State of the Banking Industry

August 2007

Moderator: *Welcome to the Federal Reserve Bank of Atlanta's* Financial Update Focus *podcast. We're speaking today with Brian Bowling, assistant vice president in the Atlanta Fed's banking Supervision and Regulation Department, about the general state of the banking industry in the Southeast. Thanks for joining us today, Brian.*

Brian Bowling: Thank you.

Moderator: *Brian, despite a lot of challenges, Southeast banks seem to be holding up generally well. Can you recap briefly the overall state of banks in our region?*

Brian BowlingBowling: Yeah, they are. Banks in the Southeast and in most regions of the country, for that matter, have performed quite well over the past several years, benefiting from a growing economy, strong housing market, low interest rates, and a very stable credit environment. Over the past couple of years, however, and particularly over the past 12 months, the operating environment for banks has changed considerably. Short-term interest rates are now higher, a flat and volatile yield curve has really limited the spread that banks can earn on loans relative to their cost of funds, and housing markets are, as you know, now slowing quite rapidly in some parts of the country.

Banks in the Southeast are faring pretty well thus far. If you look at asset returns, profitability is down from records levels of a couple of years ago but is still pretty good. And credit quality problems appear to be contained right now despite the well-publicized problems in the subprime mortgage area. And banks are also still seeing some good demand for certain types of credit, certain types of business, consumer, and commercial real estate lending. I do think, however, that the remainder of this year and into 2008 will continue to be a very challenging environment for banks in the Southeast and elsewhere, particularly given the slowing housing market.

Moderator: *Are any of those conditions in our region different from other parts of the country Brian, or do we pretty much reflect what's going on around the nation?*

Bowling: No, I think they are different. In fact, I think banking tends to differ somewhat region to region, especially among smaller institutions because they tend to be more directly linked to what's going on in their local economies. For example, in the Midwest, agricultural lending is a big part of the banking business there. In other parts of the country, it may be commercial industrial lending, small business lending. In the Southeast, the dominant business for most banks is real estate development lending.

That really goes back over several decades as the South has seen a steady in-migration of people from the Northeast and the Midwest over many years, throughout the postwar period, really, attracted by the climate as well as the low cost of living and a relatively low cost of doing business. And as the recent population has grown, there's a corresponding need for more houses, more office space, more places to eat, places to shop, things of that nature, so local banks have provided much of the financing of that development. And so, as a result, the banks in this region look a little bit unique when you look at balance sheet structures in that they tend to have a higher percentage of real estate construction and development-type loans on their books.

Moderator: *Brian, can you describe briefly what it is that the Fed's Supervision and Regulation staff actually does in helping banks to work through marketplace conditions, whether they be very strong or challenging?*

Bowling: Yeah. I should probably start by saying bank supervision and regulation really has a dual mission. There's safety and soundness and consumer protection. With respect to consumer protection, our role is really to ensure that banks treat customers fairly and that laws governing things like fair credit, truth in lending, and community reinvestment are being followed.

I believe your question is directed more to the safety and soundness side of bank supervision, and for that let me start by saying what our role is not. It's not credit allocation, and by that I mean we're not there to tell the banks when to lend, when to stop lending, or how much of each type of loan they should have on their books. Those are market-driven decisions, and we have to recognize that banks are in the business of taking those kinds of risks. Our role in bank supervision is to ensure that banks understand the risks that they are taking and that they have the appropriate processes and expertise in place to manage those risks. And also, obviously, that they have sufficient capital and earnings to support the activities that they're engaged in. When we see risks developing, or if we identify deficiencies in risk management, it's our responsibility to recommend changes and improvements. And in cases where we think those weaknesses are material to the point that they would threaten the safety and soundness of the institution or pose a threat to the deposit insurance fund, then we have a number of informal and formal actions that we can take to ensure that corrective actions are taken.

Moderator: *I know that our region continues to be the most fertile ground in the country, I believe, for new banks, start-up banks, or de novos. What are some of the reasons for that?*

Bowling: Well, it is among the most active, and it has been for several years. Florida and Georgia have long been leaders, very active markets for start-up, or de novo, banks. And over the past couple of years we're starting to see more new bank activity in Tennessee as well. I should mention that there are some markets outside of the Southeast that also have seen a lot of de novo activity, most notably California and the metropolitan Chicago area in recent years. They've seen a lot of start-up banking activity. But as a region, the Southeast consistently ranks at or near the top.

There may be any number of reasons that you would see a new bank open in a particular market, but in my view there are two main drivers of start-up banks. The first is population growth, which goes back to what I said earlier about the steady inflow of people and jobs into this region over the past several years. The second is consolidation. If you're in a growing market and a local bank of any size is acquired, as has happened at numerous times across the industry over the years, especially if that bank is bought by a nonlocal, out-of-market bank, then it's not at all uncommon to see a new bank open up in that area, because in the case of a merger you'd typically have displaced bankers, borrowers, and depositors, really everything you'd need to start a new bank. And based on the capital levels that we're seeing these new banks open with today, there's certainly no shortage of investors that are willing to put their money into launching a new bank.

Moderator: *What would you say are the most important factors to watch in coming months to get a general sense of the health of the banking industry?*

Bowling: I think that differs to some extent depending on which segment of the industry you're talking about. For the very largest banks, obviously I think the current liquidity concerns and the volatility in global capital markets right now are probably the front-and-center issue. But for most community and regional banks, including those in the Southeast, I believe that the key issue to watch in the coming months will continue to be the housing market and the extent of any related deterioration in mortgage and construction loan portfolios.

Moderator: *All right, Brian, thanks a lot for your time. Again, today we've been speaking with Brian Bowling, assistant vice president in the Atlanta Fed Banking Supervision and Regulation Department. And this concludes our* Financial Update Focus *podcast on the state of the banking industry in the Southeast. For more information, please see* Financial Update *on the Atlanta Fed Web site at www.frbatlanta.org. Thanks for listening, and please return for more podcasts. If you have comments, please send us e-mail at podcast@frbatlanta.org.*