The Economic and Community Banking Landscape

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I'm pleased to be back in Baton Rouge and to continue to build on the Federal Reserve Bank of Atlanta's partnership with the Graduate School of Banking at LSU. The Graduate School of Banking at LSU has worked closely over the last two years with our supervision and regulation staff to put on banking outlook conferences. In our view, these conferences have been thought-provoking and have achieved a better dialogue between banks and regulators.

I'm also pleased to be back on the campus of LSU. Our research department at the Atlanta Fed partners with the university on local economic analysis.

Here's what I plan to cover this evening: I'll address the approach of the Federal Reserve to supervision of community banks as well as some of the challenges, as I see them, of operating a community bank. And I'll give you my sense of the economic outlook and the outlook for monetary policy.

Please keep in mind that you're hearing my personal views. My colleagues on the Federal Open Market Committee and in the Federal Reserve System, including colleagues principally engaged in supervisory activities, may not fully agree with my views.

A few weeks ago, Fed Chair Janet Yellen gave a particularly thoughtful speech at the Independent Community Bankers of America policy summit. I think selected highlights of her remarks are worth repeating. I'll take the liberty of elaborating on a couple of her points.

Chair Yellen stressed the important role that community banks play in serving Main Street America "by providing credit to small business owners, homebuyers, households, and farmers."

She devoted much of her speech to the notion of tailored supervision of community banks. She stressed that there is no one-size-fits-all supervision scheme for banks. In both guidance from the Board of

Governors and execution of supervisory programs at the Reserve Bank level, the Fed is working to tailor expectations of bank management to the size and complexity of the institution.

By way of example, we do not intend that community banks be held to the same formal requirements and standards as large banks in regard to stress testing portfolios and capital planning. That said, let me editorialize. Every bank is expected to know the risks in its portfolio and the potential impact on earnings and capital. This may not require, however, the extent of modeling and scenario planning required of larger banks.

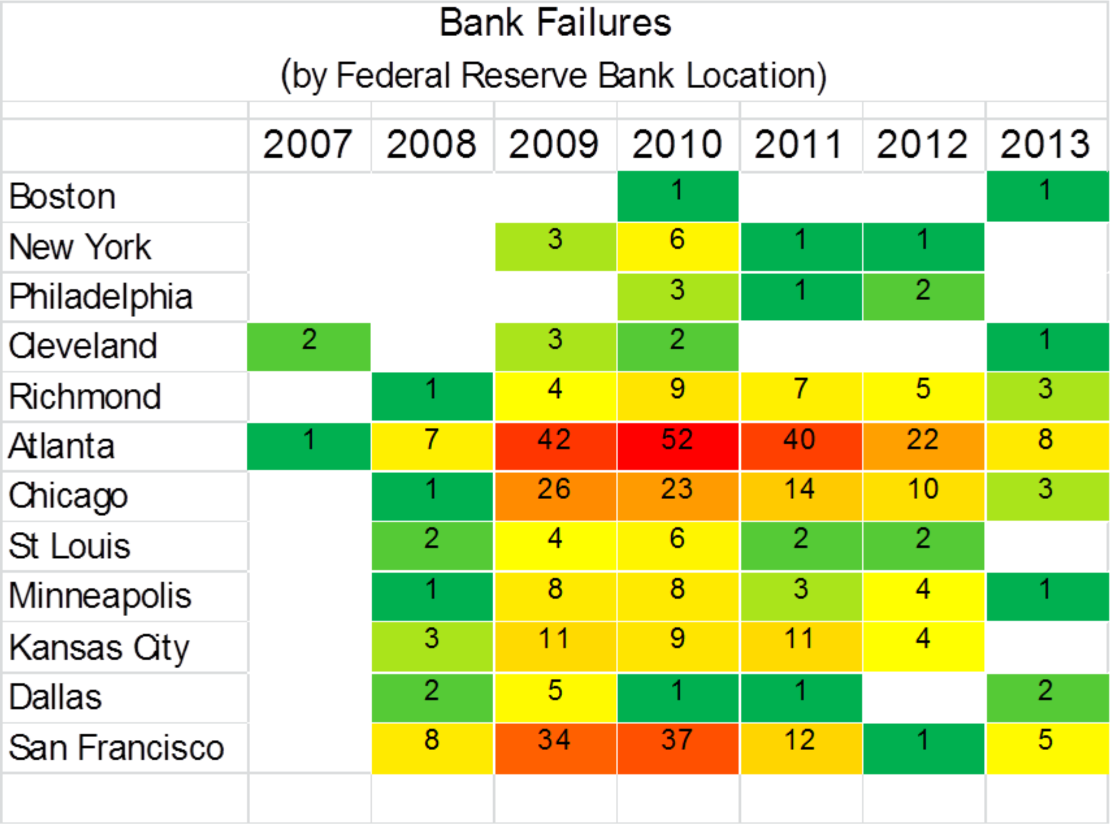
Chair Yellen also commented that the Fed has been monitoring how reliant banks are on short-term wholesale funding. She took care to point out that community banks are not considered a source of potential systemic vulnerability related to wholesale funding.

In a summary statement, Chair Yellen reiterated that the Federal Reserve is committed to understanding community banks and their unique challenges.

Why so many community bank failures in the Southeast?

One way to put those challenges in perspective is by taking a look back at bank failures over the period 2007 through 2013.

To tee up this subject, let me show you two slides that depict bank failures in recent history; in particular, the slides show the geographic concentration of bank failures in the Southeast.



Bank Failures

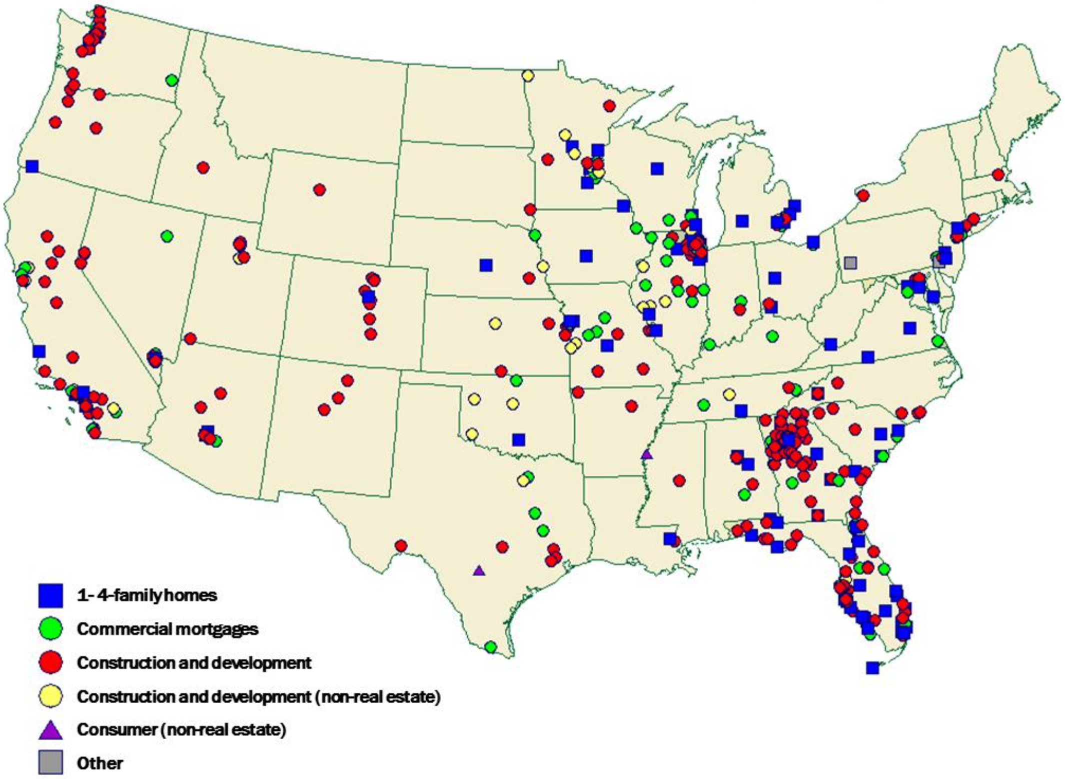
(by Federal Reserve Bank Location)

	2007	2008	2009	2010	2011	2012	2013
Boston				1			1
New York			3	6	1	1	
Philadelphia				3	1	2	
Cleveland	2		3	2			1
Richmond		1	4	9	7	5	3
Atlanta	1	7	42	52	40	22	8
Chicago		1	26	23	14	10	3
St Louis		2	4	6	2	2	
Minneapolis		1	8	8	3	4	1
Kansas City		3	11	9	11	4	
Dallas		2	5	1	1		2
San Francisco		8	34	37	12	1	5

Here you have a heat map of sorts. The horizontal cut is by Federal Reserve District, and the vertical shows the years. The numbers are the total failed banks by year.

The Atlanta Federal Reserve District covers the entirety of Georgia, Alabama, and Florida and portions of Mississippi, Louisiana, and Tennessee.

Bank Failures by Highest Delinquencies
as a Percent of Total Loans and Leases (2007–13)


■ 1- 4-family homes
● Commercial mortgages
● Construction and development
○ Construction and development (non-real estate)
▲ Consumer (non-real estate)
■ Other

Sources: Federal Deposit Insurance Corporation, Federal Reserve Board of Governors, SNL Financial

This second slide shows the same information across the United States with some added information on the drivers of individual bank failures in terms of portfolio delinquency concentrations. The key categories are residential acquisition and development loans, mortgages, commercial real estate, and consumer. As you can see, bank failures in the Southeast were mostly concentrated geographically around Atlanta, South Florida, and the panhandle of Florida.

I don't intend to present here tonight an in-depth analysis of the many factors that contributed to this experience. I simply want to ask—and then try to answer, at a high level—the question WHY? Why was it that the banking system in this part of the country was, apparently, especially vulnerable, and what lessons can be drawn from this experience?

At the risk of some oversimplification, I'll propose four takeaways.

First, concentrations can be deadly. Many of the banks that failed, especially around Atlanta, were relatively young banks that became highly concentrated in residential real estate loans, particularly acquisition, development, and construction, or ADC, loans.

Second, many of the banks that failed were excessively reliant on wholesale funding. The median wholesale funding-to-asset ratio of the Georgia banks that failed was 30 percent. Hot money can burn you.

Another factor that contributed to failures was inexperience with severe conditions along with overdependence on collateral values without an understanding of cash flows under various scenarios. I'm a former commercial banker. I was taught that cash generation repays loans, and analysis of the borrower's ability to repay is basic. I've heard the view that a lot of bankers weren't ready for what happened. Their inexperience showed up in lending practices.

Finally, many of the failed banks suffered from weak governance. Banks need board members who understand their role as directors. Directors as a group set policy, define the risk appetite of the bank, and hold management accountable for risk management. I know most of you here are line bankers. In my opinion, you should welcome a board that challenges management. To perform this role, directors don't necessarily have to be banking experts, but they should be individuals with business acumen.

The current economic context and outlook

I'll now turn to the here and now and talk about the economic context in which you are currently operating.

The recovery began almost five years ago. On the whole, economic growth over this period has been subdued. Up until the middle of last year, growth averaged a little more than 2 percent.

But the second half of last year showed a significant step-up in economic activity, with the pace of growth in excess of 3 percent.

Then came the first quarter of this year. The first-quarter growth rate in the national economy was essentially flat. A new estimate is due Thursday, and it may show a slight decline in activity—that is, contraction of the economy.

The view is widely held that the weak first-quarter performance can be explained mostly by bad weather. As one of my contacts put it, the first quarter was wrecked by weather. My staff and I ascribe to that view.

My going-in forecast for the second quarter was for the economy to resume growth at a run rate similar to that exhibited in the second half of last year—that is, a growth trend close to 3 percent.

The March and April data have been consistent with this view. Said differently, looking through the normal month-to-month noisiness of economic data, there are no indications that an outlook of 3 percent or better growth through the rest of the year is wildly off base.

As you know, the Federal Open Market Committee (FOMC) is tasked with two principal objectives—achievement of full employment and low and stable prices (or low inflation). The Committee has defined the desirable rate of consumer price inflation to be 2 percent per annum.

Neither objective has yet been achieved. That is to say, there is still slack in the employment situation of the country, and inflation is running below the desired rate.

Let me update where the economy stands opposite these two objectives. Again, these are my personal views.

We are making progress on the full employment goal—by some measures, like the rate of civilian unemployment, a lot of progress. The rate of unemployment fell to 6.3 percent last month and is closing in on levels that many believe to be consistent with a practical definition of full employment. But a number of other measures of labor market performance tell me that the economy is still operating well short of full employment. Notably, there remains an unusually high percentage of prime working-age people who are marginally attached to the labor force, who are working part-time jobs when they would prefer to be working full-time, and who are leaving the workforce. These indicators and others suggest to me that fulfillment of our employment mandate is still a ways off.

Regarding inflation, we saw rather broad-based firming of prices in the April Consumer Price Index. It's too early to conclude that the inflation trend is sustainably closer to target, but the risks associated with disinflation do appear to have receded.

Looking ahead, I'm holding to an outlook of continuing growth over the next several quarters at a rate around 3 percent. With that, the official unemployment rate should decline and other measures of labor market health should continue to improve. I don't expect dramatic improvement in labor resource utilization, but I do expect steady progress.

In the same vein, I'm forecasting inflation to converge to the 2 percent target over the medium term. The inflation and employment objectives connect in the area of wages. Recently, we've seen some modest growth of wages, but again it is hard to conclude that the employment gap is very near to being closed.

I've given you the broad strokes of a pretty optimistic outlook. Such an outlook is supported by anecdotal feedback from many of our business contacts. I would emphasize, however, that considering the weakness of the first quarter, it's still early in what you might call an assumption-validation process that would serve to confirm that the economy is indeed on the trajectory I've laid out.

As confirming evidence, I'll be paying attention to consumer spending and consumer confidence. Data on both have been, on balance, encouraging. I'll be monitoring industrial activity closely. While the manufacturing production numbers stepped down in April following very strong gains in February and March, the April report from purchasing managers on production and orders was quite positive. And I'll be looking for sustained employment gains. Payroll jobs growth was at 288,000 in April, and jobs have shown a decided firming since December.

On policy

Achievement of economic progress along the lines of the outlook I've laid out will likely bring about conditions in which higher interest rates will be appropriate. The question is when. There is already much talk and speculation among commentators about the timing of "liftoff"—the date when the FOMC will begin to move the policy interest rate higher.

I'm sure you are quite interested in this question. The management of interest-rate risk is a front-and-center concern for banks, a point that we have been emphasizing in our interaction with banks and bank holding companies we supervise.

I'll conclude with comments on policy considerations, as I see them.

I believe the wind-down of asset purchases continues to be appropriate. I expect tapering to continue at the pace we've seen since December with the result that the quantitative easing, or QE, program will come to a conclusion in the fourth quarter.

On the question of the timing of liftoff, let me make a few points.

At any given juncture, absolute certainty of the economy's direction is not achievable. As I've suggested, I feel the need to see confirming evidence in the data validating the view that above-trend growth is occurring and is sustainable, and that the FOMC is closing in on its policy objectives. One quarter's data isn't enough. I expect it will take a number of months for me to arrive at conviction on that account.

When the first move to tighten policy is taken, I would expect it to begin a cycle of gradually rising rates. This will be a significant, even historic, transition that must be executed skillfully, with tools sufficient to the task, and with clear communication that fosters orderly market adjustment, to the extent possible. The discussion of so-called policy normalization documented in the latest minutes of the FOMC was just a first step, in my opinion.

It bears repeating that a discussion of policy normalization does not necessarily imply that a shift in policy is imminent. For the reasons I have discussed, I, as one policymaker, am not in a rush to get to liftoff. I continue to be comfortable with a projection of the second half of next year (2015) as likely timing.

Even as the economy accelerates this year to a somewhat higher growth trajectory, as I expect, I think continued monetary accommodation will be warranted for some time. When quantitative easing is done, anticipation of the next policy move will likely intensify. A combination of a shortfall from full utilization of our nation's labor resources and inflation below the FOMC's longer-term objective would, in my view, justify patience in raising policy rates.

One last comment: You are here participating in continuing education to be the best bankers you can be. The history of bank failures in the Southeast contains a number of cautionary lessons. I'll add one more. Improving conditions bring their own challenges. Conditions seem to be improving. Be careful.