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BANK ADMINISTRATION INSTITUTE

WASHINGTON, D. C.
OCTOBER 25, 1983

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Federal Reserve Bank of St. Louis

October 25, 1983

BANK ACQUISITIONS AND REGULATORY POLICY ON CAPITAL

by Stanley C. Silverberg

I have been asked to provide an FDIC perspective on a number of issues related to bank mergers: interindustry combinations; interstate transactions; forced mergers of troubled institutions, etc. I will touch on those issues, but I would like to concentrate on the financial aspect of bank and interindustry mergers and how that relates to the FDIC's role. I think you will find that is where the FDIC will have the most to say in the future and it's where we are apt to have the most discretion. I'll try to be as straightforward as I can, giving my own views, indicating where they differ from current FDIC policy and indicating those areas where policy appears to be most in flux.

Bank regulators have always been concerned about the capital structure of banks and, to varying degrees, the capital structure of bank holding companies. In an increasing number of instances, mergers involving banks have been limited by capital considerations. All private sector mergers or acquisitions are affected by capital considerations because financial markets impose restraints on leverage and risk in all corporations. Acquisitions involving too much stretching, too much leverage frequently result in increasing debt charges and poor stock price performance. Financial markets frequently display more skepticism toward aggressive acquisitions than the management of acquiring firms. Just last week I noticed that in response to a proposed South Carolina acquisition, the stock price of the apparent high bidder declined whereas the stock price of the "loser" increased.

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Bank regulators impose their own capital standards. These are not always tougher than those of the marketplace, but frequently they are. Later in my talk I will try to suggest where it may be appropriate for bank regulators to impose tougher standards and where it is not.

When the stock of acquiring institutions sells at a high multiple of book, it's possible to pay for acquisitions through stock without impairing overall capitalization or per share earnings of existing stockholders. Under the right set of circumstances, where the market pays a high premium for size and diversification, an acquiring institution can actually improve its capital position and per share earnings through an exchange of stock. For the most part that hasn't been the prevailing situation in recent years. The majority of the stocks of large bank holding companies have sold below book value. While there is some evidence that premiums paid for acquired banks have been declining, they still are generally positive.

Current Capital Policies

Capital policy at the bank regulatory agencies currently is in flux. However, some generalizations can be made. All of the agencies have moved to specific minimum ratios for banks. At the FDIC, there is no distinction made between large and small banks. The Fed and the Comptroller appear to permit some distinction, but it's less than generally prevailing practices and less than what used to be the case. That makes it much more difficult for large banks to buy up everything. Just a few years ago, discussions of interstate banking reflected concerns that the ability of money center banks to operate with smaller capital ratios would facilitate their gobbling

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up of smaller banks throughout the country. Whether large banks should have lower capital standards isn't clear. It's noteworthy that the shift in regulatory policy has not been accompanied by any convincing analysis one way or the other on this issue.

Another issue related to measuring bank capital is the treatment of intangibles. This has been particularly important in connection with cash premiums paid by acquiring banks. After wavering some, current FDIC policy is not to include core deposit or other intangibles in calculating minimum bank capital requirements. The Comptroller and the Fed apparently include certain intangibles so long as they don't exceed 20 or 25 percent of a bank's equity. If acquiring banks are already close to their minimum capital position they will not be able to bid aggressively, at least on a cash basis, for acquisitions. This may also impact the value of small bank franchises.

On subordinated debt the FDIC policy for some time has been not to include it in meeting minimum capital requirements. The Comptroller and the Federal Reserve give it some weight, making a distinction between primary and secondary capital. All three agencies do include preferred stock which has been popular in the last year or so. While accountants and lawyers may see a substantial distinction between preferred stock and subordinated debt, I personally see no important, substantive distinction, particularly where acceleration clauses are not permitted in the debt instrument.

These hard-line positions on bank capital definitions would not be so restrictive if bank supervisors did not attempt to limit leverage in bank holding companies. However, while policy is very much in flux in this area, agencies appear to be moving toward imposing tight restrictions

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on holding company leverage -- I want to come back to this issue later. Let me suggest, however, that in some recent decisions the FDIC has insisted on five percent equity in bank holding companies. I don't think the Fed or the Comptroller are inclined to be quite as restrictive in this area as the FDIC.

Impact on Acquisitions

What are examples of a restrictive capital policy on bank acquisitions?

In its handling of bank failures the FDIC has excluded from bidding lists banks that did not meet its capital standards. This has included two instances where out-of-state acquisitions of failing commercial banks were permitted under the provisions of Garn-St Germain. Whether any of the excluded institutions were strongly interested in the failed bank franchises, I don't know.

It is no secret that the high bidder in the United American Bank P&A was an out-of-state national bank that met the FDIC bid list restrictions, but was not permitted to undertake the transaction by the Comptroller because the capital structure would be too stretched after the transaction.

The FDIC has rejected merger proposals where the surviving bank was a nonmember whose capital did not meet FDIC standards or where the parent holding company did not meet FDIC capital standards. Had these transactions involved a surviving national bank or had they been effected as a holding company acquisition, they might have been approved by one of the other Federal banking agencies.

The FDIC has rejected savings and loan applications to acquire banks and savings bank branches because FDIC capital standards were not met by

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the surviving institution, even though it would not be insured by the FDIC. (When an FDIC-insured bank is acquired by an "uninsured" institution, the FDIC must approve the transaction.)

The FDIC denied insurance to a proposed well-capitalized nonmember bank in South Dakota, principally because its parent, a large midwestern bank holding company, did not meet FDIC capital standards.

These decisions have mattered to individual institutions. Whether they are of much significance from the standpoint of the overall system, I'm not sure. Most bank observers expect accelerated merger activity over the next few years, particularly if and when interstate restrictions are reduced. Capital policy by the banking agencies could materially inhibit this activity, especially if all the Federal banking agencies adhere to restrictive policies. If the Federal Home Loan Bank Board continues to be less restrictive on capital, we may see Federal savings banks and savings and loan holding companies becoming increasingly used vehicles for acquisition and expansion.

Why Do We Impose Bank Capital Standards?

Let's go back now and take a hard look at capital standards imposed by bank regulators. Do they make sense? Should bank capital be regulated?

Why do we regulate banks so much? Historically, the rationale has been that (1) banks deal principally with other people's or corporations' money and they (depositors) need some protection against excessive risk; and (2) bank failures adversely affect other parts of the economy, leading to contraction in the money supply and available credit.

Federal deposit insurance was established in 1933 to deal with these

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two issues and to provide an orderly mechanism for handling bank failures. While the FDIC has pretty well taken care of these problems, its establishment has provided another reason to supervise banks and impose capital standards. If a considerable portion of the loss arising from bank insolvencies was to be borne by the FDIC, then it needed to examine banks and impose standards on banks to protect its financial exposure in much the same manner that any private insurer needs to protect itself.

We have three Federal bank supervisory agencies -- that's part of the way things have evolved historically. In principle, the FDIC can rely on other Federal or state supervisory agencies (or perhaps accounting firms) to provide information on its risk exposure and, possibly, to implement appropriate standards. The supervisory process has been confused by efforts to limit competition, implement social policy, and protect potential bank competitors in the insurance, security, and other financially related industries. Some bad interpretation of economic history dealing with the cause of the collapse of our banking system in the 1930s also has served to confuse the supervisory process. (If you interpret this to mean that I think Glass-Steagall makes no sense in the context of today's environment -- if, indeed, it ever did -- you are interpreting my thinking correctly.)

More and more financial observers have come to accept the proposition that it is deposit insurance that makes banks special from the standpoint of safety and soundness, and it's why they are or ought to be subject to supervision. It is interesting to note that in the American Assembly Report this past spring on The Future of American Financial Services Institutions, a group of bankers, academicians, trade association representatives and Government officials agreed that supervisory authority over banks "should

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rest only in the insurer".

Bank capital provides a protective cushion to assure solvency and, most important, to provide protection to the insurer. But how much capital? Should it be related to bank size, asset diversification, management? There is no scientific way to determine the appropriate or minimum capital ratio. The insurer-supervisor is likely to favor a high number for its own protection. A very high number will impose costs on the banking system, requiring high margins on bank services, possibly pricing banks out of certain markets.

How should capital be calculated? If the purpose is to protect the insurer, then subordinated debt will serve as well as equity and probably reduce a bank's capital cost. If the purpose of capital is to protect the insurer or even to keep the bank solvent, then why do bank supervisors need to fuss about the capital structure of bank holding companies?

A Suggested Approach

Let me suggest a reasonable way to resolve some of these issues. Impose a minimum capital requirement on banks: perhaps five or even six percent. Try to enforce it. If a bank falls below the required level, permit no acquisitions or branch expansion and, possibly, impose a higher insurance premium. At some point later on, seek to remove deposit insurance. Don't attempt to regulate holding companies. Let financial markets decide how much leverage the holding company can carry. If a holding company goes too far and has difficulty servicing its debt, it need not bring down the bank subsidiary. There are restrictions on financial transactions between banks and affiliates and these can be enforced.

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The attractiveness of this approach is that, even if the insurer-supervisor is arbitrary in setting capital standards, financial markets can adjust appropriately at the holding company level so that the market can make distinctions among banking organizations according to management, diversification, profitability, etc.

There is no way that bank regulators can meaningfully regulate holding company capital using consolidated equity ratios. What is the significance of line-by-line consolidations for a diversified financial institution? Think of some of the perverse incentives. A bank holding company would be encouraged to acquire poor quality institutions at less than book capital to dress up the holding company balance sheet. That sort of consideration should not be a concern of bank regulators. Hopefully, when capital policy is sorted out by bank regulators, focus will be concentrated on banks and why we regulate them.

Now let's come back to acquisitions and mergers. If we go in the direction I have suggested, I think we can implement reasonable financial standards that will protect the insurer, not be overly restrictive and provide for an important role by the financial marketplace. Are we about to move completely in the direction I have suggested? Unfortunately, not yet, although we may see some liberalization at the holding company level. In evaluating our policies it is important to note that we have been flexible in adjusting to market conditions, and further future adjustments are possible.

In any case regulatory capital policy is going to matter and it will affect the pace of acquisitions, how they are structured financially and the premiums paid to acquired institutions.

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