenders, especially those in the district, confront challenges from an energy sector collapse, one much more profound than the most recent 2015–16 oil price slump.¹

Economic conditions are the biggest driver of bank performance. Under-scoring the challenges are median projections from the Federal Reserve's June Summary of Economic Projections for a 6.5 percent contraction in U.S. gross domestic product (GDP) and a 9.3 percent U.S. unemployment rate this year.² Both fiscal and monetary policy have provided support to some businesses and households, and regulatory changes have aided banks, helping offset some of the pandemic's economic impacts.

The banking sector appears better capitalized before COVID-19 than it

was prior to the 2007–09 global financial crisis. Still, commercial real estate and many nonfinancial corporate sectors show signs of credit-quality deterioration, and sectors most dependent on consumer discretionary spending face significant headwinds. We expect bank profitability to decline, asset quality to weaken and bank capital to fall in 2020.

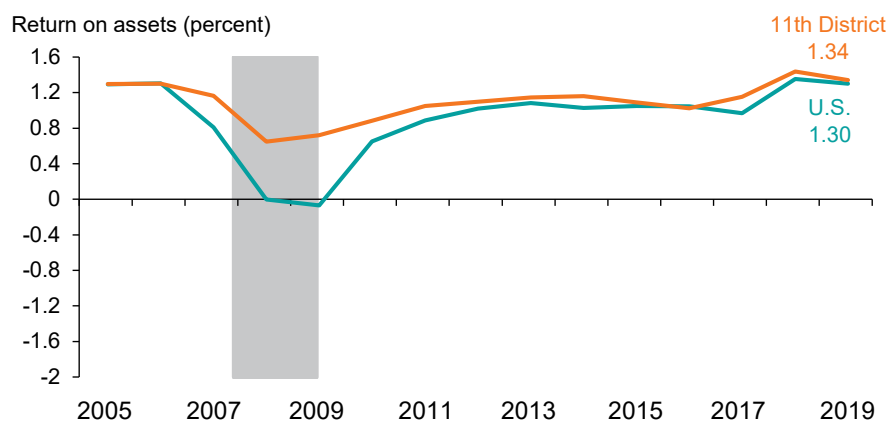
Falling Bank Profitability

Profitability growth, while remaining high, had begun slowing in 2019. Eleventh District banks earned an annualized return on assets of 1.34 percent in 2019—down from 1.44 percent in 2018—while U.S. bank profits were 1.30 percent—down from 1.35 percent in 2018 (*Chart 1*). Lower net interest margins and higher expenses mainly drove the profitability decrease.

Net interest margins—the difference between a bank's interest income (loan yields) and interest expense (deposit costs) weighted by average earning assets—were pressured in the second

CHART
1

Bank Profitability Dips in Eleventh District, U.S.



NOTE: The shaded area indicates U.S. recession.

SOURCE: Reports of Condition and Income, Federal Financial Institutions Examination Council.

half of 2019.³ With three federal funds rate cuts in the latter half of 2019, loan yields fell more quickly than deposit costs, lowering banks' net interest margins. With further rate cuts at the beginning of 2020, net interest margins are likely to decline further this year and reduce profitability.⁴

Asset quality overall was solid at the start of 2020. The district noncurrent loan rate—the percentage of loans past due 90 days or more or on nonaccrual status—measured 0.79 percent at year-end, about even with year-end 2018, the lowest such rate since 2007. The U.S. noncurrent loan rate was 0.89 percent, down from 0.97 percent at year-end 2018. Improvement in the credit quality of residential real estate drove improvement nationally.

Asset quality likely will deteriorate this year across loan types. The impacts will differ between banks in the district and the nation in part because of loan portfolio mix.

District banks are noticeably more concentrated in loans secured by commercial real estate (CRE) than those in the nation. CRE loans are those made for commercial construction and for the financing of shopping centers, office buildings and apartments. These loans make up 35.4 percent of bank loans in the district, compared with 22.2 percent nationwide (*Chart 2*).

Some CRE borrowers may struggle to maintain positive cash flow, with COVID-19 changing consumers' activities and increasing work-at-home arrangements temporarily at some firms and permanently at others.

Additionally, the quality of commercial and industrial (C&I) loans will likely deteriorate. C&I loans include those to the energy industry and to business customers in COVID-19-affected industries such as restaurants and retail.

Worsening C&I loan quality could have a marginally larger impact on community banks in the district—institutions with less than \$10 billion in total assets—relative to those in the rest of the nation. C&I loans account for a greater share of community banks' lending portfolios in the district (17.9 percent) than in the nation (14.7 percent). Consumer portfolio credit quality, particularly credit cards, may also weaken this year, which would have a greater effect nationally.⁵

Overall bank capital levels—a bank's assets less liabilities—increased in 2019. Equity capital was 11.8 percent of assets at the end of 2019, up from 11.4 percent at year-end 2018. Nationwide, the equity capital ratio rose to 11.3 percent from 11.2 percent a year earlier. The purpose of bank capital is to buffer against unexpected losses.

Inadequate capitalization of banks can reduce overall credit availability and negatively affect the economy. While the banking sector was generally well-capitalized heading into 2020, unexpected losses due to deteriorating economic conditions from COVID-19 and energy sector strains could diminish bank capital later this year.

Energy Dims Outlook

Even before COVID-19, banks were confronting deteriorating energy sector conditions and outlooks. In late 2019, the credit quality of loans to the industry began declining, with energy firm defaults expected to increase in 2020.

A supply shock earlier this year, in part the product of a Saudi Arabia and Russia oil price war, further weighed on banks with direct lending to energy firms.⁶ Lenders located in energy-producing regions were indirectly affected as the downturn touched area household and commercial customers.

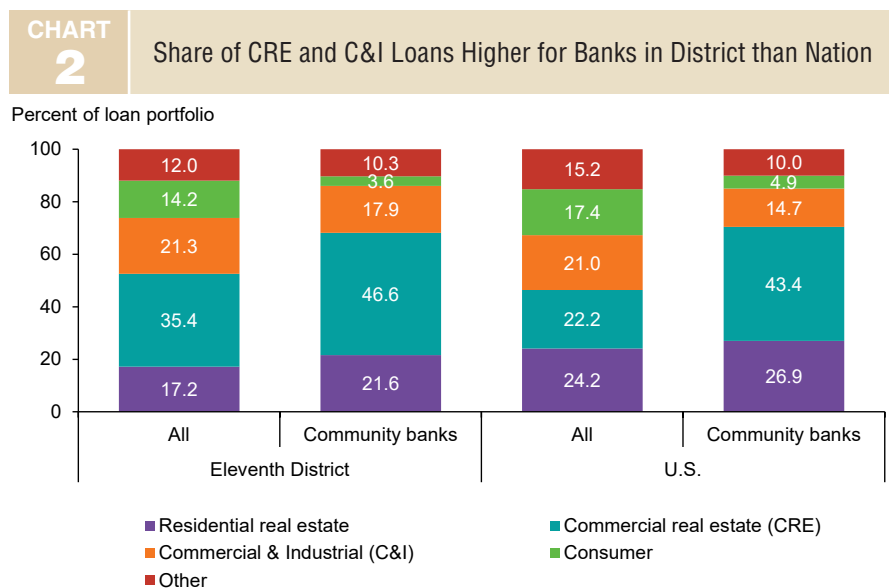
Moreover, the pandemic created a negative demand shock for the energy industry. With people across the world facing shelter-in-place orders, demand for oil products such as gasoline and jet fuel declined dramatically. The decrease in demand, occurring simultaneously with a large supply increase, sank oil prices (*see Go Figure, page 15 in this issue*).

West Texas Intermediate crude oil prices plunged in early 2020 to levels well below breakeven prices reported by regionally based energy companies.⁷ In addition, oil prices are anticipated to remain below Eleventh District breakeven levels through year-end 2021. The concurrent demand and supply shocks could make this energy downturn worse than that in 2015–16, with more restructurings and bankruptcies anticipated in the sector.⁸

Because bank lending to energy firms is included in a bank's C&I portfolio, deteriorating energy industry conditions will contribute to diminished C&I portfolio quality.

COVID-19 Crisis Changes

The COVID-19 pandemic has touched banks on a number of levels,



NOTES: Community banks are institutions with less than \$10 billion in total assets. Data are as of Dec. 31, 2019. The "other" category includes loans to other depository institutions and government entities.

SOURCE: Reports of Condition and Income, Federal Financial Institutions Examination Council.

notably complicating their ability to maintain operations and serve customers with employees' movements limited by health concerns, social distancing guidelines and other restrictions.

Operational challenges are a significant concern. In some cases, banks conducted transactions only through drive-through windows; in other cases, they limited the number of customers in lobbies or allowed meetings by appointment only. Some branches were closed temporarily for deep cleaning. As a result, banks have encouraged customers to conduct business online when possible.⁹

Banks must also continue to monitor their customers' financial standing. The crisis has materially affected corporate cash flows, and some businesses—and, in turn, households—may face repayment issues.

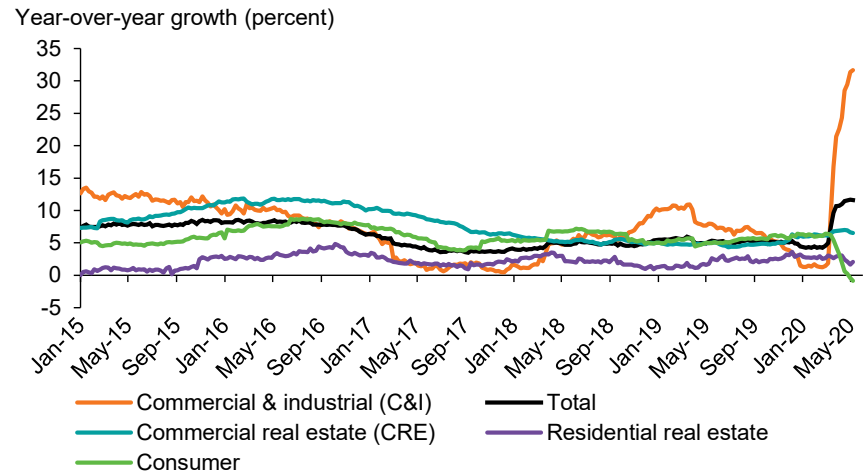
Vulnerable sectors include oil and gas, transportation, employment services, travel arrangements, and leisure and hospitality, a Moody's Analytics report said.¹⁰ Lending to firms in these sectors is included in banks' C&I portfolios. Financing for these industries' commercial construction and buildings/offices is included in banks' CRE portfolios. Such lending, therefore, poses a challenge in a district with an outsized share of C&I and CRE loans in the portfolio mix.

Nationally, bank C&I lending accelerated in late March and early April 2020 in response to the cash needs of corporate clients. While district lending data are only available quarterly, and with a lag, national figures can bring into focus COVID-19 lending trends.

These data show year-over-year loan growth jumped substantially during the last two weeks of March and continued to increase through the first two weeks of May, driven by a historic pick-up in C&I loan growth (*Chart 3*). This was partly from corporate customers making large draws on existing credit lines, likely to have additional cash to buffer against COVID-19 strains.

From the week of March 11 to the end of April, C&I loan balances grew by over \$600 billion nationally. Some of the growth may also be due to first-

CHART 3 Loan Growth Picks Up as Businesses Draw Down Credit Lines



NOTE: Data are through the week of May 27 for U.S. bank lending.
SOURCE: Federal Reserve, H.8 report of selected assets and liabilities of U.S. commercial banks.

round Paycheck Protection Program (PPP) loans from the Small Business Administration, part of a congressionally approved stimulus package.¹¹ While PPP loans should present no repayment risk to banks—they are federally guaranteed—the drawdowns on existing lines could increase some banks' C&I loan concentrations.¹²

Another factor to consider when assessing a bank's exposure is lending to vulnerable industries relative to capital levels. In the Eleventh District, 27 percent of banks have a C&I loan concentration greater than 200 percent of risk-based capital, the financial cushion available to absorb losses for a given level of risk (*Chart 4*).¹³

Nationally, 24 percent of banks have a C&I concentration exceeding 200 percent of risk-based capital. Some banks have even higher concentrations—8 percent of district and 7 percent of national banks' C&I concentrations exceed 300 percent of risk-based capital.

For CRE loans, 27 percent of district and 26 percent of U.S. banks' concentrations are greater than 200 percent of risk-based capital. Five percent of district and 8 percent of national banks have CRE concentrations greater than 300 percent of risk-based capital. The banks with higher proportions of C&I and CRE loans to capital may see their

capital levels take a greater hit to resolve problem loans in these categories.

Official Crisis Response

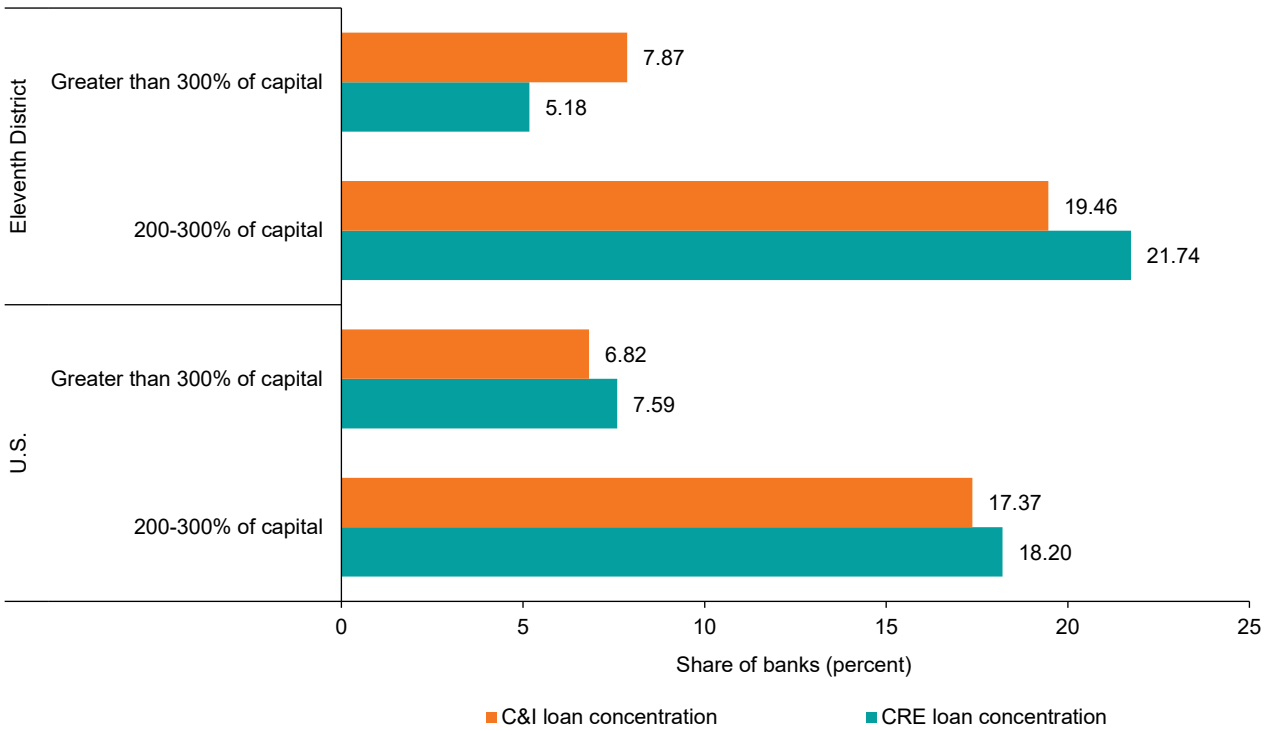
A number of Federal Reserve and U.S. government programs began as the pandemic took hold in the U.S., including ones intended to support financial institutions. To enhance the liquidity and functioning of money markets and to support the economy, the Federal Reserve launched several facilities—special purpose vehicles or other entities for providing credit—and is supplying trillions of dollars in loan support.¹⁴ The Federal Reserve, along with the other federal bank regulatory agencies, eased capital rules so that financial institutions could utilize and support the functioning of these facilities.

Bank regulatory agencies also issued policy statements encouraging banks to work with COVID-19-affected borrowers, providing flexibility to mortgage servicers and supporting banks that choose to use their capital and liquidity buffers to lend and undertake other supportive actions in a safe and sound manner.

The Coronavirus Aid, Relief, and Economic Security (CARES) Act approved in March, which included the Paycheck Protection Program, also reduced the amount of regulatory

CHART
4

Few Banks Have C&I, CRE Loans Exceeding 300% of Risk-Based Capital



NOTES: Loan concentrations are calculated as a share of total risk-based capital; data are as of Dec. 31, 2019. Commercial real estate (CRE) loans include construction and land development loans, multifamily loans and non-owner-occupied nonfarm nonresidential real estate loans. Commercial and industrial (C&I) loans include C&I loans, owner-occupied nonfarm nonresidential real estate loans and other leases.

SOURCE: Reports of Condition and Income, Federal Financial Institutions Examination Council.

capital banks must hold. The Federal Reserve, along with the other federal bank regulatory agencies, temporarily lowered the community bank leverage ratio requirement for banks with less than \$10 billion in total assets, granting relief by decreasing the capital these institutions must hold.

In addition, a required new loan-loss accounting standard was delayed. Banks that were originally required to adopt the new standard in 2020 no longer need to, potentially reducing the amount of capital they must hold. They can, however, choose to adopt the new standard this year, which some banks are doing, as indicated on first-quarter earnings calls. Because of the reduced capital banks must hold, they may increase lending to businesses and consumers.

In addition to changes to capital and liquidity requirements, the Federal Reserve also encouraged financial institutions to participate in the CARES

Act’s small business programs, including PPP lending.¹⁵

Looking Ahead

The banking sector ended 2019 generally on solid footing. Before the arrival of COVID-19, direct and indirect energy sector exposure had begun to weigh on some banks, as had reductions to the federal funds rate, which pressured net interest margins.

The outlook dramatically changed in first quarter 2020. The pandemic reduced cash flows for many businesses and consumers and will likely cause loan losses. Fiscal and monetary stimulus and regulatory changes should help banks and borrowers respond to these challenges.

Chapel is a macro-surveillance manager and Killgo is a financial industry analyst in the Banking Supervision Department at the Federal Reserve Bank of Dallas.

Notes

- ¹ Eleventh District banks are headquartered in Texas, northern Louisiana or southern New Mexico.
- ² See Federal Open Market Committee projections materials, Federal Reserve Board of Governors, June 10, 2020, www.federalreserve.gov/monetarypolicy/fomcprojtabl20200610.htm.
- ³ Earning assets are assets on which banks earn income; e.g., loans and securities. Earning assets exclude, for example, the value of the bank’s premises and cash in the vault.
- ⁴ Most institutions that publicly reported first-quarter earnings noted a decline in earnings. First-quarter regulatory data for all commercial banks was unavailable at the time of writing. The filing deadline for bank regulatory data for institutions with \$5 billion or less in total assets during the first quarter was extended due to the COVID-19 crisis. See www.federalreserve.gov/newsevents/pressreleases/bcreg20200326b.htm.
- ⁵ Consumer loans account for 17.4 percent of total loans nationally and 14.2 percent at district banks; credit cards account for 9.0 percent of total loans nationally and 5.4 percent at district banks.

(Continued on the back page)

Black Workers at Risk for 'Last Hired, First Fired'

By Aquil Jones and Joseph Tracy

The COVID-19-induced global economic downturn shuttered businesses that have begun slowly reopening and reassessing whether to recall laid-off employees.

If these firms use job seniority as a criterion for returning to work, individuals most recently hired may be at greater risk of prolonged unemployment. In the U.S., black unemployment rates have spiked much more than white jobless rates during recessions.

Additionally, black unemployment rates tend to more slowly recede, a phenomenon encapsulated in the phrase “last hired, first fired.”

High Unemployment Legacy

In the years leading up to the Great Depression (1929–39), blacks held mostly low-skilled jobs that subsequently either went away or were filled by whites in need of employment during the tough times. The black unemployment rate was approximately 50 percent in 1932, more than twice that of whites, according to the Library of Congress.¹

Despite the passage of time and the Civil Rights Act of 1964, which banned employment discrimination based on sex, race, religion and national origin, blacks still suffer more adverse labor market outcomes, including higher unemployment, than whites. This gap widens during recessions.

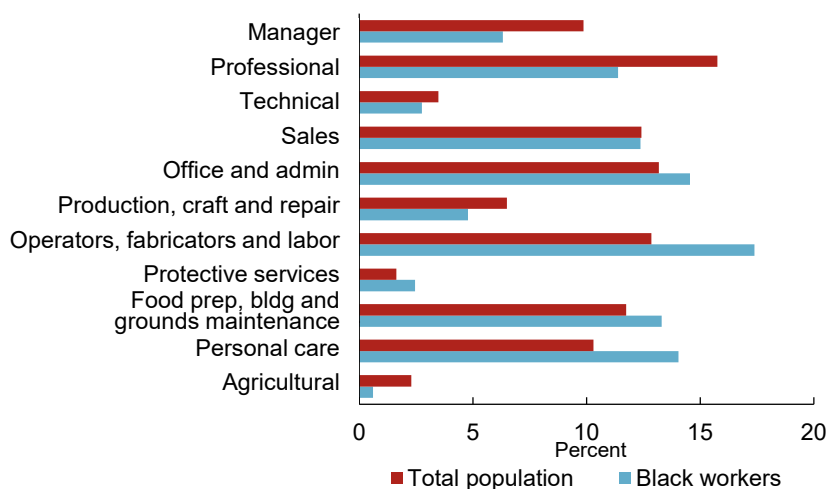
For example, black “prime-age” workers (ages 25–54) experienced declining employment rates associated with the Great Recession (2007–09) two months sooner and 15 months longer than did whites. In the aftermath of that downturn, black employment rates dropped to a low of 66.7 percent in October 2011, while the low for whites, 76.5, percent occurred in July 2010.² Moreover, it took blacks longer to find new jobs than whites afterward.

History Repeating Itself?

The benefit that blacks received from the tight labor market in recent years

CHART
1

Black New Hires Predominate in Occupations Vulnerable to Pandemic



SOURCE: Bureau of Labor Statistics, Current Population Survey, January 2020.

may dissipate as the economy falters. Measures to slow the spread of COVID-19 “paused” many businesses or left them with reduced staffing, often favoring the retention of employees who can work from home.

A Dallas Fed study found that only 38.8 percent of full-time U.S. workers had remote-compatible jobs, compared with 37.3 percent in Texas.³ Within the state, 33 percent of blacks hold jobs suitable for working from home, compared with 47 percent of whites. The study separated workers based on the fraction of occupational time spent sitting, kneeling or twisting the body; the prevalence of email usage; and an occupational requirement to work within arm’s length of another person.

The Current Population Survey in January 2020 provides another perspective on employment. It can be used to identify “new hires,” people who transitioned from nonemployment to employment since January 2018 (*Chart 1*).

Responses from survey participants who remained in one place—there was no relocation—are viewed at 12-month intervals. The series shows blacks over-represented among new hires relative to the overall U.S. working population.

The data indicate individuals in occupations such as food preparation, personal care, operators, fabricators and sales—representing 57.1 percent of new black hires—may be at particular risk because of an inability to telecommute. Additionally, underrepresentation of black hires in managerial and professional roles—18 percent compared with 26 percent for the overall population—indicates another vulnerability.

Thus, the current economic situation may offer a test of the last hired, first fired phenomenon.

Notes

¹ “Last Hired, First Fired: How the Great Depression Affected African Americans,” by Christopher Klein, History Channel website, April 18, 2018, www.history.com/news/last-hired-first-fired-how-the-great-depression-affected-african-americans.

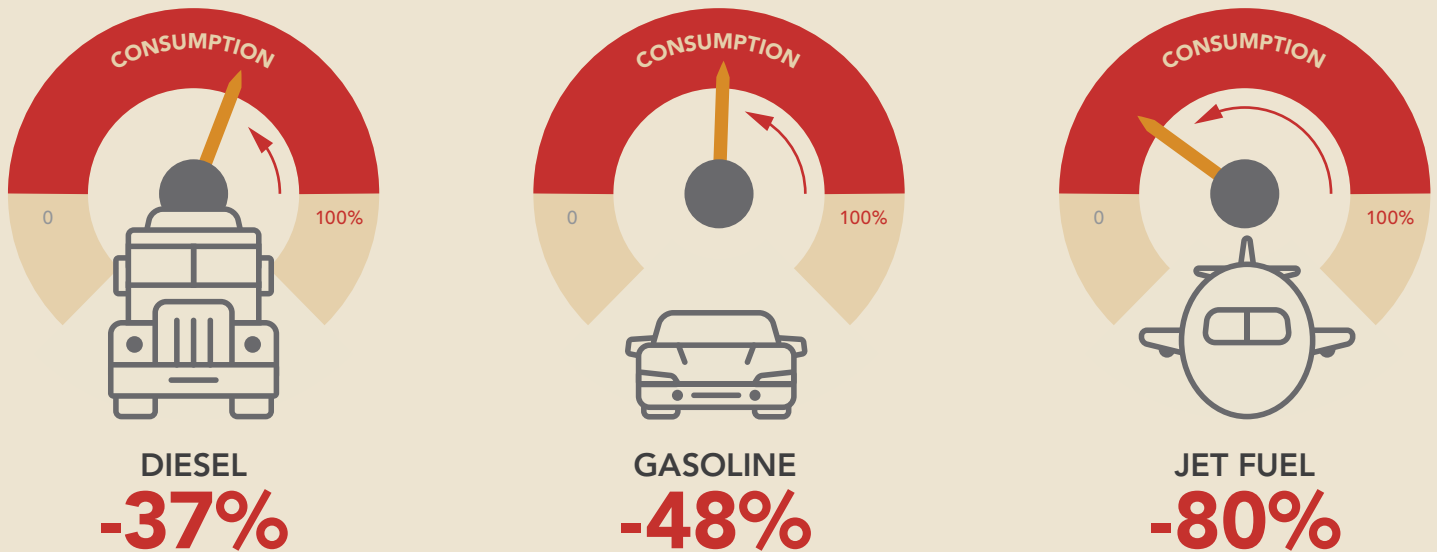
² “African Americans Face Systematic Obstacles to Getting Good Jobs,” by Christian E. Weller, Center for American Progress, Dec. 5, 2019, www.americanprogress.org/issues/economy/reports/2019/12/05/478150/african-americans-face-systematic-obstacles-getting-good-jobs/.

³ “Working from Home During a Pandemic: It’s Not for Everyone,” by Yichen Su, *Dallas Fed Economics* (blog), April 7, 2020, www.dallasfed.org/research/economics/2020/0407.

COVID-19 Tanks U.S. Fuel Consumption, Prices

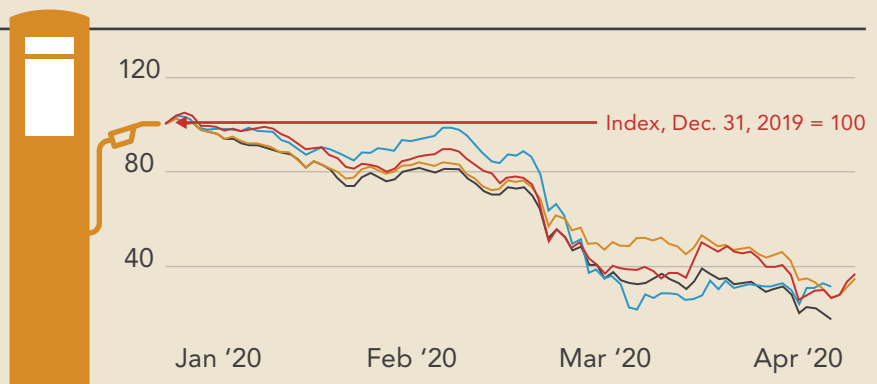
Design: Olu Eseyin; Content: Jesse Thompson

The effects of the pandemic, including working from home and reduced travel, dropped fuel consumption from mid-March to mid-April 2020.



With consumption curtailed, inflation-adjusted fuel prices plummeted to almost 40 percent of December levels.

- Brent crude
- Diesel
- Gasoline
- Jet fuel



As consumers benefited somewhat from lower prices, producers struggled.

Soft fuel demand hurt Texas refiners, which depend on domestic and export markets.

TEXAS REFINERIES

are responsible for:

31%

of fuels manufactured in the U.S.

2-3%

of state gross domestic product.

NOTES: Consumption is measured as thousands of barrels per day of product supplied. Numbers compare the average daily consumption level between early March and mid-April. Data are not seasonally adjusted.
SOURCE: U.S. Energy Information Administration.

COVID-19, Oil Price Collapse to Challenge Banks in 2020

(Continued from page 13)

⁶ See "How the Saudi Decision to Launch a Price War Is Reshaping the Global Oil Market," by Lutz Kilian, *Dallas Fed Economics*, April 2, 2020.

⁷ The breakeven price is the oil price at which production becomes profitable.

⁸ See "Heavily Indebted U.S. Upstream Industry on Track for Record Number of Chapter 11 Filings in 2020," Rystad Energy press release, April 3, 2020, www.rystadenergy.com/newsevents/news/press-releases/heavily-indebted-us-upstream-industry-on-track-for-record-number-of-chapter-11-filings-in-2020.

⁹ The American Bankers Association has been detailing the industry's response to COVID-19 on its website, which notes that banks have instructed customers on how to utilize mobile and digital banking platforms.

The notice, which the association has been updating, includes information on what individual institutions have done. See www.aba.com/about-us/press-room/industry-response-coronavirus.

¹⁰ See "COVID-19: A Fiscal Stimulus Plan," by Mark Zandi, Moody's Analytics, March 2020.

¹¹ See "Small Business Hardships Highlight Relationship with Lenders in COVID-19 Era," by Wenhua Di, Nathaniel Pattison and Chloe Smith, Federal Reserve Bank of Dallas *Southwest Economy*, this issue.

¹² See "Federal Bank Regulators Issue Interim Final Rule for Paycheck Protection Program Facility," joint press release from the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corp. and the Office of the Comptroller of the Currency,

April 9, 2020, www.federalreserve.gov/newsevents/pressreleases/bcreg20200409a.htm.

¹³ Specifically, risk-based capital is a method of measuring the minimum amount of capital (assets less liabilities) required by regulation to support an institution's operations. The calculation is based on riskiness of the lending portfolio given the institution's size.

¹⁴ For more information, see the Board of Governors of the Federal Reserve System's Funding, Credit, Liquidity, and Loan Facilities webpage, www.federalreserve.gov/funding-credit-liquidity-and-loan-facilities.htm.

¹⁵ See Federal Reserve Supervision and Regulation letter 20-10: Small Business Administration and Treasury Small Business Loan Programs, www.federalreserve.gov/supervisionreg/srletters/SR2010.htm.



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