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"THE FDIC VIEWS QUESTIONS OF CAPITAL ADEQUACY"

Address of

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It seems hardly possible to say something new on the subject of bank capital adequacy. The literature is already extensive, bank regulatory authorities have grappled with different views of capital adequacy over many years, reasonable men continue to differ and bankers still tend to resist supervisory demands for more capital.

In my view, adequate capital is the least amount necessary for others to have confidence in your bank and its operations. The "others" you have to convince are large customers, other banks, investors and, in this imperfect world, bank regulators. There is no simple formula or rule of thumb that will assure outside confidence for all banks: there are just too many variables in achieving this status and, not surprisingly, too many instances where confidence is high but the apparent mathematical ratio is relatively low to conclude that a particular ratio is the "right" one for all banks.

It has been suggested that the free play of the market should determine the adequacy of a bank's capital, and that the supervisory agencies should not presume to enforce a different judgment of their own. This approach presupposes, however, a much more knowledgeable market than we have today -- at least for the vast majority of the nation's 14,000 banks. Relatively few of these banks

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have more than 500 shareholders which makes them subject to the fuller disclosure requirements of Regulation F. On the other hand, an increasing number of banks are members of holding company systems which, on a consolidated basis, are subject to SEC disclosure requirements. But even assuming one-sixth of the nation's banks are subject to Regulation F-type disclosures or to SEC requirements, these disclosures do not include all of the information available to bank regulatory agencies or all of the information which may be necessary for a market determination of the bank's condition.

While the largest banks have become increasingly open with financial analysts about management goals, performance and even adverse developments, the fact remains that the marketplace is either uninformed or imperfectly informed about most of the nation's banks. So I question whether the market's view of capital adequacy is really the answer -- even for the nation's billion-dollar banks. I'm certain it's not the answer for banks of lesser size or prominence.

In a sense, the bank regulatory agencies are exercising for most banks the judgment as to capital adequacy which a perfectly informed market might be able to exercise. In terms of the entire universe of banks in this country, I think we do that job reasonably well although we can make mistakes just as the market can. The

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fact that bank earnings have been relatively high and that bank failures have been relatively few in recent years, despite considerable shocks within the economy, suggests that we are at least viewing capital adequacy today on a reasonable basis.

Average capital ratios vary by size categories throughout the broad spectrum of American banks. The highest ratios are most often displayed by the smallest banks (i.e., those under $5 million in total deposits). The 8 percent average ratio shows up most frequently in the $10 million-deposit range, and progressively lower ratios seem to be the rule as we go up from $25 million in total deposits. And generally speaking, these average ratios have declined moderately for smaller and medium-sized banks during the past 10 or 15 years. This, again, is empirical evidence that none of the bank agencies view the matter of capital adequacy simply in terms of some average nationwide ratio.

For the largest banks, capital ratios have been declining even more rapidly in recent years. Overseas deposits have increased appreciably. That, plus active participation in the time deposit market, has resulted in asset gains by the large wholesale banks that equalled or exceeded those of smaller banks. Holding company

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activities of some larger banks have resulted in overall operations with much more leverage than that indicated by the bank's own balance sheet.

Detailed balance sheet data on banks and bank holding companies indicate that for year-end 1972 the 11 largest banking organizations had a ratio of equity to total resources of about 4.5 percent (including loan reserves raises the figure to about 5.4 percent). Figures for the big Chicago banks are almost as low, and those for the major California banks are lower. I suspect the comparable figures for 10 years ago would have indicated ratios approximately double those of today for this same group of banks. What accounts for the shift? Partly it's a rapid growth of resources and generally more aggressive behavior by these banks. Additionally, it may have to do with the relationship between large banks and large corporate customers. The latter are no longer willing to maintain large active balances apart from those required by loan commitments. However, as one consequence of this, large corporations are no longer able to insist on high capital ratios by virtue of their balances and there is no advantage in wholesale banks maintaining such ratios. This may all be very rational and in the interest of a more efficient economy, but the acceptance of the resultant numbers and ratios is not easy for bank regulators.

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How then do we go about evaluating the adequacy of capital in particular banks? Our current instructions to FDIC examiners have this to say about the use of ratios and the identification of the more important factors that enter into the evaluation:

> ". . . , the Corporation has traditionally been concerned with the general level of capital ratios, because of the close relationship between these ratios and the Corporation's risk. However, this emphasis on capital ratios, which simply measure the ability of the banking system as a whole (or the average bank) to withstand unexpected losses or shrinkage in asset values, should not be taken out of context and misconstrued as a minimum standard applicable to individual banks. On the contrary, banks are sufficiently dissimilar as to the quality and character of their assets, the relative competency of their managements, and the relative stability of the economic environment in which they operate that it is never practicable to generalize on the subject of capital adequacy. If any generalization may be made, it is that the capital of any given bank should be sufficient to support the volume, type, and character of the business presently conducted, provide for the possibilities of loss inherent therein, and permit the bank to continue to meet the reasonable credit requirements of the area served.
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> "In attempting to evaluate capital adequacy, there are several important factors that must be weighed and judged:
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> (a) Management - The ability, attentiveness, integrity and record of management, together with the soundness of its policies are of major importance. Sound management, prudent policies, and effective

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operating procedures are probably the key elements in the overall risk equation of business enterprise, and it is, after all, [as] protection against risk that capital plays its singular role in any business enterprise.

(b) Assets - The general character, quality, liquidity and diversification of assets, with particular reference to assets adversely classified, are necessarily vital factors in determining the adequacy of capital.

(c) Earnings - The earnings capacity of a bank is of marked significance in assessing the ability of a bank to maintain an adequate capital position. The dividend policy of the institution is also of importance, as is the willingness of management to recognize and absorb losses currently. Supervisors generally feel that earnings should first be applied to the elimination of losses and depreciation and the establishment of necessary reserves and that dividends should be disbursed in reasonable amounts only after full consideration has been given to those needs and other factors impinging on capital needs.

(d) Deposit Trends - If the trend of deposits is upward and appears likely to continue, and if retained earnings have not kept pace with the growth in the size and the scope of the bank's operations, there can be little question that management should recognize its responsibility and make all reasonable efforts to augment capital through whatever means possible. The potential volatility of [the] deposit structure, on the other hand, adds another dimension of a different character to the analysis of a bank's capital structure.

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(e) Fiduciary Business - The volume and nature of the business transacted in a fiduciary capacity are of significance in determining capital needs. Contingencies in this area, as well as the possibility of surcharges, must be carefully appraised.

(f) Local Characteristics - The general type of clientele, stability and diversification of local industries or agriculture, and the competitive situation are important considerations.

"The question frequently arises regarding the importance of ratios in determining capital adequacy. As previously noted, 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. A low capital ratio by itself, however, is no more conclusive of a bank's weakness than a high ratio is of its invulnerability. It would be hard to find much correlation between book capital ratios and the incidence of bank failure -- that eventuality against which capital protects, but does not prevent. Banks with high capital ratios have failed because of the low quality and/or unwise distribution of their assets, while others with low ratios have survived because of a hyper-liquid condition.

"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. In the average bank, with average management, the capital-asset ratio or the risk-asset ratio, when they go beyond reasonable

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bounds, may be of importance in deciding that additional capital is necessary, even though existing asset problems are relatively minor. The relative degree of quality in a bank's loans, bonds, and other risk assets, is a valid argument in relation to capital needs up to a certain point, but the validity of this argument decreases rapidly and disappears when the sheer volume of such assets completely overshadows the capital structure. On the other hand, certain banks have reasonable capital ratios but management and asset weaknesses necessitate requesting additional capital. In other words, ratios alone are not conclusive, and they always must be integrated with all other pertinent factors. However, once this integration has been effected they do have a bearing, their relative importance increasing in direct relation to the degree of seriousness attached to management and asset problems, or conversely, decreasing in direct relation to the degree of management competency and asset soundness in the bank under consideration."

The average capital-asset ratio approach has special relevance in the case of applications of new State-chartered banks for deposit insurance, on the premise that a new entrant in the market should at least meet the capital standards of the industry in order to obtain a license to compete. At the FDIC, we tend to apply industrywide capital standards more rigorously in such instances. As a general rule, such new banks are expected to provide an initial capitalization sufficient in amount to provide a prospective capital cushion at the end of the first three years of operations at least equal to 10 percent of estimated

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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 to two percent) to compensate for (i) the increased risks accompanying the formation and development of a new bank and (ii) the historical bias of both examiners and applicants in underestimating the deposit potential of new banks. The Corporation has, in addition, adopted a firm policy of not approving applications of proposed new banks with less than $250,000 initial total capital, unless special circumstances (such as a location in an isolated, unbanked community) warrant a lesser capitalization. The rationale for this policy is that any new bank should have the capability of generating deposit totals of at least two and one-half million dollars within three years to be assured of success in today's increasingly complex and competitive banking environment.

The composition of bank capital, as you know, has undergone significant change within the past decade. The old antipathy toward the use of debt capital has been displaced by a willingness among bank supervisors to accept, in certain circumstances, subordinated debt into the permanent structure of bank capital accounts. However, although debt capital offers added protection to depositors and

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creditors, it is not a complete substitute for equity capital. First, it is fundamentally a debt obligation and must ultimately be retired in accordance with its terms, although we recognize, of course, that a growing, profitable bank can readily refinance maturing notes at or prior to maturity. Second, interest on capital notes and debentures is a fixed charge against future income that must be met, whether earnings are available or not, and the payments necessary for debt servicing represent reductions of funds available for additions to undivided profits or the payment of dividends. In many respects, therefore, debt capital represents the capitalization of future income. Finally, debt capital generally may not be used to absorb losses although it does provide an additional cushion for depositors and creditors if the issuing bank should have the misfortune to fail.

Most supervisors today would interpose no objection to debt capital that has the following characteristics:

(a) A principal amount which is in reasonable proportion to the total capital structure (our guide is about one-third of total capital and reserves);

(b) An interest rate which is commensurate with prevailing conditions;

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(c) Sinking fund provisions (where they exist) that are adequate and a retirement schedule that is practical and realistic;

(d) A principal amount that provides for the bank's reasonably foreseeable needs; and

(e) The circumstances of issue support a general conclusion that the bank's best interests would be served thereby.

Some observers, including members of the FDIC staff, feel that the above guidelines are too restrictive. They argue that the limit of one-third of total capital in the form of debt is arbitrary and probably was developed because that figure approximately coincides with the borrowing limit of a national bank with an average mix of capital, surplus and undivided profits. Why, they ask, should the regulatory agencies place any limit on debt capital, as long as a bank has sufficient equity capital? Far better, they add, to let the banks and the capital markets decide appropriate debt levels, for insofar as debt gets out of line with acceptable market standards, the effect on borrowing costs should result in appropriate discouragement. This point of view has considerable merit, but also some limitations

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insofar as it relies on the capital markets for an evaluation of the appropriate debt-equity relationship. We are, however, reviewing the subject at the present time with an open mind.

An area of particular current concern relates to the capital position of banks and parent holding companies. It has been suggested that one of the reasons why banks are now eager to move into a variety of activities where they were not traditionally active or permitted to operate is a desire to increase leverage. For the most part, acquisitions of related businesses under the 1970 Bank Holding Company Act Amendments have not been accompanied by significant additions to equity. This makes such entry very attractive so long as additional earnings can be generated, for there is no capital cost associated with the incremental additions to earnings. These expanding activities of banks and one bank holding companies may, of course, provide increased competition in markets for a number of financial services and there may be substantial benefits to the public. However, insofar as they result in thinner equity coverage, the concern of bank regulators will increase. Moreover, changes in the product or asset mix of banks and bank dominated holding company organizations might have additional implications for determining appropriate capital levels. While it is possible

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for a bank to continue to function while its holding company is in financial difficulty, I don't think bank regulators can assume that this will always or even usually be the case.

In summary, the determination of the appropriate level of bank capital in the individual case and on an industrywide basis is complex and does not seem to lend itself to the application of inflexible, rigid formulae. Nevertheless, the importance of making such a determination both from a supervisory standpoint and from the vantage point of the banking industry, is self-evident. In the final analysis, the task of the Corporation in evaluating the capital adequacy of individual banks is to assure confidence in the nation's banking system without fostering an overcapitalized position which would be properly subject to criticism as an inefficient use of increasingly scarce capital resources.

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