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THE WORLD WOULD SLEEP

(Or, All You Would Ever Care To Hear About Capital Adequacy)

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before the

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By: William M. Isaac*

Introduction

It is a pleasure to appear before you today and participate in your annual meeting. With some trepidation -- for this issue has gotten the better of a lot of good people -- I have decided to explore the subject of capital adequacy. I will review a little of the history relating to this issue, discuss why I believe it to be of such importance, and then highlight some of the specific questions that are currently under consideration at the FDIC.

Every member of the Board of the Federal Deposit Insurance Corporation, since its inception in 1934, has had occasion to address, formally or informally, the issue of capital adequacy. The tradition of the Corporation is so strong in this area that many bankers understand the FDIC initials to mean "Forever Demanding Increased Capital." Perhaps it is the FDIC's insurance role, or that we have our roots in a national banking crisis, that makes us particularly attuned to this issue. But, of course, each banking agency, the banking industry itself, investors, Congress, and the general public have a vital stake in bank capitalization and solvency.

The dialogue on capital adequacy is over 100 years old. The debate has sometimes been heated; at times the issue has lain dormant; perspectives have changed; analytical tools have been developed and refined; and the nature and structure of the industry has changed. The passage of time, however, has done nothing to alleviate the problem; capital adequacy, in my judgment, stands today as one of the most crucial longer-term issues confronting bankers and regulators.

One can hardly hope to add anything new to the debate; the quest for an objective and absolute test of bank capital adequacy has been undertaken by many great minds, and no final answer has been discovered. Indeed, I have been advised by some that this issue is so thorny it is simply not susceptible to resolution. There is no question these people have history on their side, but this kind of talk reminds me of P. C. Johnson's couplet:

> The world would sleep if things were run
> By men who say "It can't be done!"

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* The views expressed in this speech are personal and do not necessarily reflect FDIC policy.

Conflicting Goals: The Necessity of Balance

There are many factors which combine to make the capital adequacy debate so complex and enduring. First of all, there are the differing perspectives and conflicting goals of shareholders, depositors, management, and regulators. Secondly, there exists the analytical problem of determining an intellectually satisfying definition of exactly what constitutes adequate capital for a bank or the industry. Finally, there is the difficult issue of enforcement. Too often capital discussions become embroiled in the definition of "adequacy." In my opinion, it is more appropriate to begin by recognizing the conflicting goals and competing policy considerations and developing the philosophical framework within which these conflicts can be resolved.

Certainly there are conflicts. For bank supervisors there is tension between the goals of ensuring a safe and sound banking industry and fostering a competitive and innovative banking industry. I personally would prefer to see the marketplace regulate capital decisions. Unfortunately, it is unrealistic to expect the marketplace to function properly with respect to this issue. Many investors, depositors, and other creditors, particularly with respect to smaller banks, do not have, and perhaps can never have, timely access to sufficient information to fully evaluate capital adequacy. Moreover, particularly with respect to larger banks, the marketplace has come to rely to a fair degree on the supervisors, the lender of last resort, and the deposit insurance system. In addition, the preferences of private institutions may not be the same as public policy preferences. A shareholder evaluates the potential for gains or losses based on an individual bank's soundness and prospects for growth. However, the impact of a bank failure could extend well beyond the losses to the shareholders and creditors of that institution and create ripple effects throughout the entire economy. While I see no satisfactory alternative to bank supervisors accepting responsibility for capital adequacy, we must be aware of the impact the level of capital has on the return to shareholders, on the ability of banks to finance economic growth, and on the pricing policies and market shares of banks.

The regulatory conflict has a counterpart within the private sector. Shareholders focus on the growth and profitability of the institution; the first and foremost concern of depositors and other creditors is the safety of their funds. Yet, there are common interests as well. While depositors are properly concerned with safety, they are typically users of other bank services and the prices of those services will likely be higher the more capital a bank is required to maintain. Thus, even depositors do not want excess capital. Shareholders focus on growth and profitability; but with high leverage and thin capital buffers, they run the risk of losing all.

We must seek a balance among sometimes conflicting objectives and focus on our common interests. Bankers, bank supervisors, shareholders, and creditors all share a common interest in maintaining an independent and viable financial network, and the existence of private equity capital -- at risk -- plays a vital role. My concern is that events -- changes in the economic environment and in the banking industry, accompanied by continued erosion in bank equity capital ratios -- are propelling us down a path that could debilitate the free enterprise spirit in the banking industry. This path could, for example, lead us to a system of 100% deposit insurance. While this might enhance public confidence in the banking system, it would further weaken the discipline imposed by the marketplace and would result in greater government involvement in the credit allocation process.

Historical Perspective: Key Trends

Let us briefly review the key trends, beginning with the changes in the risks associated with the banking business and the general economic environment. After the conclusion of World War II, the banking industry entered a period of rapid change and growth. Certainly one must acknowledge the tremendous contribution that banking made to the development of the U.S. and world economy during this period. One cannot help but applaud the imagination and innovation that sprang from an industry responding to its customers and opening new markets. But this was accomplished at a price -- an increase in the riskiness of the banking business.

Risk assets, which (due largely to war-financing needs) were only 22% of total assets in 1945, grew to 68% by 1965 and an estimated 80% in 1978. Banks, often through the holding company vehicle, entered new product and geographic markets. Domestically, they offered new services such as credit cards, travelers cheques, lease-financing services, and longer-term commercial loans. Mortgage banking, factoring, and consumer finance companies were acquired. International banking grew rapidly as banks financed both international trade and the growth of less developed countries. To finance the growth into new and existing markets and to circumvent interest rate controls, banks introduced certificates of deposit, entered the commercial paper and Eurodollar markets, and made increased use of other sources of funds as "liability management" became the byword. In many markets, banks faced new competition from thrifts, investment bankers, large retailers, credit unions, and foreign institutions. The increased risk became apparent in the last recession when many banks experienced their highest charge-off ratios in the post-World War II economy.

Some also question whether the fundamental underpinnings of the economy are as solid today as they were thought to be in the 1960s. Inflation has accelerated from the nominal levels of 1% or 2%, to 4%, then 6%, and perhaps 8% or higher today. The economy is more prone to "stagflation," uncertainty has risen, and confidence in the dollar has declined. We have weathered three credit crunches in the last 15 years, each one more severe than the last. The recession of 1973 to 1975 was the most severe since the 1930s, and during the past 5 years we have witnessed the eleven largest bank failures in the history of the FDIC. At the present time, the FDIC is administering approximately $2 billion in assets that have been acquired from failed banks.

One would think that with banks assuming a greater degree of risk and the economy becoming more volatile, capital ratios -- one of the principal buffers against risk -- would be increasing. In fact, just the opposite has occurred. The ratio of equity capital-to-risk assets was approximately 30% at the turn of the century. This ratio trended lower over the next two decades reaching 15% in 1920. A combination of the Great Depression and then war financing demands caused the equity-to-risk asset ratio to increase to 26% in 1945. After World War II, the ratio steadily declined to 14.5% in 1960, 11.3% in 1970, and approximately 8% last year. For banks with assets of less than $100 million, the ratio of equity-to-risk assets was 10% in 1978, while for banks over $5 billion, the ratio was 6%. When the effects of holding companies downstreaming debt as equity are considered, the large bank ratio is even lower.

Where Do We Go From Here?

Certainly inflation, competitive pressures, tax policies affecting both loan loss reserves and common stock dividends, and an increasing regulatory burden have had an important role in lowering the capital cushion. But an understanding of why these trends have developed only partly assuages concern over where we are today and where we are headed. Banks played a valuable role in our post-war economy by seeking out new markets, by increasing their risk assets, and by leveraging. It is obviously not realistic, or desirable, for banks to maintain equity capital as high as 26% of risk assets or to maintain only 22% of total assets in risk assets. Banks cannot properly serve the public's needs if they do not assume risks and incur losses. But it is critically important that we not lose sight of the need for balance -- between profitability for shareholders and safety for depositors and between encouraging competition and ensuring the safety and soundness of the system. How can banks continue to grow and prosper and serve the needs of their communities if their capital base is not strong? How can banks face future deregulation, such as the elimination of branching restrictions and interest rate controls, without an adequate buffer against adversity? How can banks hope to get the government out and keep it out of their management decisions without substantial private investment ?

Once the issue of capital adequacy is perceived as a necessary part of a balanced regulatory approach and as a vital element in a free enterprise system, other parts of the puzzle, such as standards and enforcement, fall into place. You fashion a standard that is reasonable, you communicate it so that bankers can anticipate their long-range capital needs, and you enforce it. A capital adequacy measure should take into account the essential characteristics of a bank -- such as asset quality, management, earnings, and liquidity -- but to be effective it must be quantifiable. It must, of necessity, be a little arbitrary. Scholars have debated and studied for decades in an attempt to define "capital adequacy" in an intellectually satisfying, nonarbitrary fashion. While they have produced some useful research, they have not achieved their ultimate objective and are not likely to do so in the foreseeable future. All the while, capital ratios have continued to decline.

All three federal agencies are reviewing their capital standards and enforcement policies. At the FDIC, the objective of our review is to ensure that our policies are well-founded, giving due regard to our nation's economic goals; are fairly and consistently applied; and are designed to preserve the viability of a free enterprise banking system.

We are giving close attention to a number of specific issues, some of which I want to discuss with you today. The risk in laying these issues before you is that some of you might misinterpret my remarks. I want to clearly state at the outset that we have not reached any final conclusions on any of these subjects. My purposes in raising these issues are to stimulate your thought processes, encourage a public dialogue, and request your assistance in addressing these important and complex problems.

(1) Alternative Capital Standards. Our discussions relating to capital standards are focused primarily on the practical questions of how much capital we can and should expect banks to maintain. There are approximately seven options being studied with regard to capital standards, ranging from a simple, single-ratio test to the development of a complex model. Close attention is being given to some middle-course options which integrate such factors as asset quality, earnings, liquidity, and management expertise into an assessment of capital adequacy.

(2) Enforcement Tools. Enforcement issues are often overlooked in capital adequacy debates. It can be extremely difficult to implement a capital policy if the enforcement tools are too flimsy or too blunt, such as exclusive reliance on moral suasion at one end of the spectrum or revocation of insurance at the other. Enforcement tools within this spectrum are being considered.

We are also focusing on the need for concerted effort and consistent policies on the part of the three federal bank regulatory agencies. Of all the issues that demand coordination and cooperation by the three agencies, capital adequacy is certainly at or near the top of the list. While I have long favored a multi-agency approach to bank regulation at the federal level, the long-run viability of that approach may well be determined by our success in dealing with some of the larger issues such as capital adequacy.

(3) Use of Debt. A third issue we are focusing on is the use of "debt capital." Debt has played an increasingly important role in bank capitalization -- with bank regulatory acquiescence -- rising from less than $150 million in 1965 to over $7.5 billion last year. Frankly, some people have expressed doubts about whether debt should be included in an assessment of capital adequacy. Long-term debt can play a valid role as a source of funds in a bank's liability management program. If subordinated, it can protect depositors and the FDIC in the event of an insolvency. But on what basis can it be considered part of the permanent capital structure in analyzing the adequacy of capital in a going concern? It is not available to absorb fraud losses, loan losses, or operating losses. If, hypothetically, we view a bank operating with equity to assets of 6% plus long-term subordinated debt of 2% to have adequate capital, should we not be willing to settle for 6% equity without the debt?

(4) Large Bank/Small Bank Disparity. Another issue raised by the capital adequacy debate is the disparity in equity capital ratios between large and small banks. Some contend that there are valid fundamental justifications for lower capital ratios in large banks than in small banks. Others contend that the quality, rather than the size,

of the institution should be the controlling factor in our analysis. It is argued that large banks have more sophisticated management and more management depth than small banks. But are those managers any stronger in a relative sense -- are they any better equipped to meet the particular management challenge before them? It is argued that large banks tend to be more diversified geographically. But geographic diversification is often accompanied by the problems of less control over far-flung operations and of greater risks in dealing with borrowers who are less familiar to the bank's board and senior management. It is argued that large banks have greater access to the financial markets. But they are also more dependent on volatile sources of funds and, if trouble should arise, those financial markets can be impersonal and calculating; and it is less practical to turn to the directorate, existing shareholders, or a correspondent bank for assistance when a large bank encounters difficulties. Considering the apparent inequities in requiring substantially higher capital ratios for smaller banks -- and the implications that this has for the structure of the industry -- it would seem that those who argue in favor of this disparate treatment must bear a substantial burden of proof.

(5) Holding Company Capitalization. It is difficult, if not pointless, to deal with bank capitalization issues without at the same time addressing the issue of holding company capitalization. A bank cannot be properly evaluated without reviewing the condition and activities of its parent holding company and other subsidiaries. A requirement that equity capital be injected into a bank can be rendered ineffective if the parent holding company borrows the requisite funds. There was a time when we believed that it was possible to insulate banks from problems experienced by their affiliates. Events have proved us wrong.

The split in responsibility for bank supervision and bank holding company supervision has made it difficult to deal with these issues. While I would hope that Congress will address this problem, there are some steps that the FDIC can take without legislative change. We have instituted a new course at our training school to provide our examiners better instruction in bank holding company financial analysis. The FDIC Board of Directors recently approved a merger upon the condition that the bank involved obtain additional equity and that the bank's parent not borrow the funds. We also recently denied a capital note application on the ground that the consolidated debt-to-equity ratio of the bank and its parent would have been out of line.

Some Closing Thoughts

Before closing today, I want to re-emphasize the importance of the capital adequacy issue. Simply put, equity capital ratios, particularly in the larger organizations, cannot continue to decline without some unfortunate consequences. Unless this problem is met squarely, it could have implications for our economy, for the future viability of our free enterprise banking system, and for the structure of banking and bank regulation.

Senator Proxmire, in addressing this problem, recently chided the banking agencies for devoting too much attention to smaller, comparatively unimportant matters, such as branch applications, and not enough to fundamental issues, such as capital adequacy. The observation has some validity. In my opinion, the foremost responsibility of bank supervisors is to ensure that the institutions we supervise are soundly capitalized and capably managed. If we are satisfied that these conditions exist, we can and should allow the institutions a great deal of flexibility to make their own management decisions and their own mistakes. Undoubtedly, we will lose some individual institutions from time to time with this approach toward regulation. But, in my judgment, this approach will result in a sounder and more dynamic and responsive banking system.

The problem of capital inadequacy will not resolve itself. We must take affirmative steps on a variety of fronts to deal with it. By "we", I do not mean just the regulators. Resolution of this problem is of vital concern to the banking industry itself. You have the most at stake, and you possess valuable insight and experience. Through your actions and your words you can help to provide the requisite leadership and vision. I encourage you to do so because your efforts and cooperation will add immeasurably to the quality of the end product.