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The Pandemic's Effect on the Economy and Banking

Remarks by

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Good afternoon. It's great to be with you, and I look forward to our discussion. As you all know, the COVID-19 pandemic has caused significant disruption and hardship in nearly every aspect of our lives, and it continues to weigh heavily on our national economy, which is why it will be the central focus of my remarks here today. Let me set the stage for our discussion by outlining the economic effects of the pandemic most relevant to the banking sector, describing the Federal Reserve's response to the crisis, and then making some observations about conditions for smaller banks.

The Pandemic's Effects on the Economy and Banking

We began this year with the economy in excellent shape—by some measures the strongest in decades. From my seat as a monetary policymaker, we appeared to be in a good position regarding both legs of our dual mandate, which are maximum employment and stable prices.

But that picture was dramatically altered with the onset of the COVID-19 pandemic. Efforts to contain the spread of the virus caused a sudden stop in economic activity during March and April. While the extent of the closures and shutdowns varied widely throughout the country, the sudden loss of employment and the contraction in output were like nothing our nation has experienced before.

The decline in activity was mostly due to temporary business closures, and the economy has bounced back noticeably in recent months as businesses reopen and fiscal support was distributed to many Americans. Even so, the economy is still far from back to normal. The future course and timing of the recovery is still highly uncertain, and its pace and intensity are likely to vary across areas of the country—heavily influenced by the decisions of state and local governments. That speaks to another aspect of this episode that is unusual—how the timing and severity of the pandemic's impact seem to differ greatly from one area to the next.

Among Kansas's major industries, oil and gas production and equipment manufacturing have been hurt by the worldwide slump in energy demand. Aviation manufacturing has been hit hard by the downturn and by the uncertainty over the recovery in air travel. Agriculture continues to face challenges but is faring somewhat better than many sectors of the economy. Ag producers are still facing tough financial conditions, including the low commodity price environment. While most indications are that agriculture land prices continue to hold fairly steady, I have seen some reports that less-productive land has been showing some hints of cracks in valuations.

Turning to employment, nationwide, we know that the initial job losses were heavily concentrated among the most financially vulnerable, including lower-wage workers, young people, women, and minority groups. According to the Fed's latest *Report on The Economic Well-Being of U.S. Households*, 20 percent of people surveyed in April reported a recent job loss. Among those surveyed who live in households with annual incomes below $40,000, the reported job loss was nearly double that, at around 40 percent.[1] That said, both of those figures are likely to include a number of layoffs due to pandemic-related shutdowns of businesses that were hopefully only temporary.

Households were in a generally strong financial position at the beginning of this year, but the restrictions implemented to fight COVID-19 resulted in an unprecedented spike in unemployment, which likely led to a number of families finding it difficult to keep up with their payment obligations. That is especially true for lower-income households, which may have had much less of a financial cushion before the onset of the crisis. Along with our monetary policy actions, stimulus checks and enhanced unemployment benefits provided in the CARES Act have been a substantial and timely source of financial support to households during this difficult time.

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[1]Board of Governors of the Federal Reserve System, *Report on the Economic Well-Being of U.S. Households in 2019 - May 2020* (Washington: Board of Governors, May 2020), https://www.federalreserve.gov/publications/2020-economic-well-being-of-us-households-in-2019-preface.htm.

Understanding the financial stress this could place on many borrowers, the Fed and other federal regulators implemented guidance to encourage banks to work with their borrowers. By mid-July, only around 8 percent of outstanding residential mortgage loans were in forbearance, well below what many industry observers had feared. It remains possible that the economic challenges will persist beyond the forbearance time period provided in the CARES Act, and if so, we would almost certainly see some of these loans transition into longer-term delinquency status or enter into renewed deferment periods. Thus far, however, the data have been encouraging.

Turning to the impact on businesses, we know the effects have been most severe in the services sector, especially travel, leisure, and hospitality. To give some sense of the losses, employment in the leisure and hospitality sectors nationwide was down nearly 40 percent in the 12 months through May and still down about 25 percent through July. Retail employment fell 15 percent over March and April, though it has recovered substantially since then, and in July it was 6 percent below the pre-COVID level.

It is encouraging to see that even those sectors most heavily affected by the crisis are finding ways to innovate. Stores are adjusting hours and ramping up delivery, restaurants are changing menus and creating outdoor space, distilleries shifted from making bourbon to hand sanitizers, and independent businesses that hadn't previously relied heavily on technology are now using it to stay connected to customers and regulate workflow.

Timely and supportive fiscal and monetary policy measures also have helped, but with the progress of the recovery still tentative, I expect that many businesses will continue to fight for survival in the months ahead, with the support of their lenders and communities.

Looking ahead, the economic outlook will continue to evolve quickly. We experienced a pronounced and very welcome bounceback in national retail spending and housing activity over the early summer months. We also saw positive news on progress toward a vaccine and in the effective treatment of patients. Even so, positive cases and hospitalizations have risen in some areas and continue to weigh on some regions and the overall economy. As Chair Powell has noted, the timeline for the recovery is highly uncertain and will depend heavily on the course of the pandemic. We must therefore recognize that progress toward a full recovery in economic activity may well be slow and uneven

The Fed's Response to the Pandemic

Now let me turn to the Federal Reserve's role in the government's response to the pandemic. During the initial phase of the crisis, we took a number of actions to stabilize financial markets that came under intense stress, including purchasing sizable amounts of Treasury and mortgage-backed securities. To support households and businesses, the Fed quickly lowered our target for the federal funds rate, which has helped to lower borrowing costs but created a different challenge for financial institutions—depressed net interest margins. The Fed has also supported actions by Congress and the administration by creating a number of new emergency lending programs. These programs were designed to restore and sustain proper functioning in certain financial markets that had seized up in March and to facilitate the continued flow of credit from banks to households and businesses.

One federal stimulus program that relied heavily on the participation and expertise of community bankers is the Paycheck Protection Program (PPP). Working through banks, the PPP program has delivered more than $500 billion to small businesses to help them weather the storm. Community bankers played a crucial role in getting these funds to businesses that needed it, showing once again how essential community banks are to the customers they serve. And in response to feedback we received from a number of community bankers, the Fed created the PPP lending facility to alleviate balance-sheet capacity issues for banks that otherwise would not have been able to provide PPP loans to their small-business customers.

The PPP was created to help small businesses keep their employees on staff, and the Main Street Lending program is designed to support lending to mid-sized businesses through the recovery. The Federal Reserve has not engaged in lending directly to businesses before, but it was a step that seemed appropriate considering the breadth and depth of the challenges we face. We continue to solicit feedback and make adjustments to the program based on the suggestions received from bankers and other stakeholders, and we continue to welcome your thoughts and ideas on how we can make Main Street more effective. I would be interested to visit with those who may already have experience with this new loan program, and I would also be interested to hear about how you plan to use it to meet the needs of your business customers.

Together, these policy actions have helped stabilize financial markets, boost consumer and business sentiment, and assist millions of households and thousands of businesses harmed by the response to the pandemic. Credit markets, which had seized up earlier this year, have resumed functioning.

In our other role as a prudential regulator and bank supervisor, the Federal Reserve took several steps intended to reduce burden on banks and help them focus on the needs of their customers and communities.

Together, with our fellow federal regulators, we delayed the impact of the CECL accounting standard in our capital rules and temporarily eased the leverage ratio requirement for community banks. We also delayed reporting dates for Call Reports and other data collections. In addition, to address concerns about real estate appraisal delays, we provided temporary relief from certain appraisal requirements.

From a supervisory perspective, beginning in late March the Fed paused examinations for most small banks and took steps to lengthen remediation timeframes for outstanding issues. We considered the exam pause an important step to provide bankers time to adjust operations to protect the health of customers and employees, to prioritize the financial needs of their customers and communities, and to play an essential and vital role in implementing critical relief programs like the PPP.

As we continue to support the recovery and work to ensure that supervision and examination is as effective and efficient as possible, I think it's important to hear directly from you, who are actually working in the economy, about the conditions facing your communities and any challenges impeding your ability to meet the needs of your customers. In addition to my regular outreach to community banks, I am currently engaged in an effort to speak with every CEO of the more than 650 community banks supervised by the Fed. I want to hear directly from bankers about what you are seeing and your thoughts and ideas about the recovery. These conversations are incredibly valuable to me as a bank regulator and policymaker. They give context to the mountains of data we analyze and a unique perspective with real-world local examples to a complex and dynamic economic picture. For those of you from Fed member banks who I have not yet had the opportunity to meet or speak with by phone in these times of COVID, I look forward to our conversation. Your local Reserve Bank will be in contact to find a convenient time for us to meet.

Conditions for Smaller Banks

This audience knows better than most that smaller banks entered the pandemic in strong condition. At the end of 2019, over 95 percent of community and regional banks supervised by the Fed were rated a 1 or 2 under the CAMELS rating system. After coming through the last financial crisis in generally stronger condition than larger banks, smaller institutions had strengthened their capital positions and substantially improved asset quality in the years since, leaving them better positioned to deal with the current stress related to the pandemic. Likewise, credit concentrations, especially in construction and commercial real estate, were lower for smaller banks than at the outset of the last financial crisis, and risk management of concentrations improved over the last decade. Smaller banks also entered the pandemic with high levels of liquidity, and this liquidity has further improved with deposit inflows associated with pandemic-related stimulus programs.

Overall, community and regional banks remain well positioned to continue to extend credit and play an essential role in supporting our nation's recovery from the effects of COVID-19.

With this in mind, on June 15 the Federal Reserve announced our plan to resume bank examinations. We recognize the unique and challenging conditions under which the industry has been operating, and we will certainly consider that as we resume examinations. Our initial focus will be to assess higher risk banks, particularly those with credit concentrations in higher risk or stressed industries. Finally, we will continue to be sensitive to the capacity of each bank to participate in examinations and strive to prevent undue burden on banks struggling with crisis-related operational challenges.

The Road Ahead

Like many native Kansans, I am an eternal optimist, so let me end my formal remarks on a hopeful note. While the road ahead is highly uncertain, and we don't yet know when the economy will return to its previous strength, America will recover from this crisis, as it has from all of our past challenges. Our economic fundamentals are strong, and we have the solid foundation of the entrepreneurial spirit and resiliency of the American people. For its part, the Federal Reserve will continue to monitor progress and respond promptly and flexibly to support the recovery. We will closely watch economic and financial conditions, and we will use our monetary policy tools to respond as appropriate to pursue our dual mandate of maximum employment and price stability.

We will also remain open to further adjustments to supervisory schedules and expectations, as needed.

Thank you for the opportunity to speak with you today. I look forward to our discussion.