As we all know, the past few years have been very difficult for banks in the Southeast—especially here in Georgia and, to a lesser extent, in Alabama. Of the 246 bank failures nationally in the past three years, 73 have been from the Atlanta Fed’s six-state region. Virtually all these failures have been community banks.

I realize there are representatives of some large regional banks in the audience. But because this audience is predominantly community bankers, I’d like to address my remarks mostly to you.

I have been a banker, but never a community banker. That said, I think I have a pretty good appreciation of the challenges your business presents.

During my remarks this morning I want to share some views I’ve formed from recent experience. I doubt I will say anything you don’t know or haven’t heard before, and I expect we’re on the same page regarding some of my observations about community banking. I’ll also comment on some lessons that apply particularly to those of us in the regulatory community, including the Federal Reserve.

As always, these views are mine alone and don’t necessarily reflect the views of my colleagues on the Federal Open Market Committee (FOMC) or the Federal Reserve System.

Economic situation
To provide some context, I’d like to begin with an overview of the economic and banking situation in the Southeast. It’s worth noting parenthetically that our region serves as an excellent economic proxy for the whole country, so I frequently make the claim in Washington that economic intelligence from the Sixth Federal Reserve District has relevance to the nation overall.

In general, the Southeast’s economy continues to rebound. A growing body of evidence suggests a sustainable recovery is under way. Regionally, that recovery is not yet well established.

Retail merchants in the region continue to experience increased traffic and sales, and their outlook has become more optimistic.

Homebuilders indicate that new home sales softened recently but remain above very low levels compared with this time last year. Residential real estate agents, including those in Alabama, report a recent increase in existing home sales.

Commercial property markets continue to experience falling rents and rising vacancy rates. Challenging conditions persist, especially in the retail and office markets. One area of good news is the multifamily category in general. This property type is stabilizing after three consecutive months of rent growth.

The Southeast’s manufacturing and transportation segments continue their steady rebound as new orders and production grow.

Labor market reports are generally more positive than in 2009 and earlier this year, though unemployment remains high. Most Southeastern states, including Alabama, reported job gains in April. Unemployment declined modestly in April in most Southeastern states. The unemployment rate in Alabama was 11 percent in April—down a bit from the first quarter but still well above the national unemployment rate.

I believe it is fair to say that, taken as a whole, the region’s economy is improving.

Southeast banking update
I have said repeatedly that stabilization of financial markets is a precondition of a return to economic growth. Here in the Southeast, the banking industry still needs more time to heal. To generalize, I believe that banks are stabilizing and, although not improving rapidly, not getting significantly worse as a group. That said, as I look forward, more bank failures in the region are likely.

Conditions at community banks in the Southeast remained weak during the first quarter of 2010. While in better shape than a year earlier, about a third of district banks had negative return on assets in the first quarter. Annualized net charge-offs have declined, however, from record high levels at the end of 2009. Bank asset quality remains a concern because the recovery is not well established in many industries, the restructuring and workout of commercial mortgages is still substantially ahead of us, and unemployment remains high.

Loan demand is soft. Lending across the six states in our district fell last quarter by more than $20 billion from a year earlier. Declines were led by ongoing runoff—in some cases intentional—in construction and development (C&D), commercial and industrial (C&I), and consumer lending. Some new loan production has occurred with the migration of borrowers from large banks to community banks.

Deposit growth has been healthy. Some growth of demand deposits has come from marketing efforts. Other growth in demand deposit accounts has occurred because of corporate cash accumulation, which is likely to get drawn as business activity picks up.
Alabama banks
Alabama bank profit performance has improved modestly in the past year. Aggregate return on assets (ROA) in Alabama rose 20 basis points to 0.41 percent, and the percentage of unprofitable institutions declined to 17 percent.

This performance is far short of early 2007 (the days before the recession). In that period, ROA was above 1 percent and only 5 percent of banks were unprofitable.

Asset quality for Alabama banks deteriorated in early 2010 compared with last year. Annualized net charge-offs rose to more than 1 percent of total loans, and 4 percent of loans were noncurrent in the first quarter.

Lessons from recent experience
I joined the Fed in March 2007, just a few months before the financial crisis and subsequent recession began to develop. It's been a trying period for everyone. We've all learned a lot. I can't possibly do justice in a short talk to all the banking and regulatory lessons of this period. So I'll put forward five basic points: three about banking and two about supervision and regulation.

First, concentrations are deadly. The most fatal concentrations for community banks have been in real estate, particularly residential construction and development loans.

Stepping back, I think it is a concern that, industrywide, secured real estate loans as a percentage of overall loan portfolios have been growing for decades. This trend has been driven in part by the migration of corporate borrowers to securities markets. I would argue that C&I lending capability has atrophied to a degree as a consequence. In the most recent reading we have, half of small banks across the nation had more than 73 percent of their total loans secured by real estate.

Concentrations in construction lending particularly have been a problem. Southeast banks that have failed or are now in trouble had higher levels of construction lending as of year-end 2003 and then greatly expanded lending in this area during the housing expansion after 2003.

In Alabama, construction and development loan exposures are on the decline. In the first quarter of 2010, C&D-to-total assets stood at just over 10 percent, down 4.6 percentage points from two years earlier but still well above levels in the early 2000s.

In contrast, commercial mortgage exposure among Alabama banks continues to rise. In the first quarter of 2010, commercial mortgage loans stood at just under 20 percent of total assets. Between 2003 and 2008, commercial mortgage loan exposures averaged less than 17 percent.

It's fair to ask: Given the painful consequences of overexposure to residential and commercial real estate, why did bankers and regulators allow a concentration to build in this area of lending?

The answer I often hear from bankers is because it's there. There's not a lot else—there are not a lot of other lending opportunities. Bankers cite competitive realities, ease of valuation, and abundance-of-caution collateral as the underlying logic of this real estate bias. Direct real estate lending is more available and, in my interpretation, easier than C&I lending to small and midsized businesses, the natural business banking niche of community banks.

As credit scoring models have improved, national and regional banks have successfully competed for small business commercial and industrial loans. In this competitive situation, bankers may perceive that a loan backed by real estate collateral is easier to evaluate than one that requires an intensive individual analysis of the borrower's business plan and expected future cash flow.

Update on small business lending
I just referred to small business C&I as a natural market niche of community banks. The Atlanta Fed's research department—leveraging contacts from our Regional Economic Intelligence Network—recently conducted a survey of over 300 established small businesses in the Southeast. The survey focused on credit availability and usage. I thought you might find a summary of responses interesting.

For one thing, banks are these small businesses main source of financing. Bank loans and lines of credit trump credit cards, home equity lines of credit, and personal credit as a source.

Large national and regional banks more often compete for non–real estate secured C&I loans. We found that construction and real estate firms are more likely to seek credit from a regional or community bank.

At the moment, loan demand is soft. Thirty-eight percent of firms surveyed sought credit in the first quarter of 2010 while 42 percent plan to seek credit over the next six months.

Those firms that sought credit recently were most often looking to refinance an existing loan or obtain additional working capital. Firms planning to seek credit over the next six months mentioned business expansion, acquisition of another business, or purchase of real estate as their financing need.

Finally, we found that of those firms applying for credit, about half received all or most of the financing they sought.

Clearly, there are challenges to recapturing the C&I niche, but there also are opportunities.

Realistic growth goals and reduced reliance on wholesale funding
Let me return to lessons from recent experience. My second basic point is speed kills. Trying to grow too fast can overwhelm organizational capacity, resulting in deterioration of discipline. Growth in banking results from general economic growth in the community, competitive share capture, and, of course, expanding the geographic footprint. In my view, it is very hard to grow at a pace much above the general growth rate of the area's economy without either assuming undue concentrations or gaining share at the expense of competitors, typically accomplished through relaxed standards. Share capture of loan assets too often is a wolf in sheep's clothing.

Bank assets historically—over a 30-year period—have grown in nominal terms 6.7 percent a year, according to the Federal Deposit Insurance Corp. (FDIC). During the real estate boom of 2003 to 2006, banks grew on average by 10 percent. Banks that failed often grew faster. In Georgia, for instance, non de novo banks that eventually failed grew on average by about 30 percent during that period.
My third point is hot money can burn you. Often, rapid growth brought dependence on wholesale funding, another factor that distinguished troubled banks in the recent period. From 2003 to the present, many banks now considered troubled entered this period with a greater dependence on wholesale funds and became even more dependent during the housing bubble.

Alabama banks’ reliance on net noncore funding increased substantially prior to and following the onset of the recession, with the median net noncore funding dependence ratio rising from a low of just under 20 percent in 2003 to nearly 30 percent in 2009.

Core deposits form a more stable base on which to grow and build franchise value and serve as a healthy constraint to excessive asset growth. Many years ago—1974, to be precise—I filed away in my head the warning that the farther away a bank gets from consumer deposits, the greater chance it has to be blown away by changing market sentiment. I think this idea still holds.

**Supervisory lessons**

So far, my observations have focused on banks. But I’d also like to make some comments that apply to the regulatory community.

My first point concerns de novo bank charters. Between 2000 and 2008, 112 new institutions were established in Georgia. By comparison, 26 opened in Alabama. I believe new bank charters have been granted too liberally, and the entry bar needs to be raised.

I will note that the Federal Reserve is not a bank charter granting agency. We get involved when a bank holding company is to house the new bank or if they choose to be a state member bank.

Some of the recent bank failures grew out of an investment concept that looked something like this: Take experienced—but sometimes narrowly experienced—regional bankers who left their former employers as a result of consolidation. These executives would capitalize the bank with private investor money with a medium-term investment horizon, put together a business plan with what turned out to be optimistic assumptions regarding deposit growth, loan origination and diversification, and then grow the bank aggressively with the intent to sell to a larger bank in five or six years.

Too often management deviated from the business plan at an early stage when their starting assumptions proved to be unrealistic. As regulators, we’ve learned we need to be more realistic in our assessment of proposed business plans and less tolerant of deviations from those plans. This observation connects to my final point—how bank supervisors define their task.

We regulators need to broaden supervision from point-in-time solvency and compliance evaluation to include a more strategic, forward-looking, anticipatory, and holistic evaluation of the bank's operating mix. The Fed is working to incorporate a horizontal approach (looking across institutions) and to become more multidisciplinary. We are, for example, involving economists and others with specialized expertise in asset and funding markets. The objective is to realistically assess not only the current condition of the banks we supervise but also their future prospects.

**The challenge of the community bank business model**

As I said at the outset, I think I have some appreciation of the broad challenge top managers of community banks face. I see it as management of an imperfect business model. No business model is flawless, but community banking presents particular challenges.

The competition from larger regional and national banks for commercial and industrial lending relationships, mortgage origination, and consumer deposits requires community banks to trade on local knowledge and ties and highly responsive service. Community bankers must find a workable balance of often conflicting pressures. You must originate earning assets from a limited geographic market without excessive concentrations. To achieve a spread of risks, you often are forced to diversify your asset mix beyond your known market. You have to marshal underwriting capability across a variety of borrowers with limited human resources.

In so doing, you have to strike a balance between soft criteria-based, relationship lending and hard criteria-based analysis of a limited set of opportunities. And you must compete hard for core deposits—often competing on rate and thereby compressing margins—in order to fund growth without undue reliance on volatile wholesale funding. And you don’t need to remind me you have regulators to deal with. I know your job is not easy, and I appreciate the demands—sometimes competing demands—you are under as community bankers.

Let me close with this thought: As bankers and regulators, it’s our collective responsibility to heed the lessons of recent experience and get it right going forward to ensure a healthy, well-functioning banking system for our communities and our nation.