Financial UPDATE

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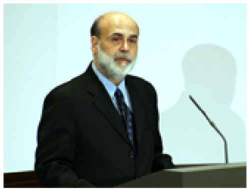
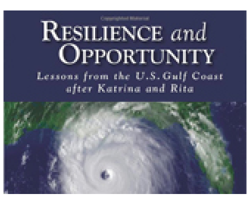


Fed Chair Bernanke: Research into Financial Crisis Essential
Federal Reserve Chairman Ben Bernanke recently addressed the importance of research into the causes of the recent financial crisis and on systemic risk more broadly. Given regulators' mandate to take a macroprudential approach to financial regulation, the Fed chair said developing directions for future research is essential.

Fed Gov. Duke Discusses Steps to Rebalance Housing Market
Federal Reserve Governor Elizabeth Duke recently discussed ways to restore balance to the nation's housing market. Her suggestions included helping borrowers obtain lower-interest mortgages and converting foreclosed properties into rentals.

Fed Chairman Bernanke: Recession, Financial Crisis Won't Leave Major Scars on U.S. Economy
Slow economic growth has raised concerns about the U.S. economy's long-term growth prospects, Fed Chairman Ben Bernanke recently noted. Growth coming out of the recession has been slow, he said, partly because of the downturn's global nature and the fact that it was accompanied by a financial crisis and housing slump.

Banking Agencies Urge Responsible Lending
Lending by community banks must be done in a way that avoids past mistakes and does not create new ones, according to congressional testimony by bank supervision and regulation officials, who also discussed recent community bank performance.

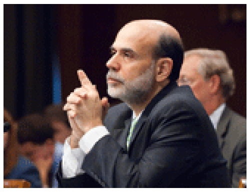


Harnessing the Power of Social Networks to Rebuild Communities
Following hurricanes Katrina and Rita, strong community ties played a critical role in the rebuilding process. A new book with content by Atlanta Fed staff explores the important role of social networks in the rebuilding of two Gulf Coast communities.

Credit Quality of Large Loan Commitments Improves
Credit quality for large loans that domestic and foreign banks as well as nonbanks were committed to make in 2011 continues to improve, according to the Shared National Credits Review. Loans deemed questionable by regulators declined more than 28 percent in 2011.

Lending Conditions Ease Slightly, Says Fed Survey
Banks reported easing credit standards and terms on nearly all types of business and consumer loans in recent months, according to the Federal Reserve's most recent Senior Loan Officer Opinion Survey. It indicated that while consumer credit is loosening, real estate credit remains tight.

Atlanta Fed's Lockhart: Market Swings Could Affect Consumer Spending
In a recent speech, Atlanta Fed President Dennis Lockhart discussed how swings in equity markets could affect consumer spending and thus the overall economy. Fragile consumer psychology could be a victim of market volatility, he said.



Fed Chairman Bernanke Discusses Outlook, Deficit to Congress
During his recent monetary policy address to Congress, Federal Reserve Chairman Ben Bernanke discussed the modest pace of economic recovery. He expects the second half of 2011 to demonstrate stronger growth, noting that consumer spending will determine much of the near-term pace of recovery.

Data Breaches and Risk Management in Emerging Payments: An Economist's View
Advances in technology have enabled companies to collect and share massive amounts of personal data from individuals and companies. An Atlanta Fed economist discusses the advantages of such data collection as well as the potential pitfalls and steps that can be taken to prevent fraud.

Federal Reserve Approves Rule Allowing Banks to Pay Interest on Demand-Deposit Accounts
Beginning July 21, financial institutions that are members of the Federal Reserve System are able to pay interest on demand deposits. The change is a result of a final rule approved by the Federal Reserve Board.

Federal Reserve Summarizes Meetings to Discuss Regulatory Reform
The Federal Reserve Board has held a series of meetings intended to allow the Board to gather information and help educate the public on matters subject to agency rule making and contribute to an informed rule-making process.

Fed Chair Bernanke: Research into Financial Crisis Essential

Research into the causes of the recent financial crisis and on systemic risk more broadly is critical in formulating macroprudential regulations and policies, Federal Reserve Chairman Ben Bernanke said in opening a Sept. 15 conference in Washington, DC.

Furthering research into policymaking

The chairman spoke at the Conference on the Regulation of Systemic Risk, which was jointly sponsored by the Federal Reserve Board and the *Journal of Money, Credit, and Banking*. The conference supports original research on topics relevant to the Fed's public policy mission, specifically its new requirement to take a macroprudential approach to financial regulation. A macroprudential approach considers the health of the financial system as well as the well-being of individual firms and markets.

The nine papers presented at the conference focused on various aspects of the central bank's duty to maintain financial stability and contain systemic risk, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The papers examined topics such as the rise and fall of mortgage securitization and related fluctuations in real estate lending, the causes and indicators of systemic risk and how well macroprudential regulations might address those causes, and specific regulations from a macroprudential perspective.

Working with an eye on the future

"The discussants' remarks, the general discussions, and the policy panel will surely be very helpful in identifying fruitful directions for further research," Bernanke said.

The conference proceedings will be published in special issues of the *Journal of Money, Credit, and Banking* and disseminated to researchers at central banks and academic institutions worldwide.

September 23, 2011

Fed Gov. Duke Discusses Steps to Rebalance Housing Market

The housing market has led most of the recent economic recoveries in the United States, but today's market is so imbalanced that it's actually hampering the recovery, said Federal Reserve Governor Elizabeth Duke during a September 1 speech.

Duke, speaking at a Fed conference in Washington, DC, discussed some of the near-term steps that could help stabilize and rebalance the housing market.

Lightening homeowners' load
One way to rebalance is to reduce the number of homes entering foreclosure by easing financial strains on homeowners, which can be done by modifying past-due mortgages or helping borrowers refinance into lower-rate loans, Duke said. However, despite low mortgage rates, refinance activity has been subdued compared to previous low-rate periods.

Duke also discussed the Obama administration's Home Affordable Refinance Program (HARP), which helps homeowners with little or no equity refinance their mortgages. Roughly 8,000 borrowers have refinanced through the program, even though an estimated 4 million homeowners are eligible. Several factors may be impeding wider participation in HARP, including up-front fees added to refinancing costs and lender concerns about taking on risk from previous underwriting.

"Finding different approaches to the policies that are hindering refinancing would likely provide some support to the economic recovery while improving the circumstances of homeowners," Duke said.

Reorganizing into rentals
Converting a portion of the large volume of real estate owned (REO) properties to rental properties would also help bring balance to the housing market, she added, noting that "the weak demand in the owner-occupied housing market and the relatively high demand in the rental housing market suggest that transitioning some REO properties to rental housing might benefit both markets."

Currently, these conversions are mostly happening on a small scale because managing the rentals is expensive, and regulatory guidance and servicing practices have traditionally encouraged the active marketing of these properties as opposed to renting.

Banking supervisors, for their part, can help smooth the process of converting REO properties to rentals by clarifying existing supervisory guidance to recognize that such conversions may be a sensible option for financial institutions, Duke said.

September 23, 2011

Fed Chairman Bernanke: Recession, Financial Crisis Won't Leave Major Scars on U.S. Economy

The sluggish economic recovery in recent years has raised concerns about the U.S. economy's long-term growth prospects, noted Federal Reserve Chairman Ben Bernanke in an August 26 speech, but "the healing process should not leave major scars," he said.

The chairman discussed the near- and long-term prospects for the economy at the Kansas City Fed's annual economic policy symposium in Jackson Hole, Wyoming.

The pace of economic growth coming out of the recession has been slower than in previous recoveries, partly a result of the global nature of the downturn and the fact that it was accompanied by a deep financial crisis and housing slump. These factors combined "have acted to slow the natural recovery process," Bernanke explained.

"Quality" economic policymaking essential to long-term growth
Despite numerous challenges, the U.S. economy has several underlying strengths working in its favor, including its status as the world's largest economy. It also benefits from flexible capital and labor markets, a robust entrepreneurial spirit, and a leading edge in technology. These strengths will play an important role in determining the country's economic path, but so too will the quality of its economic policymaking, Bernanke said.

Many of the policies needed to support long-term economic growth are beyond the Fed's realm, however. Fiscal policymakers in particular must balance the goals of setting the nation's fiscal policy on a sustainable path while avoiding actions that jeopardize the fragile recovery.

Bernanke listed the key objectives for the nation's tax policies and spending programs, including creating incentives to work and to save, stimulating investments in workforce skills, promoting research and development, encouraging private capital formation, and building essential public infrastructure.

Importantly, the chairman stressed the need for a better process of fiscal policymaking. Pointing to the recent protracted negotiations in Congress over raising the debt limit, he said that similar events in the future could jeopardize the country's economic and financial prospects.

Fed prepared to act, if needed
In terms of monetary policy, the Fed will continue to do its part to support the recovery, Bernanke said, highlighting the recent Federal Open Market Committee (FOMC) decision to give more clarity to its so-called "forward guidance." Following its August meeting, the FOMC said that it would keep the federal funds rate at "exceptionally low levels" through at least mid-2013. Further, the FOMC is "prepared to employ its tools as appropriate to promote a stronger economic recovery in a context of price stability," he said.

Despite the difficulties confronting the U.S. economy, Bernanke expressed confidence "that those challenges can be met, and that the fundamental strengths of our economy will ultimately reassert themselves."

Banking Agencies Urge Responsible Lending

Lending by community banks is an important piece of the economic recovery, but it must be done in a way that "avoids past mistakes and does not create new ones," said Kevin Bertsch, the associate director of the Federal Reserve's division of banking supervision and regulation.

Bertsch and officials from other regulatory agencies testified at an August 16, 2011, field hearing in Newnan, Georgia, and addressed concerns that overly conservative bank examinations are making it difficult for community banks to lend. They also discussed recent community bank performance amid still-tough economic conditions.

Community banks under strains
Although community banks have seen stronger earnings and improved asset quality in recent quarters, their performance is still weak by historical standards, noted Bertsch. Many of the challenges facing community banks stem from their exposure to construction and commercial real estate loans, he said. This is particularly true for the southeastern region, which is responsible for nearly 40 percent of the 388 bank failures nationally since 2007. Community banks in Georgia were especially hard hit. According to Bertsch, 41 percent of the state's insured commercial banks were unprofitable through the second quarter of 2011, compared to 15 percent of banks nationwide.

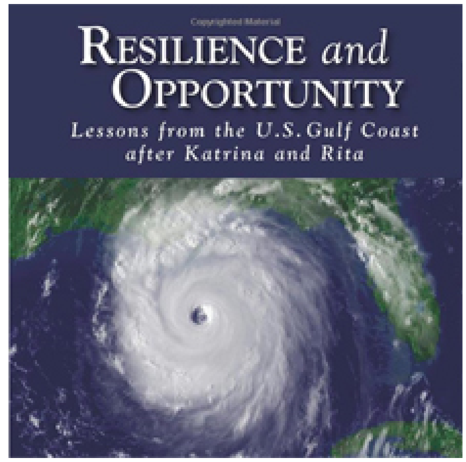
Pointing to ongoing questions about whether examiners have been overly restrictive of bank's activities, Bertsch laid out several steps the Fed has taken in the past several years to ensure "a balanced approach to supervision."

The Fed, along with other federal banking regulatory agencies, has issued examination guidance stressing the importance of taking a balanced approach. For instance, in February 2010 the Fed and other regulators issued a joint statement on lending to creditworthy small businesses, he noted. The Fed has also put in place training programs for examiners and outreach programs for bankers emphasizing the importance of sound lending practices.

Ensuring consistent supervision
Additionally, all examination findings are reviewed before they are finalized, and management teams vet the findings to ensure that issues are addressed consistently, among other things. Board staff also conduct more specific reviews, such as one recently that focused on commercial real estate loan-classification practices. According to Bertsch, the board's monitoring efforts so far "suggest that Federal Reserve examiners are following established guidance in evaluating supervised institutions."

August 31, 2011

Harnessing the Power of Social Networks to Rebuild Communities



In the wake of the devastation caused by hurricanes Katrina and Rita, strong community ties played a critical role in the rebuilding process. Atlanta Fed staffers Ann Carpenter and Nancy Montoya explored the important role of social networks in *Resilience and Opportunity: Lessons from the U.S. Gulf Coast after Katrina and Rita.*

Carpenter and Montoya, both from the Bank's community and economic development department, coauthored a chapter titled "Plugging into the Power of Community: How Social Networks Energize Recovery." The book is a publication of the Brookings Institution.

Networking the benefits
Robust social networks help communities build resilience in facing outside forces, such as the hurricanes and other disasters visited upon the Gulf Coast region in recent years. These networks offer a host of benefits to individuals, organizations, and communities, the authors wrote. One of them is the ability to facilitate emergency response and disaster mitigation planning "from the ground up."

The authors shared results from a case study involving two communities affected by Hurricane Katrina in 2005—Bay St. Louis, a small beach town on Mississippi's Gulf Coast, and the mostly residential Broadmoor neighborhood in New Orleans, Louisiana. In both cases, social networks in the form of organizations and businesses played an important role in the disaster recovery process. For instance, a senior citizen home served as an impromptu shelter, and places of worship became gathering places and information centers as residents returned to those communities in the days following the storm.

Using lessons learned for future events
The authors also share some suggestions for how to harness social networks to increase a community's resilience, such as incorporating informal social networks into the formal emergency planning and management process.

For more insight into the role of social networking in building resilient communities, be sure to listen to the *Financial Update Focus* podcast with Carpenter and Montoya.

August 31, 2011

Credit Quality of Large Loan Commitments Improves

For the second consecutive year, the credit quality improved for large loans that domestic and foreign banks as well as nonbanks were committed to make in 2011, according to the Shared National Credits (SNC) Review for 2011.

Total criticized loans—essentially those judged as questionable by regulators—declined more than 28 percent to $321 billion in 2011. Criticized assets represented 13 percent of the overall SNC portfolio, down from 18 percent in 2010.

Questionable loans remain
However, the percentage of criticized assets remained higher than it was before the financial crisis. A criticized loan is rated by regulators as "special mention, substandard, doubtful, or loss." Loans rated in the two weakest categories—doubtful or loss—declined 50 percent to $24 billion in 2011.

The Federal Reserve attributed the improvement in credit quality to such factors as better operating performance by borrowers, debt restructurings, bankruptcy resolutions, and ongoing access to bond and equity markets. Industries that led the improvement were real estate and construction, media and telecommunications, and finance and insurance.

Past lending decisions' effects linger
Despite this progress, poorly underwritten loans made in 2006 and 2007 continued to hurt the SNC portfolio. Roughly 60 percent of criticized assets originated in those two years.

Meanwhile, refinancing risk remained high as nearly $2 trillion, or 78 percent of the SNC portfolio, matures by the end of 2014. Of this maturing amount, $204 billion was criticized.

Although nonbanks, such as securitization pools, hedge funds, insurance companies, and pension funds, owned the smallest share of loan commitments, they owned the largest proportion, 58 percent, of classified credits (rated substandard, doubtful, or loss).

In other highlights of the review:

- Total SNC commitments increased less than 1 percent from the 2010 review. Total SNC loans outstanding fell $93 billion to $1.1 trillion, a decline of 8 percent.
- Classified assets declined 30 percent to $215 billion in 2011 and represented 9 percent of the portfolio, compared with 12 percent in 2010.
- Credits rated special mention, which exhibited potential weakness and could result in further deterioration if uncorrected, declined 25 percent to $106 billion in 2011 and represented 4 percent of the portfolio, compared with 6 percent in 2010.
- Nonaccruals declined to $101 billion from $151 billion. Adjusted for losses, nonaccrual loans declined to $92 billion from $137 billion, a 33 percent reduction.

August 31, 2011

Lending Conditions Ease Slightly, Says Fed Survey

Banks reported easing credit standards and terms on nearly all types of business and consumer loans in recent months, according to a Federal Reserve survey. The quarterly Senior Loan Officer Opinion Survey covered 55 domestic banks and 22 U.S. branches of foreign banks.

Increased competition drove banks to ease lending standards and terms on commercial and industrial (C&I) loans. Lending conditions improved especially for large and midmarket firms, or those with annual sales of $50 million or more. A modest percentage of banks also reported stronger demand for C&I loans as businesses shifted from other funding sources, said the report.

Real estate lending remains tight
In contrast, banks reported little change to lending standards for loans secured by real estate. In response to a special survey question, banks indicated that "standards for all types of CRE [commercial real estate] lending remain tight relative to the range that has prevailed since 2005." Meanwhile, roughly one-third of banks reported stronger demand for such loans. Household demand for prime mortgages was little changed, while a small net fraction of banks reported weaker demand for nontraditional mortgages.

When asked about their expectations for residential mortgage originations in the second half of the year, about 75 percent of banks said they expect the pace of originations to remain at about the same level, largely the result of lower demand among creditworthy borrowers and weaker forecasts for the economy and house prices.

Consumer demand loosens up
Consumer lending was slightly easier to come by in recent months. Roughly one-third of respondents said they were "somewhat more willing" to make consumer installment loans. More banks reported easing standards for auto loans than for credit card and other consumer loans, the report said. On the demand side, a moderate portion of banks reported stronger demand for auto loans, in contrast with demand for credit card and other consumer loans, which was largely unchanged.

August 30, 2011

Atlanta Fed's Lockhart: Market Swings Could Affect Consumer Spending

The most important real economic effects of the stock market's recent swings could be on consumer spending, Federal Reserve Bank of Atlanta President Dennis Lockhart said during an August 15 speech in Florence, Alabama.

"Volatility alone could have a negative impact on consumer psychology at a time of already weakening spending," Lockhart said. "Furthermore, if the loss of stock market value persists, the effect from the loss of investment value could combine with the loss of value in home prices to discourage consumers more and longer."

The causes and effects

Speaking to Rotary clubs from the Florence-Muscle Shoals area in northwest Alabama, Lockhart framed his remarks as answers to topical questions about the economy and financial markets. In addition to the question concerning the impact of the market gyrations, he also addressed their causes.

Lockhart said the reasons for the volatility include the increasing recognition of an economic slowdown in the United States and Europe, a reaction to the downgrade of the United States' credit rating, and concerns about government debt in European countries.

Looking down the road

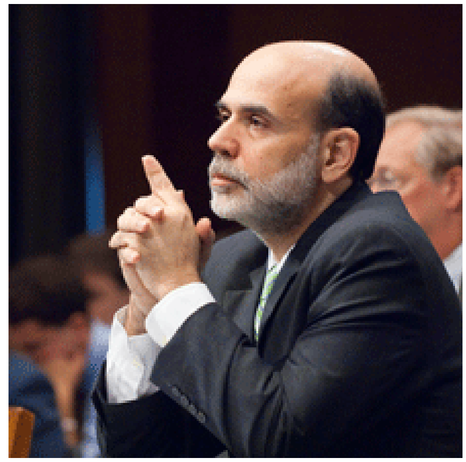
As for the economic outlook, Lockhart said that amid "a fog of uncertainty that is thicker than normal," the Atlanta Fed has lowered its near-term and intermediate forecast for national economic growth. Still, he expects the economy will continue to grow modestly. "In other words," he remarked, "we do not expect the onset of outright contraction—a recession—but I have to say the risk of recession is higher than we perceived a month or two ago."

Lockhart said he is cautious about the need for further monetary action. He believes the economy will resume a healthier pace of growth. But if that assessment proves wrong, Lockhart said the Federal Open Market Committee has the tools available to address whatever circumstances arise.

"At this juncture, we should not jump to conclusions," Lockhart said. "A clearer picture of economic reality will be revealed in time as immediate uncertainties dissipate. It's premature, in my view, to declare these important questions relating to our economic future settled."

August 30, 2011

Fed Chairman Bernanke Discusses Outlook, Deficit to Congress



Federal Reserve Chairman Ben Bernanke discussed economic conditions during his recent semiannual monetary policy address to Congress, noting that "the pace of expansion so far this year has been modest." The weaker-than-expected growth in the first half of 2011 was, in part, the result of temporary factors such as higher food and energy prices and supply chain disruptions following the earthquake in Japan, he said.

The second half of the year should see stronger growth. However, "the ability and willingness of consumers to spend money will determine much of the pace of recovery in the near term," Bernanke said. "Once the temporary shocks that have been holding down economic activity pass, we expect again to see the effects of policy accommodation reflected in stronger economic activity and job creation."

If the economy does weaken, however, the Fed stands ready to provide further stimulus, the chairman said, while noting that the central bank also stands ready to raise interest rates if inflation becomes a problem.

Looming deficits pose obstacle

Bernanke also discussed the need for Congress to resolve the issue of raising the U.S. government debt limit, noting that even a partial default would likely result in a downgrade of the government's triple-A credit rating, with potential negative consequences for the economy, including higher borrowing rates for the government as well as for businesses and consumers.

While urging Congress to reach an agreement before August 2, the chairman also stressed the need to address "the unsustainability of our fiscal position." Bernanke championed a long-term approach to bringing down the deficit, warning that making deep cuts now could derail the fragile economic recovery.

July 28, 2011

Data Breaches and Risk Management in Emerging Payments: An Economist's View

Advances in technology have enabled companies to collect and share massive amounts of personal data from individuals and companies. While this practice certainly offers important benefits, such as allowing companies to offer credit more efficiently, it also imposes potential costs.

Originally posted in the most recent edition of the Federal Reserve Bank of Atlanta's *Payments Spotlight* podcast series, *Financial Update Focus* also features this podcast, which explores this dilemma from an economist's perspective. The podcast, "Data Breaches and Risk Management in Emerging Payments," features Atlanta Fed research economist and senior policy adviser Will Roberds, who in 2008 coauthored "Data Security, Privacy and Identity Theft: The Economics behind the Policy Debates," a working paper on the topic. (The topic will be explored further in the third-quarter issue of the Atlanta Fed's *EconSouth*, in print and online.)

More data, more problems

Collecting a greater amount of personal data can increase security by helping companies match credit histories to the correct person or business. At the same time, the data are a gold mine for individuals looking to commit identity theft. This risk can be hard to manage, said Roberds. With so many entities collecting data, it is difficult to coordinate on two important dimensions: how much data are collected and how much effort is given to protect it. The challenge is particularly acute for emerging payments providers because of their diverse make up, he explained.

Further, electronic payments data follow what economists refer to as a "weakest link rule," meaning that the system is only as secure as its weakest point of access. So if one participant is not matching the effort of all the others, it puts the entire system at risk.

The carrot or the stick?

So how do you make sure all participants are doing what they should to protect their data? It all comes down to carrots and sticks, says Roberds. Incentives—monetary rewards, for example—can compel participants to keep their data secure. Conversely, another option is to impose monetary penalties or even exclude participants from the system if they fail to maintain their data security standards at an acceptable level.

July 27, 2011

Federal Reserve Approves Rule Allowing Banks to Pay Interest on Demand-Deposit Accounts

Beginning July 21, 2011, financial institutions that are members of the Federal Reserve System are able to pay interest on demand deposits. The change is a result of a final rule approved by the Federal Reserve Board, which prohibits member banks from paying interest on checking accounts and other demand-deposit accounts.

The rule implements a provision of the Dodd-Frank Act repealing section 19(i) of the Federal Reserve Act. The repeal of that section of the Federal Reserve Act also "eliminates the statutory authority under which the Board established Regulation Q," said the Fed in a July 14 statement.

July 21, 2011

Federal Reserve Summarizes Meetings to Discuss Regulatory Reform

The Federal Reserve Board has held a series of meetings between the Board and the public—representatives of bank organizations, consumer groups, trade associations, and researchers and academics—that allow the Board to gather information and help educate the public on matters subject to agency rule making. The meetings are intended to contribute to an informed rule-making process.

The meeting subjects comprise systemic designations, enhanced prudential standards, and banking supervision and regulation; derivatives markets and products; interchange fees; payments, settlement, and clearing activities and utilities; consumer financial protection; and resolution framework.

July 21, 2011

ViewPoint Introduction

By Michael Johnson, Senior Vice President
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Mike Johnson

It certainly has been an interesting past several months. First, we experienced the suspense of U.S. debt ceiling negotiations. On the heels of that event, Standard & Poor's downgraded, by one notch, U.S. government debt. Then we received news that economic growth was dramatically slower in the first half of the year than anticipated, causing most forecasts to be revised downward as well. So with all of this uncertainty and the continuing European debt crisis and fiscal woes, it's not surprising that market volatility has returned. Although we are seeing stabilization and even some signs of improvement in bank performance, as I reported in the last edition of "ViewPoint," I envision the overall environment will continue to be stressed for some time.

In this edition of "ViewPoint," we have our usual feature on Sixth District banking conditions, providing some room for optimism. We also address interest rate risk, which deserves particular attention as banks work to find yield in a low interest rate environment. In a similar vein, we revisit commercial real estate (CRE) conditions because of the pivotal role this sector plays, both directly and indirectly, in the performance and financial condition of Sixth District banks.

State of the District
Midway through 2011 amid the mounting concerns over the state of the economy, banking conditions in the Sixth District appear to be improving after hitting bottom. During the second quarter of 2011 and for the first time since 2008, Sixth District banks reported a positive, though small, annualized net income at the aggregate level. Many institutions returned to profitability as a result of lower provisions for loan losses, which were based on continued improvement in noncurrent loans and related charge-offs. In addition to the aggregate positive return of net income at the District level, each state in the District reported positive net income as well.

Today, more and more banks are focusing on revenue growth, not just problem asset resolution. Unfortunately, loan growth within the Sixth District continues to be challenging as new lending opportunities remain scarce and highly competitive. Net interest margins in the Sixth District, though up slightly year over year driven by low-cost deposits, remain lower than the rest of the country. In an effort to improve earnings through loan growth, competition for high-quality borrowers is intense, and we are seeing some pricing concessions. As long as broader economic concerns prevent businesses from expanding, finding new revenue opportunities will be difficult for many banks. Overall, we see some signs of improvement, but major challenges remain. You'll find more details concerning second-quarter results in this edition.

The quest for yield in a low-rate, high-volatility environment
In the current low interest rate environment with strained banking profits, it can be tempting to get added return by, in essence, assuming greater risks and extending duration farther out on the yield curve. It is particularly important to be aware of actions that may help earnings in the short term but expose institutions to excessive downside risk over a longer time horizon. While the current low interest rate environment should remain in place for some time, investment and pricing decisions made today will have an even longer-term impact. You can read more on current market conditions and potential interest rate risk implications for banks here.

Commercial real estate markets
CRE conditions are of particular importance to the Sixth District, as CRE is a significant source of lending, creating both jobs and government revenue. High levels of unemployment, tighter lending standards, and low consumer spending are a few of the reasons why CRE has struggled. However, some tentative positive signs are beginning to appear. For instance, increased demand for multifamily housing has led to significant growth in rental income and higher occupancies. These developments have heightened investor demand and prompted greater investment, higher transaction volume, and even some new construction. Demand for office space has increased over recent quarters, though so-called trophy office space has seen most of the improvement.

Slow consumer spending has hindered the recovery of the retail sector while also acting as a headwind for improvement in the office and warehouse sectors. Overall, continued recovery in CRE depends on job growth and general improvements in the economy. For more information on conditions in national and regional markets, see our spotlight on the CRE market.

Dodd-Frank turns one year old
In case you didn't notice, July 21 was the first anniversary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, marking the effective start date of the Consumer Financial Protection Bureau and the date when supervisory and rule-making authority for savings and loan holding companies transferred from the Office of Thrift Supervision to the Federal Reserve. This anniversary has spurred a flurry of new proposed rules related to the implementation of Dodd-Frank, which can be found on the Federal Reserve's public website.

With that, I hope everyone is ready to enjoy the cooler—and hopefully less stressful—autumn days. As always, please let me know if you have any feedback and do not hesitate to contact me at ViewPoint@atl.frb.org.

ViewPoint National Banking Trends

In the second quarter of 2011, U.S. commercial bank performance, as measured by aggregate return on average assets (ROAA), dipped slightly (see chart 1) but remained higher than the same quarter last year (see chart 2).

Midsized community banks—those with assets between $1 billion and $10 billion—experienced their strongest quarter since banks started recovering back in the first quarter of 2010. Loan-loss provision expense continued to decline, as did net interest margin, falling once again as deposits have fully repriced. The good news for both banks and the overall economy is that annualized loan growth turned positive during the second quarter and was up nearly 5 percent on an annualized basis. Banks are actively seeking more commercial lending opportunities and are reviewing their current lending standards. At the same time, nonaccrual loan levels have steadily declined over the past three quarters. Unfortunately, economic conditions remain largely uncertain with continued high unemployment and market volatility, which ultimately puts banks' gains in jeopardy.

ViewPoint State of the District

Asset Quality :: Balance Sheet Growth :: Bank Failures :: Deposits :: Earnings Performance

Asset Quality

Even though many economic conditions still appear weak, asset quality in the Sixth District looks as if it has turned a corner in 2011 as noncurrent loans and charge-offs have been trending downward over the past three quarters (see the table).

While charge-offs remain elevated when compared with charge-offs before the crisis, they fell to the same level they were in the third quarter of 2008 (see chart 1).

Out-of-District banks' noncurrent loans have been declining (see chart 2), but of late the decline has not been as rapid as the decline in the Sixth District; however, the level of noncurrent loans at Sixth District banks is still higher than for peer banks outside of the District.

Banks in the District are reacting to the decline in noncurrent loans by keeping their coverage ratio—which increased slightly over the previous quarter—low and their allowance for loan loss stable to trending slightly down (see chart 3).

Balance Sheet Growth

Loan growth remains a concern for banks in the Sixth District (see chart 1).

District lending levels continue to fall as new lending opportunities remain highly elusive and very competitive. For almost two years, loan growth has been negative quarter to quarter. Loan growth has declined by 9 percent from the prior year, which is nearly double the decline observed by out-of-District banks. Sixth District banks continue to shed construction and development (C&D) loans, seeking other loan types to replace the highly volatile loans on their balance sheets. On a year-over-year basis, outstanding balances for C&D loans have declined by more than $7 billion. Although there have been some noted pockets of improvement, many of the real estate markets within the District remain depressed, which ultimately limits any additional lending opportunities (see the table).

On a national basis, banks are renewing their interest in commercial real estate (CRE) loans, particularly with regard to multifamily properties like apartments. According to a July 27 report from an analyst at the real estate information firm CoStar, interest in this type of real estate lending is coming from both big banks and community banks. For example, BB&T's CEO said that he expects BB&T to grow its CRE portfolio over the next several quarters. Even though Sixth District banks are trying to diversify their portfolios, CRE still remains a critical component of the balance sheet. Lending on multifamily projects has declined the least since last year. However, problems within the commercial mortgage-backed securities market, which has had some offerings pulled recently, along with generally depressed property prices, could pose substantial risks for banks. Besides CRE, banks in the Sixth District are aggressively pursuing commercial and industrial (C&I) loans. Lending officers are reporting that there has been some easing of loan terms for the C&I portfolio (such as maximum maturity of loans or credit lines) in order to stimulate new lending (see chart 2).

Sixth District small business loans, a type of C&I lending, is leading out-of-District peers (see chart 3).

For more detailed information on small business conditions in the Sixth District, see the Federal Reserve Bank of Atlanta's Small Business website.

Bank Failures

Despite the return to positive earnings in the second quarter of 2011, Georgia and Florida continued to lead the nation in terms of year-to-date bank failures. Although challenges remain, evidence suggests that the number of stressed banks is moderating. Nationwide, although still elevated, the number of problem institutions has fallen for the first time since 2006 (see the chart). Similarly, in the Sixth District, the aggregate Texas ratio—a widely used measure of a bank's credit trouble—has declined, which indicates that the pace of failures will abate going forward.

Deposits

New core deposits have been both a help and a hindrance to banks. Without any loan growth, core deposits have been essential to banks in stabilizing or maintaining their net interest margin. Since the crisis began, core deposits to assets have steadily climbed as economic uncertainty has caused people to increase their savings rate (see the chart).

However, businesses with large deposit balances are unlikely to increase borrowing before drawing down at least some of their cash deposits. For banks seeking new C&I loans to add to their portfolios, such cash deposits are proving to be an overwhelming hurdle. Given the level of core deposits that banks have, noncore funding in the Sixth District has fallen from a peak of more than 30 percent to its lowest level in six years. Use of noncore funding by Sixth District banks remains higher than banks not in the District but appears to have bottomed out, while noncore funding increased slightly in out-of-District banks.

Earnings Performance

Although the earnings performance among Sixth District community banks (assets less than $10 billion) continues to lag their out-of-District peers, District banks have reported their first positive earnings in more than two years (see the table).

Banks posted an aggregate quarterly annualized net income of $452 million in the second quarter of 2011. A combination of factors helped to push net income into positive territory. For instance, the net interest margin continues to improve due to a greater reliance on core deposit funding by banks, which in turn lowers interest expense. Sixth District banks have also been able to lower their provision expense while maintaining the coverage ratio at roughly the same percentage as last year. Still, the net income achieved by Sixth District banks pales in comparison with that of its out-of-District banks whose aggregate annualized net income more than doubled again this quarter.

With the issuance of rules to implement controls on interchange fees, banks are becoming more focused on preserving noninterest income, which ahead of implementation fell by 13 percent from last year for Sixth District banks. Banks are going to have to find a way to replace this income, which is leading some banks to develop new deposit account fees. In fact, some banks have publicly stated that they will seek to increase fees charged to customers to offset their lost interchange revenue. Noninterest expense was up once again in the second quarter, continuing a trend started in the previous quarter as a result of incurring costs associated with working out problem loans and other real estate expenses.

ViewPoint Spotlight: Commercial Real Estate

Commercial Real Estate Still Encounters Headwinds

Commercial real estate (CRE) markets have been under pressure since late 2007. Within the last 18 months, the spread between cap rates and 10-year U.S. Treasuries—reflecting the risk premium associated with investing in CRE and indicating a potential "flight to safety" as the risk premium that investors require—appears to be increasing between the property segments associated with lesser risks (multifamily/office-Central Business District) and the greater risk segments (strip center, industrial, and office-suburban [see chart 1]).

The National Council for Real Estate Investment Fiduciaries' property index showcases the rates of return for a large pool of individual private market commercial properties. Following stresses in the CRE market, rates of return improved steadily in 2009–10; however, in 2011 downward pressures have reemerged (see chart 2).

The bottom line is that commercial real estate (CRE) markets continue to give off conflicting signs. High unemployment and sparse job creation are delaying the recovery of several segments within the CRE market. The exception is the multifamily segment, which has benefited from increased renter and investor demand (see chart 3). However, recent data indicate a possible slowing in multifamily. A lack of consumer confidence, income growth, and employment continues to hamper the recovery of the office and warehouse markets. Many analysts expect the retail market to continue to decline in the short run before stabilizing (see chart 4). Hotel properties rebounded nicely, many with double-digit gains off the 2010 lows. The commercial mortgage-backed securities (CMBS) market continues to work on overcoming recent setbacks associated with its ratings issues and the tightening of the market.

Multifamily. While the pace of improvement moderated relative to the first quarter, the multifamily segment remained the best-performing CRE property type. Landlords continue to see healthy gains in effective rental growth rates that have risen for five consecutive quarters. This improvement followed nearly a year and a half of declines. On a year-over-year basis, rents are up 6 percent while vacancy rates fell to their lowest levels since mid-2007. Industrywide vacancy rates have decreased for six consecutive quarters, and absorption continues to outpace new units delivered to the market. This rebound has been aided by turmoil in the single-family home market (see chart 5).

Office. Vacancy rates have decreased for the last four quarters. The decreases have been small (less than 20 basis points), however, as underlying job growth, economic factors, and property fundamentals remain weak. Market performance is still highly influenced by geography and product type. Finance, insurance and banking have been key drivers of market absorption. There has been job growth in other key industries that use office space, but the recent resurgence in these markets is still in the early stages (see chart 6).

The volume of office sales among the top ten markets with the lowest vacancy rates has rebounded. Investors are looking for quality assets, and significant competition has emerged for well-located trophy properties. Recent market information indicates that trophy properties appear to be fully priced. In the Sixth District, Miami and Orlando were ranked number 9 and number 11, respectively, on the list of markets with lowest vacancies. Atlanta, Miami, and Palm Beach were among the markets with the highest office sales volume (see the table).

Warehouses. Warehouse CRE continued to stabilize with a 20 basis point decrease in the overall vacancy rate. Performance varied widely based on geography. The recovery of the warehouse market is highly dependent upon shipping, manufacturing, and job creation. As each of these categories remains flat, recovery will most likely be modest in the short run. Almost half of the major markets tracked by the Atlanta Fed showed an increase in vacancy rates. Negative net absorption reached record levels in Nashville. Atlanta's vacancy rate also increased (see chart 7).

Retail. Retail market fundamentals continue to deteriorate. Vacancy rates have been climbing since mid-2006, and rents have generally declined since mid-2008, though the rate of decline for both vacancy rates and rents has slowed in recent quarters. The most recent data indicate the retail market experienced falling rents while vacancy rates increased slightly, by 10 basis points. Personal bankruptcies and a lack of consumer confidence and spending continue to weigh on the sector. Several analysts expect the retail market to stabilize sometime next year. Sixth District markets saw mixed results. Tampa and Jacksonville saw minor decreases in vacancy, while Orlando saw a small increase. Atlanta and Miami experienced larger vacancy increases (see chart 8).

Hotels. The hotel segment improved during the second quarter of 2011 with strong gains in all three key metrics (occupancy, average daily rate (ADR), and revenue per available room). The gains included both the full-service and limited-service product types. Locations in the Sixth District rebounded from the lows of the second quarter of 2010. Miami, West Palm Beach, Fort Lauderdale, Nashville, and Orlando experienced significant increases in both ADR and occupancy. Atlanta and Tampa had positive, though smaller, gains (see chart 9).

CMBS. Delinquency rates for CMBS continued to climb in 2011; however, the rate of deterioration has been moderated by a spike in the increased amount of troubled debt resolutions. The CMBS delinquency rates merit close surveillance in the near future as the volume of maturing loans increases (see chart 10).

Headwinds continue to persist in CRE. However, performance varies by sector and class, and some markets are experiencing more improvement than others. A broad-based recovery in CRE is highly dependent upon improvement in labor market conditions.

This article was written by Brian D. Bailey, a financial policy analyst in the Atlanta Fed's Supervision and Regulation Division.

ViewPoint
Spotlight: Interest Rate Yields

The Quest for Yield in a Low-Rate, High-Volatility Environment

August 2011 opened with a bang and has turned out to be a wild time in financial markets. The last-minute debt ceiling decision, Standard & Poor's credit downgrade of U.S. debt, and the Federal Reserve's decision to publicize its intent to keep short-term interest rates low into mid-2013 were some especially noteworthy events.

Extreme volatility in the financial markets occurred, with a sharp stock market correction followed by large daily stock market gyrations. In spite of the U.S. debt downgrade, U.S. Treasuries experienced a flight to quality, which increased prices (thus decreasing yields) as stock market volatility increased. Put another way, prices of the downgraded assets increased—a market reaction that took some participants by surprise. Just when it appeared rates could not go much lower, rates across the yield curve dropped. All of these events are happening against the backdrop of global economic concerns, especially in Europe, renewed fear over banking conditions, and talk of a double-dip recession. These are complex and challenging times for the markets and for financial institutions.

Earnings pressure and profitability challenges
Much of the focus over the last few years has been on deteriorating credit conditions and maintaining appropriate capital levels, which were high-priority risks facing financial institutions. During this period, interest rate risk took a secondary position as many banks struggled to survive while working through credit problems. As the industry is starting to see some positive trends in credit conditions, the strategic focus for institutions has shifted from survival to building capital and profitability over the longer term. Generally, deposit growth has been positive and loan demand weak, a development that places added pressure on profit margins. The historically low interest rates make it difficult to achieve attractive returns—especially when investing in high-quality, short-term products—so for banks there is a strong temptation to consider tactics to achieve better returns. As history and finance principles have proven, tactics that improve returns also add risk.

Risk and return: Interest rate risk implications
While interest rates overall have trended lower, long-term rates have remained high relative to short-term rates. Consequently, the shape of the yield curve is fairly steep (see the chart). The current environment has been characterized as a "low rate setup" where yield-chasing strategies tend to emerge. Under these conditions, banks may be tempted to engage in strategies to boost short-term yields by purchasing longer-term assets funded by shorter-term liabilities at a time when the riskiness of these strategies is increasing and the longer-term risk implications are more costly.

Net yields can be increased by purchasing assets with maturities further out on the curve, by purchasing assets with optionality such as callable or prepayable securities, or by increasing credit risk. Credit risk can be added in a number of ways, such as entering new markets or lowering underwriting standards to pick up additional interest spread.

An interagency advisory on interest rate risk, SR 10-1, dated January 11, 2010, highlights the need for active oversight and a comprehensive risk management process that effectively measures, monitors, and controls interest rate risk. SR 10-1 is especially relevant given the increase in the number of reported instances of yield-enhancing strategies such as the lengthening of duration in loan and investment portfolios, purchasing structured securities (which have complex embedded options), and seeking alternative loan products. Though offering higher promised returns, each of these strategies can elevate a firm's risk profile, and some strategies are more complex with additional risks that are difficult to quantify.

Some bankers have been approached recently by third parties promoting various yield-improvement strategies. One such strategy includes asset swaps where problem loans or other real-estate-owned properties are sold at par simultaneously with the purchase of high-yielding assets that pose significant credit risk. For any balance sheet strategy, banking supervisors expect a firm's management and board of directors to completely understand the full spectrum of risks a strategy may produce and how these risks may affect the firm.

All in all, expect the unexpected

If anything has been learned over the recent past, it is that markets are unpredictable and that events that seem unlikely can actually occur. Ill-considered long-term interest rate strategies and positions undertaken by an institution in a low-rate environment can be very costly to unwind and greatly limit a bank's flexibility to adjust its balance sheet. Banks and supervisors need to be aware of current yield-chasing tactics that pose undue risks and address those tactics now.

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