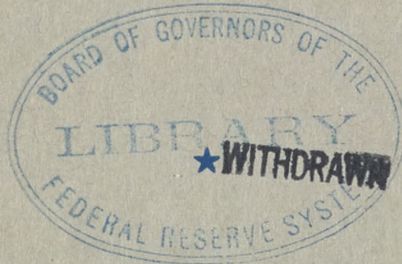
Bank Capital Ratios Today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FEDERAL RESERVE SYSTEM

An Address Delivered By

HONORABLE LEO T. CROWLEY
Chairman, Federal Deposit Insurance Corporation

Before the

WISCONSIN BANKERS CONFERENCE

April 7, 1942

FEDERAL DEPOSIT INSURANCE CORPORATION

WASHINGTON, D. C.

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"Bank Capital Ratios Today"

Mr. Chairman, ladies and gentlemen:

Today, as always, it is a pleasure for me to meet with the Wisconsin Bankers Association. It has been some time since we had a chance to visit together, so it is especially good to be with you again.

Recent Events Lend New Importance to Capital Ratios

Fay Elwell asked that I speak to you today on the question of bank capital ratios. This subject, always of interest where bankers meet, has assumed new importance in recent months. Bank assets continue to grow at steadily high rates, further distorting their relationship to relatively static capital accounts. The uncertainties growing out of our active participation in the war add many complications to an already knotty problem.

It is particularly timely, therefore, that I outline for you today what we in Federal Deposit Insurance Corporation are currently thinking and doing about the capital ratios of insured banks.

As the cushion which protects banks against fluctuations in values and other broad economic forces, bank capital is a major concern of each insured bank and, in a broad sense, of our whole economic structure. In its more tangible, immediate role as the primary margin of safety over-lying bank deposits, bank capital is a matter of important, selfish concern to the depositing public and to Federal Deposit Insurance Corporation.

Capital Ratios Continue to Trend Downward

It is a matter of historical record that the ratio of bank capital to bank assets has tended generally downward for as long as there are records. There have been a few report periods during which the ratio rose slightly, but the rise on these occasions resulted nearly always from a marked reduction in bank assets, rather than from an increase in bank capital. The trend was halted abruptly in the period from 1933 through 1935 by the injection of large amounts of new capital into our banks during the period of rehabilitation following the bank holiday. Soon thereafter, though, the downward trend resumed, and it has continued without noticeable interruption to this day, largely as the result of the most steady and phenomenal growth of bank assets that the country has ever seen.

With capital funds of all insured banks constituting less than $9.00

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of each $100 of bank assets today, as against the $12.00 and $14.00 that represented capital in years gone by, concern about the adequacy of bank capital is quite naturally widespread. Since talk and conjecture on the subject center largely around the traditional 'ten-to-one ratio', let me first discuss that basic premise.

Ten-to-One Ratio Has Served Well As Measuring Rod Heretofore

In speaking before a meeting of the American Bankers Association in October 1934, I said:

> "We have felt it imperative that members of the Insurance Fund be protected by the existence of an adequate cushion in the form of capital over-lying deposit liability. We have felt that maximum protection to the depositors in an insured bank, as well as the funds of the Corporation, could only be afforded through such an adequate capital cushion. In undertaking to rebuild where necessary the capital structure of banks becoming members of the Insurance Fund, we have used as a measuring rod a ten-to-one ratio of deposits to capital."

Because of its acceptance in custom, this ratio was adopted as a yardstick during the program of bank rehabilitation in 1933-1935. It served its purpose satisfactorily then, when the tremendous volume of work to be done in a short time made simple, generally applicable standards necessary for quick action. Since then its use has been continued as a desirable, workable, basic standard. We have endeavored to apply it without being too rigid and have striven concurrently for improvement in asset quality. That the joint efforts of bankers and bank supervisors have been successful in this regard is amply attested by the present generally satisfactory condition of the insured banks.

Today's Circumstances Call for Adaptation of Standards

Today, when the banks are being called upon for vigorous financial support of the war effort, when we witness tremendous increases in bank assets and expect this tendency to continue, it is timely that we re-examine our thoughts on bank capital and on other banking standards as well. I am confident that you believe with me that we should not abandon any of our fundamental concepts, but rather that we should adapt them to the necessities of the times.

Adequacy of a Bank's Capital Depends on Many Factors

The adequacy of capital protection in a given bank must continue to be the basic standard for supervisory measurement of the institution. No longer, however, can supervisors look upon an arbitrary yardstick alone as an infallible, inflexible criterion. The adequacy of a given capital ratio must be weighed and judged in the light of other factors making up the whole picture of a bank.

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A decline in the capital ratio of a bank is not, of itself, conclusive evidence of weakness. Capital is intended to cushion the bank against assets that are subject to shrinkage in value. The growth in assets which caused the ratio decline during recent years occurred preponderantly in the cash and Government securities accounts, the least risky types of bank assets. Marked improvement in the quality of earning assets of banks—those most likely to constitute claims upon capital—is another factor in the present picture that must be weighed in considering the adequacy of capital. Whereas in 1933 examiners set up $10.47 as net deductions from each $100 book value of *all assets* of insured banks not members of the Federal Reserve System, and in 1934 set up net deductions of $6.73 per $100 of such assets, examinations made in 1940 classified only $.77 per $100 as deductible. Note further that where in 1934 examiners classified $40.64 of each $100 of *loans and discounts* of banks examined by FDIC as deductions and substandard, only $10.68 per $100 of loans were so classified in 1940.

I find that there is no quarrel among the many parties at interest over the need for adequate and sizable capital protection in each bank. There is, however, a rather wide division of opinion as to the minimum acceptable capital ratios and as to the proper means of building up deficient capital accounts.

The minimum acceptable capital ratio, particularly under present conditions of rapid change, appears to me to be a matter that must be determined for individual banks on the basis of their condition and trends. Establishment of a general inflexible minimum capital rule without regard to other factors in the bank would be undesirable from many angles. The adequacy of a given capital ratio varies widely from bank to bank, even from season to season within a given bank. Experience shows that a formally sanctioned minimum tends quickly to become the maximum, thus weakening supervisory efforts to obtain correction in banks where twice the legal minimum capital would probably still not be sufficient. Finally, it has always been our hope to keep bank restrictive legislation at a minimum, leaving as wide a scope as possible to the efforts of bank managers and to the cooperative negotiations of bankers and supervisors.

By Any Standards, Capital Deficiencies Exist in Some Banks

Yet, by whatever standards we measure, there are today several banks with capital deficiencies of varying degree. When we face the problem of repairing these deficiencies, our attention must be focused both upon capital and upon assets. Any remedy for the deficiency must take into consideration both factors in the ratio, the cushion and the weight upon the cushion.

No Market Today for New Bank Capital Issues

The obvious way—and what used to be the simplest way—to repair capital deficiencies, is to round up additional bank capital. In fact, it is the most satisfactory manner under usual conditions. Today, however,

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it appears unlikely that any large amounts of new capital can be obtained from private investors—certainly no amounts that would keep pace with the increases in assets occasioned by the country's war effort. Increasing taxes and other urgent demands on the people have diverted private investment funds from many common stocks and particularly from bank stocks. Even if it were possible to obtain new capital, except in a small percentage of the cases, there are some doubts as to the urgency or wisdom of this course. In the first place, the apparent deficiency may be temporary to a large degree. Secondly, it would be an easy matter needlessly to destroy confidence in the banks by the constant emphasis on the subject that would be necessary to accomplish such an objective.

The Government in the past has aided in supplying bank capital not obtainable from private sources and some have suggested that it reenter the field on an active scale. Generally, because of the sound condition of our banks and for the same reasons stated above, I believe there is no real and immediate need for such assistance. The sight of Government coming again to the aid of our banks would probably shake the confidence of our people at a time when a stable supply of bank credit is essential, and would be likely to raise again the question of the ability of our traditional banking system to serve American business and the American people.

Additions to Capital Must Come Primarily from Earnings

In the light of these considerations, augmentation of bank capital today would appear to depend almost entirely upon retention of a large portion of bank earnings and upon reduction of the claims upon capital and earnings through extraordinary attention to bank assets. Retention of a large proportion of bank earnings will involve increased attention to operating economies within certain banks, as well as ultraconservative dividend policies so long as growth of assets continues.

If Remedy Cannot Be Found, Closure with FDIC Aid Is Best Course

On the other hand, there are and will be some banks with capital deficiencies and asset conditions in respect to which the retention of earnings as a means of correcting the situation would be a fruitlessly slow process. New capital is the only solution in many such cases, while in others with doubtful future earnings prospects elimination with the assistance of the Federal Deposit Insurance Corporation seems the only feasible course. Unfortunately, there are some bankers as well as a few state authorities who do not want to face the facts in certain problem cases. We must be realistic about these matters. It is obviously unfair to the banking system as a whole to temporize with uneconomic and weak units.

The Corporation, as in the past, is ready and willing to meet its financial responsibility immediately whenever the need arises. It will

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continue to recognize its losses and absorb them as they occur as it is asking you bankers to do. This is the surest way of maintaining public confidence. During the eight years of deposit insurance ended December 31, 1941, the Corporation has aided 370 insured banks having 1,205,154 depositors with total deposits of $468,417.000. Of this total of deposits, $457,640,000 or 97.7% was fully protected. Only 1,920 depositors, or less than one-quarter of 1% of all depositors in these banks, held accounts in excess of $5,000. This was accomplished with total disbursements actually made or pending of $259,967,598.37, of which $131,628,256.61 actually has been recovered. Future recoveries are estimated to be $81,740,913.01. The resulting deposit insurance losses and expenses of $46,598,400, together with administrative expenses and other charges totaling $25,739,800 during the same period, are $1,710,000 less than the Corporation's income other than assessments. Therefore, on December 31, 1941, the Corporation had a surplus of $264,199,900 in addition to its capital stock of $289,299,600, a total capital and surplus of $553,499,500. We believe that you agree that we should continue to build on this foundation to provide for any emergency that may come in the readjustment following the war. In the last analysis, the funds of the Federal Deposit Insurance Corporation are intended to supplement bank capital as protection for depositors.

Attention to Bank Assets Is Most Fruitful Approach to Capital Problem

In the great majority of banks, the most promising and fruitful avenue of approach to the problem of capital deficiencies lies in bank assets, the second factor of the capital ratio. Improvement in bank assets is the influence that has helped most to ease the seriousness of the decline in capital ratios. It is likewise the aspect of the capital problem about which most can be done now and in the immediate future.

Care in the selection of earning assets continues to be the primary responsibility of bank managers, particularly in these times of stress when they are urged to give weight to many factors other than intrinsic soundness in making their decisions. Thoughtful bank management will temper the enthusiasm of borrowers who become too visionary. Also, it will profit by our experiences with mortgages and require that borrowers make provision for regular reductions, if not complete repayment, of their loans at intervals so that they will not be faced with debts which cannot be liquidated when the war is over. Do not misunderstand me; banks can and should continue to assist in our war effort. However, let none be misled into the belief that bank credit standards should be relaxed now. The war effort will not be aided by any basically unsound credit advances, and the task of post-war readjustment will be made harder by each of them.

Bank managers should move promptly, too, to take advantage of improved markets to dispose of substandard assets which now burden their institutions. In many localities improvement in the real estate

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market has given banks a splendid opportunity to reduce their other real estate accounts. Managers who fail to take advantage of this condition are really derelict in their duty. Even in localities where markets still do not permit realization of book values on other real estate, bankers should still get busy on reduction of that account, since it is unlikely that any better prices than those that presently prevail will be obtained.

There should also be a particular incentive for bankers today to charge out known losses and depreciation in their assets. Bank earnings generally are at their highest level in many years, and as tax deductions, charge-offs will assume new justification.

In summary, then, I believe the problem of deficient bank capital can best be solved today by bankers and supervisors through attention to bank assets, both in acquiring new assets and in properly pricing those they already hold; by operating economies, conservative dividend policies determined only after elimination of all known losses and depreciation; by retention in capital accounts of a large portion of current earnings; and by special attention to the relatively few problem cases, with courage to eliminate unsound units when it becomes necessary. To only a minor degree can we look to the sale of new private capital or to the Government for relief of acute situations.

Bank Capital Only One Factor in Building Public Confidence

It is important, too, I believe, that we not lose our perspective. In the last analysis, the question of bank capital is but one aspect of the many-faceted basic problem of bankers and supervisors, namely, maintaining public confidence in our financial institutions. It is an important aspect because, like Federal deposit insurance, it is a tangible, measurable indication of safety, readily understood by the public. Banks with sizable capital ratios have been known to fail when they drew public suspicion, while banks that momentarily were barely solvent have weathered severe crises because the public had faith and confidence in their managers.

Public confidence presupposes faith in the soundness of our banking system. That faith can be bolstered and solidified by good management and good supervision working in harmony with the Federal Deposit Insurance Corporation in the solution of our mutual problems as they arise. Our greatest contribution to our country's war effort is a sound banking system. We are fortunate, indeed, that it is sound now. Our duty henceforth will be to keep it that way.

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