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"CAPITAL ADEQUACY"

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I. Title

The question, "What constitutes adequate capital for a given bank, a holding company system, or the banking system as a whole?" is one of the most enduring and least understood of the issues that confront bankers and bank regulators. In a March 1952 monthly report of the Guaranty Trust Company of New York, the bank's economists posed the problem in simplistic but essentially accurate terms, stating:

> "The problem of maintaining an adequate level of bank capital is one that has been giving concern to bankers and bank supervisors for some time...
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> "...(I)n some way the question is one of the most indefinite in the whole field of business. True, the broad principles are easy to lay down. The purpose of bank capital is to absorb losses that occur in the regular course of business, enabling banks to incur normal credit risks without endangering their depositors' funds. Capital should be large enough for this purpose without becoming so large that it is impossible to earn a reasonable return on stockholders' investment.
>
> "The difficulty lies in translating these broad principles into concrete terms."

That we are today little further along in this effort is symbolized by Carter Golembe's recent assertion that "...there are no easy solutions to the question of capital adequacy--and perhaps none at all." Accordingly, I have no intention of hinting at definitive answers and freely acknowledge that I find myself in the position of the Salomon Brothers analysts who modestly acknowledged in a recent issue of their Bank Weekly:

> "While we have devoted several previous issues of the Weekly to various aspects of this subject, we claim no special insights with respect to capital adequacy."

Historically, bank capital ratios have been declining since early in the nineteenth century, when capital amounted to between 60 and 70 percent of total assets. As the nineteenth century progressed, the business of banking evolved as the "industrial revolution" and the use of the corporation fundamentally altered our economy. By 1900 ratios had moved to 20 percent or less. Expansion of assets to finance the First World War and the succeeding boom of the twenties brought the ratio still lower to approximately 13 percent by the onset of the Depression. Again the financing demands of war brought about a decline in the ratios. In 1945, the ratio of total capital and reserves to assets was less than 6 percent. Rising to 9.0 percent by 1960, the ratio again declined in the sixties and early seventies so that by 1973, it stood at 7.4 percent.

Supervisors have typically expressed concern with this phenomenon. Bankers, on the other hand, have traditionally taken the position of Wes Lindow who argues:

> "Bank capital ratios have been declining for a long time and probably will decline further. However, improvements in bank managements and in the environment in which banks operate have reduced the need for bank capital over the years."

Before discussing some factors which, in my judgment, may raise serious doubts about this assertion, it is probably useful to outline briefly the various functions which are ascribed to capital. That they are multiple and not generally agreed upon offers a hint as to one cause for the analytical confusion which pervades the area. Moreover, such a discussion puts in some perspective the perpetual tug of war between banker and bank supervisor.

First of all, the function most generally agreed upon is that capital enables a bank to absorb unforeseen losses or reduction in asset values in excess of earnings in order to continue as an ongoing concern until earnings recover. While there is general agreement that this is an appropriate function, there is significant disagreement as to the level of risk that should be provided for.

Supervisors are accused of adopting a "worst case" approach or of still being mesmerized by the trauma of the Depression. For example, Carter Golembe began his very helpful memorandum, "Capital Adequacy: The Search For Certainty," with the following:

> "Therefore, since the world has still
> Much good, but much less good than ill
> And while the sun and moon endure
> Luck's a chance, but trouble's sure
> I'd face it as a wise man would
> And train for ill and not for good."

Of this verse, Golembe opined "that rarely has there been a better description of the regulatory attitude toward capital adequacy."

The aggressive banker's position was stated by George Vojta in his study for Citibank entitled "Bank Capital Adequacy." He argued that "the range of conditions which is operative for the proposed tests of capital adequacy extends from conditions of external stability or 'normalcy' to conditional severity short of the peak pressures experienced in the credit crunch of 1969/70," and that "in severe cyclical swings caused by economic policies, the authorities must assume responsibility for public confidence in the financial system." (At this point I should note that Mr. Vojta's work represents a genuine contribution to the literature in an area in which most of the sound arguments were made long ago.)

While not seeking capital sufficient to weather a repeat of the Depression or even conditions close to economic collapse, most supervisors would feel that bank capital should be adequate to cover the sort of losses that were experienced during the "credit crunch" of 1969/70 and are likely to result during the present troubled period. One might wonder whether Mr. Vojta would now write with as much confidence in the ability of fiscal and monetary authorities to manage the economy quickly out of difficulties as he did some months ago.

Second, it has been noted that initial capital requirements satisfy organizational and physical costs and as a sort of entry fee. We at the FDIC take this position and it does not seem to be a controversial one.

Third, as Brenton Leavitt observed recently, capital requirements may serve as a restraint on asset expansion. Though not traditionally thought of in these terms, it is certainly true that the effective imposition of capital requirements will serve to restrain asset expansion in the present economic climate. And, as we shall see, this may be a highly desirable result.

Fourth, some have pointed out that capital serves to protect depositors in the event of liquidation. This is not a primary goal of supervision, since deposit insurance is the tool of public policy directed to this end. However, it is true that larger capital accounts may facilitate the Corporation's finding that assistance to the merger of a failing bank with a healthy institution will "reduce the risk or avert a threatened loss to the Corporation," thereby meeting the statutory test for provision of such assistance. In such a case the level of capital will have served to protect uninsured depositors and other creditors as well.

Fifth, because of the existence of the insurance fund, it has been thought that the FDIC has a special interest in the level of capital in a given bank and the system as a whole. This view results from the fact that banks' capital accounts provide the cushion against bank failure and because in the event of insolvency the capital accounts work for the benefit of the Corporation much as they do for the uninsured depositors or other creditors. It should be pointed out in this regard, however, that numerous studies of the subject have failed to establish any direct correlation between bank failure and the size of the bank's capital accounts. Moreover, in my judgment, while the Corporation's interest as insurer cannot be avoided, great care should be taken to minimize the extent to which that interest intrudes upon the Corporation's function as supervisor.

Traditionally, the FDIC has taken the "hard line" in its capital requirements, earning the assertion that its initials must stand for "Forever Demanding Increased Capital." This has probably resulted, as the Corporation Manual of Examination states, from "...the close relationship between these ratios and the Corporation's risk," and from the fact that smaller banks have historically been thought to be more vulnerable to unexpected losses than their larger National and State member bank cousins. However, the Federal Reserve Board is presently the center of action and focus of controversy with respect to capital adequacy. The Board has evidenced both its concern with the matter and its intention to resist further expansion of deposits or assets without parallel expansion of equity capital in recent speechs by Governors Sheehan and Holland, and Board staff member Brenton Leavitt; in decisions of the Board regarding holding company acquisitions; and in the quiet exercise of moral suasion.

The source of the Fed's concern is, in my judgment, based on circumstances more complex and troublesome than the historical decline in ratios for the banking system as a whole. The February 16 issue of Business Week noted that "(in) 1972, the nation's eleven largest banks had an average capital ratio of only 4.5 percent, and that may have declined during 1973 in the wake of record-high bank lending." The dramatic decline in the capital positions of our largest banks has been paralleled by three other phenomena: the holding company movement, the explosion of multinational operations, and the advent of liability management. While most pronounced in institutions with assets of a billion dollars or more, the impact of these phenomena is by no means limited to the relatively few very large banks.

While bringing significant benefits, each of these factors has introduced new risks and complexity into the business of banking. While many bankers speak with confidence of new skills and increased competence, I am not at all certain the implications and risk for banking inherent in each of these phenomena have been fully explored. Certainly our experience this past year in dealing with troubled banks would indicate that considerably more care should be taken in each of these area--especially in light of the present economic environment in which banks must function.

Before looking at these three bases of concern, it is well to note parenthetically that totally apart from such considerations, assets in the banking system as a whole have become more risky. Since 1960, holdings of cash and U. S. Government securities as a percentage of assets have declined from 43.8 percent to 24.1 percent. At the same time, the ratio of loans to deposits has increased from 52.3 percent to 72.6 percent. These changes have tended to be significantly more pronounced among larger banks.

While the total equity of some holding company systems is significantly greater than that of its banking subsidiary, that is not always the case. In some cases equity capital may actually be less when computed on a consolidated basis than for the bank alone. As a result, the amount of equity which once supported the risks of a single banking system now supports the bank plus a variety of business enterprises. This is all the more disconcerting in light of statistics published by Salomon Brothers in March which showed that the composit ratio of total capital funds to total assets, less cash and due from banks, of the twenty-five largest bank holding companies declined from 8.8 percent in 1972 to 7.7 percent in 1973. Furthermore, at the same time the ratio of equity capital to non-cash assets declined from 7.2 percent in 1972 to 6.2 percent.

More troubling than the risks inherent in such leveraging is the fact that we do not know what effects the failure or trouble of an affiliate in the holding company system will have on the bank itself. The danger is twofold. First of all, there will be great temptation to tap the bank as an answer to the problems or needs of affiliates. As I have recounted elsewhere, the failed U. S. National Bank is an extreme case in point.

Secondly, even where the bank is effectively insulated from direct financial drain the holding company problems are often reflected in judgments about the bank itself. This is encouraged by the fact that many holding company executives would agree with Ronald Terry, President of First Tennessee National Corporation, who stated: "I think we should keep the bank's prestige behind the capital market issues of affiliates." The dark side of this approach was graphically illustrated in the Beverly Hills Bancorp case--undoubtedly a source of Fed concern in this area. An affiliate of the Beverly Hills Bancorp, the Beverly Hills National Bank, had been selling some of its parent company's commercial paper. When the troubled parent was unable to meet interest payments on the paper, a run on the otherwise sound bank was triggered. As a result, the holding company was forced to liquidate the bank's assets through sale to Wells Fargo.

Though it is the inevitable and desirable consequence of the patterns of business development, the great expansion of international banking operations is a second source of concern. Foreign assets range between 42.8 and 30.4 percent of the total assets of our five largest banks, and they are, in many cases, responsible for the dramatic drop in capital ratios. For example, one money center bank has a ratio of equity plus reserves to total assets of 6.6 percent when computed on domestic basis and 2.9 percent when international operations are included.

In addition to spreading more thinly the system's capital resources, such operations contain their own peril, especially for the aggressive uninitiate. Franklin National Bank's experience in the foreign exchange market is a case in point, but the losses of Lloyd's Swiss branch in the foreign currency area demonstrate that even the most established and prudent of institutions can be burned. Furthermore, the precarious state of the international payments systems, the disruptive effects of the flood of Petrodollars and the financial problems of countries which are substantial debtors to American banks have each served to greatly increase the risk of international operations.

In recent years, banks have applied the concept of liability management. When carefully and skillfully executed, these techniques are both profitable and efficient. There are, however, serious pitfalls when expensive and sometimes volatile money is involved. The dangers are, of course, exacerbated when brokered deposits or otherwise purchased funds are used in lieu of a stable deposit base to finance rapid expansion. We have found that quite often such practices go hand in hand with the making of high-yield high-risk loans. The view of some bankers was described by Lehman Brothers economist, Leonard Santow:

> "The pragmatic view of banks is that you can't look at the old ratios. They don't apply anymore when people can buy all the liquidity they want in the market place if they are willing to pay the price. You just don't need capital anymore."

Banks taking this too much to heart and abusing the techniques of liability management are vulnerable in a number of other respects. "Hot" funds are easily lost in an economy in which there are many institutions competing for funds, and a setback which would not otherwise be disastrous may lead to a loss of confidence and the outflow of such funds.

Indeed, these practices have given rise to the possibility of a modern kind of "run" on banks. The Franklin experience suggests that deposit insurance maintains the confidence of most smaller depositors in the face of even the worst sort of adverse publicity. On the other hand, the willingness of the lender of last resort and the stabilizing efforts of the other agencies do not seem to have stimulated the confidence of large individual and institutional depositors sufficiently to cause the return of such funds. Thus, the greatest danger to a financial institution today seems not to be a loss of confidence by the public at large, but rather the mistrust of other financial institutions, corporate entities and the very large individual depositor.

To these three factors must be added present economic conditions. While interest rates may decline, it is clear that our economy and, hence, the banking system can look forward to an uncertain and potentially rocky year. Already, financial institutions are feeling the effects of the "credit crunch" on the real estate markets. The insolvency of American Bank and Trust in South Carolina was, in no small part, the result of an undue concentration of loans to real estate developers which became illiquid. Where requisite prudence is not exercised, difficulties will occur.

While I have not studied in detail the rulings of the Board of Governors and am, of course, not privy to less public arm twisting, it seems to me that the Fed's policy of taking a strict approach to capital is appropriate at this time. This flows both from the state of the economy and from the fact that each of the three areas discussed--the holding company movement, international operations, and liability management--entail risks that may not have been fully appreciated in balmier days.

I have deliberately not devoted a great deal of time detailing the FDIC approach to capital adequacy. Both Chairman Frank Wille and Ed Roddy, Director of our Division of Bank Supervision, have recently discussed the subject in great detail and their remarks have been reported extensively. But I will summarize our policy briefly.

First of all, it is our stated policy that the various ratios are to be used as benchmarks and not the final determinants of capital adequacy. Our Manual of Examination Policies states: "...capital ratios (or risk asset ratios) are merely simple, objective measures of the shrinkage in asset values a bank's capital structure can absorb at a given point in time, and, as such, are but a first approximation of a bank's ability to withstand adversity." And, further: "Ratios may also have limited use as rough benchmarks, representative of industry practice and custom, and in that limited sense, may be useful as a starting point in evaluating an individual bank's capital position." The Manual makes clear that a bank's capital structure must be evaluated in light of six factors: management, assets, earnings, deposit trends, fiduciary business and local characteristics.

In this regard, I am aware of Carter Golembe's observation that "(b)ankers... would rub their eyes in amazement if we were to write that this top-level attitude toward ratios by the agencies is reflected in actual practice. For the fact is that in the field (and for that matter often-times in Washington) ratios are applied with a single-minded dedication which brooks no qualification." Those of you who are associated with State nonmember banks are better able than I to evaluate the accuracy of this statement. However, management and the other factors have been given careful consideration in the deliberations in which I have participated. In this regard, I hasten to emphasize that where a banker finds that he is being treated arbitrarily or that relevant information has been ignored in the field, he should pursue his remedies through both the Regional and Washington offices.

I should add, however, that while a low capital ratio is by no means the necessary mark of an unsound bank, dramatic declines in one or more ratios may very well be reflective of potential problems and, at the very minimum, indicate the need for further scrutiny.

Second, the Corporation's policy with respect to capital is modified in the case of applications of new banks for deposit insurance. There the average capital-asset ratio is given special weight on the premise that a new entrant should at least meet the capital standard of the industry in order to obtain a license to compete. Generally, new banks are expected to provide initial capitalization sufficient to prospectively provide a capital cushion at the end of the first three years of operations at least equal to 10 percent of the projected total assets at the end of that period. This is roughly comparable to existing capital ratios of small banks with an added margin of one or two percent to compensate for the increased risks accompanying the formation and development of a new bank and the difficulty in estimating the deposit potential of new banks.

In addition to these guidelines, the Corporation has a firm policy that no application for deposit insurance will be approved when proponents are unable to raise at least $250,000 capital. It is felt that any new bank should have the capability of generating a deposit total of at least two and a half million within three years in order to compete successfully. Only in special cases such as an isolated community without banking services will applications with smaller capitalization be approved.

And, finally, the Corporation does not frown upon the use of subordinated debt as part of the permanent structure of bank capital accounts. As Chairman Wille pointed out in a talk earlier this year:

> "Most supervisors today would interpose no objection to debt capital that has the following characteristics:
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> 1. A principal amount which is in reasonable proportion to the total structure (our guide is about one-third of total capital and reserves);
> 2. An interest rate which is commensurate with prevailing conditions;
> 3. Sinking fund provisions (where they exist) that are adequate and a retirement schedule that is practical and realistic;
> 4. A principal amount that provides for the bank's reasonable foreseeable needs; and
> 5. The circumstances of issue support a general conclusion that the bank's best interest would be served thereby."

A number of analysts, as well as industry proponents, have suggested that the public interest would be best served if the agencies abandoned the effort to insure adequate capital, thus allowing the market to determine the appropriate level of capital. In their 1966 study, "Policies for Optimum Bank Capital," Robinson and Pettway concluded:

"In earlier periods, when facts about banking were concealed and public sophistication in financial analysis was slight, regulatory systems were needed as a substitute for better public information. Now, with greater disclosure of banking facts and more competence on the part of financial managers and institutional investors, the ability of these groups to judge for themselves has improved. Is the need for banking regulation dwindling?"

And in her more recent study, "Impact of Federal Bank Supervisors on Bank Capital," Lucille Mayne suggested that the agencies might "abandon completely the use of capital adequacy standards in the examination process and concentrate instead on the competency of bank management."

While this suggestion is certainly appealing to those of us who believe in the efficacy of a competitive free enterprise system and who deplore the necessary vagueness of our approach to the problem of capital, there are a number of considerations that the proponents of the market approach have not met.

First of all, notwithstanding Robinson and Pettway's assertions about increased knowledge and sophistication regarding banking, this suggestion would require additional and extensive disclosure procedures for even those institutions already subject to securities regulation. Moreover, smaller banks not now subject to SEC requirements would for the first time be subject to a new body of regulation which is costly and burdensome. For example, in order to properly assess the adequacy of a bank's capital a depositor should have a great deal of knowledge regarding the bank's asset portfolio.

Second, as proponents of this approach seem willing to accept, reliance on the market entails a significantly increased number of bank failures. Vojta stated, "The market will vote substandard banks out of existence relying on the FDIC to assure protection of the general public. In the abstract one can imagine and even find desirable such a system. Responsible men have argued that we need more and not fewer bank failures. And it is true that to a certain extent our present banking structure protects the inefficient and incompetent, and conversely "the best and the brightest" of the banking system are restrained from competing as vigorously as they might. But it must be recognized that serious implementation of such a system would entail a radical reordering of the existing banking structure.

Certainly, the market would have to be disabused of the idea expressed by Golembe and many others that the agencies will not tolerate the failure and payout of a large money center institution. Moreover, procedures would have to be devised to handle many bank failures in a given year. And, much more significantly, such a policy would greatly accelerate the concentration of banking resources. While such a change might in the long run prove beneficial to both the industry and the consumer, both the economic and political consequences of such reordering should be analyzed in far greater detail than has been done to date.

In conclusion, I simply note that we at the FDIC are well aware that the conflict between examiners and bankers with respect to capital adequacy is not merely a question of depositor safety on the one hand and the maximization of return on equity on the other. There is also a substantial public interest in allowing banks sufficient leverage in order to compete effectively with other financial institutions and among themselves. However, prudence demands that leveraging not go unrestrained, especially in the present economic climate. In the context of the present banking system, as defined by public policy, it falls to the lot of the banking agencies to provide that restraint. That we do so does not mean that we are unmindful of the complex and conflicting interests that must be served.

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