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TESTIMONY OF



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ON

# THE IMPACT OF BANK CAPITAL STANDARDS ON CREDIT AVAILABILITY

BEFORE THE

COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

10:00 A.M.
THURSDAY, JULY 9, 1992
ROOM 2359-A, RAYBURN HOUSE OFFICE BUILDING

Mr. Chairman and members of the Committee, I am pleased to have this opportunity to testify on behalf of the Federal Deposit Insurance Corporation regarding bank capital standards and their impact on credit availability.

Existing and prospective capital standards have had, at most, a marginal adverse impact on credit availability. At the same time, these standards have contributed to the protection of the deposit insurance funds. The current capital standards recognize the diversity inherent in our banking system while requiring appropriate levels of capital that reflect potential risk.

Background

Banks are currently subject to two capital standards, both of which must be satisfied. The first of these is the so-called "leverage" standard by which bank capital has traditionally been measured. The second measure is based on a risk-weighting of individual banks' assets and off-balance sheet exposures.

The leverage ratio is essentially a measure of owners' equity as a percentage of total bank assets. Under current regulations, a bank may have 3 percent leverage capital if the bank is in a very sound condition and not experiencing or anticipating significant growth. Most banks, however, must maintain a minimum leverage capital ratio of at least 4 to 5 of at least 4 to 5 percent of total assets. These are regulatory minimums and additional capital may be required based on the risk profile of the particular institution as determined by examination.

Prior to the risk-based/leverage standards, the agencies utilized a measure of primary capital (which included equity capital, plus loan loss reserves) to total assets. That standard worked fairly well until some banks expanded their off-balance sheet activity. Also there was concern that the measure discouraged banks from holding an appropriate level of liquid assets given that the same capital charge was assessed against cash and government securities as was charged against other more risk prone assets. To deal with these concerns, the risk-based capital standard was adopted to take into account the perceived relative riskiness of individual bank assets and to require appropriate capital support for off-balance sheet business.

Under the risk-based capital standard, particular risk weights are assigned to various asset categories depending on the types of assets held. Generally, cash, federal and local government debt securities and interbank debt are given favorable (low) weightings and traditional bank risk assets are assigned a risk-weight of 100 percent which means that the prescribed percentage of capital must be maintained for the entire amount of such loans. In the interest of completing complex international negotiations, one exception to the traditional bank risk asset base was made. Loans secured by certain types of owner occupied residential real estate were assigned a 50% weighting.

Under current regulations, banks are required to maintain minimum capital equal to 7.25 percent of total risk-weighted assets. This is an interim standard that will increase to 8 percent at the end of this year. Risk-based standards for analyzing the sufficiency of bank capital were initially developed in coordination with international bank supervisors primarily to assess capital levels in institutions engaged in international operations. However, in the interest of equal capital standards for all domestic banks, U.S. regulators have applied the risk-based standards to all U.S. domestic banks without regard to charter or whether they engage in international operations.

The United States is not the only nation to apply risk-based standards to its domestic institutions. The European Community countries, including Germany, France and the United Kingdom among others, are adopting risk-based capital requirements that implement the EC capital adequacy directives. These directives, which are broadly consistent with the Basle Committee's risk-based capital rules, are intended to apply to all banks within the EC, including those with only domestic banking business. In addition, although the standards do not apply directly to some Japanese banks, all city banks, trust banks, and long-term credit banks in Japan are subject to the framework. Further, Switzerland applies the Basle standards to all of its banks.

We strongly support risk-based capital. The relative newness of the scheme under which it is measured, however, makes it difficult to assess its effectiveness at this point in time, especially since it does not take into account interest rate or concentration risks. It was those factors that led to the current tandem capital requirements -- leverage ratios and risk-based ratios. The leverage ratio was added as a check against the potential for banks to take excessive interest rate risk under the risk-based scheme. We believe the two requirements work well together to assure adequate minimum levels of capital but that neither standard alone necessarily suffices. At the same time, we are prepared to move forward and further enhance the risk-based system. After the risk-based system is fully developed and we have had further experience with it, we intend to consider whether the risk-based scheme alone is sufficient and whether the leverage ratio can be reduced or eliminated.

From a regulatory stand-point, one of the principal functions of bank capital is to protect depositors and the deposit insurance funds. While higher capital standards offer more protection, one of the unfortunate side effects in some isolated cases may be some marginal credit constriction. In our view, protecting the fund and taxpayers is a responsibility we cannot ignore. The alternative is to compromise capital standards or forbear in enforcing those standards. Past experience within the financial institutions industry suggests that would be an unwise course.

Capital Levels

The vast majority of banks already meet existing capital standards and meet the higher risk-based standards of 8 percent scheduled to take effect at year-end. Currently, less than 2 percent of banks holding slightly more than 3 percent of industry assets fail to meet the 4 percent leverage standard. Similarly, less than 2 percent of all banks fail to meet the current 7.25 percent total risk-based standard. These banks hold less than 2 percent of industry assets and most are troubled institutions.

Existing capital standards are currently undergoing refinement for purposes of implementing the prompt corrective action provisions of section 131 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). The FDIC recently published for comment proposed regulations defining the five different capital levels, the lower ones of which trigger various operating constraints or regulatory actions pursuant to FDICIA. Under the proposed regulations, a well capitalized institution is one with a leverage ratio of 5 percent or more and a total risk-based ratio of 10 percent or more, including 6 percent Tier 1 (basically equity) risk-based capital. An adequately capitalized institution is one with a leverage ratio of 4 percent or more and total risk-based capital of 8 percent or more, including Tier 1 risk-based capital of 4 percent or more. An institution is undercapitalized if it has a leverage ratio under 4 percent, total risk-based capital under 8 percent or Tier 1 risk-based capital under 4 percent. An institution is significantly undercapitalized if its leverage capital ratio is under 3 percent, its total risk-based capital ratio under 6 percent or its Tier 1 risk based ratio under 3 percent. An institution is deemed critically undercapitalized if it has tangible equity capital (Tier 1 leverage ratio) of 2 percent or less. The comment period on this proposal expires in mid-August.

There are strong incentives in the prompt corrective action provisions of FDICIA for banks to meet the capital standards of a well capitalized institution. Consequently, we would anticipate that most banks will make every effort to meet those standards to achieve maximum operating flexibility and minimum regulatory constraints. We have already observed that a number of banks have increased their capital, primarily by injections from their holding companies, in order to meet the standards for a well capitalized institution under the brokered deposits regulation. Increased capital levels will permit these institutions to maintain unfettered access to brokered deposits funding and avoid other regulatory restrictions anticipated for lesser capitalized institutions. However, we do not anticipate that the process of obtaining higher capital levels will have a significant adverse impact on credit availability.

Bank supervisors have traditionally favored flexibility and discretion in administering bank capital standards on a case-by-case basis. For this reason, we have some concerns about the impact and the effectiveness of FDICIA's "tripwire" approach. We will be evaluating the implementation of these provisions closely and, if changes appear to be warranted, we will share our findings with Congress. In addition, we welcome the newly granted authority for an institution to be taken over before it is book insolvent. The 2 percent critically undercapitalized standard should provide at least some additional measure of protection against loss to the insurance fund.

Banks may satisfy capital standards by raising additional capital, by retaining larger portions of their net income or by shrinking their asset base. However, intentionally shrinking the asset base in order to meet a prescribed capital ratio, may be detrimental to the institution's overall earnings capacity. The current favorable market for bank stocks has enabled a number of banks, including some larger institutions, to raise additional equity to augment their capital base. Moreover, most banks increase capital through retained earnings. This past quarter, the industry earned a record $7.6 billion. Dividend payments were one-third lower than the first quarter of 1991 and retained earnings contributed $4.7 billion to a $7.5 billion increase in banks' equity capital during the quarter. This growth in earnings and increase in capital, if sustained, bodes well for the continued availability of bank credit to all types of borrowers.

Impact of Capital Standards

In a changing economic environment, it is difficult to point to any one factor to account for a decline in lending. There may be a variety of factors, including, most notably, the market demand for certain types of credit given the underlying general economic conditions, strengthened credit underwriting standards as well as a weakened condition of many prospective borrowers. The recent decline in lending appears only marginally related to credit availability.

Available data suggests that a fair number of banks have in fact experienced negative growth. In comparing data on asset size from the March 1992 and December 1991 call reports, we found that 4,966 banks were in fact smaller in March than they were at the end of 1991. Moreover, the loan portfolios in these banks shrank by a collective total of $26.7 billion or 2.37 percent from December.

Although a certain amount of credit contraction has occurred as a result of industry shrinkage, relatively little appears solely designed to meet capital standards. Most of this contraction ($19 billion) occurred in 4,712 banks with leverage ratios of 5 percent or higher. Indeed $9.9 billion of the shrinkage occurred in 4,097 of the banks with leverage ratios over 6.5 percent. Moreover, almost the same number of these banks had over 5 percent capital at the end of 1991 (4,669 at year-end 1991 versus 4,712 on March 31, 1992). Any shrinkage appears attributable to factors other than capital standards, such as a desire to shift to more liquid securities or to concentrate on working out problem assets. It is also important to note that even as an institution shrinks, it most likely will extend credit to its creditworthy customers in order to maintain both its customer base and earnings.

While the risk-based capital standards may favor or encourage certain types of investment by assigning lower risk weights, we believe this consideration is normally outweighed by traditional considerations in selecting bank investments. These include credit risk, interest rate risk, liquidity, and diversification. The tendency to favor lower risk weighted investments is further constrained by the need to satisfy leverage standards as well as by the lower yields realized on less risky assets.

The perennial question in bank supervision has always been how much capital is enough. The basic function of capital is to absorb unanticipated losses and prevent bank failure. How much capital is necessary obviously varies by institution and is a judgment call based on a variety of factors -- asset risks, earnings, liquidity, strength of internal policies and controls, management competence, market competition, location and economic conditions. Yet, every bank must be required to have a minimum amount of capital in order to be in the banking business and to be permitted to leverage that capital with government insured deposits. Although reasonable people may differ as to what the amount of capital should be, it is clear that it should increase relative to riskiness of the institution's asset base and its overall operations.

## Conclusion

A number of events have been attributed to what has come to be known as the credit availability or "credit crunch" problem. For example, tax incentives enacted in the late 1970's encouraged a boom in real estate investment, much of which was financed by commercial banks and thrifts. At the same time, general economic prosperity helped to mask inherent weaknesses in many commercial real estate projects. Fallout from the commercial real estate downturn was the main reason for a rise in nonperforming assets at many commercial banks and thrifts and for the need to increase loan loss reserves and restore capital levels.

Regardless of the efforts by institutions to meet the new higher capital standards, the industry, at present, has the capacity to meet legitimate credit needs of worthy borrowers. The vast majority of the industry, both in number of institutions and assets held, currently meets existing capital standards. Moreover, liquidity does not appear to be a limiting factor in the ability of the industry to make additional loans. The industry's net-loan-to-deposit ratio is at its lowest level since the aftermath of the 1981-82 recession. Moreover, the reduced proportion of loans in asset portfolios, while below the level of recent years, is still higher than following the recessionary period of 1982-1983.

There should not be any significant balance sheet constraints to small business lending. The commercial loan portfolios of small banks (under $100 million in assets) have not significantly decreased which suggests these banks are able to serve their traditional customer base which includes small businesses. Rates on deposits are at their lowest level in years which suggests that banks can tap into the pool of savings by simply paying marginally higher rates.

Efforts by banks to meet existing and prospective capital standards have had a positive impact on protecting the deposit insurance funds and only a marginally adverse impact on credit availability. Recent real estate based credit problems prompted financial institutions to review their lending practices and many institutions wisely tightened their underwriting standards. Nevertheless, there is ample capacity in the industry currently to satisfy the credit needs of creditworthy borrowers in all sectors of the economy.