



The Long Recovery in the Southeast

Federal Reserve Bank of Atlanta 2010 Annual Report

The Federal Reserve Bank of Atlanta is one of 12 regional Reserve Banks in the United States that, with the Board of Governors in Washington, DC, make up the Federal Reserve System—the nation’s central bank. Since its establishment by an act of Congress in 1913, the Federal Reserve System’s primary role has been to foster a sound financial system and a healthy economy.

To advance this goal, the Atlanta Fed helps formulate monetary policy, supervises banks and bank and financial holding companies, and provides payment services to depository institutions and the federal government. Through its six offices in Atlanta, Birmingham, Jacksonville, Miami, Nashville, and New Orleans, the Federal Reserve Bank of Atlanta serves the Sixth Federal Reserve District, which comprises Alabama, Florida, and Georgia, and parts of Louisiana, Mississippi, and Tennessee.

The Long Recovery in the Southeast

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Letter from the President



Dennis P. Lockhart, president and chief executive officer

Economically speaking, we in the Southeast probably became a bit spoiled. During all of the nation's recent recessions but the last—2001, 1990–91, 1981–82—our region generally outperformed the rest of the country. However, that did not happen during the Great Recession. What's more, the Southeast continued to lag the rest of the country as the recovery gained momentum in 2010.

This year's annual report examines the halting progress in the region's long recovery from the recession that lasted from December 2007 to June 2009. It explores why the Southeast has fared comparatively worse than the nation as a whole and what the Atlanta Fed did to better grasp the complex realities of today's economy. In addressing these issues, the Atlanta Fed's 2010 Annual Report considers several crucial and timely economic topics, including:

- The debate surrounding long-term unemployment
- The gradually improving but still challenging banking conditions
- The role of small business in job creation and economic recovery
- The housing industry's prominent role in our regional and national economy

RELATED LINK

President Lockhart's speech:
"The Great Rebalancing"

http://www.frbatlanta.org/news/speeches/110404_lockhart.cfm

A look inside the Bank

In one section, the annual report profiles the Bank's corporate citizenship program, which is central to our mission as a public institution. We also report on our work in identifying and mitigating new sources of fraud and risk in the nation's payments system, which are the by products of advancing technology in the payments industry. Finally, we pay tribute to Atlanta Fed retiring First Vice President and Chief Operating Officer Pat Barron. Pat devoted 44 years to the Federal Reserve System. As an advocate for modernizing America's payments systems, he led the critical but delicate task of overhauling the Federal Reserve's nationwide check processing operations in response to the migration toward electronic payment methods.

Accountability is a watchword

Beyond the report's content, I'd like to also note the reasons why we as a Federal Reserve Bank publish an annual report. As a public policy organization, we strive every day to earn the public's trust. We are rightly held accountable for our actions in pursuit of the Federal Reserve's three areas of economic stability, financial stability, and payments system effectiveness. Accordingly, each year, this document serves as a record of our performance and contributions to our communities, region, and nation. We hope it demonstrates the value that the Federal Reserve Bank of Atlanta delivers to residents throughout the Southeast.

Victims of past success?

Much of that value, of course, comes through understanding our region's economy from the grass-roots. By understanding what is happening "on the ground," so to speak, we can make our most effective contribution to the nation's monetary policy.

I turn again briefly to the Southeast's economy. Rapid population growth, especially in Florida and Georgia, helped propel the region through earlier national downturns. But in the current cycle, in-migration slowed or even reversed. In fact, to a significant degree, some of the very forces that helped create widespread prosperity in recent decades bedeviled the Southeast during the Great Recession. The story was that too much of a good thing really was too much.

Excess residential construction fed severe housing market woes. Falling home values undercut household wealth, which in turn hampered consumer confidence and spending. Large accumulations of unsold homes and planned but incomplete subdivisions not only eroded the finances of construction and development firms across the region, but also led to one of the most difficult periods the Southeast's banking industry has endured in decades. Meanwhile, throughout 2010, unemployment in the region remained higher than in the rest of the nation.

We're tied to the fortunes of the country at large

Despite certain regional differences, the Southeast's fortunes are in the main bound up with those of the nation at large. Specifically, the United States faces serious fiscal and economic imbalances that must be resolved in order to lay a foundation for long-term prosperity. It is critical that financial regulatory reforms are enacted in a manner that genuinely helps to minimize the likelihood of future crises. A vital component of any sound regulatory regime is, of course, a truly independent central bank.

We face uncertainties, to be sure. Yet as the calendar turned to 2011, we at the Atlanta Fed detected stirrings of renewed business and consumer confidence. Improving attitudes, we know, can help steer the economy in a positive direction.

On behalf of all my associates at the Atlanta Fed, thank you for your continued confidence and trust. Please read on, and let us know what you think.



Dennis P. Lockhart

The Long Recovery in the Southeast

Certainly, 2011 brought some encouragement, but the year was one step in what promises to be a long recovery.

The Southeast economy in 2010 was much like the nation's, only more so.

Simply put, we have a steeper climb ahead. After weathering the past four national recessions comparatively well, the Southeast may have paid in the most recent downturn for its past successes. Rapid population growth and its attendant industries, such as construction and retail, powered the region's bellwether states of Florida and Georgia through earlier national slumps. But as the Southeast lived by the hammer, this time it was hammered by the hammer. Florida and Georgia suffered severe housing market woes, widespread job losses, and numerous bank failures. Florida alone accounted for an outsized 50-plus percent of the region's employment losses during the recession. The state was home to about 40 percent of all jobs in the Southeast as of November 2007, the month before the recession officially started.

Certainly, 2010 brought some promise, but the year was one step in what promises to be a long recovery, which began in June 2009 as the national recession officially ended. Small improvements emerged in the region's major economic sectors, including banking and credit markets, tourism, and energy production. Auto manufacturing was a standout (see chart 1). The region's assembly plants and the parts makers added 1,000 jobs, bringing the regional total to 75,000, according to the U.S. Bureau of Labor Statistics, or BLS. Three more assembly plants will open in the region in 2011 and 2012.

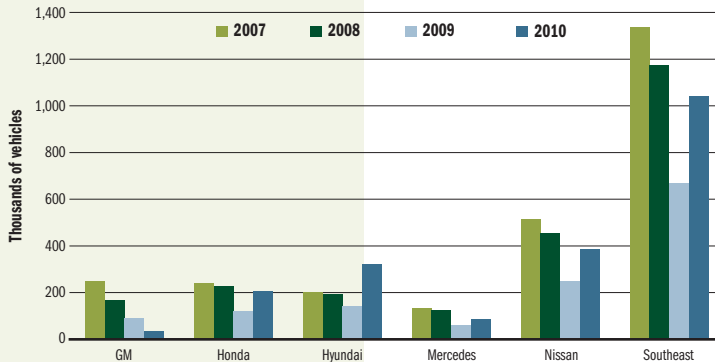
The bigger picture, however, remained clouded. The Southeast's progress was hindered by several intertwined forces: tepid employment growth, general economic uncertainty that restrained consumer and business spending, challenging banking conditions, and still-sickly housing markets in the region's largest states and metropolitan areas.

In this report, we examine the region's economic fortunes in 2010. We also explore the Federal Reserve Bank of Atlanta's efforts to cultivate a deeper understanding of the complex dynamics underlying this performance and the ways in which monetary policy can make a difference. More specifically, we address the vexing problem of persistent unemployment in the Southeast, banking conditions, and the role of small business in job creation and economic recovery. In this report, "Southeast" refers to the six states of the Sixth Federal Reserve District in their entirety: Alabama, Florida, Georgia, Louisiana, Mississippi, and Tennessee.

Jobs tell the story of how long the recovery will be

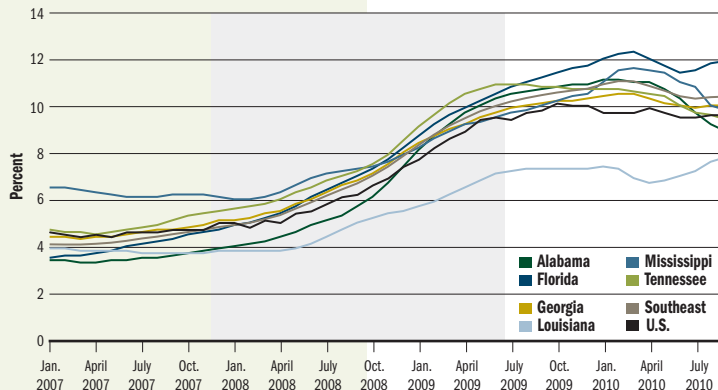
The labor market perhaps best illuminates just how long the recovery will likely be. Despite modest growth in 2010, employment in the

Chart 1: Production by Regional Vehicle Companies, 2007-10



Note: Data are through Sept. 2010 and are in thousand-vehicle units.
Source: Monthly Autocast.com

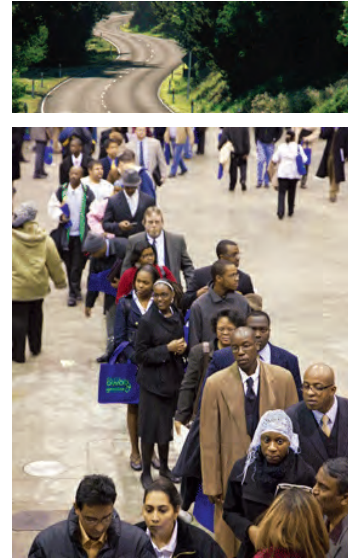
Chart 2: Unemployment Rate in the Southeast



Note: Data are through Sept. 2010. The gray bar indicates recession.
Source: U.S. Bureau of Labor Statistics/Haver Analytics

Southeast remained well below prerecession levels. The region added 81,300 nonfarm jobs on net last year, according to BLS figures, but these added jobs replaced only about 1 in 20 jobs lost during the recession and the early stages of the recovery. From December 2007 through the end of 2009, roughly 1.6 million, or 8.1 percent, of the region's jobs vanished (see chart 2).

Slow job growth is not unusual after a recession. Labor markets are historically among the last to benefit from a rebound. Yet in this cycle, southeastern employment has recovered even more slowly than it did after any of the past four recessions, according to Atlanta Fed research and BLS data. At the end of 2010, the combined



Labor markets are historically among the last to benefit from a rebound.

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Georgia Economy at a Glance
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Homes are where the jobs were

A homebuilding bonanza that peaked in 2005 brought the Southeast hundreds of thousands of jobs. But when the housing market faded, so did many of those paychecks. Since the recession officially began in December 2007, the Southeast's jobless rate has exceeded that of the nation.

In the Southeast, housing—historically, about 5 percent of U.S. GDP—was possibly even more important than it was to the rest of the nation. Propelled by decades of Sunbelt in-migration, the region contained some of the country's fastest growing housing markets before its dramatic reversal. In 2005, the peak of the residential construction cycle, southeastern states authorized 510,020 new private housing units, valued at \$75.9 billion, according to U.S. Census Bureau data. But by 2010, the number of units permitted and the value were both down about 80 percent from peak levels.

Housing bust brought destruction of construction jobs

The homebuilding swoon staggered construction, the employment segment most tightly tethered to home building. This segment accounted for 20 percent of the 1.4 million nonfarm jobs lost in the Southeast during the recession, according to U.S. Bureau of Labor Statistics (BLS) figures.

As 2010 ended, the region's construction job losses lingered. Construction employment at year's end totaled

728,200, 46 percent below the 2006 peak and the lowest level in 17 years, according to BLS data. Considering that by the end of 2010, the region had regained only about 1 in 20 total jobs lost during 2008 and 2009, regaining lost construction jobs in the near term appears a dim prospect.

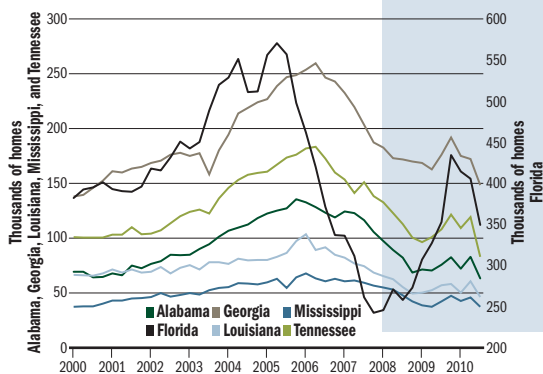
Housing market woes worry workers nationwide

Perhaps the housing-related job losses were a harbinger of economic setbacks to come, as the worst of these job losses happened before the national recession officially began in December 2007. Indeed, it appears that economic sectors closely tied to housing began to lose jobs sooner, and in greater numbers, than other sectors. During the last 10 months of 2006, for example, the nation added jobs overall while housing-related sectors lost about 49,000 jobs, according to Atlanta Fed research. Employment did not even start falling in many service sectors until the spring of 2008.

North Georgia is home to one example of the ripple effects of the housing downturn's undertow in the Southeast. According to the Carpet and Rug Institute, an industry trade group, mills based in and around Dalton, Ga., supply more than 80 percent of the U.S. carpet market. Between the end of 2006 and the end of 2010, the Dalton metropolitan area shed nearly a quarter of its 30,200 manufacturing jobs, according to the BLS. Lower residential carpet sales alone may not completely explain the jobs losses, but housing is certainly a critical market for floor covering companies.

Bankers felt the housing bust, too. Given southeastern community banks' heavy dependence on residential construction and development lending, the housing slowdown likely contributed significantly to job losses at financial institutions. Employment at the region's commercial banks declined 19 percent—by roughly 38,000 jobs—between 2005 and 2010, according to data from the Federal Deposit Insurance Corporation. ■

Southeast Existing Home Sales



Note: Data are seasonally adjusted, represent an annual rate, and are through Sept. 2010.
Source: National Association of Realtors

unemployment rate in the region was 10.5 percent, compared to 9.2 percent in the rest of the country excluding the Southeast. What is more, during 2010, the region's jobless rate improved by only a third as much as it did in the rest of the country. Not only was the region's jobless rate well above the national average throughout 2010, but also it was the Southeast's highest since 1983, according to the Atlanta Fed.

Florida suffered the worst job losses of any state in the country during the recession. Employment is coming back gradually in the state. By the end of 2010, the Sunshine State had regained 5 percent of the 920,200 jobs it lost between March 2007 and the end of 2009. As 2010 ended, Georgia was still shedding jobs. The Southeast's second-most populous state posted in December its worst nonfarm employment level since before the recession began.

Unemployment remained stubbornly high despite modest economic growth. This disconnect prompted extensive discussion and research, notably into the causes of an alarming increase in long-term unemployment. (See sidebar on the problem of long-term unemployment.) In December, 44.3 percent of unemployed workers nationally reported that they had been out of work for more than six months, nearly double the highest level following the 2001 recession, according to the BLS.

Clearly, slimmed-down companies were generally not rehiring in 2010. Atlanta Fed research and business contacts made it clear that many firms that pared their workforce during the recession were slow to add to payrolls even as business improved. A surge in productivity probably explains some of that. In several speeches across the Southeast, Atlanta Fed President Dennis Lockhart pointed out that output per worker in the U.S. business sector in early 2010 increased at more than double the long-run average. Productivity gains of that magnitude aren't likely to last. So eventually, Lockhart said, businesses will probably need to hire again, but they will likely do so only gradually.

The housing market also weighs heavily on the labor market, especially in the Southeast, where residential construction supported at least hundreds of thousands of jobs earlier in the decade. (See sidebar on housing-related employment.) In 2010, southeastern housing markets made halting progress. During the first half of the year, the market benefited from the federal housing tax credit stimulus. Existing home sales continued year-over-year gains, and new home sales rose temporarily in the spring. The upturn in demand boosted home prices early in the year.

Good news did not last. The market dropped sharply when the stimulus expired at the end of April. Furthermore, the number of foreclosures remained high, and the inventory of distressed homes—mostly short sales and foreclosures—continued to weigh down prices across the region.

Florida suffered the worst job losses of any state in the country during the recession. Employment is coming back gradually in the state.

The perplexing problem of long-term unemployment

The last three months of 2010 marked the sixth consecutive quarter of modest growth in the nation's gross domestic product. Yet at 9.4 percent, the unemployment rate at the end of the year was more than double the prerecession level. The Southeast's jobless rate was even higher, at 10.5 percent.

Worse, more people were out of work longer than in past recessions. In December 2010, 44.3 percent of unemployed workers nationally reported being jobless for six months or longer, nearly double the peak of long-term unemployment during the 2001 recession, according to the BLS.

As unemployment remained widespread and entrenched, a public debate unfolded over the causes. Was it simply a cyclical result of economic growth being too feeble to spur hiring? Or was something more permanent and structural at work? To the second point, economists questioned whether the slow employment recovery reflected a fundamental shift in the "employment contract" between employees and employers, according to Atlanta Fed research economist Julie Hotchkiss. To examine those questions, she and other Atlanta Fed researchers reviewed current economic literature, surveyed business contacts throughout the Southeast, and hosted a conference of leading labor market economists.

Below is a summary of what Hotchkiss found regarding several prominent hypotheses that economists and other ob-

servers have floated to explain slow job growth and long-term unemployment:

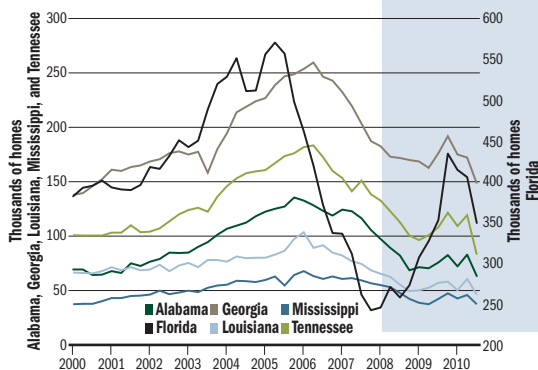
- "House lock."** According to this view, because of the drop in housing equity, unemployed people cannot afford to sell their homes, perhaps at a loss, and move elsewhere to take a job.

Research mostly shows this is not a major cause of persistent unemployment. Declines in the number of people moving within the United States continue to follow longer-term trends, and there was no shift in those trends during or after the housing bubble. Further, some research has found that homeowners with negative equity are more, not less, likely to move.
- Skills mismatch.** This hypothesis holds that job seekers lack the skills that employers want. Therefore, jobless workers will not find a job until they acquire the skills that are in demand, which will take time.

It is clear that people working in the construction and financial services industries, for example, were disproportionately affected by the recession. And, though there might be pockets of mismatch, most research suggests that the slow employment recovery is explained by weak employer demand overall, rather than by employers generally having trouble finding the right workers.
- Shortage of credit to small business.** This view holds that if companies can't secure credit, then they will lack the funds to hire to prepare for an upturn in business.

The Atlanta Fed's quarterly small business survey generally does not support this assertion. Numerous firms are getting the financing they need or want, according to the survey. Not surprisingly, those having the most trouble securing financing are in the most troubled industries, such as real estate and construction.
- Extended unemployment benefits.** Congress passed unprecedented emergency unemployment insurance extensions. The theory here is that continued unemployment checks make some people less likely to accept a job, especially one paying less than the job they lost.

Southeast Existing Home Sales



Note: Data are seasonally adjusted, represent an annual rate, and are through Sept. 2010.
Source: National Association of Realtors

Business contacts have told the Atlanta Fed they are restructuring jobs in a way that will require fewer workers than they had before the recession, even as they increase production levels.



Most economists agree that extended unemployment insurance does indeed act as a “perverse incentive,” though they estimate the impact to be small.

- **Uncertainty: regulatory reform, health care reform, general consumer demand, continued availability of credit.** The idea is that if firms are uncertain about future revenues or costs, then they are unwilling to hire.

Feedback from Atlanta Fed business contacts mostly supports this view. Almost without exception, businesspeople polled by the Atlanta Fed have said they are in fact uncertain about future costs and demand and are therefore not increasing production or hiring permanent workers.

- **New employment contract: more temp and contract workers, newly structured production process.** If companies are simply producing more with fewer workers by working their staff harder, this can only last so long. Eventually, as demand increases, firms will add staff. However, if the firm has maintained production by working differently, rather than just harder, those changes could mean a permanent need for fewer workers. For instance, if businesses are more likely to use temporary workers to cover busier times, then the whole employment contract

has changed. There is, by definition, less permanency in the relationship and therefore less stability.

There is some evidence that these dynamics are indeed changing over time. Business contacts have told the Atlanta Fed they are restructuring jobs in a way that will require fewer workers than they had before the recession, even as they increase production levels. While some production adjustments may have been made during the recession, it appeared that most contacts have been adjusting their use of temp workers over a longer period. This longer-term adjustment may be resulting in longer employment adjustments—slower hiring of permanent workers—as the economy improves. Nevertheless, these adjustments would not be a significant hindrance to hiring if overall demand in the economy were stronger and more predictable.

Hotchkiss concluded that the main reason unemployment has not fallen faster is “that we were in a very deep hole and it will simply take us a while to crawl back out.” Uncertainty, she said, makes the path out even harder to find. ■



Smaller banks face abundant challenges. But community banking has history on its side.

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FDIC Failed Bank List
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Southeast banking climate still challenging, bifurcated

Housing affects many economic sectors, notably banking. A robust housing recovery would invigorate the region's community banks. As a group, a rebound would bolster loan portfolios and generate loan demand. It didn't happen in 2010. Consequently, the Southeast's banking sector continued to lag its national peers. We'll explore specifics on that later.

The industry also became more bifurcated by size and by location. A gap widened between larger banks, whose conditions generally improved, and smaller banks, which continued to face significant concerns, noted Brian Bowling, a vice president in the Atlanta Fed's banking supervision and regulation department. The more diversified loan portfolios of bigger institutions began to stabilize. Thus, the banks could set aside less money to cover loan losses, which contributed to better earnings. Large banks have also found it easier to raise capital, something that remains a challenge for many smaller institutions. Nonetheless, for the first time since the crisis began to unfold, the Atlanta Fed supervision and regulation staff during 2010 began spotting signs of stabilization, if not improvement, at some large and small banks across the Southeast.

The year saw other positives. Nationally, more than 60 percent of the \$389 billion in Troubled Asset Relief Program funds lent to banks was repaid by the end of 2010. The Fed's October 2010 Senior Loan Officer Survey indicated that 86 percent of the responding banks had stopped tightening standards on business loans.

Obstacles still abound, however. At the end of 2010, the Federal Deposit Insurance Corporation (FDIC) listed 860 "problem institutions" nationwide. In the Southeast, community banks suffered 10 consecutive quarters of net losses through the end of 2010, mainly because of heavy lending to residential real estate developers, according to Atlanta Fed banking supervision and regulation officials. Community banks—institutions with under \$10 billion in assets—account for all but six of the 877 commercial banks headquartered in the Sixth Federal Reserve District. Absent a housing market recovery that absorbs much of the inventory of unsold homes, many of these banks with a heavy real estate focus will continue to face serious challenges, Bowling said.

To appreciate housing's effect on community banks, consider metropolitan Atlanta. At the peak of the boom, during 2004 and 2005, residential builders took out nearly 150,000 permits, according to the U.S. Census Bureau. In 2010, that number plummeted to about 14,000. At the top of the housing cycle, Georgia institutions were twice as dependent as the national norm on financing construction and development, as measured by commercial banks' share of total net loans and leases in construction and development, according to FDIC data. Not coincidentally, the Atlanta area suffered more bank failures than any other metropolitan area in the country—34

from 2008 through 2010. Few observers, Bowling said, believe the housing industry in the Southeast will return to its mid-2000s level soon. As a result, many community banks could be forced to find new sources of loan demand. Bowling added that it may be difficult for some banks to shift their focus from real estate development to other lending categories, such as commercial and industrial or small business lending. Those are different businesses that may require different lending and risk management skills.

Not surprisingly, lending for construction and development has already fallen dramatically. Since its peak in early 2008, outstanding construction and development loans in the region have declined by more than half, according to the Atlanta Fed supervision and regulation department.

Housing isn't the only concern for the region's banks. The costs of complying with regulation are rising after passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act. A consensus began to emerge among bankers during 2010 that, in order to afford those costs, an institution might need to be a minimum size, according to Atlanta Fed supervision and regulation experts.

Smaller banks face abundant challenges. But community banking has history on its side. The demand for local financial institutions—from small businesses as well as consumers—has endured through many previous economic downturns and outlived many dire predictions, Bowling noted.

Florida, Georgia banking conditions toughest by far

As the performance of large and small banks in the Southeast diverged, a geographic split also took place. Georgia and Florida stood apart from the rest of the region during 2010. Those two states accounted for 97 of the Southeast's 103 bank failures from 2007 through 2010. Problem real estate loans—again, tied mainly to housing—explain most of the trouble. To cite a single but representative case: from 2004 to 2006, a south Florida bank that later failed more than doubled its commercial real estate loans. The bank made most of these loans to finance home construction and land acquisition for subdivisions, according to a June 2010 Federal Reserve Inspector General report. Meanwhile, the number of building permits issued in the bank's four-county market area dropped by 79 percent from 2005 to 2007. That scenario is all too common in Florida and Georgia.

Beyond failures, troubles in the two biggest states colored the wider performance of southeastern banks. More than 43 percent of banks lost money in 2010, according to data compiled by the Atlanta Fed. More than half of the community banks in both Florida and Georgia were unprofitable. In no other state in the region did more than 20 percent of community banks lose money.

That is not to say that performance was especially strong in the other states. In fact, profitability measures region-wide remained



Troubles in Florida and Georgia, the region's two biggest states, colored the wider performance of southeastern banks.

FDIC-Insured Bank Failures in the Southeast

	2007	2008	2009	2010
Alabama	0	0	3	1
Florida	0	2	14	29
Georgia	1	5	25	21
Louisiana	0	0	0	1
Mississippi	0	0	0	1
Tennessee	0	0	0	0
Southeast	1	7	42	53

Note: 2010 data are through December 31.
Source: FDIC press releases



Retrenchment was the banking norm in 2010.

below prerecession levels. Through the first three quarters, only Louisiana's community banks recorded a state-wide median return on average assets above 1 percent, often considered a benchmark for healthy earnings, and Louisiana's median fell below 1 percent in the fourth quarter. Across the region, the median return on average assets for community banks was 0.15 percent during the fourth quarter, compared to the national median of 0.66 percent.

Lenders cautiously seeking new business

Retrenchment was the banking norm in 2010. Loan growth is typically the lifeblood of commercial banks. Yet many southeastern institutions focused instead on "cleaning up" their portfolios, not expanding them. The October–December period of 2010 marked the ninth consecutive quarter of declining loan levels for the region's community banks, according to bank call report data. Although led by persistent drops in construction and development loan levels, all major areas of banks' lending portfolios declined, according to data compiled by the Atlanta Fed.

Lending has declined for various reasons. In addition to institutions shoring up their balance sheets, credit standards have tightened since the recession. At the same time, loan demand from creditworthy borrowers has fallen as wary businesses and consumers hesitate to assume debt.

Small business is a big deal for banks, the economy

Prominent among the cautious were small businesspeople. To help disentangle the complex contributions of small businesses to economic growth and development, the Atlanta Fed in 2010 sponsored conferences, stepped up research, and launched an online small business information hub.

Credit was a major focus. The Atlanta Fed and its partners sought to advance the conversation about how to encourage safe lending while ensuring credit availability to creditworthy small businesses. As part of a nationwide series of meetings convened by the Federal Reserve, the Atlanta Fed held gatherings in each southeastern state to examine the credit challenges facing small businesses. Those meetings produced a consensus that small business sales and balance sheets had been pinched by the recession, hurting the creditworthiness of many firms and discouraging many from taking on debt.

However, opinions differed concerning the reasons why lenders curtailed credit. Some small businesspeople argued that banks' lending requirements were making it difficult for even solid firms to borrow. Many bankers countered that there simply was insufficient demand from the small companies that could meet tougher lending requirements necessitated by tighter regulation. They also pointed to their own troubled balance sheets and the difficult economy. As Atlanta Fed head of supervision and regulation Michael Johnson

Recommendations to improve small business financing



The Federal Reserve convened more than 40 meetings across the country during 2010, including six organized by the Atlanta Fed in the Southeast, to examine small business credit concerns. Lenders, government agencies, small business assistance providers, and other experts shared their perspectives on the financing challenges facing small businesses and strategies to address those issues. The Federal Reserve hosted a national event to culminate the series of meetings. At that event, high-level decision makers including the Federal Reserve Board of Governors and the Small Business Administration (SBA) received recommendations. Here is a summary:

- Increase funding to community development financial institutions and improve the referral network between banks and community development financial institutions.
 - Provide technical assistance to small businesses before and after they receive financing, and encourage advisory service providers to consider the entire financing continuum from equity to debt.
 - Assemble more timely and comprehensive data on small business lending activities.
- The series of forums is not all the Federal Reserve did in 2010 to work toward improving small business access to credit. Through its Community Affairs offices, the Federal Reserve System developed strategies to address the issues identified in the regional forums, including additional outreach and research initiatives. The Atlanta Fed continued to host forums on small business credit needs and to promote new programs designed to increase access to financing. In addition, the Atlanta Fed sought to tighten links among banks, alternative financing providers, and small business assistance providers. The Reserve Bank also convened focus groups on business incubators and alternative financing. ■
- Modify SBA programs to extend indefinitely the higher loan guarantee limits and fee waivers instituted by the 2009 American Recovery and Reinvestment Act and to increase loan sizes for popular SBA programs. The Small Business Jobs Act of September 2010 addressed many of the recommendations related to the SBA.
 - Improve communication between banks and regulators and clarify supervisory practices. Possibly expand Community Reinvestment Act consideration to include small business credit and investment activities.
 - Encourage lenders to offer “second-look” programs for denied loan applications and improve processes for referring businesses to alternative financing and technical assistance resources.



Small firms that historically relied on personal credit, including credit cards and home equity lines, were “much more likely to receive no financing.”

said in his quarterly *Financial Update* column, “The story is not straightforward.”

Untangling the complex story of small business credit availability

A few things seemed fairly clear. For one, small business lending remained near record low levels throughout 2010. According to the December issue of the Atlanta Fed’s monthly *Small Business Trends* report, the volume of small business loans outstanding in the Southeast fell in each successive quarter of 2010. Late in the year, the level was less than it was six years earlier. To be sure, credit contraction was hardly isolated to the Southeast: in 2009, total credit market borrowing in the United States fell by \$634 billion, only the second such decline since World War II, before it picked up slightly in 2010, according to Atlanta Fed research.

It appeared that not many small firms actually sought credit. Less than a third of small businesses in a National Federation of Independent Business survey reported borrowing on a regular basis during the third quarter, “not surprising given the persistent emphasis on cost cutting and the curtailment in capital expenditures,” according to *Small Business Trends*. “Borrowing that does occur tends to be for the purpose of smoothing cash flow rather than for funding expansion or hiring.”

Small construction and real estate companies, in particular, had difficulty securing credit. On average, more of those businesses than small firms in other industries sought credit, according to an Atlanta Fed survey conducted in late 2010.

On the flip side, small business sentiment might be improving. The number of discouraged borrowers—that is, the percentage of small companies that did not borrow only because they expected denial or unfavorable terms—declined in the second half of 2010. Furthermore, just 17 percent of small firms applying for credit said they received none of the financing they requested.

Most of the Atlanta Fed survey information came from established small companies. But capital to start businesses—notably, personal wealth—also continued to dwindle during 2010. As commercial banks traditionally do not offer high-risk seed financing, entrepreneurs commonly turn to friends and family, credit cards, and their own wallets. Research presented at an Atlanta Fed conference noted that plummeting home values across the United States have not only eroded individual wealth, but also limited access to home equity lines of credit, sapping a key source of startup funding. American homeowners’ equity in real estate at the end of the third quarter of 2010 totaled \$6.4 trillion, 52 percent lower than at the end of 2005, according to the Federal Reserve’s Flow of Funds Accounts of the United States. Meanwhile, American households’ combined net worth was \$54.9 trillion at September 30, 2010, down more than \$10 trillion from the peak in 2007.

With traditional seed capital sources blocked, when entrepreneurs turned to commercial banks, the results were not always good. Small firms that historically relied on personal credit, including credit cards and home equity lines, were “much more likely (than other companies) to receive no financing” during the third quarter of 2010, according to the Atlanta Fed’s Small Business Survey.

All things considered, it appeared both sides of the small business credit debate were right, Bowling pointed out. Credit supply decreased, as many banks instituted more restrictive lending criteria and shrank their loan portfolios. Small companies also demanded less credit. Fewer qualified to borrow under stricter lending policies, and creditworthy firms were generally not keen to assume debt in an uncertain economy, or they chose not to borrow because they didn’t like the terms banks offered.

These are important concerns. Bank financing is vital to small companies because they typically cannot access the corporate credit markets open to large firms via vehicles such as corporate bonds and commercial paper.

When small businesses borrow, what do they do with the money? Atlanta Fed survey respondents on average said credit availability most affected whether they diversify operations by, for example, introducing new products or expanding into new geographic markets. In a late 2010 survey, 108 firms—about a third of firms responding—indicated that credit substantially influences whether they hire or rehire employees.

Money isn’t the only issue facing small businesses

Important as it is, financing is but one issue facing small businesses. Unlike larger corporations, most small firms do not enjoy a financial cushion to withstand a temporary downturn in business, nor the option to turn to global markets if growth opportunities at home are limited. Moreover, startup companies, an important class of small businesses, are less likely to form when financing is scarce. That matters not just to individual small businesspeople, but also to the U.S. economy at large.

That’s because start-up businesses are job creators. Over the past 20 years, start-up companies less than two years old generated about one of four gross new jobs, Fed Chairman Ben Bernanke said in a July 2010 speech. Though these companies are small employers overall—they employ less than 10 percent of the nation’s workforce—based on their size, they are responsible for a disproportionate share of new jobs.

“If small and, importantly, young firms are a significant jobs engine and they are not growing, then it means a slower recovery,” said Atlanta Fed senior economist Paula Tkac.

Not surprisingly, start-up activity appeared to stall during the recession. In developed countries generally, the formation of



Seed capital is often not available to young firms.

RELATED LINK

Small Business Trends newsletter
<http://www.frbatlanta.org/research/smallbusiness/sbre-search/>

RELATED LINK ON OTHER SITES

Bernanke speech: “Restoring the Flow of Credit to Small Businesses”
<http://www.federalreserve.gov/newsevents/speech/bernanke20100712a.htm>



As businesses become more assured that growth will continue and their revenues will grow, they will increase investment and hiring.

incorporated companies showed zero growth in 2008 and declined 10 percent in 2009, according to research presented at an Atlanta Fed conference. Other research from the conference indicated a significant rise in the number of “entrepreneurs of necessity” at the same time. These entrepreneurs of necessity are people who start working for themselves in an informal, unincorporated capacity and generally do not hire employees. Metropolitan areas with high unemployment saw more of these entrepreneurs than did other areas, according to a research paper presented at the conference.

How do we square those perhaps contradictory findings? It is not entirely clear what they ultimately mean for the recovery of the regional and national economies, Atlanta Fed research economist John Robertson observed in the Atlanta Fed’s *macroblog*. For example, researchers do not know how quickly or how often new one-person businesses start hiring other people, nor how fast those enterprises tend to grow. It is an area that warrants additional study, Robertson noted.

Another step in a long recovery

In small business, banking, housing, and the entire economy, 2010 was a transitional milestone in the long recovery. While conditions remained difficult, there was progress. Importantly, consumer and business confidence appeared to be improving as we entered 2011, according to business contacts and other soundings taken by Atlanta Fed researchers.

Psychology matters. Until late in 2010, Atlanta Fed economists detected scant confidence among the region’s businesspeople and consumers, according to Michael Chriszt, who coordinates the Atlanta Fed research department’s Regional Economic Information Network, or REIN. The Atlanta Fed identified this uncertainty as a serious impediment to a durable and sustainable recovery. Improving attitudes about the future, therefore, could be a significant positive influence on the direction of the economy.

“I believe,” Lockhart said in a January 2011 speech, “that as businesses become more assured that growth will continue and their revenues will grow, they will increase investment and hiring.” ■

Feature Pages

A Salute to Pat Barron

It's a long way from the service department at Buckhead Chrysler Plymouth to the executive suite at the Federal Reserve Bank of Atlanta.

Corporate Citizenship Integral to Atlanta Fed

Corporate citizenship is essential to the Federal Reserve Bank of Atlanta.

The Retail Payments Office

Amid the long recovery, the Federal Reserve's Atlanta-based Retail Payments Office, or RPO, continued to refine a key component of the nation's financial infrastructure.

A Salute to Pat Barron



Culminating 44 years with the Federal Reserve, Pat Barron retired in early 2011 as first vice president and chief operating officer of the Atlanta Fed. Pat began his working life as an auto mechanic in his hometown of Atlanta. Known for integrity and a tenacious work ethic, he joined the Atlanta Fed in 1967 in the computer operations area and worked his way steadily upward.

It's a long way from the service department at Buckhead Chrysler Plymouth to the executive suite at the Federal Reserve Bank of Atlanta.

But Pat Barron made the trip in grand style. Barron, who retired in early 2011 as first vice president and chief operating officer of the Atlanta Fed, began his working life as an auto mechanic in his hometown of Atlanta. The first in his family to graduate from college, Barron was never a stranger to hard work. Growing up, he helped his mother pluck chickens, ran a paper route, and mowed lawns.

His modest childhood, he said, "always pushed me to want to do better."

So he did. Barron launched his Atlanta Fed career in 1967 in the bank's computer operations area, when computers were curiosities the size of small cars. It was a time when people paid for things with pieces of paper—cash and checks. That has changed, and Barron has been instrumental in effecting that change and many others.

That is no surprise. Long-time Atlanta Fed colleague Rich Oliver calls Barron "the hardest working person I know." That work ethic fueled a steady rise at the Federal Reserve: from data processing, to the check collections section, to a vital role in establishing the Atlanta Fed's Miami Branch, to branch manager. After five years as first vice president and chief operating officer of the San Francisco Fed, Barron for the past 15 years held the same position at the Atlanta Fed, while serving as retail payments product director for the entire Federal Reserve System.

It was in the latter role that Barron perhaps made his most lasting contribution to the Federal Reserve and the nation. As an advocate for modernizing the nation's payments systems, Barron led the critical but delicate task of overhauling the Federal Reserve's nationwide check processing operations in response to the migration toward electronic payment methods. "In this effort, he made tough but appropriate decisions for the Federal Reserve and the nation's economic welfare while treating employees with empathy and respect," reads a resolution in Barron's honor signed by Federal Reserve Chairman Ben Bernanke and the Atlanta Fed board of directors.

Barron likewise was at the forefront in restoring check processing and other retail payments across the country after the September 11, 2001, terrorist attacks. Four years later, he led an Atlanta Fed team that overcame major obstacles to keep cash, checks, and electronic payments flowing in the wake of Hurricane Katrina. Just as important, he ensured that the 179 members of the New Orleans Branch staff were safe and secure.

"No matter the challenge," Barron's resolution states, "he will long be remembered for his steady calm in the eye of any storm." ■



"No matter the challenge" Barron's resolution states, "he will long be remembered for his steady calm in the eye of any storm."

Corporate Citizenship Integral to Atlanta Fed



This engagement is mutually beneficial, helping both the Atlanta Fed and the public we serve. Maintaining the public trust necessary to function as a central bank requires engagement on several fronts.

Corporate citizenship is essential to the Federal Reserve Bank of Atlanta. It embodies the Bank's commitment to participate fully in the life of our communities, both within and outside the normal scope of our work. The Atlanta Fed's mission is critical to the economic health of our region and communities, so it is only logical that the bank be engaged in volunteer and civic activities that strengthen their economic vitality.

This engagement is mutually beneficial, helping both the Atlanta Fed and the public we serve. Maintaining the public trust necessary to function as a central bank requires engagement on several fronts, including three we will spotlight:

- Operating in an environmentally responsible manner
- Serving in civic and nonprofit organizations that strengthen our communities through education, sustainability, and health and well-being
- Respecting our employees and valuing the diversity of ideas, skills, talents, and cultures they bring to the bank

Environmental stewardship and sustainability

In 2010, the Atlanta Fed adopted its first five-year environmental plan. The document addresses nine areas that cover the Sixth Federal Reserve District's environmental impacts: recycling and waste reduction, water, energy, transportation, green purchasing, buildings, education and communications, business methods, and public engagement.

The plan includes specific goals for each area. For instance, over the next five years, the Bank aims to reduce water use by 10 percent, electricity consumption by 15 percent, and paper use by 20 percent. The Bank is making progress toward these and other green objectives through a comprehensive recycling program, water conservation measures including low-flow faucets, automated lighting systems, and fuel-efficient fleet vehicles.

The Atlanta Fed has also incorporated sustainable design and construction standards. Last year, the bank achieved the coveted Leadership in Energy and Environmental Design, or LEED, certification for the renovation of the employee café in the Atlanta office. Moreover, the Bank's early steps to green its operations received recognition from the state of

Georgia in 2010 with the Partnership for a Sustainable Georgia's Silver Award.

Community and civic engagement

Atlanta Fed employees have a firm commitment to community involvement. Throughout the Sixth Federal Reserve District, employees volunteer time and expertise through a strategic program focused on three areas critical to the economic vitality and general health of our communities: education, health and human services, and community development. Last year, employees volunteered more than 5,500 hours of their time in 99 different projects. In addition, many Atlanta Fed staff members serve in leadership roles in numerous nonprofit organizations throughout the Southeast.

One of the bank's longest-standing projects is the annual Financial Education Day, which takes place every fall. Since its inception in 1997, this program has reached more than 2,000 eighth graders, who learn basic personal finance from Atlanta Fed volunteers.

More than 50 years ago, staff members created an employee-owned charitable fund that regularly donates to nonprofit agencies in the Southeast. In 2010 alone, the fund raised and donated more than \$430,000. (The Federal Reserve itself is prohibited from directly contributing to charitable organizations.)

Diversity and inclusion

Like environmental stewardship and community involvement, diversity and inclusion, in action and thought, are essential to the Atlanta Fed. Since 2004, the bank has woven this commitment into the daily fabric of our organization by

- Codifying a business case for diversity
- Adopting a Diversity and Inclusion Strategic Plan
- Instituting mandatory diversity and inclusion training for all employees

Building on this foundation, in 2010, the Atlanta Fed established an Office of Minority and Women Inclusion, as called for by the Dodd-Frank Wall Street Reform and Consumer Protection Act. ■

The Retail Payments Office



In 2010 alone, the RPO's costs plummeted 36 percent from the previous year, to \$270.5 million. As the RPO's costs have fallen, it has in turn lowered fees to its customers, mainly financial institutions.

Amid the long recovery, the Federal Reserve's Atlanta-based Retail Payments Office, or RPO, continued to refine a key component of the nation's financial infrastructure: national retail payments services, the system through which consumers and businesses pay for goods and services.

The RPO handles billions of dollars in transactions every day. Those transactions pass through Fed networks, such as the automated clearinghouse (ACH), which processes online bill payments, direct paycheck deposits, mortgage payments, and other consumer and business transactions. The RPO also processes a large number of check payments deposited at the Fed by financial institutions across the United States.

While the RPO does not process all retail payments—it does not handle credit and debit cards—its suite of payments services is extensive enough to make the Fed an important and influential player in the industry. The RPO undertook a multi-year initiative to enhance the speed and efficiency of check clearing by converting paper checks into electronic images. In addition to helping to make the nation's overall payments system more efficient, that effort has allowed the RPO itself to operate with significantly fewer personnel and to largely stop transporting paper checks across the country. Since November 2003, the RPO has reduced the number of Federal Reserve check processing sites nationwide from 45 to one in response to the rapid slide in paper check writing and the accompanying rise in electronic payments.

In 2010 alone, the RPO's costs plummeted 36 percent from the previous year, to \$270.5 million. As the RPO's costs have fallen, it has in turn lowered fees to its customers, mainly financial institutions. The RPO structured these prices to encourage customers to use electronic methods of processing payments.

Importantly, the RPO also serves as a knowledge center. Every three years, the RPO conducts the only comprehensive, ongoing study of the fluid payments industry. The study is one of the primary tools the RPO uses to track the industry. Released in December 2010, summary findings of the RPO's most recent study showed that Americans increasingly prefer electronic payments methods, including debit cards, credit cards, prepaid cards, online payments, and ACH transactions. Electronic payments accounted

for more than three-quarters of noncash payments in 2009, the biggest portion ever. Meanwhile, the share paid by check kept falling, from a third in 2006 to less than a quarter in 2009. In particular, during the three years covered by the study, debit cards surpassed checks to become the single most popular noncash retail payments option, representing about 35 percent of payments made with a method other than cash.

New technology also means more fraud

As technological advances create new methods of payment, they likewise open new channels for fraud and crime. To help identify and mitigate these emerging risks, in 2008, the Retail Payments Risk Forum grew out of the RPO. The Forum addresses challenges faced by the payments industry, bank regulators, and law enforcement in managing retail payments risks and enhances collaboration among these parties to detect and mitigate fraud.

To that end, the Forum convenes conferences, conducts research, serves on industry workgroups, and disseminates information through channels including a blog, podcasts, and white papers. Forum research has helped to illuminate truths about the risks of America's traditional plastic. To wit, the magnetic stripe debit and credit cards that predominate in America are far more vulnerable to fraud than are the chip-implanted cards rapidly being adopted in many other countries.

The Forum's role as convener has proven particularly valuable in a fragmented industry. For example, the Forum fostered collaboration between financial institutions and law enforcement agencies that produced a set of tools the financial industry will use to better report fraud and thus help in criminal investigations.

Significant in 2010 was the Forum's partnership with the payments research group at the Boston Fed to establish the Mobile Industry Work Group. The group is the first initiative that convenes all participants in the burgeoning mobile payments industry—from banks to telecommunications firms to card networks to handset makers—to examine common concerns and to advance the adoption of mobile payments in the United States. ■

Milestones

First quarter

- The Real Estate Research blog debuted, which showcases analysis of topical research and issues in housing and real estate economics.
- The Local Economic Analysis and Research Network conference examined the economic outlook in six southeastern states.
- New banking supervision and regulation department head Michael Johnson joined the Atlanta Fed. The department restructured its supervisory framework to incorporate a systemic, multidisciplinary perspective.
- The supervision and regulation department hosted the annual Industry Outlook Conference on challenges facing bankers and regulators.
- The Atlanta Fed launched its five-year plan for environmental sustainability.
- The Atlanta Fed website added the Inflation Project, a compendium of links to indicators, reports, and research on inflation.
- The Atlanta Fed processed its last paper check, ending an era that lasted 96 years.
- The Bank published its first report on corporate citizenship activities.
- The Atlanta Fed expanded communications with elected officials about the implications of regulatory reform.

Second quarter

- FDIC Chairman Sheila Bair spoke at a financial literacy forum cosponsored by Operation Hope and the Atlanta Fed about the renewed urgency of financial education after the financial crisis and recession.
- The Atlanta Fed launched its social media presence with a Facebook page and Twitter account. The new outlets give readers easy access to Fed research, information, and policy views.
- The Atlanta Fed announced that its Nashville cash operations will be discontinued in favor of a cash depot in mid-2011.
- The Atlanta Fed's Financial Markets Conference gathered policymakers and financial practitioners to consider the postcrisis financial landscape from policy and practical perspectives. (Podcasts: Research director Dave Altig and economist Paula Tkac discuss the conference.)
- The Bank hosted a Public Affairs Forum on the economics of income inequality.
- President Dennis Lockhart, cochair of the United Way of Metropolitan Atlanta's Early Education Commission, completed work on institutionalizing improvements in early childhood education.

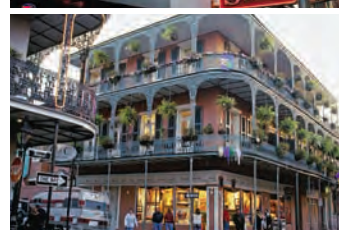
- Through the Regional Economic Information Network, or REIN, the research department closely tracked the economic effects of the Gulf oil spill.

Third quarter

- The U.S. Census Bureau Research Data Center selected the Atlanta Fed as regional host. Bank partners include Georgia State, Emory, Georgia Tech, the University of Georgia, the University of Alabama at Birmingham, and the Centers for Disease Control and Prevention.
- New Orleans staff contributed to a Brookings Institution study on the city's recovery five years after Hurricane Katrina.
- The Center for Real Estate Analytics sponsored a conference on the crisis in real estate and its impact on government finances.
- The Bank hosted hearings on potential changes in the Home Mortgage Disclosure Act, which requires mortgage lenders to provide regulators and the public detailed annual reports of their lending.

Fourth quarter

- The Atlanta Fed held a historic conference to mark the 100th anniversary of the 1910 Jekyll Island meeting that resulted in draft legislation (the Aldrich Plan) for the creation of the U.S. central bank. Participating in the conference were current Fed Chairman Ben Bernanke and former Fed chairmen Paul Volcker and Alan Greenspan, among others.
- The Americas Center and the American Society of Hispanic Economists organized a workshop on Hispanic economic issues.
- The Atlanta Fed held a conference that explored the dynamics of small business, entrepreneurship, and economic recovery.
- The new Center for Human Capital Studies hosted a conference on employment and the business cycle.
- More than 10,000 teachers attended 207 Atlanta Fed workshops and presentations throughout the year.
- The Retail Payments Office released summary findings of its 2006–9 study showing that debit card payments are more popular than checks and credit cards.
- Leaders were appointed for the new Office of Minority and Women Inclusion.
- The Atlanta-based Retail Payments Office launched cross-border service that allows U.S. financial institutions to send payments to more than 20 European countries.
- The Atlanta Fed's cash operations processed 5.43 billion notes.
- The Fed's Atlanta-based Retail Payments Office processed 10.5 billion electronic commercial automated clearinghouse transactions and 7.8 billion checks. Of the checks, 99.4 percent were electronic; the remaining 0.6 percent were paper.



Cities from top to bottom: Atlanta, Birmingham, Jacksonville, Miami, Nashville, New Orleans

Sixth Federal Reserve District Directors

Federal Reserve Banks each have a board of nine directors. Directors provide economic information, have broad oversight responsibility for their bank's operations, and, with the Board of Governors approval, appoint the bank's president and first vice president.

Six directors—three class A, representing the banking industry, and three class B—are elected by banks that are members of the Federal Reserve System. Three class C directors (including the chair and deputy chair) are appointed by the Board of Governors. Class B and C directors represent agriculture, commerce, industry, labor, and consumers in the district; they cannot be officers, directors, or employees of a bank; class C directors cannot be bank stockholders.

Fed branch office boards have five or seven directors; the majority are appointed by head-office directors and the rest by the Board of Governors.

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Left to right: Moore, Head, Reilly, Mauldin; not pictured: Hawkins, Langloh, Stanton

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Left to right: Jenkins, Horton, Jones, Dailey, Healan, Landrum; not pictured: Weatherman

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Left to right, standing: Hudson, Thompson, Estes, Banks, Abess; left to right, seated: Shea, Padrón

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Left to right: Stuller, Topazi, Host, Slaughter, Suquet, Milling; not pictured: Boh

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Left to right, standing: Johnson, Altig, Herr, Jones, Lockhart, Gooding, Anderson, Brown, Davenport; left to right, seated: Berthaume, Barron, Oliver; not pictured: DeBeer

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Auditing

In 2010, the Board of Governors engaged Deloitte & Touche LLP (D&T) for the audits of the individual and combined financial statements of the Reserve Banks and the consolidated financial statements of the limited liability companies (LLCs) that are associated with Federal Reserve actions to address the financial crisis and are consolidated in the financial statements of the Federal Reserve Bank of New York. Fees for D&T's services are estimated to be \$8.0 million, of which approximately \$1.6 million were for the audits of the LLCs. To ensure auditor independence, the Board of Governors requires that D&T be independent in all matters relating to the audit. Specifically, D&T may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of Reserve Banks, or in any other way impairing its audit independence. In 2010, the Bank did not engage D&T for any non-audit services.

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Each LLC will reimburse the Board of Governors for the fees related to the audit of its financial statements from the entity's available net assets.

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