Remarks of J. L. Robertson, Member of the

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"BANK CAPITAL ADEQUACY"

Some of you know, from painful experience, that I am not usually reluctant to plunge into a controversial topic, or above introducing the spark of a seemingly fixed (though actually provisional) idea into a highly-charged atmosphere in the hope that I - and perhaps others - will be educated in the course of the resultant explosion. However, even I am not prepared to jump feet first into the quicksand of capital adequacy; more capable men than I have attempted that and have sunk from sight without a trace. Instead, what I hope to do is to present some questions that we can explore together.

The force of tradition is exceptionally strong among bankers, and any man who has spent his business career in this field has been exposed throughout that time to innumerable discussions about the relative merits and demerits of capital/deposit ratios, capital/risk-asset ratios, and the like, especially in recent years. This is because of the facts that since 1939 (1) total deposits of commercial banks have tripled ($58 billion to $172 billion) while capital accounts have only doubled (from $7 billion to $14 billion); and (2) the ratio of capital funds to risk assets has fallen from 28% to 17%.

In this matter, as in so many others, men strive for an elusive and sometimes impossible precision - a will-o'-the-wisp of certainty, expressed in a mathematical formula, that is "correct" and easy to apply. Let us agree, before going any further, that we are not going to find any such delightful solution to our question. If complex banking problems, such as adequacy of capital, were susceptible of solution by formula, the banking system could save a great deal of money by firing its expensive top management and hiring a few competent statisticians in their places.

Formulas and ratios do have a useful function - they serve as economical and valuable shortcuts in screening out those cases which the supervisor should look at thrice instead of twice. But they do not and cannot give us a pat answer as to how much capital is "adequate". They merely show us which cases call for an extra dose of judgment; a careful analysis of <u>assets</u>, especially with respect to quality and degree of risk, and of <u>liabilities</u>, with emphasis on their nature, trends, and volatility; and a thorough review of the past performance of management (since every banker thinks his bank has the best possible management, this is about the only feasible approach, and even it isn't much good if the record covers only the last decade or so, when losses were hard to "make"). This judgment must be based also on careful thinking about the soundness of present lending and investing policies, the potentialities of growth for both the bank and its community, the profitability of operations, the dividend policy, the amount invested in fixed assets, and the adequacy of internal audits and controls.

But to my mind, the really crucial question is not the mechanics of measuring capital adequacy. It is an underlying problem that is sometimes overlooked or taken for granted. Before we can make any progress in determining whether a bank's capital structure is adequate, we must first know the answer to: Adequate for what? We may flounder indefinitely if we ask only whether a bank has "enough" capital; the real question is: Enough for what purpose?

From the point of view of one who is interested in the welfare and vigor of the banking system as a vital part of our economy, bank capital performs two functions. Most obviously it serves to protect the current funds of its customers - its depositors, whose funds serve as the principal medium of exchange in this country. But perhaps no less important is the fact that adequate capital is necessary if a bank is to perform effectively the key function of providing adequate credit for the needs of its community. Banks can meet the need for loans most effectively, without involving risk to depositors, if they have adequate capital to cover any reasonable risk. When such protection is lacking, banks tend to become unduly cautious or timid in extending credit when it is most needed to keep the wheels of our free enterprise economy turning. For banks to meet the challenge of a growing demand for credit - as our economy grows - bank capital must be increased to support an expansion of risk assets.

The extremes of possible capitalization also are obvious, but unrealistic and impracticable. Of course, deposits would be absolutely safe and the bank would never close its doors on account of insolvency if the capital cushion were equal to the total risk exposure in the bank's assets. However, a bank with that much capital simply could not pay its way; even the most public-spirited shareholders eventually would liquidate the institution and invest their capital in an enterprise where it would yield a more satisfactory return.

At the other extreme, from the immediate dollars-and-cents point of view of the bank's owners, the ideal situation would be an extremely thin layer of capital, which might earn 20% or 30% a year. Put that way, the proposal seems absurd, but I have encountered a few bankers who have come close to espousing that position, although they would not have put it so crudely. Let me outline a representative example, which is a composite of several actual cases.

Between 1940 and 1952 the deposits of Bank X increased from $100 million to $300 million. During the same period, the capital structure grew from $9 million to $15 million. The bank had this distribution of assets: some $90 million of loans, $30 million of municipal and corporate securities, and $100 million of Governments. The Comptroller of the Currency (I was there then) had suggested the sale of additional stock, and the bank's president was explaining why he was dragging his feet.

He told me candidly that he and several other large shareholders could take up their proportion of an additional bank stock issue only by selling other lucrative securities. He pointed out that if the bank's capitalization were increased from $15 million to $20 million, there would be a relatively small increase in earnings and the dividend rate probably would have to be reduced from eight dollars to six. In a word, his own annual income from securities would drop substantially, and he did not like that.

He said: "You know we'd want to do it if it were really necessary. My father founded the bank, and most of the stock has been in the same families for more than forty years. The bank is almost sacred to most of us, and I, for one, would gladly give up my personal fortune rather than have the bank lose prestige or have any depositor lose a dollar." And I know he really meant it.

"But", he continued, "the bank has plenty of capital cushion right now, and I don't relish reducing my family's standard of living just because of an old banking shibboleth about a 1-to-10 ratio or something like that. Here's a schedule", he said, "of our loans and investments, and if you can honestly show me five million of probable losses, I'll get behind any capital increase program you want."

Those words may sound familiar to you; you may have said something like that at some time or another, or heard it from someone on the other side of your desk. There is nothing ridiculous about his argument. In an economy that has grown great under the stimulus of private initiative and profit motive, there is no justification for insisting on an increase of bank capital merely for the sake of a fatter figure near the lower right corner of the balance sheet, or to fit some arbitrary mathematical formula. We have no right to demand more capital unless there is a real need for it.

I went over that list with my friend. I was not able to show him $5 million of prospective losses. What I did try to do was to stress that we were running along in a boom period of unprecedented duration and magnitude; that loans never look bad when they are made, particularly in such an economic climate; that the very best bonds with twenty years to run can drop from par to 86 if current interest rates rise from three per cent to four; and that he would not always be around to insist upon "quality" and proper supervision of loans and investments. I called on precedents, including the portfolios of banks apparently in a similar situation in 1928 and in the hands of a receiver in 1933.

I need not burden you with the rest of our conversation. The man on the other side properly brought out that the banking situation had changed fundamentally in the past twenty years. He hadn't thought that point through completely, but certainly it behooves all of us to bear in mind that there are many factors in the picture today which may tend to avert bank liquidity crises, and thereby eliminate the strain on bank capital which at times in the past has resulted from emergency liquidation to satisfy panic withdrawal of deposits. For example: (1) broader lending authority of the Federal Reserve, (2) deposit insurance, (3) government guarantees of various classes of assets, (4) better supervisory policies, and (5) governmental policies and actions contributing to economic stability, such as crop support programs, disaster aid, old age and unemployment insurance, fiscal, debt management and monetary policies, etc. But let's remember, too, that these factors, while beneficial to the banking system and helpful to individual banks, do not assure the solvency of any particular bank. Individual institutions must have capital strength and liquidity to meet prudent business tests.

Well, anyway, it would be pleasant - but false - to tell you that the several bankers who enter into my composite story were overwhelmed by the cogent logic of my arguments and joyfully boosted their capital to a lush figure. For the most part, they reluctantly went ahead with a capital-increase program, sometimes for substantially less than the supervisor recommended - but almost always, I am glad to say, with subsequent gratification that they had taken the step, and sometimes with remorse that they had not gone the whole way.

But I am not prepared to brand bankers who cannot see their way clear to increasing their capital as selfish and shortsighted men. Ours is still a dynamic economy. That has been said so frequently that it has almost ceased to mean anything to us, but it remains true. Our economic situation <u>is</u> very different from that of the 20's, as that was very different from the 1890's. Perhaps our "built-in stabilizers" <u>will</u> so greatly moderate future downturns that a relatively thin capital cushion will prove to be "adequate" for our lifetime.

However, it seems to me that we must make haste slowly in this matter. Commercial banks perform such vital functions in our economy, and any interruption of those functions is so profoundly injurious, that we are justified in leaning in the direction of conservatism in reaching a decision that may determine whether American banking will stand firm in economic crises or will collapse.

As many of you know, the last few years have seen several serious efforts at analysis of bank capital adequacy. Some of these have been broad and sweeping, dealing with principles developed from decades of banking or bank supervisory experience. Others have been factual, even statistical - based on what actually has happened to the several classes of bank assets in periods of stress, and deriving therefrom some approximation of the "risk element" in the various classes of assets. We certainly do not have the answer, as yet, but we do have a solid foundation of fact, figure, opinion, and tentative methodology. Our job now is to analyze, criticize, and refine this material; to correct its flaws, to supply its omissions, and to co-ordinate its several phases.

I repeat: We will never develop a formula that determines by arithmetic whether the capital of a bank is adequate. We never will be able to measure mechanically the attitude and competence of a bank's management and staff, and how these may change within a few years. Nor can we forecast with any precision the economic future of a community or area. But we can strive to give suitable weight to each of these factors, judged with experienced intelligence, as well as the nature and quality of loans and securities. Having done that, we must add a generous margin of safety, as do the engineers: like a great arterial bridge, the banking system is too vital - too much depends on it - to take a chance that it might ever again collapse. If we measure and maintain adequate capital by these tests, with integrity, intelligence and courage, we shall have honorably oerformed, in this field, our responsibilities as bankers and bank supervisors.