PAST TREND OF THE CAPITAL RATIO

Summary of Remarks

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Although we have been keenly aware in the last five years of the declining capital ratio, there has been a fairly steady downward trend for a long time. In 1875 the average capital ratio for all operating banks in the United States was about 35 percent. It fell to about 30 percent in the next five years and remained at about that figure until 1895. During the business upturn of 1897 to 1899, the average capital ratio for all operating banks showed one of the sharpest declines on record and fell from 26 percent to 20 percent. This decline was almost entirely due to a 31 percent increase in bank assets. The ratio then fluctuated around the 20 percent level until the First World War. In the 40 years from 1875 to 1915, the capital ratio was cut nearly in half, from 35 percent to 16 percent. This decline reflected the more rapid increase in bank assets--which grew ten-fold during the forty years whereas bank capital increased about five times the 1875 total.

The two accompanying charts show the trend for the last three decades in the capital ratio and in total bank assets of all operating banks. During the First World War the rapid growth in bank assets brought a substantial decline in the capital ratio. From June 1915 to June 1919 assets increased about 70 percent, while capital increased about 20 percent and the ratio fell from 16 percent to 11 percent. In the postwar depression of 1920-21 bank assets declined while bank capital increased and the ratio rose to 13 percent in June 1921. From 1922 to 1925, assets again grew more rapidly than bank capital and the ratio gradually fell. However, from 1925 to 1930 the reverse was true, and capital grew at a faster rate than bank assets. In June 1930, bank assets reached a peak of $74 billion dollars while bank capital totaled $10½ billion--giving a ratio of a little over 14 percent.

When banking difficulties became serious in the early thirties, both bank assets and bank capital declined, but assets shrunk more rapidly than did capital so that the ratio rose and reached a peak of 15 percent in June 1932. Between the middle of 1932 and the middle of 1933 about 4,500 banks went out of business. Total bank assets declined to $51 billion from the 1930 peak of $74 billion and total capital accounts fell from $10.5 billion in 1930 to $7.4 billion in the middle of 1933.

From the time the program to rehabilitate the American banking system got under way in late 1933 to the present, bank assets have shown an almost continuous growth. The only exception was during the business dip in 1938 when there was a slight contraction of bank assets. Bank capital has followed a similar pattern, but the growth has been at a lower rate. As a consequence, the capital ratio has declined steadily. This decline was accelerated by the sharp upturn in bank assets during the war. Total bank assets more than doubled from the middle of 1940 to the end of 1945, while bank capital increased about 25 percent. In this period the capital ratio dropped from 10.3 percent to 5.9 percent.

The long-run downward trend in the capital ratio has occurred despite a remarkably steady growth in the dollar amount of bank capital. Bank capital has increased in amount each year for the past 70 years with few exceptions. There were moderate decreases in the years 1878 to 1880 and again in the 1896-97 business depression. The next period of decline was not until 1930-1933 when bank capital decreased about 30 percent.

Recently we have heard a great deal about another kind of capital ratio, namely, the ratio of capital to so-called "risk" assets. Risk assets are generally defined as assets other than cash and U. S. Government obligations. The current interest in this capital ratio is in part the result of the tremendous increase in bank holdings of U. S. Government obligations during the war, and in part this ratio is being used to counteract the criticism being directed against the rapidly declining ratio of bank capital to total assets.

Although there was some increase in the ratio of total capital accounts to total assets other than cash and Governments during the war, the rise was not as great as most people believe and the ratio has now returned to approximately its prewar level. This ratio has been more stable than has the ratio of capital to total assets and in the last 10 years there has been surprisingly little change in the ratio of capital to so-called "risk" assets.

In 1875 this ratio was about 55 percent. During the next 40 years, the trend of this ratio was generally downward, and in 1915 it was 21 percent. In the 1920's when bank loans were expanding rapidly, the ratio of capital to total assets other than cash and Governments declined to about 15 percent in 1926, but by 1929 it had risen to 17 percent. In June 1934 the ratio was 23 percent and in June 1939 it was 25 percent. It rose to 27 percent in 1943 but by the end of 1945 it had returned to about 25 percent. Should bank loans increase substantially in the future, we can expect a further decline in this ratio.

It is interesting to note that during the First World War the ratio of capital to assets other than cash and Governments declined whereas in this war it rose. The difference was caused by the variation in the method of financing the industrial expansion needed to carry on the two wars. In the last war the banks had a major part in financing the industrial expansion, and with bank loans increasing, the ratio of capital to risk assets declined. This time, however, the bulk of the industrial expansion was financed directly by the Government and only indirectly by the banks through their purchase of Government securities. The result was an increase in so-called riskless assets held by the banks. Since bank loans and investments of securities other than U. S. Government obligations remained relatively stable while bank capital rose, the ratio to so-called risk assets increased.

The current interest in the ratio of bank capital to so-called "risk" assets is just one aspect of the point of view that favors relating bank capital to the quality of bank assets. At the present time, bank assets are of the highest q uality and appear to entail very little risk.

This fact is used to argue that the declining trend in the ratio of capital to total assets is not serious and that our banking system can operate safely on a capital ratio less than half the 1929 figure. It is, however, questionable how far such an argument can be carried, particularly when the capital ratio appears to be rapidly approaching the zero point.

Bank capital is chiefly important from a supervisory viewpoint as a cushion against asset depreciation. The question of the quality of bank assets is primarily a problem of the examination program. It is up to the examiners to discover substandard assets and to attempt to take corrective action. But even after the most careful examination, there remains an irreducible minimum of uncertainty. The quality of bank assets is susceptible to rapid and unpredictable changes. Therefore, capital must be provided as protection against the uncertainty which remains in a bank whose assets contain no measurable risk of loss.

PERCENTAGE OF TOTAL CAPITAL ACCOUNTS TO TOTAL
ASSETS OF ALL OPERATING BANKS, 1915-1945