The Story of the Year in Southeast Banking Is Both Complex and Simple

> Although the sources of the crisis were extraordinarily complex and numerous, a fundamental cause was that many financial firms simply did not appreciate the risks they were taking. Their risk-management systems were inadequate and their capital and liquidity buffers insufficient. Unfortunately, neither the firms nor the regulators identified and remedied many of the weaknesses soon enough.
>
> —Federal Reserve Chairman Ben Bernanke, December 2009

The year 2009 was one of stabilization for the financial system and recovery for the U.S. economy. Yet in the Southeast the banking system fared worse than in previous years and worse than banks in most other regions. This annual report examines what happened to southeastern banks, explores causes of the problems, and assesses factors that will shape the future of banking institutions in the region.

The story told is both complex and simple. The financial crisis associated with the economic downturn that began in 2007 resulted from highly complicated and interrelated factors. These factors include growth in the market for mortgage-backed securities and complex investment instruments, unusually large amounts of leverage by households and financial institutions, deterioration in risk management by financial institutions, the growth of off-balance sheet activities by many banks and of the unregulated “shadow” banking system, a flawed business model for the housing-related government-sponsored enterprises, regulatory issues, and the global savings glut. (See the sidebar “Fannie Mae and Freddie Mac: Past, present, and future” on page 6.) Scholars will likely spend years untangling the root causes. At the same time, the problems for most troubled southeastern institutions were straightforward, involving real estate.

This report does not delve into the numerous issues that brought on the larger financial crisis but instead focuses on reasons for the problems that plagued many small and midsized banks in the Southeast. In this report, "Southeast" refers to the states of Alabama, Florida, Georgia, Louisiana, Mississippi, and Tennessee in their entirety.

The immediate problem that damaged many southeastern banks was essentially that many banks lent heavily to builders and developers before it became clear that the Southeast's long jobs-and-building boom was ending. In some cases, institutions strayed from their own guidelines concerning asset allocation by taking on a heavy concentration in real estate loans (see chart 1). In addition, corporate governance may on occasion have been too lenient or even absent. Finally, at many of the troubled institutions, much of the lending was funded not by traditional deposits but by more volatile and sometimes more expensive brokered deposits.

The general operating assumption that prevailed in financial institutions before the crisis was that the population influx would continue, buyers would keep snapping up speculative houses, and therefore developers and builders would make profits, repay their bank loans, and borrow more money to build more houses to accommodate the growing population. But this virtuous circle eventually broke. When it did, financial regulators by many accounts did not move aggressively enough to anticipate the downward cycle or its scope and depth. In retrospect, bank examiners found themselves with tools that proved inadequate. Neither the guidance on commercial real estate lending nor separate guidance concerning nontraditional mortgage products included specific limits on those activities. Likewise, neither guidance included minimum capital requirements.

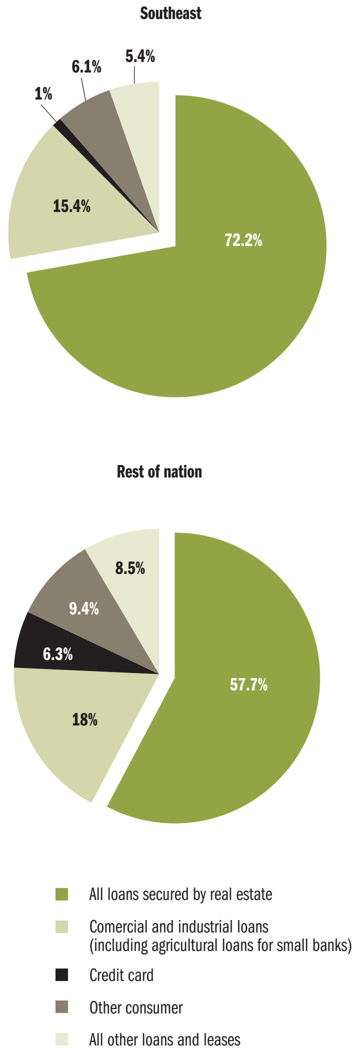
For banks in the Southeast, the consequences have been stark. Three performance measures make this clear:

- **Failures:** Seven banks in the six states of the Southeast failed during 2008 and forty-two failed in 2009, after only two failures in the previous five years.
- **Earnings:** After amassing cumulative profits exceeding $50 billion from 2002 through 2007, FDIC-insured financial institutions based in the six states lost $8 billion in 2009 and $8.8 billion in 2008, according to data compiled by the Federal Deposit Insurance Corporation (FDIC) from bank call reports.
- **Loan quality:** At the end of 2009, the region's financial institutions reported a combined $4.4 billion in loans ninety or more days past due, more than triple the amount at the end of 2006 and six times the level at the end of 2004. Southeast banks ended 2009 with $29.7 billion in assets no longer accruing interest, eleven times the amount at the end of 2006.

Before the recession, an economic boom

These numbers evidence a dramatic reversal. In the years preceding the financial crisis, vigorous economic growth had created a robust banking environment across much of the Southeast. Indeed, rapid population and job growth powered the regional economy. The population of the Southeast had more than doubled since 1960, reaching 46.2 million and far outpacing growth in the country as a whole. Florida's population alone grew nearly 300 percent, to 18.3 million, while the nation's population increased by 68 percent. Florida and Georgia were among the nation's most prolific jobs machines before the economic downturn began in 2007. In total, the region created 5.3 million net jobs during the decade and a half (see chart 2 on page 7).

Chart 1
Bank loan portfolio exposure



Note: Data are through the fourth quarter of 2009.
Source: Bank call reports

Fannie Mae and Freddie Mac: Past, present, and future

Editor's note: This is an excerpt from Atlanta Fed economist W. Scott Frame's April 2009 working paper, "The 2008 federal intervention to stabilize Fannie Mae and Freddie Mac," available online at ***frbatlanta.org/pubs/wp/working_paper_2009-13.cfm****.*

Fannie Mae and Freddie Mac are government-sponsored enterprises that play a central role in U.S. residential mortgage markets. In recent years, policymakers became increasingly concerned about the size and risk-taking incentives of these two institutions. In September 2008, the federal government intervened to stabilize Fannie Mae and Freddie Mac in an effort to ensure the reliability of residential mortgage finance in the wake of the subprime mortgage crisis. This paper describes the sources of financial distress at Fannie Mae and Freddie Mac, outlines the measures taken by the federal government, and presents some evidence about the effectiveness of these actions. Looking ahead, policymakers will need to consider the future of Fannie Mae and Freddie Mac as well as the appropriate scope of public sector activities in primary and secondary mortgage markets. ◆

Fact

Real estate as a percentage of net loans and leases in three southeastern states:

- **Florida—70 percent in 1999 to a high of 80 percent in 2008**
- **Georgia—67 percent in 1999 to a high of 87 percent in 2009**
- **Alabama—62 percent in 1999 to a high of 74 percent in 2006 and 2007**

Source: FDIC

This expansion fueled demand for housing, retail centers, office space, and other real estate. Low interest rates and easy access to credit furnished the ideal backdrop for rapid residential and commercial real estate development. Consequently, real estate lending proliferated, and new banks opened across the southeastern region to join with existing institutions.

On average, a financial institution opened in the Southeast almost every week from 2000 through 2007, for a total of 327 new banks. Most of them were in Florida, Georgia, and Tennessee (see chart 3 on page 7). Between 2001 and 2007, these three states ranked second, third, and fifth among all states in bank and thrift formations. More than 60 percent of those new institutions were chartered by state banking departments. The region in total was home to 26 percent of the nation's new bank and thrift formations during these years, according to the FDIC. Though this figure may seem high, it is not far out of line with the growth of the region, as the Southeast accounted for 22 percent of the nation's population increase in those years, according to Census Bureau estimates.

The abundant financing helped to feed the building boom. Among Georgia's FDIC-insured institutions, CRE lending increased almost eight times from 1999 to the end of 2007, according to FDIC data. Florida-based banks' loans to buy land and build increased about five times during the period 1999–2006 (see chart 4 on page 9). At the same time, many banks based outside of Florida entered that market to take advantage of the real estate development boom, a move that further fueled increases in credit and development in the Sunshine State.

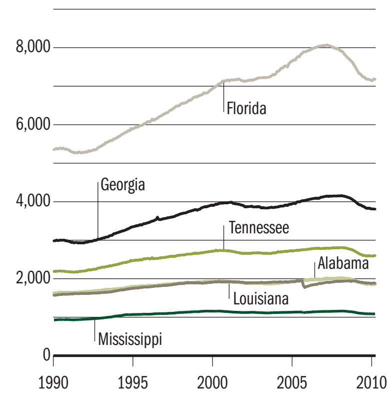
Residential developers put the money to use. According to the U.S. Census Bureau, Florida developers applied for 959,948 housing permits from 2003 through

2006, more than the number of permits applied for in the entire country in the year 2008. The drop in Florida permit requests from 2005 to 2009 was dramatic, falling from a peak of 287,250 down to 35,329. In metropolitan Atlanta, the Southeast's fastest-growing metro area before the recession, officials issued an average of about 68,000 residential building permits each year from 2000 through 2006 (see chart 5 on page 9). To lend some perspective, the entire city of Tallahassee, Florida, has a little more than 68,000 housing units, according to U.S. Census data.

Recession brings a new reality

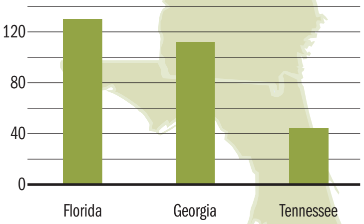
The Southeast's banks rode the crest of this economic wave through the 1990s and early 2000s, interrupted only by the 2001–02 recession. But as this most recent crisis halted and then reversed the region's once-spectacular job growth, residential development outstripped demand. Perhaps nowhere were the effects of slowing job

Chart 2
Payroll employment



Source: U.S. Bureau of Labor Statistics

Chart 3
New banks established in three southeastern states, 2000–07



Note: The total number of new banks established in the Southeast during this period was 327, including 28 in Alabama, 6 in Louisiana, and 7 in Mississippi.
Source: FDIC

The region's many "pipe farms" are visual evidence of the sudden drop in housing construction in 2008.

Too big to fail

Atlanta Fed economist Larry D. Wall republished in April 2010 an article originally published in 1993 on the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). The paper, "Too big to fail: No simple solutions," says that the intent of the legislation was to reduce taxpayers' exposure to financial system losses, including their exposure to too big to fail financial institutions. Wall notes in a new preface to the article that the recent financial crisis demonstrated that too big to fail has still not been eliminated for the very largest banks.

While too big to fail has not directly affected the Sixth District, the negative effects from the national issue have cast their shadow on us here in the Southeast. The article is available online at **frbatlanta.org/cenfis/pubscf/vn_no_simple_solutions.cfm**. ◆

Relatively new banks were also hit particularly hard. Among forty-nine southeastern institutions that failed in 2008 and 2009, twenty-two were less than ten years old.

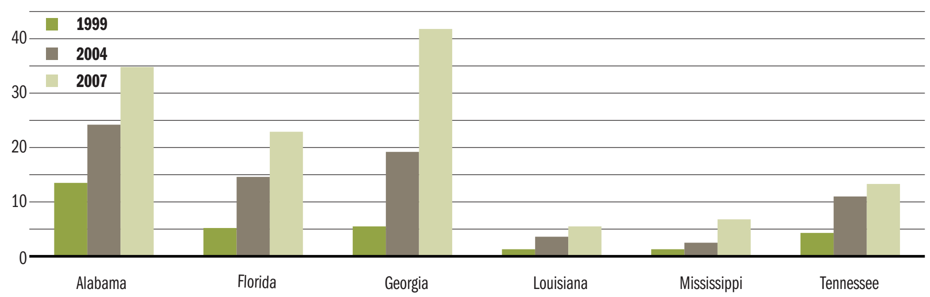
growth more apparent than in Florida. As of December 2009, the state had shed roughly 920,000 jobs since its peak nonfarm employment in March 2007, according to the Bureau of Labor Statistics. With fewer jobs to pursue, fewer people moved to the state. In an astounding turnabout, from July 2008 to July 2009, more people left Florida than arrived, according to U.S. Census data. It was the first twelve-month period in sixty-three years in which Florida lost population.

The effect of slowing in-migration on the Southeast's homebuilding industry was sobering. So-called "pipe farms" littered places like metro Atlanta. (The term "pipe farms" refers to land that developers had graded and planted PVC pipes in for subdivisions that they would now never build.) The inventory of the area's partially developed vacant lots soared from a twenty-one months' supply during 2005 to more than ten years' worth by the end of 2008, according to a Federal Reserve Inspector General's report on a failed metro Atlanta bank. Eighteen to twenty-four months is considered an acceptable inventory. Housing construction came to a virtual standstill during 2009. For instance, in metropolitan Atlanta, builders secured 6,533 construction permits, down from a peak of 74,007 in 2004.

The heavy concentration in real estate lending became problematic for many of the region's financial institutions. As the hammers and saws fell silent, the Southeast shouldered a disproportionate share of bank failures. The region's forty-two failed institutions in 2009 accounted for 36 percent of the nationwide total, which is more than double its share of U.S. banks. In terms of assets, the region's banking institutions at the end of 2009 accounted for 6.7 percent of the total assets of all FDIC-insured institutions nationally.

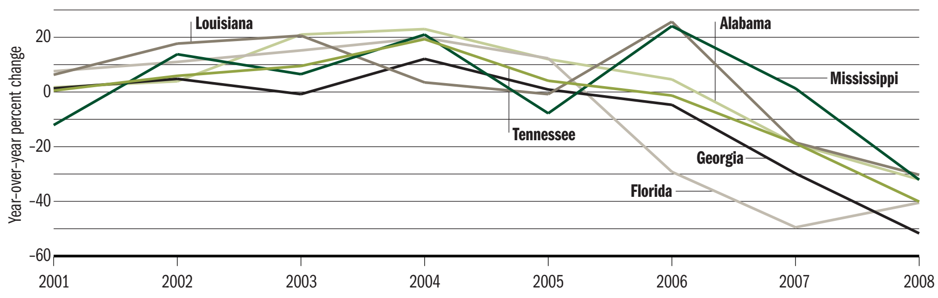
The state of Georgia led the nation in bank failures in 2008 and 2009, with twenty-five failed institutions in 2009 and five in 2008. Three-fourths of them were based in metropolitan Atlanta. Most of Georgia's failed banks were relatively small, with less than \$1 billion in assets. Relatively new banks were also hit particularly hard. Among forty-nine southeastern institutions that failed in 2008

Chart 4
Cumulative construction and land development loans



Note: Numbers are in $billions, and are from FDIC-insured institutions based in the Southeast.
Source: FDIC

Chart 5
Building permits in the Southeast



Source: U.S. Census Bureau

and 2009, twenty-two were less than ten years old. Fifteen of these were based in metropolitan Atlanta.

The small size of the Southeast's failed institutions did not pose systemic risks of the kind associated with much larger financial institutions that failed or required substantial public aid. However, the sheer number of failures often unsettled communities and bank customers and imposed a cumulative cost to the FDIC deposit insurance fund (DIF) of more than $3 billion, according to FDIC estimates as of March 2010. Among the recent bank failures in the Southeast, only two had assets of more than $10 billion, and neither was close to the so called "too-big-to-fail" range (see the sidebar "Too big to fail" on page 8). Thus, the too-big-to fail conundrum has not been predominant in this region.

Real estate loans falter

By the end of 2009, loans secured by real estate accounted for 82 percent of assets that were ninety or more days past due at FDIC-insured institutions headquartered

Fact

Of $29.7 billion in assets not accruing interest at the Southeast's FDIC-insured institutions at the end of 2009, $27.3 billion, or 92 percent were secured by real estate.

Source: FDIC

Who regulates whom?

Different types of banking organizations in the United States are chartered and regulated by different federal and state agencies.

The Federal Reserve ("The Fed") is the primary supervisor for bank holding companies, including financial holding companies; state Federal Reserve-member banks; Edge and Agreement corporations; and state-licensed foreign banks operating in the United States, along with foreign banks' representative offices in the United States.

The Office of the Comptroller of the Currency (OCC) charters, supervises, and regulates national banks and federally licensed foreign banking operations in the United States.

The Federal Deposit Insurance Corp. (FDIC) is the primary federal supervisor and regulator of nonmember state banks, some savings banks, and certain state licensed and federally licensed foreign banks.

The Office of Thrift Supervision (OTS) supervises and regulates thrift holding companies, savings banks, and savings and loan associations.

States also maintain financial regulatory agencies that supervise state-chartered banks and certain other state-licensed financial institutions such as insurance companies and nonbank lenders.

The National Credit Union Administration (NCUA) charters, supervises, and insures federal credit unions.

The following table is a breakdown of institutions headquartered in the Sixth Federal Reserve District, as of December 31, 2009:

Entity type	Primary regulators	Institutions/ 2009 failures
National banks	OCC	142/7
Federal savings banks	OTS	62/6
Savings and loan associations	OTS	26/0
State-chartered member banks	Fed, FDIC, States	54/5
State-chartered nonmember banks	States	731/24
State-chartered savings banks	States, FDIC	6/0
State credit unions	States, NCUA	357/0
Federal credit unions	NCUA	508/0

in the Southeast. Those problem real estate loans amounted to 3.6 percent of total equity capital. That figure is more than triple both the level of troubled real estate loans at the end of 2006 and the amount relative to capital.

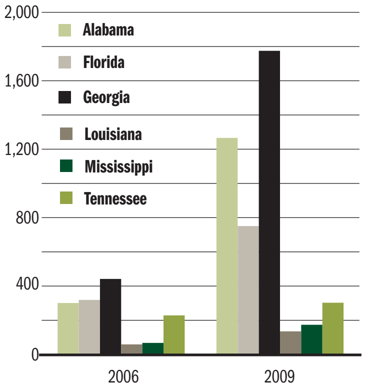
Florida-based institutions carried the highest level of real estate assets ninety days-plus past due relative to capital, at 4.85 percent. Louisiana banks had the lowest level of problem real estate assets compared to capital: 1.68 percent. Georgia institutions as a group showed the largest three-year increase: 325 basis points (see chart 6).

Reviews: Real estate caused most failures

For each bank failure resulting in an FDIC payout exceeding the greater of $25 million or 2 percent of an institution's assets, the inspector general (IG) of the responsible regulatory agency must examine the causes of failure and issue a material loss review

Chart 6

Southeastern loans 90 days past due



Notes: Numbers are in $millions, and are from Institutions based in the Southeast.
Source: FDIC

The Atlanta Fed took several measures in 2009 to keep the foreclosure crisis in its sight, including tapping into the Real Estate Analytics team, planning the Real Estate Research blog to cover foreclosure issues and other real estate topics, enhancing the bank's online foreclosure resources for consumers, and launching the Foreclosure Response podcast series. (Go to frbatlanta.org.)

(MLR). (The federal regulatory agencies are the FDIC, the Federal Reserve, the Office of the Comptroller of the Currency [OCC], the National Credit Union Administration [NCUA], and the Office of Thrift Supervision [OTS]. See the sidebar "Who regulates whom?" on page 10.) As of the end of January 2010, the IGs had issued MLRs on nineteen southeastern institutions that failed in 2007, 2008, and 2009. These MLRs almost invariably identify excessive real estate lending as the primary cause of failure.

Several themes run through the reports. In many cases, as already noted, failed institutions violated their own guidelines regarding both management and board of directors' oversight of operations and how much of their portfolio could be devoted to any single industry or category. The IG reports attest that a few failed institutions falsified information in call reports that they filed with regulators.

Not surprisingly, the most common thread among the MLRs is a focus on problems related to real estate lending. Eighteen of the nineteen MLRs cite inadequate risk management of a heavy concentration in real estate lending as a primary cause of failure. This excerpt from a Federal Reserve IG review of a Georgia institution is typical: "The risks associated with the ADC [land acquisition, development, and construction] portfolio were magnified by the speculative nature of the residential construction loan component; 93 percent of these loans were made to builders for constructing homes that were not pre-sold." The bank's own internal policy, the IG report adds, limited such loans to 60 percent of the residential construction loan portfolio.

Another MLR, this one from the FDIC's Office of Inspector General, says a Florida institution "failed primarily due to bank management's aggressive pursuit of asset growth concentrated in high-risk CRE loans with inadequate loan underwriting and a lack of other loan portfolio and risk management controls."

They conclude that the foreclosure crisis was primarily driven by the severe decline in housing prices... not by a relaxation of underwriting standards on which much of the prevailing literature has focused.

Other missteps plagued banks

Some institutions encountered different types of real estate lending difficulties. For example, a Georgia lender that specialized in loans to redevelop low-income neighborhoods relied too heavily on appreciation in property values at the expense of sound underwriting practices, according to an MLR by the U.S. Treasury Department's Office of the Inspector General (see the sidebar "Depreciation or bad underwriting?" on page 13). In the report, the IG cites examples of loans originated "with no consideration of borrower credit-worthiness," including one to a borrower made days after he left prison for mortgage fraud.

In another Treasury Department MLR, the inspector general describes how a failed Florida bank installed a relative of the owner as CEO in 2004. This relative had no experience running a bank. As CEO, he directed an aggressive growth strategy relying on high-risk products. Even as the bank incurred operating losses, it continued paying dividends to its holding company. The holding company's majority shareholders were the bank owner and his family.

Regulators also come in for criticism

Bank managers and directors are not the only parties faulted for their role in the financial crisis. MLRs frequently report that the regulatory agencies were not forceful enough. Meanwhile, members of the Federal Reserve Board of Governors and officials throughout the Fed conducted a critical self-examination of the Fed's super-

Depreciation or bad underwriting

*Editor's note: This is an excerpt from "Decomposing the foreclosure crisis: House price depreciation versus bad underwriting," a September 2009 working paper by Atlanta Fed economist Kristopher Gerardi, Boston Fed economist Paul S. Willen, and Adam Hale Shapiro, an economist with the Bureau of Economic Analysis. The paper is available online at **frbatlanta.org/pubs/wp/working_paper_2009-25.cfm**.*

The authors, using a data set that includes every residential mortgage, purchase-and-sale, and foreclosure transaction in Massachusetts from 1989 to 2008, study the dramatic increase in foreclosures that occurred in Massachusetts between 2005 and 2008. They conclude that the foreclosure crisis was primarily driven by the severe decline in housing prices that began in the latter part of 2005, not by a relaxation of underwriting standards on which much of the prevailing literature has focused. They argue that relaxed underwriting standards did severely aggravate the crisis by creating a class of homeowners who were particularly vulnerable to the decline in prices. In the absence of a price collapse, they conclude that the emergence of this new group of homeowners in itself would not have resulted in the substantial foreclosure boom that was experienced. ◆

vision and regulation function. As a result, the Fed began in 2009 to change how it supervises financial institutions. (See the section "Unsparing self-assessments" on page 18.)

Numerous MLRs note that regulators should have considered compelling institutions to curtail their loan concentrations in residential ADC. An FDIC material loss review of a failed Florida de novo bank notes that even though an FDIC examiner recommended more frequent than normal examinations, neither the agency nor state regulators followed the recommendation of quarterly reviews. Instead, the FDIC visited the institution three times in three years. "More timely supervisory action, directed at the performance of [the institution's] president/CEO, high-risk lending, weak credit underwriting and administration practices, and the bank's increasing risk should have been taken as a result of the FDIC's 2006 examination," the review states.

An OCC material loss review on an Atlanta bank that failed in 2009 is equally straightforward: "Until 2008, OCC's examinations of [the failed bank] were not adequate and allowed the bank's risky lending practices to continue unabated." The IG adds that in February 2008, the OCC examiner in charge had stated that formal enforcement action was likely needed against the institution, yet the agency did not enter into a consent order with the bank until eight months later.

Some of the content in the MLRs is clearly critical of front-line examiners. Whether supervisory action alone would have prevented the outcomes that occurred is less clear. The Federal Reserve IG states in a report that circumstances at a Georgia community bank warranted "a more forceful supervisory response." However, the

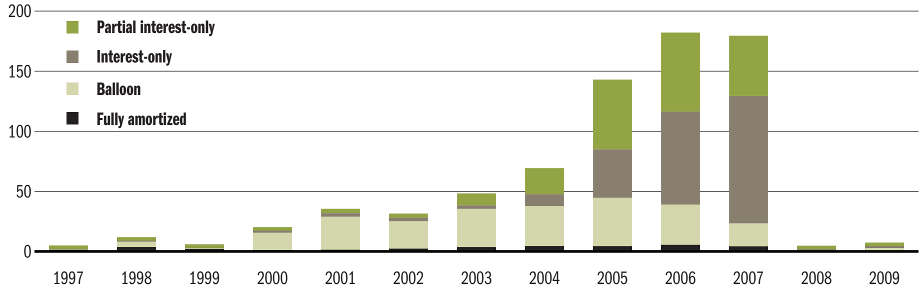
Fact

In 2009, commercial banks in the Southeast carried $132.7 billion in CRE loans. Banks with assets under $1 billion carried 42 percent, or $55.3 billion, of these loans.

Source: Bank call reports

Chart 7

Outstanding commercial mortgage-backed securities by vintage (year)—U.S. only ($Bls)



Source: Bloomberg

report also notes that such a response might not have mattered anyway. Given the deteriorating real estate market, determining whether more decisive regulatory action would have affected the bank's subsequent decline or the failure's cost to the DIF was not possible, according to the review.

One reason is that federal regulatory policymakers did not issue guidance on subprime lending and other issues until the elements that contributed to the crisis were firmly in place. And when the crisis came, that guidance did not include specific limits on subprime and nontraditional real estate lending. Moreover, the idea of conducting forward-looking, "what-if" assessments of banks' portfolios was not instituted until the 2009 Supervisory Capital Assessment Program (SCAP), the stress tests of the nation's nineteen largest banking companies (see page 18).

Smaller institutions hold almost half of all CRE loans, even as they account for only a fifth of the nation's commercial banking assets . . . .

Commercial real estate issues loom

Commercial real estate (CRE) markets were cause for continuing concern through 2009, exacerbating the problems associated with troubled real estate loans. The total dollar value of CRE loans is considerably smaller than that of residential real estate loans. The CRE market is important to commercial banks, however, especially those with less than $10 billion in assets. Total CRE debt in the country amounts to a third of residential mortgage debt, but banks hold a far greater portion of overall commercial real estate debt than residential, in part because investors the world over hold substantial securitized residential mortgage debt (see chart 7). Commercial banks, in fact, hold about 40 percent of all CRE debt in the form of whole loans, Atlanta Fed President Dennis Lockhart noted in a November 2009 speech. That amounts to roughly $1.4 trillion on banks' books. Smaller institutions hold almost half of all CRE loans, even as they account for only a fifth of the nation's commercial banking assets, according to bank call report data. The FDIC reports that southeastern banks with assets under $1 billion held forty-two percent of the region's total CRE loans.

The recession weakened these CRE portfolios. Simply put, job losses and a slowing economy sapped demand for CRE, leaving more office space, warehouses, shopping centers, hotels, apartments, and condos empty across the Southeast. In turn, rental rates fell, reducing cash flows for building owners and making it more difficult for them to service bank debt. This problem could become even more significant. From 2010 through 2012, tens of billions of dollars in commercial mortgages will be up for renewal by banks. In many cases, those properties will be worth less than they were when the loans were made, introducing new challenges to the already stressed smaller banks as well as the CRE market.

Some Southeast real estate markets saw signs of equilibrium toward the end of 2009. As unsold condo units and apartment vacancies mounted, builders began taking out far fewer multifamily construction permits. Throughout the Southeast, the number of apartment and condo building permits issued declined on a year-over-year basis in every month from April 2006 through 2009. In addition, inventory was being absorbed more quickly as prices fell and supplies leveled off. For example, sales of existing condos in Florida in December 2009 were 91 percent higher than in December

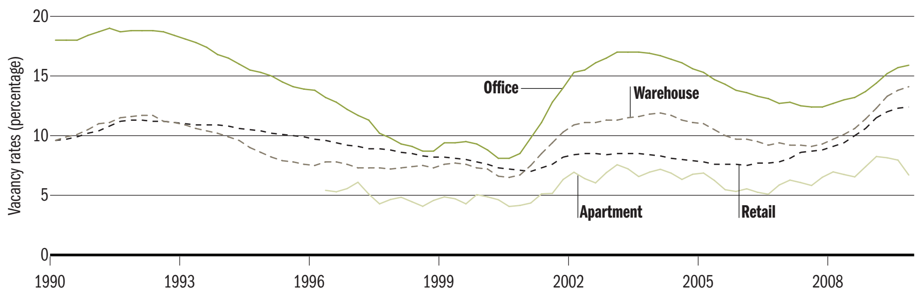
A national real estate slump following a development boom in the Southeast has left the region's landscape dotted with empty retail space.

Returning to a Healthy Banking System

In looking ahead to 2010, the FDIC sees improving conditions for many banks, but also projects that there will be substantially more bank failures through at least the third quarter of 2010. These are lagging results of the difficulties in commercial real estate loans.

For more information, go to http://www2.fdic.gov/qbp/index.asp

Chart 8
Commercial real estate vacancy rates



Source: CBRE Econometric Advisors, Axiometrics Inc.

2008, albeit at an 18 percent lower median sale price, according to the Florida Association of Realtors. The same dynamic of higher year-over-year sales at lower prices held in every month of 2009 in the Sunshine State, though the price declines were smaller later in the year.

Problems lingered in other sectors even as the condo market showed some signs of stabilizing. Some Southeast markets still had substantial numbers of apartment units under construction as 2009 ended. Atlanta, Nashville, and Tampa all had more than 2,500 apartment units "in the pipeline" at year end, according to F.W. Dodge Pipeline/CBRE Econometric Advisors. Meanwhile, elusive job growth, along with competition from distressed homes and condos whose owners gave up on selling and decided to rent their properties, also hurt apartment markets.

Vacant office space also proliferated. The construction boom early in the decade, followed by pervasive job losses in 2008 and 2009, sent vacancy rates climbing. By the end of 2009, seven southeastern markets—up from just three a year earlier—had vacancy rates above 20 percent.

Much the same story played out in industrial real estate. Vacancies across the Southeast began to climb in late 2007 and early 2008. At the same time, development slowed and rents declined, forces that continued through the end of 2009.

Similarly, retail vacancies rose throughout 2009. In many cases, shopping centers were nearly empty shells as nearby planned subdivisions were never finished. In the fourth quarter of 2009, twenty-six of the region's twenty-eight largest markets saw retail vacancy rates climb compared to the year-ago period, according to REIS, a commercial real estate research firm (see chart 8).

These indicators of CRE market weakness are a concern to banks, and problem CRE loans could hinder smaller banks' role in the economic recovery. These banks may have to set aside larger reserves as a cushion against troubled CRE assets. That action could, in turn, limit the amount of credit they can make available to the numerous small businesses that rely on them for financing. With credit tight for small businesses, then, their ability to grow and hire would be limited, undermining one engine of economic recovery.

However, at this writing, some evidence exists that many small firms are not taking on new bank loans. A December 2009 Atlanta Fed survey of 206 small businesses in the Southeast found that nearly half of respondents had not sought a loan or line of credit from a bank in the past six months. The reason they cited most was uncertain sales prospects. Of those businesses that sought credit, about 60 percent said they were able to obtain all or most of the bank financing they requested. Not surprisingly, construction firms had the most difficulty. Seventy percent of those that sought credit were unable to secure it. It is important to keep in mind that survey respondents represented established, relatively successful firms.

It is true that the CRE problem does not appear to threaten the broader financial system despite tight credit and underwater CRE loans. The size of CRE debt, as noted, is smaller than that of residential real estate, and the exposure is more concentrated in smaller banks, whose failure does not pose a systemic threat. Nevertheless, CRE debt adjustment and resolution is an important element in economic rebuilding, in large part because of the ripple effect on small banks and the businesses that rely on them.

Recognizing this fact, the Federal Reserve and other financial regulatory agencies in October 2009 updated longstanding guidance regarding the workout of CRE loans. The new statement calls for a balanced and pragmatic approach to CRE loan workouts and examiner loan classifications, consistent with accurate and timely recognition of losses. The guidance is intended to promote supervisory consistency, enhance the transparency of CRE workout transactions, and ensure that supervisory policies and actions do not inadvertently limit credit availability to sound borrowers. Properly done, such workouts are often in the best interest of both the institution and the borrower. According to the updated guidance, financial institutions that undertake prudent loan workout arrangements after thorough reviews of borrowers' financial conditions will not be subject to criticism for these efforts, even if the restructured loans have weaknesses that cause adverse credit classifications.

Signs of improvement emerge

In 2009, the goal of both banks and their regulators was to try to regain stability. They worked to bolster banks' capital and enhance liquidity and made some progress. Measures of capital firmed up. Late in the year, signs that the worst of loan quality problems could be easing in the Southeast's banks were evident. Indeed, the functioning of interbank and other short-term funding markets improved considerably, interest rate spreads on corporate bonds narrowed significantly, prices of syndicated loans increased, and some securitization markets resumed operation. In addition, equity prices of banks whose shares are publicly traded increased sharply, on net, since their low in early 2009.

Evidence also suggests that further tightening of lending standards in many loan categories might be coming to an end. According to a January 2010 Federal Reserve national survey of senior lending officers, commercial banks generally ceased tightening standards on many loan types in the fourth quarter of 2009. Banks' policies on commercial real estate lending were an exception, as large fractions of respondents continued to tighten their CRE credit standards and terms during the quarter. Moreover, respondents have yet to unwind the considerable tightening overall that occurred over the preceding two years

Sales of existing condos in Florida in December 2009 were 91 percent higher than they had been in December 2008.

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Regulatory reform principles

*Editor's note: The following statements are excerpted from Federal Reserve Chairman Ben Bernanke's speech to the Economic Club of Washington, D.C., on December 7, 2009. For the full text of the speech, go to **federalreserve.gov/newsevents/speech/bernanke20091207a.htm**.*

First, *all* systemically important financial institutions, not only banks, should be subject to strong and comprehensive supervision on a consolidated, or firm-wide, basis.

Second, when a systemically important institution does approach failure, government policymakers must have an option other than a bailout or a disorderly, confidence-shattering bankruptcy. The Congress should create a new resolution regime… to wind down a troubled systemically important firm in a way that protects financial stability.

Third, our regulatory structure requires a better mechanism for monitoring and addressing emerging risks to the financial system as a whole. ◆

Credit quality also showed hints of recovery in the final months of 2009. For example, a couple of the Southeast's largest banking institutions reported in Securities and Exchange Commission, or SEC, filings that their volumes of new nonperforming loans declined in the third and fourth quarters of 2009 from the previous three-month periods.

These developments reflected a positive trend: many financial institutions were clearing problem assets off the books and solidifying their capital bases. Several accessed various sources of funding and raised significant new capital during 2009. The Federal Reserve's SCAP stress tests played a role. After SCAP results were released in May 2009, the firms that the SCAP determined needed to raise capital increased common equity by more than $75 billion. One of the two southeastern firms that participated in the stress test has also repaid capital from the Troubled Asset Relief Program, or TARP, as did a handful of smaller institutions in the region.

Depositors also appeared more comfortable, improving financial institutions' access to core deposit funding. Concerns about the safety of their funds during the immediate crisis of 2008 largely abated, in part because of expanded FDIC guarantees.

Unsparing self-assessments

The banking industry is striving to strengthen risk management models, tighten underwriting standards, fortify capital positions, and regain sound health and consistent profitability. It remains an open question, however, whether the industry has fundamentally changed the way it operates after its most severe crisis in nearly eighty years. Ongoing issues center on the strength of the nation's economy, the outcome of changes implemented by regulators, and legislative reforms by Congress. Federal Reserve officials, including Chairman Ben Bernanke, have articulated a set of principles that in their view should underlie the nation's regulatory framework. (See the sidebar "Regulatory reform principles" on page 18.)

Financial regulatory agencies are already undertaking what Bernanke calls "unsparing self-assessments." "At the Federal Reserve and other agencies, the crisis revealed weaknesses and gaps in the regulation and supervision of financial institutions and financial markets," Bernanke said during the February 2010 swearing-in ceremony for his second term as Fed chairman. "Working together, the Fed staff and the Board have made considerable progress in identifying problems and improving how we carry out our oversight responsibilities."

Fed Involvement in Bank Supervision

Healthier depositor confidence, resulting in part from the FDIC's expanded guarantees, helped replenish some of the core deposit funding for financial institutions.

In cooperation with other agencies, the Federal Reserve is also toughening regulations to limit excessive risk-taking and to help banks withstand financial stress. For example, on the international level, the Fed has worked with such organizations as the Basel Committee on Bank Supervision to increase the quantities of capital and liquidity that banks must hold. Domestically, the Fed is implementing standards that require banking companies to adopt compensation policies that link pay to the institutions' long-term performance and avoid encouraging excessive risk taking.

A multidisciplinary approach will be a central feature of the Fed's supervision. The Federal Reserve's ability to draw on a range of disciplines, using economists, market experts, accountants, and lawyers, in addition to bank examiners, was essential to the success of SCAP. The Fed has begun using this varied expertise to augment traditional onsite examinations with offsite surveillance programs. In these programs, multidisciplinary teams combine supervisory information, firm-specific data analysis, and market-based indicators to identify problems that may affect one or more banking institutions.

Perhaps most importantly, the Federal Reserve is taking a more "macroprudential" approach to bank supervision. Drawing from the Fed's experiences in conducting the SCAP, this industry-wide approach transcends the health of individual institutions and instead scrutinizes the interrelationships among firms and markets to better anticipate sources of systemic financial contagion.

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Do no harm

The Fed and other regulatory agencies are beginning the necessary process of internal change. Yet there is a balance to be struck. They must take care not to stifle lending and damage the economy as they strengthen oversight of the financial system. To that end, in January 2010, the Federal Reserve joined the other financial regulatory agencies in issuing a statement reassuring banks, businesspeople, and the public that the agencies are working with the financial industry to ensure that supervisory policies and actions do not choke off credit to sound small business borrowers.

Many parties must collaborate in strengthening our financial system. Financial institutions, regulators, and lawmakers have important roles in ensuring that lessons learned from the crisis that began in late 2007 are applied in the service of the greater good. How these institutions and individuals perform is critical not just to those who make a living in the financial industry but also to the majority who depend on financial services and the nation's larger economy.

"The country is just now emerging from a long and painful recession caused largely by a crisis in our financial system," Lockhart said in January 2010. "We need to fix things, but purported reforms that weaken how the country's economic affairs are governed will be harmful and tough to undo."

The Southeast's banking industry has made progress in escaping the depths of the crisis. As noted, prospects for longer-term, sustainable recovery in the financial services industry and the broader economy were mixed at the end of 2009. Yet this region boasts a historically dynamic economy. Along with a better capitalized, managed, and supervised financial sector, that dynamism should stand the people of the Southeast in good stead in the coming years.

International institutions face different pressures

Dozens of overseas banks maintain a presence in the Southeast. At the end of 2009, sixty-one foreign banking operations (FBO) were doing business in the region, including twenty-six branches and agencies, eleven foreign-owned bank holding companies, sixteen representative offices, and eight Edge Act corporations, which hold special charters to conduct international banking operations.

The financial crisis affected foreign banks in the Southeast, but the impact on them was less dramatic than it was on domestic banks because of the smaller scope of their business in the region. None failed, and very few were in severe distress. One major reason is that heavy lending in U.S. real estate was not central to their business plans. However, some FBOs have increased their exposure as they've expanded their general banking business in the Southeast.

Presence of international banking declines

The international banking presence in the Southeast has been declining for more than a decade. In the 1980s and early 1990s, scores of Japanese and European banks had operations in the Southeast, mainly in Miami and Atlanta. Most of those institutions have since pulled out of the region.

More recently, though, large Spanish banks have expanded here through acquisitions and new branch offices. These banks have found appealing buying opportunities among troubled U.S. institutions. Acquirers can often pick up the healthy assets and operations of problem banks at a favorable price. The Spanish acquirers became more careful as the crisis spread. They learned from earlier deals, in which the banks they bought had more problems than were at first apparent. The acquiring foreign banks became more adept at taking on only healthy assets, often through arrangements with U.S. regulatory agencies that seek buyers to preserve the working parts of distressed institutions.

The primary risks facing FBOs in the Southeast do not change with economic currents. Those risks involve compliance with Bank Secrecy Act provisions regarding matters such as money laundering. Enforcing FBO compliance with Bank Secrecy Act and anti-money laundering regulations is a primary duty of the Atlanta Fed's Miami-based supervisory group. That work is evolving in response to the growth of certain FBOs. When a foreign institution's combined U.S. assets exceed $5 billion, a new level of supervision takes effect. This involves collaboration between the Atlanta Fed's international supervisory team and the group that supervises large domestic banking organizations. ◆

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