Letter from the President

Banking Issues in the Southeast

Following the turmoil of late 2008 involving very large financial institutions and the interbank market, many banks experienced a year of upheaval and financial pressure in 2009. Home foreclosures, commercial real estate revaluations, and a range of other credit quality problems came to a head for many financial institutions despite encouraging signs that the financial system as a whole had stabilized and a deep and protracted recession was finally coming to an end.

This year's annual report examines how many smaller and midsized banks in the Southeast responded to a series of real estate problems exacerbated by severe job losses, slumping household incomes, and widespread business uncertainty.

Financial and economic challenges in the Southeast were magnified by the high concentration of real estate investment in a region that had grown accustomed to strong population and income growth. For many years leading up to the recent recession, builders and developers profited from favorable demographic and economic trends for Sunbelt states. In-migration, homebuilding, and associated manufacturing industries like furniture, textiles, and household appliances fueled growth, and the Southeast had consistently outpaced the rest of the country by a range of economic measures. Development in some coastal markets was even more robust.

But fortunes reversed, and growth in the Southeast was slower than in the nation as a whole in 2009. Unemployment in the Atlanta Fed's six-state region was slightly higher than nationally. The aftermath of the housing bust has been especially challenging for southeastern banks—from small community banks to regional firms. In 2009, forty-two banks failed in the Southeast, and Georgia led the nation in the number of bank failures, although not in terms of assets. Nearly eighty southeastern banks received capital infusions from U.S. Treasury Department programs, although a few began to pay back these funds by year's end.

To further the financial sector's path to recovery, the Federal Reserve bolstered troubled housing markets by purchasing large volumes of agency-guaranteed mortgage-backed securities, along with agency debt and Treasury securities. Also, the Fed kept the fed funds rate exceptionally low, at just above zero for the entire year, and was explicit in describing this policy. While the low fed funds rate was a macroeconomic monetary policy measure, it also facilitated banks' efforts to repair their balance sheets.

Bankers, regulators, and lawmakers in 2009 began working toward building a better postcrisis financial system. Bankers learned many painful lessons from the financial crisis and have been forced back to basics. Bankers I have spoken with say they understand the need to refocus on strengthening risk management and capital and liquidity buffers.

Regulators, meanwhile, are refining their approach to financial supervision in some notable ways. For example, the crisis has made clear the need for greater horizontal supervision. This approach considers interconnections among financial firms and the ways those interconnections could affect the broader financial system and economy. For another, supervisors are transitioning to more forward-looking evaluations of individual institutions' safety and soundness.

Acting on those lessons, the Atlanta Fed began reorganizing its supervision and regulation operations. The aim is to make the supervisory function more flexible, forward-looking, and clear in communicating its messages and expectations to the staff and the institutions they supervise.

On the legislative front, Congress initiated deliberations on proposals to reform our nation's financial regulatory structure. A particular focus of this debate has been on preventing isolated problems from causing broad damage to the financial system and economy. Legislators discussed numerous and multifaceted measures, including ideas that would alter the Fed's duties in banking supervision. In my view, the Fed should continue to play a strong role in the nation's financial supervision, not only to help prevent and mitigate potential crises but also to effectively serve as a liquidity provider in times of stress. Only the Fed can act as lender of last resort because only the monetary authority can increase the money supply in an emergency. To make sound decisions, the lender of last resort needs intimate, hard, qualitative knowledge of individual financial institutions, their connectedness to counterparties, and the capacity of management.

At the time of this writing, the outcome of the debate on financial reform and the resulting legislation is unclear. It is vital that the regulatory regime for the future truly strengthens our defenses against the recurrence of financial crises.

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