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FEDERAL DEPOSIT INSURANCE
CORPORATION

① CAPITAL, YES IT IS IMPORTANT.

Presented by

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William M. Isaac, Chairman
Federal Deposit Insurance Corporation
Washington, D.C.

to the

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In the English language capital is a word with many uses. A "capital crime" is a most serious crime punishable by death. A "capital virtue" is a principal or chief virtue. A "capital city" is a city of political importance -- a seat of government. A "capital idea" is an excellent or first-rate idea. The uses vary but the meaning is the same -- capital is the term applied to that which is ranked at the head of its kind or class because of its importance or significance.

In a financial context the word is no less important. Capital is the symbol of financial strength. Capital is the measure of solvency. Capital is also the most important determinant of the degree of confidence with which firms and individuals do business with one another. This is illustrated by the fact that well-capitalized firms and individuals normally qualify for unsecured credit and more favorable terms while poorly-capitalized firms and individuals usually must put up collateral, pay higher rates, or both.

The function of capital is no less important in banking than it is in any other industry. Those who would take exception to this statement point out what they perceive to be the uniqueness of banking and the ability of well-managed banks to operate with very low levels of capital. Some even theoretically argue that banks can operate without capital so long as they generate profits sufficient to cover expenses and losses. I maintain that, if governmental support mechanisms for maintaining depositor confidence did not exist, bank capital needs would be as high as those of other enterprises.

Each of us here today represents a part of the capital structure of our respective systems. I represent the Federal Deposit Insurance Corporation in the United States. The FDIC's \$16 billion plus insurance fund in a broad sense augments the capital structure of each and every insured bank in the United States. Many of you represent central banks or governments whose job it is to monitor risk in your banking systems, to resolve failing bank situations and to promote the high level of confidence which is essential to banking. This is capital in the sense that it also performs a capital function. This capital support is structured in many ways, such as the pooling of bank insurance assessments we have in the United States, direct or implied government guarantees or central bank support. For purposes of this discussion I will simply call it "public capital."

Thinking of capital in this nontraditional way forces us to recognize a system which has lulled us, as regulators, into a state of some complacency and has caused us to permit too much of the capital function to be shifted from the private to the public sector. Let me expand upon this a little; it is a point worth making well. Through a combination of private and public capital, we have sustained a very high level of confidence in banking throughout the world. Bolstered by this confidence, banks have been able to take on more and more risk without fully incurring the discipline which the private capital markets are supposed to provide. Depositors and other creditors have been willing to provide continually increasing levels of funding without any real regard for the rising level of risk within the system. Equity markets have been willing

to tolerate smaller and smaller spreads because of the increased leveraging of those equity investments. Returns on equity and favorable year to year earnings comparisons are maintained in this way, keeping shareholders happy. We in the public sector have prided ourselves on how well the system works without really focusing on what is happening. What is happening is a buildup of risk, declining profitability and a much smaller (in relative terms) private capital base with which to withstand adversity. As a consequence, risk is being increasingly borne by the public sector.

As an illustration of what can result, we need look no further than the plight of the thrift industry in the United States during the past several years. This industry is quite different from the commercial banking industry in terms of its structure (predominantly a mutual form of ownership) and its problems (interest rate and maturity mismatches rather than loan quality). The lessons are there, however, and should be heeded.

For many years, thrift institutions were perceived to contain little risk and were often operated with lower capital levels than commercial banks. Periods of disintermediation in the 1970's caused problems for many of these institutions, and they began to acquire higher cost and more volatile funding. Interest rates began to rise steadily beginning in 1978 and then escalated sharply in 1980. There was finally a recognition of the enormous interest-rate risk which had been building up in this industry for many years. The cost of funding increased dramatically and many thrifts, which were burdened with large portfolios of long-term, fixed-rate assets, experienced negative interest rate spreads. These funding losses quickly eroded the capital bases. In some institutions capital was completely exhausted within two years. Suppliers of uninsured funding quickly realized the risk, and liquidity problems developed for institutions relying on this funding.

While there were many variables other than capital involved in this situation, the better capitalized thrifts generally fared better than the poorly capitalized ones. One of the major reasons was that they had better staying power; that is, they had the luxury of additional time to await a more favorable interest rate environment, and they had more flexibility to assume some losses from the portfolio restructuring which was necessitated by this new environment.

Despite these massive problems, there was capital support for the industry in the form of public capital. Some institutions failed and drew upon this capital support directly at great cost to the FDIC and our counterpart in the savings and loan industry, the Federal Savings and Loan Insurance Corporation. Public capital also maintained the confidence of insured depositors and this is now almost the sole funding source for much of the industry. Public capital was the one thing which kept the industry from being decimated; however, it cannot solve the industry's fundamental problems. It can and will handle additional failures and can continue to maintain a funding capability for the industry. It cannot restore the industry to vitality. That will be a job for private capital. Many institutions have been able to maintain their

capital positions and will survive in mutual form if they so choose. Others are turning to the private capital markets through conversion to stock form of ownership. Private capital is selective, however. It will support the stronger institutions and eventually return them to vitality. For the others, public capital can do little more than maintain some level of funding stability and eventually help merge the weaker institutions which cannot survive independently.

Lessons are here for the commercial banking system as well. If we allow too much risk to be shifted to the public sector, there are some very real dangers. The first danger is a loss of funding discipline for individual banks. Private capital is a measure of the financial strength of individual banks. When large depositors and creditors are forced to look to private capital as the measure of financial strength, there is a natural selection process at work which channels funding to our strongest institutions and denies funding to weaker firms. This market discipline is an effective way of controlling system risk. When depositors and creditors begin to look to public capital for primary support, this natural selection process breaks down. If the strength of the bank does not matter, funds suppliers seek the protection of public capital and the competition is based on who pays the highest rate. The process feeds on itself, creating additional risk in the system.

A second danger is a weakening of the equity capital markets themselves. When private capital is supporting the bulk of the risk in banking, the market can make selective judgments on individual banks. Banks which exhibit too much risk will see their stock prices fall and their access to capital markets impaired. Banks with manageable risks retain the ability to raise capital as needed. A quite different result occurs when the market perceives that too much risk is being borne by the public sector. When this occurs, the threat of bank failures looms large and the markets tend to view risk from a systemic perspective. Under this scenario the stock prices of all banks are affected and the ability of the whole system to raise needed capital becomes impaired.

It is at this point that I would like to discuss Continental Bank, which I know is of considerable interest to many of you. In the mid-to-late 1970's, Continental Bank launched an aggressive lending strategy. The bank's home state, Illinois, did not allow branch banking, thereby restricting the bank's ability to attract consumer deposits. Much of its growth was financed in both the domestic and international money markets. To enhance profitability, the bank relied heavily on short-term funding. It is safe to say the bank's funding for its corporate strategy reached a level of imprudence in terms of both volume and maturity structure. This ultimately proved to be the bank's "Achilles heel." Continental Bank had been a large purchaser of poor quality energy loans from Penn Square Bank, an Oklahoma bank which failed in July, 1982. When Penn Square Bank failed, Continental immediately began to experience some funding problems. As time passed the funding situation stabilized, although the bank was forced to pay higher rates and maturities were shortened further. I believe the market's decision at that time was probably predicated on a belief that the bank's capital structure was

sufficient to absorb losses from its Penn Square loans plus at least some measure of underlying comfort that, because of the bank's size, it would not be allowed to fail. After reporting a loss in the second quarter of 1982, the bank reported modest profits each quarter thereafter; however, by early 1984 apprehension began to grow about the bank's level of nonperforming assets (from both energy loans and from other segments of its portfolio) and the quality of its earnings. This finally culminated in an uninsured funding run, which was triggered by foreign investors who were supplying a very large part of the bank's funding. I believe the events at Continental make a strong statement about the importance of private capital in an interwoven, international banking environment.

If I can digress for just a moment, I would also like to address our solution to this very large problem. The bank's funding crisis became so severe that on May 17, 1984, the FDIC, the Federal Reserve, and the Comptroller of the Currency assembled an interim financial assistance package, which also involved a number of major United States banks. This package had to be fashioned quickly to buy the time needed to arrange an orderly permanent solution to the bank's problems. A part of this program was an announcement that all depositors and general creditors would be protected. This was not an unprecedented move as we had provided this same guaranty of protection in connection with interim assistance packages to three other banks during the past three years. In these cases the FDIC ultimately arranged mergers with other banks, which protected all depositors and general creditors.

After the interim financial assistance package was announced, we embarked upon negotiations to find a private capital solution to the bank's problems. Several parties expressed interest and a few offers were received; however, each of these was rejected as being too costly to the FDIC. We ultimately arranged a permanent assistance program which was announced on July 26, 1984. We have fashioned a solid program, which I believe will ultimately prove to be the least costly alternative to the FDIC. We have provided for a new Continental Bank which will be strongly capitalized and virtually free of nonperforming loans and have arranged for an internationally acclaimed management team to guide Continental on its road to recovery. The shareholders of Continental Bank remain completely exposed to the risk of loss, and we have maintained confidence in our banking system.

While the package has been controversial in some quarters, we simply did what had to be done. There was no acceptable private capital solution to the problem at this time, and the potential repercussions to the worldwide financial system were simply too great to allow the bank to fail. Still, private capital remains the ultimate solution to the problem, and we have fashioned a package which I believe will attract it in due time.

Our banking systems remain strong despite Continental and other similar situations which have arisen around the world in the past few years. In combination, our national systems form a viable international banking

structure capable of financing expanding international trade and investment. Some problems exist, however, and I believe the growing risk and the shrinking level of capital are among them.

Two obvious points of attack stand out with respect to the capital/risk equation. The first is to work to control risk. This is a very broad subject, and I will not attempt to deal with it in this forum except to mention that we in the United States are working on it as I am sure you are. We are fashioning programs designed to improve marketplace discipline in the system and looking at ways to improve our regulatory structure, to name but two ongoing efforts.

We have also taken recent steps to increase capital within the system. In 1981 the United States regulatory agencies adopted formal policy guidelines specifying minimum capital ratios for banks. This had an immediate impact; the decline in capital ratios was halted and an improvement was actually achieved in 1983. In July we took further action, with each of the three federal banking agencies proposing for public comment new regulations and policy guidelines on capital adequacy. These proposals would increase the minimum capital ratios for all banks, irrespective of size or type. The minimum ratios specified in the proposals are a 5.5 percent primary or equity capital ratio and a 6 percent total capital ratio, which includes subordinated debt. Banks which do not maintain the minimums will be subject to stringent supervisory measures such as enforcement actions and denial of applications. These minimum ratios will apply only to well-managed banks with no more than normal risk. Banks which contain more than normal risk, either on or off their balance sheets, will be required to maintain higher capital ratios. I am confident that, as banks reach the higher capital plateau being established through our most recent proposals, we will again act to move capital ratios even higher.

One concept we are evaluating is to require a significant increase in the level of capital, the burden of which can be alleviated by the use of subordinated debt. This would have the dual advantage of providing additional protection for depositors and enhancing marketplace discipline. Subordinated lenders are certainly apt to be more sophisticated and comfortable in evaluating credit risk than depositors. Whereas most uninsured deposits mature within a few months or can be withdrawn on demand, subordinated lenders typically are in a very different position. Once having made the investment, they generally cannot flee during adversity. They have to view bank operations from a longer-term perspective. Unlike depositors, they cannot count on the probability of being completely protected at the time a bank fails. If and when a failure occurs, subordinated note holders provide a protective cushion to the FDIC and other general creditors.

Stockholders, of course, also invest for the long-term and cushion the FDIC and other general creditors in event of a failure. Stockholders, though, receive compensation for taking long-term and sometimes speculative risks

through potential increased dividends and market appreciation. Subordinated debt holders are locked into a fixed return with no appreciation potential. Thus, their investment is predicated largely on perceived risk relative to rate of return, not speculative appreciation possibilities.

Under the concept we are evaluating, banks would be required to maintain a minimum equity ratio in the 6 percent range. Total capital requirements, however, would gradually be raised much higher, perhaps to the 9 percent range. Many banks, in order to meet the 9 percent standard, would issue subordinated debt. Only those banks perceived sound by reasonably sophisticated investors would be able to sell the debt at a reasonable price. Others would have to restrict growth. In this fashion, market discipline would serve a regulatory purpose by rationing debt, and the ability to finance growth, among the most deserving.

We in the United States are not the only ones taking positive action to reverse the deterioration in capital levels. There are other countries that are taking similar actions and these efforts are bearing fruit. Since our last conference in the fall of 1981, there has been improvement in capital on an international basis. To illustrate, equity expanded 4.7 percent between 1981 and 1982 in the 500 largest international banks, while assets grew at only a 3.4 percent rate. The improvement repeated itself between 1982 and 1983 with equity increasing at a 7.7 percent rate contrasted to 5.5 percent for assets. We sometimes use different ratios and methods for accomplishing this, but I believe there is definitely a common objective which is beginning to emerge, and it is being reflected in the numbers.

I would like to recognize the work being done by the Supervisors' Committee in fostering the improvement in capital ratios and working toward a method of uniformly measuring capital adequacy in banks around the world. As we contend with such issues as foreign ownership of domestic banks, foreign branches, risk assessment and capital adequacy, we must have a mechanism for objectively comparing banks in one nation with those in other nations. I believe the work being performed in this area will prove extremely helpful to all of us.

In conclusion, I believe that private capital is of the utmost importance to the strength of our banking system. We have paid too little attention to its importance for many years, and I believe this has contributed to some of the current weaknesses in the system. We in the United States are committed to solving this problem as, I know, are most of you.

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FRASER
St. Louis Fed



FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

Dear CEO:

In view of the great interest in the Continental Illinois transaction, I thought you might find the enclosed testimony before the House Banking Committee of interest.

Sincerely,

A handwritten signature in dark ink, which appears to read 'Will M. Isaac', is written over a horizontal line.

William M. Isaac
Chairman