Spch
FDIC
Smith, J

Assessing the Capital Needs
of Banking

Remarks of James E. Smith
Comptroller of the Currency
before the National Correspondent
Banking Conference,
American Bankers Association,
San Francisco, California
November 6, 1973

In preparation for this session, we reviewed some of the earlier annual reports of the Comptroller of the Currency. We found that Comptroller John Skelton Williams, in his 1914 Annual Report, expressed his concern about the adequacy of the capital of National banks. Specifically, he stated:

> The view is held by many practical bankers and experienced economists that it is not sound banking for an active commercial bank to be allowed to receive deposits in excess of ten times its capital and surplus. I am firmly impressed with the correctness of this view, and respectfully recommend to the Congress that the national-bank act be amended so as to provide that no national bank shall be permitted to hold deposits in excess of ten times its unimpaired capital and surplus. Perhaps it might be wiser to make this limitation eight times the capital and surplus.

To put Mr. Williams' recommendation in context, we may note that as of September 12, 1914, the ratio of total deposits to total capital for all National banks was 4.6. As of June 30, 1973, the same ratio for all National banks was 11.4.

Bank regulators must inevitably be concerned with the adequacy of bank capital. We in the Comptroller's Office are giving a good deal of attention to that question, and I would like to share with you today our early thinking on some of the issues with which we are wrestling.

As I see it, there are five major issues. These are: (1) the relevance of total economic collapse; (2) the weight to be given the quality of management; (3) the role of capital notes and debentures; (4) the role of bank capital in bank holding companies; and (5) the usefulness of capital ratios as measures of capital adequacy. I will discuss those topics in turn.

The first problem that must be faced in any discussion of capital adequacy is composing a list of contingencies threatening bank capital. At the forefront of that problem is the question: should the list include total economic collapse?

Perhaps the principal element that may distinguish our answer to this question today from the answer that may have been appropriate forty years ago is the changing role of national economic policies. Most economic authorities are agreed that our knowledge of appropriate counter-cyclical fiscal and monetary policies is vastly superior to that available to our policymakers in the early 1930's. From this, one may reasonably assume that an economic debacle of the magnitude of the Great Depression of the early 1930's is avoidable.

What does this mean for the stance of the banker and the bank regulator in connection with capital adequacy? I think it is defensible for both bank regulators and bankers to assume that fiscal and monetary policies will allow the prevention of large-scale economic crises. We are well aware, however, that cyclical movements have not been abolished, and that periodic recessions of more limited amplitude are to be expected. Those swings can bring significant pressures to bear upon banks.

The second issue to be considered is whether the quality of management should influence determinations of capital adequacy. Some views from outside and inside banking suggest that management quality has not been given its due. For example, a major study completed a few years ago by Professors Robinson and Pettway suggested that bank examiners "...should take their eyes off bank capital and focus on the quality of bank management." The authors continue:

> An analogy will help at this point: examiners do not try to specify the elements of a liquidity policy to a bank but they rightly criticize a bank if it does not have a clearly articulated liquidity policy. By the same token, why should examiners try to establish capital standards (which by their nature can't be specified)? Shouldn't their efforts and energy be directed to the problem of making sure that bank managements have clearly articulated capital policies and that they are implemented by managers of as high skill and training as possible?

Mr. George Vojta, in his recent monograph, after examining the body of research dealing with the relationship between bank capital and bank failures, concludes that "...the important causal factors relating to solvency are competence and integrity of management."

The Comptroller's Manual, until its 1971 revision, contained a section dealing with capital adequacy. It opened with the statement that, "The Comptroller of the Currency will not hereafter rely on the ratios of capital to risk assets and to total deposits in assessing the adequacy of capital of national banking associations." That is a strong, unqualified statement, and may account for deletion of the section in the 1971 revision. The section also included the well-known set of eight factors to"...be considered by the Comptroller in assessing the adequacy of capital." The very first factor listed was "the quality of management." The other seven were:

(b) The liquidity of assets;

(c) The history of earnings and of the retention thereof;

(d) The quality and character of ownership;

(e) The burden of meeting occupancy expenses;

(f) The potential volatility of deposit structure;

(g) The quality of operating procedures; and

(h) The bank's capacity to meet present and future financial needs of its trade area, considering the competition it faces.

Although this list is not contained in the current edition of the <u>Manual</u>, the factors have not been disowned by this Office. Indeed, to some degree the set of factors has come to epitomize the non-ratio approach with which the Comptroller has been identified during the past decade.

Let me now turn to the issue of capital notes and debentures. The Office of the Comptroller of the Currency in the early 1960's issued a ruling that encouraged National banks to resort, on appropriate occasions, to the sale of debentures to supplement their capital position. Until that ruling, senior capital, in the view of many bankers, was associated only with near-emergency situations at financially weak institutions. Our Office has applied a rule of thumb that limits the proportion of a National bank's total capital that can be in debentures to one-third.

Some of the capital formulae applied by bank regulators discriminate against the use of debentures. For example, one such ratio involves total equity capital plus reserves on loans and securities, divided by the sum of total liabilities plus total debentures less cash and cash items. It is obvious that a bank with outstanding debentures is penalized in the application of this ratio, as compared with a bank that has issued no debentures.

In our Office, we believe there is a place for debt instruments in the capital structure of National banks. The basic regulatory function of bank capital is to serve as protection for depositors and those who assume their risks. Capital notes and debentures extend substantial additional protection to bank depositors. Further, some market situations would penalize bank stockholders greatly, were the regulatory authorities to insist upon the sale of equity securities. Having the option of selling capital notes yields valuable flexibility.

A subsidiary question, in connection with bank debt capital, relates to the sale by one bank, usually a smaller one, of its debentures to a larger bank. There are, I believe, reasons for holding such transactions to a minimum. From the standpoint of the entire banking system, such transactions do not provide any net inflow of capital. Were such transactions to proceed on a round-robin basis throughout the system, it is evident that a substantial watering down of capital requirements for the system would have occurred. If the regulatory authorities desire to reduce capital requirements for the system, it may be preferable to take such action directly. Having stated this, I do not today advocate abolition of this type of transaction. On occasion, in a particular situation, this course of action can be beneficial to both banks involved, and perhaps, to the mental health of the bank regulator.

Let us now look at the question of bank capital for holding company banks.

There appears to be fairly general agreement that a bank and its capital position must be protected, whether or not it is a holding company subsidiary. Certainly, from the standpoint of a primary bank regulator, the relationship of a regulated bank with a parent bank holding company and its associated non-bank affiliates, should be a source of positive strength for the bank. Our Office will oppose any affiliation for a National bank when that affiliation would tend to threaten the soundness of the bank.

No single banking agency is responsible for regulating all types of banking organizations. In general, that division of responsibility is a plus for banking. However, the division of responsibility does lead to some overlap, and to occasional jurisdictional problems. One such problem involves the adequacy of capital in holding company banks, where the banks are other than state member banks.

As a primary bank regulator, our Office is concerned with the soundness of the bank and with its capital position.

We also recognize that the Federal Reserve, as the regulator of bank holding companies, is legitimately concerned with the capital position of the holding company _per se_ and its constituent parts.

I would like to offer a suggestion for discussion purposes, which I plan to pursue further upon my return to Washington. Would it be workable for a rebuttable presumption to exist in connection with the capital position of a subsidiary bank, based on the view of the primary bank regulator? In other words, in each case we would draw a conclusion as to whether or not the capital of a National bank were adequate. If our decision were in the affirmative, and if the bank in question were a subsidiary of a bank holding company, the Federal Reserve Board would accept our conclusion, unless the Board found cause for rebutting or attempting to rebut our conclusion. In the latter instance, further interagency discussion would be required.

I wish to emphasize that I view such interagency discussions as a useful educational exercise for all parties. Each agency has a wealth of experience gained from implementing its views of capital adequacy that has not as yet been fully shared with the other. No one, of course, should expect all differences of opinion to evaporate through this sharing. However, I am hopeful that major issues can be resolved.

The fifth and final issue touched on in my introduction relates to the usefulness of capital ratios as measurements of capital adequacy. In fact, somewhat more broadly, the question really is: how may the adequacy of capital be measured?

A variety of capital ratios are used by all bank examiners as initial screening devices in their attempt to determine whether an institution under examination is adequately capitalized. The loans-to-capital ratio, the capital-to-total assets ratio, the capital-to-total deposits ratio -- these and others are among the more popular measures.

As to the norms or the "acceptable" levels for these ratios, it is undoubtedly true that the current average figures tend to become a sort of standard. In my opening example, I pointed out the sharp drop in capital ratios over the past 60 years. This drop illustrates that we tend to look at the concept of capital adequacy in relative terms rather than in absolute terms.

In using ratios, one is often tempted to adopt "minimum" values for regulatory purposes. When this is done, there is a natural tendency on the part of bankers, hard pressed as they are to maintain a favorable rate of return on capital, to allow their institutions to slide gradually to the minimum acceptable levels. The choice of any minimum which lies below the ratios of a significant number of banks would tend, in and of itself, to exert downward pressure on the aggregate capital ratios of the system.

I personally believe that no strict formulation can substitute for the factor of human judgement in determining capital adequacy. Obviously, if this were not so, the world would be an easier place for bank regulators. Were mechanistic judgements to be finally determinative, one perhaps could appoint the latest generation computer as regulator.

However, bank regulators do need benchmarks and guideposts, and I would like to close by describing one exercise in which we are currently engaged. Even if this exercise bears fruit, we will not have altered our basic position that no strict formula can be finally determinative of the adequacy of capital. Rather, we will simply have another tool to help us in our determination.

As you know, our Office develops classified assets totals for National banks. Classified assets are those assets of an institution which our examiners find to be subject to some type of criticism. The volume of classified assets is related to the degree of potential loss in a bank's asset portfolio.

There are several determinants of the overall classification of a bank, but a principal one relates to the ratio of classified assets to gross capital funds. Gross capital funds include total stated capital plus reserves on securities and loans. Banks with a ratio below 20 percent are A banks, those with a ratio of 20 percent or more but below 40 percent are B banks, those with a ratio of 40 percent or more but below 80 percent are C banks, and those with a ratio of 80 percent or more are D banks.

We have also divided all National banks into a number of deposit-size categories. For our purposes here, let me confine the discussion to three broad size categories, with the smallest being those banks with less than $100 million, and the largest those with $500 million or more.

The approach we are considering as an additional tool in the capital adequacy area involves a determination of acceptable limits of certain capital ratios for banks in each of our groups. The approach assumes that the A banks, that is, those banks with relatively low ratios of classified assets to gross capital funds, can safely reach higher loans-to-capital ratios than is the case for banks in the D category.

As of the end of 1972, the ratio of total loans to total capital accounts for all insured banks was 7.4. Taking this as a jumping-off point, we have explored the question of how many National banks would require additional capital were various limits of the loans-to-capital ratio applied to banks in the A, B, C, and D classifications.

In a preliminary exercise, we have applied two different sets of limits for the loans-to-capital ratio to banks in each classification. The first ranges from 8.5 for A banks to 6.5 for D banks, while the range for the second is from 9.0 to 7.0.

Under the first set of loans-to-capital ratio limits, i.e., the set ranging from 8.5 for A banks to 6.5 for D banks, 12.7 percent of all National banks would need additional capital. Only 8.4 percent of A banks would require an injection of capital, while the percentages for the B, C, and D groups would be 30.0 percent, 64.6 percent, and 81.3 percent, respectively.

If the set of limits ranging from 9.0 for A banks to 7.0 for D banks were to be applied, 8.1 percent of all National banks would fall short. This would include 4.8 percent of A banks, 20.3 percent of B banks, 51.3 percent of C banks, and 71.9 percent of D banks.

We applied the same sets of limits to banks in various deposit-size categories. For the set of ratio limits ranging from 8.5 to 6.5, 12.2 percent of the National banks with deposits under $100 million would require a capital injection. Of National banks with deposits between $100 and $500 million, 14.8 percent would need to augment their capital, while for the banks above $500 million, the comparable percentage would be 26.6.

A similar pattern occurs with the application of the set of ratio limits ranging from 9.0 to 7.0. For the smallest-size category, 7.8 percent of the banks would need capital. For the middle size category, the percentage would be 9.1 percent, and for the $500 million and above category, 18.3 percent.

To add some perspective to these figures, it is useful to note that most of our National banks -- 85.5 percent, in fact -- are

A banks, and that a far lower percentage of A banks would require additional capital under the limits discussed than is the case for the other classifications. Secondly, for many banks showing a need for capital under the procedures outlined, a comparatively small injection would suffice. This is shown by the fact that altering limits by small amounts drastically reduces the number of banks failing to meet the limit test.

It is obvious that similar exercises can be pursued for each of a number of capital ratios. We have already made, for example, a preliminary examination of the effects of various cutoffs applied to the capital-to-total assets ratio. We have not made any determination to date as to whether different limits would be appropriate for different-size banks.

I must re-emphasize that whatever the continuing results of these exercises may be, we will never replace our judgement with any strict formulation. We do believe, however, that the more relevant data that can be brought to bear on the question, the better our judgement is likely to be. However, I am reasonably certain that annual reports of the Comptroller of the Currency well into the future will continue to provide evidence that no final resolution of this question has been achieved.