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**BANK CAPITAL ADEQUACY  
TIME TO PAUSE AND REFLECT**

**Remarks of**

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**At**

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**November 6, 1973**

**BANK CAPITAL ADEQUACY -  
TIME TO PAUSE AND REFLECT**

It is both timely and appropriate to have this Conference focus on the critical issue of bank capital and its adequacy. And I commend you for selecting this topic.

In my judgment, this issue is one of the two or three most important of those our Board has considered while I have been a member and it has and is receiving commensurate attention in our offices.

The usual disclaimer - that I speak for myself and not for the entire Board - is, of course, in order. I am not going to float a 'trial balloon' today. The Board has not chosen to test ideas in this fashion since I have been a Board member. And what follows is no exception.

Nor do I intend to offer pat solutions or simple formulas. I know of none. Experience has shown that the adequacy of a bank's capital is an enormously difficult question and is peculiar to that bank in its particular environment.

The message I wish to leave with you is a simple one. There has been a dramatic drop in the capital ratios of many banks in recent years, accompanied by a sharp rise in return on equity capital. In the aggregate, banks have overtaken the manufacturing sector of our economy as measured by return on equity and therefore should be quite competitive in bidding

for equity capital. Taking the long view, the bank holding company movement is really in its infancy but portends profound change in the structure of the nation's financial institutions. Thus, we should pause and vigorously resist a further decline in bank capital ratios while we reflect carefully on the complex issues involved and make certain that banks remain in a sound capital position.

The Federal Reserve has been continually concerned with bank capital in our examination of State member banks. Additionally, the Bank Holding Company Act specifically requires the Board to consider all relevant financial and managerial factors in reviewing bank holding company applications. While the Bank Holding Company Act is a vehicle for allowing banks to expand into a wide range of activities, most holding company assets are still banking assets. Furthermore, since the passage of the Bank Holding Company Act, there has been a substantial decline in bank capital ratios - a continuation of a trend earlier developed.

While we work with the primary supervisory agencies for particular banks and consider carefully their judgments, the Board of Governors must - in my judgment, given the law - look carefully at the capital position of holding companies and their banks.

Although both bankers and supervisors have devoted considerable resources to developing clear cut answers concerning capital adequacy,

such answers continue to prove elusive because of the complexity of the question.

Please keep two thoughts in mind as I proceed. First, that a continually evolving economy and banking structure will necessitate a constant reevaluation of this subject; and second, that it is entirely reasonable that the viewpoints of the banking industry and supervisors differ on this issue.

It seems useful to state at this point the philosophical basis for the views which follow. To me, banking is a unique industry. The normal financial market forces do not appear to function the same way in banking as in other industries. In most industries, as the debt equity ratio increases, the cost of debt normally increases, reflecting creditor's demands for higher risk premiums. This market discipline does not seem as effective in banking. Accordingly, some other determination must be made as to how highly a bank can leverage. This determination is made by the bank interacting with the regulatory agencies.

Banking is a "protected" industry, both in the sense that entry is limited and that supervisors have means of supporting and aiding "troubled" banks. Indeed, a prominent business weekly stated recently that supervisors are just not going to allow major banks to fail. In my view, it would be a mistake for a banker to operate using the foregoing

as a guideline. Banks can fail. They can fail to earn a profit and stockholders and bondholders can and do lose their invested capital. But banking does not have the same downside risk as most other industries so it follows that bank shareholders should not expect the same upside potential.

The traditional, generally accepted, functions of bank capital are first, that banks need capital to meet legal requirements -- as the price of entry and physical establishment. Secondly, capital enables the bank to absorb unforeseen losses or reductions in asset values in excess of earnings in order to continue as an ongoing concern in the short run until earnings recover. Third, and closely related to the second, capital serves to protect depositors in the event of bank liquidation.

Conceptually, I think most would agree that losses resulting from normal banking risks ought not to be borne by the depositor, or for that matter, the FDIC; losses should be absorbed by the stockholder who stands to gain if profits are produced as a result of those risks. The difficulty arises when attempts are made to quantify those business risks in order to determine an adequate level of capital to meet them. Some of the techniques ordinarily employed in such an exercise include analysis of: (1) bank failures during the 30's, (2) individual problem banks and/or recent bank failures, and (3) actual losses experienced in recent years.

While all of these are interesting inquiries from which useful insights can be gleaned, there are serious deficiencies in each of these approaches that preclude arriving at sound judgments applicable to banking in the 1970's era.

#### **THE 1930's EXPERIENCE**

Analysis of bank failures in the 30's involves examining problems in the context of a much different economic climate than exists today, both in terms of public policy and economic conditions. Failure to recognize these differences could lead to restrictive policies that might lack realism today. Therefore, we need to determine what capital requirements are necessary in order to survive the kinds of economic shocks that can arise in our present economic environment.

#### **RECENT BANK FAILURES**

Similarly, there are pitfalls in placing too much emphasis on institutions that have recently failed or have encountered serious problems. Considering the number of banks that are operating relatively free from major difficulties, the number of institutions that have experienced problems of such proportions that their very existence has been threatened are relatively few. Also, in most cases, the serious difficulties in recent years can be traced either to outright fraud or seriously deficient management.

For example, in a study of 493 banks which closed between the beginning of FDIC operation in 1934 and early 1972, none failed because of inadequate capital. Of the 54 banks in this group which have closed since 1960, 13 failures were caused by defalcation, and the remainder closed because of bank management decisions involving the misuse of brokered funds, self-serving loans to bank management, or fraud and bad loans to borrowers outside the bank's normal territory.<sup>1/</sup>

Nor have statistical studies of the relationship between bank failures and capital ratios been revealing. A typical study of the relationship found, in an analysis of over 8,000 banks failing from about 1920-31, that, in fact, the non-failing group had lower capital ratios than those which failed.<sup>2/</sup> Thus, while valuable lessons can be learned by studying the experience of these banks, these lessons do not teach that much about what level of capital a bank with capable management and reasonable lending and liquidity policies ought to maintain.

But I am not convinced by this evidence that there is no relationship between the level of capital and the ability to survive.

#### EVALUATING BANK MANAGEMENT

A third technique is to evaluate the quality of bank management. However, relying heavily or solely on such an evaluation is both quite

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<sup>1/</sup> Robert E. Barnett, "Anatomy of Bank Failure", The Magazine of Bank Administration, Vol. 48, No. 4, April 1972.

<sup>2/</sup> Horace Secrist, National Bank Failures and Non-Failures, Bloomington, Indiana, The Principles Press, 1938.

difficult and dangerous. I know of no more difficult task than judging management competence or attempting to predict the performance of a manager or management team. The effect of today's managements' stewardship can only be determined at some later time, not by an examination of recent results. And past management successes are no guarantee of future performance in a different environment.

**RELYING ON  
PROFIT PERFORMANCE**

The fourth technique that is receiving considerable attention and, apparently, a certain amount of acceptance by the banking industry, particularly during recent months, is the use of actual profit or loss records over recent years as a basis for determining "adequate" capital levels. This seems a rational approach; however, the resulting measure of capital is likely to be less than the currently existing capital level in the banking system. Indeed, loan losses charged off during 1971 - when the industry experienced its highest loss rate since 1939 - amounted to only 2-1/2 per cent of the capital of the industry or equal to approximately 23 per cent of 1971 income before securities transactions. Thus, current earnings were sufficient to absorb losses. If one looks to the large banks that suffered the greatest losses in this period, the largest proportionate loss amounted to 65 per cent of total earnings.

Considering these figures one might conclude that banks actually need far less capital than they now have. But I believe that this would be an erroneous conclusion. We have no assurance that the future will not require a greater margin of safety. Furthermore, this technique addresses only the demands placed on bank capital on an 'institution by institution' basis. It fails to consider the stress placed on the banking system as a whole if many institutions are in trouble at the same time. I am not convinced that we know enough about the economy and about the stresses of a rapidly changing international financial structure, to be certain that public policy alone can preclude periods of substantial economic stress. And I feel that bankers should not rely solely on government policy to bring them through such periods.

There are several factors that support my contention that banks should not permit their capital positions to decline further. U.S. banks have been moving into the international sphere in a major way during the past decade. Assets held by foreign branches of U.S. banks have increased phenomenally from less than \$5 billion in 1962 to over \$80 billion in 1973. While loss experience as a result of this business has thus far been low, a meaningful track record has not yet been established. In addition, there are rumblings coming from within the banking industry itself concerning the loss potential of some of this low margin business which

carries not only a credit risk but also a political risk. For example, banks are now providing a much larger share of the total capital flows to less developed countries than they did ten years ago.

This development has great promise; but, there are also some disquieting aspects of this expanded business. Losses might result from a major war or government confiscation of property in an area where U.S. banks are heavily involved. While geographic diversification can be stabilizing by protecting a bank from localized economic disturbances it can exacerbate a bank's problems if many of the areas in which it has investments are in an economic downswing at the same time.

The second development which gives rise to some concern is the liquidity position of U.S. banks, particularly the large money center banks and, to an increasing degree, some regional banks. The most striking change has occurred in the proportion of funds obtained from demand deposits and savings accounts of individuals, partnerships and corporations. As Table 1 indicates these deposits are now about 43 per cent of sources of bank funds compared to 62 per cent in 1965. On the other hand, other time deposits (mostly purchased money CD's) and borrowings (mostly overnight Federal fund purchases) now comprise 33 per cent of total fund sources, up from 13 per cent in 1965. Coupled

with this increasing use of money market sources of funds has been a general lengthening of the maturities of bank assets and a substantial rejection of traditional asset liquidity concepts. Some of this results from the new emphasis on liability management as opposed to asset management.

This has placed an increasing number of banks in a position where they are almost wholly dependent on their continued ability to access the money markets in ever larger amounts to meet their present and future commitments. I cannot help but believe that banks are in a much more vulnerable position because of this development. Clearly, lenders in the money market are more sophisticated than the average bank depositor, and while they seem to be exerting little constraining influence over the expansion of bank liabilities -- perhaps because so few people understand bank accounting -- it is not clear how these lenders would react to a series of financial shocks. Consider the holders of commercial paper when the Penn Central crisis occurred.

The risk is that an individual bank that encounters difficulty might overnight find itself unwelcome in the market place. The process is apt to be much more rapid in the market than would be the case with smaller depositors. This prospect argues for considerable caution. A generous cushion of equity capital would give the bank added flexibility when setbacks occur and would likely enhance its position with knowledgeable lenders.

I do not think it can be effectively argued that the market itself can be relied upon to police the rate of bank asset expansion financed through leveraging. As indicated earlier, the banking industry is different from other industries in this respect.<sup>3/</sup> For non-financial institutions, free market forces discipline leveraging in the following way. As a corporation finances an expansion of earning assets from borrowed funds, the return on a given level of equity will initially increase. As the level of debt rises, however, the cost of this debt will rise since creditors will require added compensation for bearing more risk. Additional leveraging will eventually cease when the increased cost of the debt has risen enough to cancel the added return on equity from the leveraging. On the other side, the added return from the leveraging will theoretically raise the P/E ratio. But here also, eventually the rising debt level will lower the ratio as the stockholders require added compensation for bearing the increasing risk associated with the leveraging.

Banks tend to be insulated from this free market regulating force in large part because of dependence of the market on the supervisory function. As a result, leverage could be extended to extremely high levels.

Given the strong incentive for banks to pursue the apparently profitable avenue of expanding assets through leveraging, a weaker

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<sup>3/</sup> S. D. Magen, Cost of Funds to Commercial Banks, New York, Dunellen, 1971.

market discipline of the banking industry could allow a self-justifying competitive downward spiral in equity ratios. The question is, then, is this in everyone's best interest -- including those of the banks themselves?

Taking a different approach, it is not clear that the movement toward added leveraging is not in some sense a self-defeating process. As Table 2 indicates the ratio of equity capital plus reserves to total liabilities less cash and due from banks has declined dramatically for banks with deposits of over \$5 billion - from 13.0 per cent in 1932 to 8.1 per cent in 1972. This increased leveraging has been accompanied by a higher return on equity -- 8.4 per cent versus 11.4 per cent. I might speculate, however, on the possibility that the initial benefits from this added leveraging might evaporate. Perhaps evidencing this, is the decline in bank earnings as a per cent of total assets that has occurred in recent years.

This decline in profit margins may be attributable in part to increased competition which has resulted in a narrower spread between the cost of funds and the return on those funds for sometimes riskier loans. This seems to suggest that the initial benefits derived from increased leveraging by a few banks which have taken the lead will be somewhat eroded by competition, if the entire industry follows that lead.

To regain the initial advantage, the leaders would then have to lower the level of capital again to obtain a further short-term profit advantage. If this is in fact what is happening, it is not apparent where the reduction of capital levels would stop. But at some point in this process the stability of the banking system would be endangered. So, we return to the historical question of the trade-off between stability and profitability.

Since the market cannot be relied upon to determine the optimum point between profitability and stability, the task devolves to the authorities. Understandably, central bankers would no doubt be inclined to be conservative. While I would prefer not to put U.S. banks at a competitive disadvantage vis-a-vis other business concerns in their relative ability to attract capital, this danger doesn't appear to be a problem at present. A comparison of return on equity for commercial banks with the return on equity for all manufacturing companies shows that currently the return for banks is quite competitive with manufacturing companies. As the attached graph indicates returns on equity for manufacturing companies fell from 13.4 per cent to 9.7 per cent from 1966 to 1971 while in banking it was rising from 8.7 per cent to 11.7 per cent. Furthermore, since bank earnings tend to be more stable than manufacturing, do banks have to reach the peaks that earnings in manufacturing sometimes do to attract capital on favorable terms?

In summary, there is little doubt that the our whole financial structure is changing. Banking is entering a new era. Considering how little any of us can project about the long run ramifications of these changes, I suggest that it is an appropriate time for all of us to pause, reflect, and carefully evaluate before allowing capital ratios to continue their decline.

We should not forget the unique position of banks in our society and how important confidence in our banking system is. The damage that would be inflicted on our economic system and our whole social order by a loss of this confidence as a result of a period of substantial instability in banking is incalculable.

In closing, I should like to emphasize again the special responsibility to the public that you as bankers, and we as regulators share. Banking is a special and unique industry. As the center of our financial system, it is at the heart of our economy. We have been fortunate in having a relatively stable financial system in a growing economy over the last few decades. You as bankers have a right to be proud of that achievement. In an era in which business is being urged to accept greater social responsibilities, recent successes should not allow us to become complacent or to forget that bankers have a responsibility going far beyond that of the ordinary business concern. Bankers have a responsibility not only to their shareholders but also to the economy and the nation as a whole.

TABLE I

## SOURCES OF FUNDS FOR LARGE COMMERCIAL BANKS

	July 7, 1965	July 4, 1973	July 7, 1965 <u>% of funds</u>	July 4, 1973 <u>% of funds</u>
<b>Demand:</b>				
IPC	74063	113967	37.2	28.1
States & Political Subdivisions	5391	7645	2.7	1.9
U.S. Government	7453	5079	3.7	1.3
Domestic Commercial Banks	12770	22448	6.4	5.5
Foreign Governments & Banks	2088	4363	1.0	1.1
Other	4832	8000	2.4	2.0
<b>Total Demand</b>	<u>106597</u>	<u>161502</u>		
<b>Time:</b>				
Savings	48313	158376	24.3	14.4
Other Time	20821	87530	10.5	21.5
States & Political Subdivisions	6379	21173	3.2	5.2
Domestic Interbank	554	4304	.3	1.1
Foreign Governments & Banks	4210	8044	2.1	1.9
Other	188	706	.1	.2
<b>Total Time</b>	<u>80465</u>	<u>180133</u>		
Borrowings from FR Banks	380	2423	.2	.6
Borrowings from Others	4259	44939	2.1	11.1
Other liabilities	7161	17094	3.6	4.2
<b>Total Non Capital Sources of Funds</b>	<u>198862</u>	<u>406091</u>	<u>100%</u>	<u>100%</u>
<b>Memorandum: Large CD's included in time</b>	<u>15587</u>	<u>59773</u>	7.8	14.7

Source: Federal Reserve Bulletin  
August 1966  
August 1973

TABLE II

Average Bank Capital Ratios and Rates of Return at Insured Commercial Banks with Total Deposits Over \$100 Million by Size of Bank for Selected Years 1962-1972<sup>1/</sup>

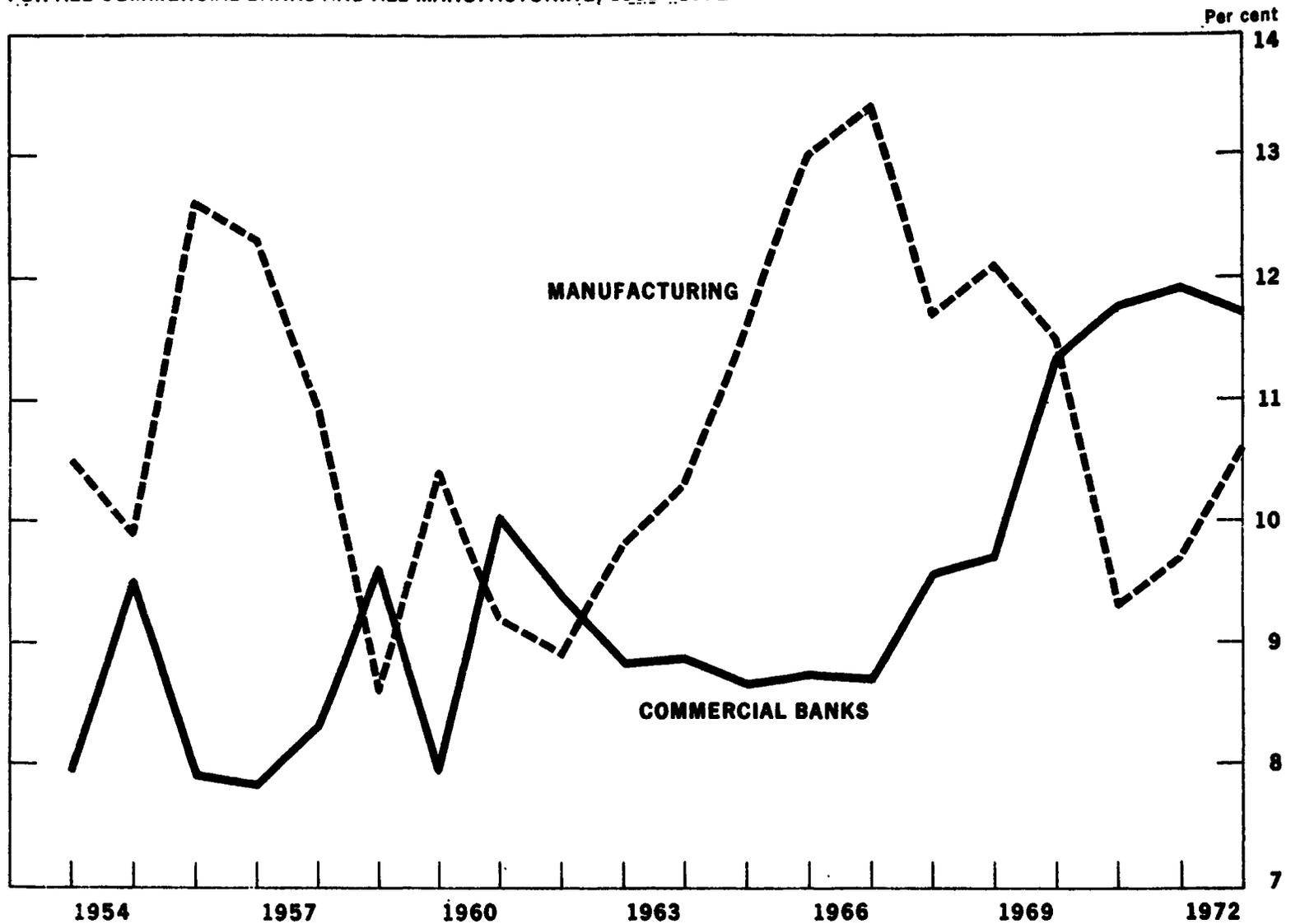
Bank Deposits (\$ millions)	Capital Ratios	<u>1972</u>		Capital Ratios	<u>1971</u>		Capital Ratios	<u>1965</u>		Capital Ratios	<u>1962</u>	
		<u>Earnings to Equity Capital</u>	<u>Total Assets</u>		<u>Earnings to Equity Capital</u>	<u>Total Assets</u>		<u>Earnings to Equity Capital</u>	<u>Total Assets</u>		<u>Earnings to Equity Capital</u>	<u>Total Assets</u>
Over 5,000	8.1	11.4	.52	8.8	11.3	.57	11.3	8.5	.58	13.0	8.4	.67
1,000 - 5,000	8.8	10.5	.62	9.5	12.3	.70	11.1	9.6	.65	11.9	8.3	.60
500 - 1,000	9.5	10.5	.80	10.3	12.7	.85	11.6	8.5	.70	12.4	7.9	.61
300 - 500	9.2	12.2	.74	10.1	12.9	.83	11.1	9.2	.63	11.6	8.7	.62
100 - 300	9.6	12.3	.77	10.3	12.6	.84	11.2	8.6	.62	11.4	8.3	.60

<sup>1/</sup> Capital ratio refers to equity capital plus reserves/total liabilities minus cash and due from banks.  
Earnings refers to net income before dividends. Income data prior to 1969 not strictly comparable to later data.

Source of data: December Reports of Condition and Annual Reports of Income and Dividends for Insured Commercial Banks.

## AVERAGE ANNUAL RATES OF RETURN

FOR ALL COMMERCIAL BANKS AND ALL MANUFACTURING, 1953-1972 <sup>1/</sup>



<sup>1/</sup> Rates of return refer to net income/equity capital.

Source: Data on bank earnings are from various issues of Annual Report of the Federal Deposit Insurance Corporation. Manufacturing data are from The Economic Report of the President, 1973.