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"BANK CAPITAL TRENDS"

Address of

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FEDERAL DEPOSIT INSURANCE CORPORATION

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"BANK CAPITAL TRENDS"

Adequate bank capitalization is a never-ending problem to bankers and supervisory authorities alike. This problem persists despite the improvement in capital margins over the past decade. The favorable trend reflected in aggregate figures is more pronounced in some States and subdivisions of the banking business than in others; and improvement has been notable in Iowa. Consequently it seems quite appropriate for the Annual Convention of the Iowa Bankers Association to have a place on its program for this important subject and I welcome the opportunity to comment about progress and prospects.

Growth is the keynote of our economic life. Expanding dimensions characterize every phase of activity--and banking is no exception. The assets and deposits of our banks today reflect this tremendous growth force. Also, other financial institutions competitive with banking have grown rapidly. Though some are relatively small as yet, these competitors display a vigorous and resourceful spirit that commands attention.

Banking has a vital place in the complex procession of enterprise that serves the needs of our nation. But it is obliged to keep pace with the rest of the procession or yield its place to others. This task is not easy for the pace is swift.

The effort to keep pace imposes especially heavy demands in the area of bank capital. Bank customers are more numerous and their needs are greater than ever before. To serve them, substantial aggregations of capital are essential. If responsibility for making the effort to accumulate the necessary capital is shirked, bankers cannot expect to enjoy the full benefits of the growth that is in prospect for them.

Though much has been said about economic growth, in my opinion it is important to reiterate the magnitudes that pertain to the banking industry. Looking into the future, then, what can we anticipate with respect to bank deposits and bank capital needs? I shall not pretend that I can give you precise answers to these questions, but let me at least suggest some reasonable expectations. Should our economy grow, on the average, at a rate of three to four percent a year, we may expect bank deposits to grow at about the same rate. A faster or slower rate of deposit growth would be disturbing to the delicate monetary balance between inflationary and deflationary forces in our economy. Accordingly, we can estimate that by the end of the second quarter-century of deposit insurance banks will have a deposit volume of approximately $600 billion, and a corresponding asset growth. In that event, it will require about $30 billion of new capital if the banking system is to merely retain the present ratio of capital to total assets.

Let us consider these figures for a moment. From 1934 to the end of 1958 total capital accounts in all banks in the United States increased by approximately $14 billion. During the next 25 years, we shall require additions to capital of more than twice this amount. And I should emphasize that even if this amount of additional capital is obtained we shall only have succeeded in this treadmill effort to keep pace with the anticipated growth in banking: the present situation will not have been improved. It is with this background in mind that I should like to turn now to some comments on the broad capital trends and the present situation.

The capital margin at mid-year was 8.1 percent of total assets for all insured commercial banks in the United States. In your State of Iowa the most recent comparable figure was 8.6 percent. Your showing is substantially better than the nationwide aggregate. Especially gratifying is a comparison of these ratios with the all-time lows in 1945 which stood at less than 6 percent for all insured commercial banks, and about 5 percent for banks in Iowa. The record since then testifies to progress.

Salutary as the trend may be in the direction of adequate bank capitalization, let me hasten to point out that the bank capital problem is ever changing. This is evidenced by developments since the establishment of the Federal Deposit Insurance Corporation twenty-five years ago. Some objectors to deposit insurance originally feared that it would be conducive to careless banking. In effect, they anticipated the contamination of the loan and securities portfolios with a large volume of poor quality assets. However, actual experience with deposit insurance soon showed the fears to be groundless. Bankers worked tirelessly to rehabilitate weak situations and to maintain high qualitative standards for their loan and investment portfolios. Furthermore, bankers were encouraged in these efforts by the examination activities of Federal and State supervisory authorities.

Notwithstanding the success of these efforts to better the condition of assets, the Federal Deposit Insurance Corporation was confronted almost from its very beginning with the quite different but equally important problem of bank capitalization. During the first decade of deposit insurance, capital margins declined very rapidly. Recovery from the depression lows followed by the financing of huge war deficits accounted for a rapid expansion of bank assets. Capital accounts, on the other hand, accumulated at only a moderate pace.

Common sense tells us that new money is the best remedy for an inadequate bank capitalization, and that a stock flotation is the obvious way to obtain funds. In the nineteen-thirties and during World War II, this method for bolstering capital accounts was impractical for the simple reason that bank shares were not sufficiently attractive to investors. Restricted earning power and prospects placed a serious limitation on dividend payments. And, in addition, wartime demands had the top priority for investment funds.

Retention of earnings in the capital accounts was the only alternative then available for improving bank capitalization. Here again the poor earning power of bank assets limited the amount of increase. As these trends persisted, both bankers and supervisory authorities became seriously concerned about the decline in the relative size of the capital margins.

Improvement in the aggregate of bank earnings after 1940 contributed significantly to the success of the earnings retention program for bettering capital margins. In 1943 banks materially increased the amount of profit retained in their capital accounts and they continued to make substantial retentions in succeeding years. Whether it is appropriate to continue to place major emphasis on this method for augmenting capital is a matter that now deserves consideration.

There is a practical limit to the rate of capital growth from the retention of bank earnings. Most banks have been operating close to this limit since the end of World War II. While the dollar amount of retentions has been substantial, the portion of earnings paid to stockholders in the form of dividends has tended to be quite modest. Nevertheless, the recovery in capital ratios from the record lows can only be characterized as partial.

Generally speaking, any attempt to squeeze additional capital out of bank earnings entails a reduction in dividend payments to shareholders. This does not affect investors' funds already committed to the capital structure of banks, but surely it would discourage new investment as a source of bank capital. If the private sources of investment funds dry up because shares are unattractive to investors, banks may be obliged to turn to the Government for help in securing at least part of the necessary capitalization. Certainly this is not a happy solution of the bank capital problem.

The reduction in dividend returns on bank capital during the Great Depression and the war years was, in my opinion, unavoidable. The slump in bank earnings, which carried the income accounts of many banks into the red during the early nineteen-thirties, forced reductions and, in many cases, suspension of dividends. Though earnings recovered slowly during the nineteen-thirties, dividends remained low and a portion of the earnings was made available for rebuilding bank capital accounts. Funds from operations also were needed to retire emergency capital provided by the RFC at the same time banks were endeavoring to restore their permanent capital structures.

From the vantage point of today, it is easy to see clearcut evidence of a neglected opportunity with respect to the availability of investment funds as a source of bank capital over the postwar years. This oversight is reflected in the continued heavy reliance by supervisory authorities and bankers alike on retained earnings to augment capital accounts long after a major change for the better has taken place in the economic climate. Conditions suggest that banks may once again be able to raise new capital by issuing shares of stock. In fact, some banks have used share flotations to augment capital accounts but they have been the exceptions rather than the rule.

Why has progress in taking advantage of this opportunity to augment bank capital by appealing to investors been so discouragingly slow? The answer to this question has several parts. In the first place, realization of a fundamental change in an economic setting takes time. But that can only be a small part of the answer, because for many years evidence that we were experiencing a vigorous phase of economic growth has been abundant. Secondly, there has been perhaps too little emphasis placed upon the need for a satisfactory dividend policy to make bank shares attractive as investments. To rely almost entirely on earnings to increase capital accounts obviously contradicts a policy of increasing bank capital by issuing shares on terms attractive to investors. It is necessary for us to recognize and resolve this contradiction as best we can in each case that presents a bank capitalization problem. The objective in any instance is a reasonable balance in the use of alternative capital sources.

Better yielding loans have once again resumed their importance in bank portfolios and interest rates have soared upward. Banks generally are relatively free of losses. By and large, times are prosperous, business activity continues to fluctuate at a high level, and the long-run prospects are good. Accordingly, banks are now in a position to make their shares attractive to investors by a more liberal dividend policy as well as by other means. In these circumstances, present holders of bank shares may be expected to increase commitments. Furthermore, new investors seeking gainful employment for their funds may be attracted to bank shares. This latter source of funds for bank capital has the added advantage of broadening the ownership base.

To be sure, broadening the ownership base of a bank should not be viewed as the primary objective for a new flotation of shares. If the owners of closely held banks contribute sufficient new capital when needed, supervisory authorities can have no grounds for complaint. However, it is always well to remember that an effective means of communication with the diversity of interests in a community is essential if a bank is to be alert to opportunities and responsive to the banking demands in the area it serves. Broadly based share ownership has long been recognized as a good way to establish the necessary contact and communication. When stockholders who have the right to participate in shaping the management of the bank represent a wide spectrum of community life the results of their efforts tend to be consistent with the interests of the entire area. Thus, a degree of harmony is achieved among competing elements.

Despite the general tenor of my remarks as regards the methods actually used by the banks to rehabilitate capital accounts, I do not mean to imply that little or no progress has been made in rebuilding capital margins. By and large, it now appears that banks have succeeded in overcoming the major effects of capital erosion which took place during World War II. Accordingly, I suppose many of you have wondered if there is any point in continuing to refer to a "capital problem," or whether more can be expected in the nature of a solution. The answer to these queries is definitely yes; and for several important reasons.

First, we must face up to the fact that the times call for speedy and substantial additions to capital. Let me repeat again, this is a period of growth in the economic life of our nation. Bank customers have greatly increased the scale of their business activities. Their own capitalizations have expanded tremendously. How can banks expect to serve customers satisfactorily if they do not likewise augment their capital accounts?

Poorly capitalized banks are often precluded by law from providing their larger customers with all the financing they require. For example, banking statutes typically place limits on the amount that may be lent to a borrower. Usually the limitation is fixed at 10 percent of the capital accounts. This is a very sound limitation on banking operations and experience has repeatedly demonstrated its effectiveness in reducing losses. But if the capitalizations of banks do not grow along with the banking requirements of their customers, the results can be easily foretold--competitors with the necessary financial capacity, and not necessarily banking institutions, will fill the void to the disadvantage of the banks. The public needs will be served in one way or another.

Secondly, you will note that I have been describing capital developments thus far in terms of averages. Now averages are useful measures for many purposes, but often they conceal more than they reveal. Thus, the fact that capital ratios on the average have been improving within recent years tells nothing about any individual bank. A great many banks are definitely in need of stronger capital margins.

Averages for all insured commercial banks also obscure important geographic differences. There are communities and regions that for one reason or another--usually rapidity of growth--suffer from inadequate capitalizations as measured by any acceptable standard.

The goal of adequate capitalization will be achieved only when each bank has a satisfactory capital margin. While that goal cannot be phrased in quantitative terms for banks in the aggregate, it can be determined for each individual case. In making such a determination it is necessary to consider several relevant factors. Of these, the most important are: the ability of the management; the quality and diversification of assets; the deposit trend; earning power, and the general economic condition of the area served by the bank.

The third, and perhaps the most important reason why none of us can afford to neglect the bank capital problem is that the very data which reveal improvement in capital margins also could set the stage for serious trouble. This is because the evidence of some improvement may give rise to complacency among bankers and bank supervisors. Yet we know that the task is not finished and that the capital problem has never retained for long the same characteristics or dimensions.

Banking history has taught us repeatedly that whenever the capital problem appears on the way to being solved a new and unexpected series of events will generate enlarged demands for capital. In a dynamic economy such as ours, spurts of economic growth may touch off rapid declines in capital margins even though the quality of assets is good and times are prosperous.

By contrast, in times of declining activity or arrested growth the quality of assets may weaken without actually causing a shrinkage of capital--though the potentialities of loss may be present. Thus, in quite different circumstances the reporting of adequate capitalization may be deceptive.

Complacency with respect to the capital problem has yet another aspect. It has become the habit in some quarters to regard the growing size of the deposit insurance fund of the Corporation as an indication that the pressure for additional capital in individual banks is thereby lessened. I should not have to remind this audience that although the deposit insurance fund is increasing in dollar amount, in relation to deposits in the banking system it is growing very slowly. As a matter of fact, the fund now stands at about the same level relative to deposits as in the first year of deposit insurance. Perhaps even more important, it should be remembered that the deposit insurance fund was never intended to replace bank capital, or to do the job which bank capital must do. The fund was viewed as a second line of defense, whereas bank capitalization together with good management was viewed as the necessary first line of defense.

In a sense, the deposit insurance fund stands as a kind of mobile capital, to be used for stamping out banking troubles singly, as they arise, thereby preventing the development of multiple banking disorders reaching catastrophic proportions. The capital of individual banks, on the other hand, must carry the burden with respect to the strengthening and the growth of the banking system. The deposit insurance fund cannot be effective in the absence of strongly capitalized banks.

As I look at the record of the past decade, the improvement in bank earnings is a testimonial to increased efficiency, measured in physical terms, as well as a reflection of the upward trend in money rates. The gross revenues of banks are increasing quite substantially. At the same time, improvements in operating routines and the mechanization of banking procedures promise important long-run economies in operating expenses.

For almost the first time in this generation, investors have come to recognize the attractiveness of bank shares and particularly the prospects for growth inherent in banking. This stems partly from the fact that banks have plowed back very substantial amounts of earnings in their capital accounts. At the same time, however, there have been increases in dividend payments to shareholders. Accordingly, bank shares are now more attractive than heretofore for income purposes and offer the opportunity to participate in an enterprise that may be expected to share in the general growth trend of our economy.

To summarize these remarks: We have a healthy and growing economy today. The picture of bank earnings is favorable. Furthermore, the distribution of assets in banks quality-wise is following a pattern typical for normal peacetime, and the opportunity to obtain investment funds as a source of bank capital seems promising. The banking community and bank supervisors are urged to unite in a renewed effort to build up capital accounts in all banks to margins generally accepted as reasonably adequate. So long as a single insured bank has a capital margin that falls short of needs, we should not be satisfied. Reasonable progress is definitely attainable. There is a rare opportunity now and it should not be ignored.

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Pleasure to be here and to enjoy the renowned hospitality of Iowa, etc, etc