ADEQUACY OF CAPITAL FUNDS IN RELATION TO DEPOSIT GROWTH AND EXPANSION OF BANKING

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The objective for this part of our program is to look at several facets of the bank capital problem that appear to be important and promise to become more so. In the course of the next few minutes it is my intention to outline very briefly a few areas that may be worthy of consideration. However, the substance of this discussion will come from your participation rather than any formal presentation on my part.

At the outset it is well to recognize that the bank capital problem is old and that it has not been solved. Some people find it very disconcerting to live with old and unsettled problems. There are many such problems, however. As bank supervisors, I am confident that you identify the bank capital problem as one subject to transitory rather than permanent solutions. In short, it is a problem that you live with from day to day.

Real progress is achieved, it seems to me, when we recognize that the bank capital problem is perennial in character. This recognition enables us to clear away all of the intellectual rubbish that has accumulated as a result of efforts to find ultimate and definitive solutions. By so clearing the scene it becomes much easier for us to define the problem as it changes in character and to devise methods for coping with each of the aspects.

To illustrate: From time to time there have been efforts on the part of supervisory authorities and others to devise measures for determining the adequacy of bank capital margins. Usually these efforts are associated with schemes for providing banks with appropriate capitalizations. These endeavors for the most part have served some good purpose by helping to shore up a few poorly capitalized banks. Unfortunately, however, many of these efforts have over-simplified or grossly distorted the total bank capital problem by placing undue emphasis on some transitory feature. More sophisticated is the recognition of the fact that the capital problem cannot be escaped and that it cannot be solved in any ultimate sense.

In addition to a recognition of the bank capital problem as essentially perennial in character, it is also well to realize that the problem is ever changing in relative importance. Sometimes the bank supervisory authorities need place only minor emphasis on the capitalization of the banking system. At other times bank capital margins may require the major attention of bank supervisors. Then again there are periods such as the present when it may appear that the bank capital problem is growing in relative importance. Thus, as I see it, the supervisory authorities are confronted with the never ending task of appraising and reappraising the banking situation with respect to capital margins. Only by so doing are they able to give the problem the amount of emphasis that is appropriate--no more and no less.

A cursory review of basic information as regards banking suggests that a consideration of bank capitalization is now quite appropriate. Over a period of years the growth in the volume of deposits has been very substantial. Moreover, marked changes have occurred in the composition of the asset structure. Finally, in recent years powerful forces have affected both the quality and the value of assets. While business activity generally has been sustained at a high level, certain portions of the picture have not been good. Owing to the record increases in money rates, dramatic readjustments have occurred in the price structure of assets held by banks. In these circumstances, it is not surprising that bank supervisors are looking very closely at bank capitalizations in many cases.

Historically, there have been many tests of a mechanical character for determining bank capital adequacy. Years ago writers in the banking field achieved a consensus of sort that the capital margin should amount to at least 10 percent of total deposits. Later this ratio was expressed as a percentage of total assets. No one, however, demonstrated that such a margin was entirely satisfactory nor that a smaller percentage would inevitably lead to trouble. At any rate, the 10 percent margin as a test of capital adequacy has long since been abandoned for the simple reason that very few banks could measure up to this standard.

The ratio reflecting the national average of capital to total assets has been used to test the adequacy of bank capital. This ratio does have the virtue of avoiding the inflexibility of the 10 percent margin which it supplanted. However, it is unrealistic to expect all banks to measure up to a so-called national average capital margin. Accordingly, the national average is primarily useful as a center of reference for appraising the capital situation of a given bank.

Many other ratios have been used from time to time in testing the adequacy of bank capital. By and large, these tend to be refinements of a gross ratio between capital and total assets. The object of the refinement is to relate more specifically assets subject to shrinkage in value and the margin available for absorbing this shrinkage. There is, for example, the so-called risk asset ratio, that is, total assets less cash and Federal obligations as compared with total capital accounts. This ratio has been further refined by excluding from the category of assets at risk those items which are protected by some form of Federal guarantee. The objection to such measures of capital adequacy is that one cannot identify assets at risk in any unequivocal manner. It has been pointed out that even cash may be subject to some deterioration--if it is a deposit in a closed bank. Still another approach to the problem of measuring bank capital margin is to relate the total amount of loans to the total capital accounts.

All of these measures of the capital margin give some indication of its relative size. However, after these various measures have been computed the supervisory authorities are still left with a judgment problem, namely, to determine whether capital in a given situation is adequate.

The determination of bank capital adequacy is essentially a qualitative judgment based upon appraisal of a total situation. Quantity tests may furnish some valuable sidelights in arriving at a judgment. However, conformity to any or all recognized mechancial tests would not in a given instance assure adequacy of the capital structure. There are many other considerations of an economic character as well as with regard to the bank management. Undoubtedly able management can make increasingly successful use of any capital margin. Moreover, it is a fact that capital is never a substitute for managerial skill.

In coming to grips with a bank capital problem, supervisory authorities in a very fundamental sense are dependent upon the information gathered by bank examiners. As a consequence, the tests and guides examiners apply in forming opinions about the quality and quantity of bank capital are matters of primary importance. For screening purposes examiners are very likely to apply the recognized statistical tests of capital adequacy. Possibly it would be interesting to consider your experience with these tests. Have you been able to develop any other guides of a quantitative character? More important, however: What has been the experience of your examiners in interpreting these various measures?

When the bank supervisory authorities come to grips with a capitalization problem, the question of alternative remedies becomes paramount. A program for retaining bank earnings within the capital structure is commonly suggested as a means of correcting capital deficiencies. Owing to the relatively low earning power of banks, however, such a program makes progress slowly. Furthermore, it has the disadvantage of reducing the attractiveness of the bank shares to investors.

As an alternative to retention of earnings capital may be obtained by the sale of new shares for cash. This approach to the problem of strengthening bank capitalizations recognizes at the outset that the banking business needs very substantial additions to the capital margin if it is to keep pace with other enterprise. However, the new issue market can only be tested successfully if investors are convinced that commitments in bank shares are attractive. This would require a record of dividend payments that is long and relatively high. Since bank earnings are stable this would seem to justify a rather high payout to shareholders. It should be noted, however, that a program designed to strengthen bank capitalizations by the sale of new shares is not consistent with the program of earnings retention. Furthermore, shares in small and medium sized banks up to now have developed very little marketability. These alternative approaches to the problem of tapping new capital funds for banking, in my opinion, are worthy of careful consideration and detailed study.