

FOR RELEASE ON DELIVERY
FRIDAY, FEBRUARY 28, 1975
9:00 A.M. EDT

SOME THOUGHTS ON CAPITAL ADEQUACY

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at a

Management Seminar

on the subject

"Banking in the Years Ahead--Challenges and Issues"

in

Washington, D.C.

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The "pause" on bank holding company expansion instituted by the Federal Reserve Board in June, 1974, indicated the Board's concern about the present level of capitalization of many of our largest banks, in addition to its concern over the heavy use of purchased funds. Since that date the markets have not been propitious for issuance of either bank equity or subordinated debt, and the principal effect of the "pause" has been to slow down bank expansion. Now, however, the markets are entering into a different phase that may make financing more feasible. At the same time, loan demand has softened materially. In this new constellation of circumstances therefore the problem of bank capital takes on a new look. Capital adequacy now can be viewed mainly in terms of achieving it through appropriate internal and external financing.

The behavior of the stock and bond markets suggests that many banks may find opportunities to issue subordinated debt capital earlier than new equity. This puts debt capital in the foreground of any discussion of bank capital adequacy. As you all know, the Comptroller since 1962 has accepted subordinated debt capital equal to 50 per cent of equity capital plus reserves. The Federal Reserve Board has not so far pronounced itself on the matter. The comments I am about to make are therefore entirely my own, and it would not be appropriate for me to go too deeply into specifics. But I think it may be helpful to you if I lay out some of the broad aspects of the bank capital problem and the place of debt capital within it.

Debt capital has the advantage of being cheaper than equity capital because of the tax deductibility of the interest paid. Debt capital has an added cost advantage when the interest rate is below the amount that must be earned on the equity. In times of inflation, debt capital has still a further advantage in that it reduces the net creditor position of a bank. As you know, net creditors, other things equal, tend to lose from inflation, while net debtors tend to gain. If the accounts of the banking system were restated in terms of the price level accounting technique, as recommended by the Financial Accounting Standards Board, this condition as it affects banks would become more clearly apparent.

Debt capital, however, has significant drawbacks from the point of view of the over-all safety of the banking system. Thanks to its subordination to deposits it does protect the depositor. But unlike equity capital, it provides no cushion for the absorption of losses. Thus, it leaves unprotected several other parties that have a legitimate interest in the safety of the banking system -- the

borrower who needs a reliable source of credit, the insurer, the central bank as a potential lender of last resort, and, broadly speaking, the entire community which has an interest in a sound banking and monetary system that goes beyond its interest in the solvency of business generally.

Clearly, to rely on subordinated debt in lieu of equity may be appropriate for different banks in different degree. Factors like the equity ratios of the bank, its policies with respect to purchased funds, its ability to displace debt capital with equity from retention over time, the maturity of the debt, the bank's prospective ability to deal with the problem of repayments, and the nature of the covenants associated with the debt all are obviously relevant.

If debt capital is to be limited to some fraction of equity capital, then the appropriate level of total capitalization, debt plus equity, needs to be examined. There are no good answers to this obviously important question. Statisticians have failed to unearth a good relationship between bank capital and bank failure. Apparently, in cases where banks have failed, it has been predominantly for reasons other than inadequate capital. Nor do insurance-type calculations, based on past loss experience and some high multiple coverage of that experience, suggest to me any reliable guide. The nature of banking risks unfortunately is not actuarial. It resembles, rather, the risks inherent in a common stock, which analysts have divided into the "own risk" of the stock and its "systematic" or market risk. The use of the Beta factor familiar to stock market analysts rests on this

distinction. The "own risk" can be met by diversification. The market risk is something the holder must bear.

Applying this reasoning to banks, one concludes that the "own risk" is that of particular misfortunes or errors of judgment that may hurt a bank and that quite likely could be guarded against on the basis of actuarial principles. But the "market risk" which relates to the prosperity, or lack of it, of the entire economy is something that is essentially unpredictable on the basis of past experience. A broader judgment is required.

Today, we do not need to make such a judgment in precise quantitative terms. Unless bank capital in the past was grossly excessive, it is clear that today the degree of protection of many banks provided by capital is less than adequate. Capital ratios of banks have declined. For instance, the ratio of equity (including reserves) to risk assets declined from 11.2 per cent to 8.4 per cent during the period 1969 through 1973, the ratio of equity to total assets declined from 7.8 per cent to 6.3 per cent, and the ratio of equity to total liabilities including capital notes and debentures less cash and due from banks declined from 10.3 per cent to 8.5 per cent. It would be difficult to argue that while this was going on, the degree of risk in the banking business has tended to move anywhere but up. More protection, therefore, is needed for many banks, although circumstances differ widely among banks. This protection could take the form of more capital, but it also could, and in fact to a moderate extent already has taken, the form of fuller deposit insurance.

It has sometimes been said that the need for more bank capital is the result of inflation, and that at high rates of inflation it is simply not possible for banks to generate enough capital from earnings. The first of these statements deserves to be questioned, although the second would have a relevant core of truth if inflation were to continue at a high level, which I do not expect. Over the years 1969-73, demand deposits increased at an average annual rate of 6.1 per cent, demand plus time deposits (excluding large CD's) increased by 8.4 per cent. A bank earning something better than 10 per cent on its equity, as was the case in recent years for many banks, and retaining something like three-fourths of these earnings, would have been able to match that rate of deposit growth with equity growth from internal accumulation.

What caused bank assets, for the system as a whole, to rise at an annual rate of roughly 13 per cent during 1969-73, thus far outstripping any possible growth of equity from normal retentions, was the use of purchased funds which enabled the banking system to increase its share in the total supply of credit. I am not arguing, of course, that banks ought to be able to finance their capital requirements entirely from internal sources. But since estimates made by various analysts of the amounts of new bank capital to be raised in the market sometimes reach remarkable levels, I wanted to point out that apart from the effect of purchased funds, a large part of capital needs could have been covered from retentions. On the other hand, if the banking industry finds it desirable, from a profit maximizing point of view, to increase its share of the total credit business,

it seems not unreasonable to expect that banks back up this bigger share by externally raising appropriate amounts of capital.

The concern that is sometimes expressed that large-scale equity or debt financing by the banking system would unduly further increase the already very heavy prospective burden upon our capital markets is, in my view, greatly overstated. This applies in particular to debt financing -- the amount of equity that can be absorbed by the market is of course more limited than the amount of debt. An increase in bank debt, through the flotation of a subordinated bond or note, unlike debt issued by a nonfinancial borrower, produces no net drain of funds from the market. When the banking system issues such securities, it is paid, in effect, with checks on itself -- deposits go down, long-term subordinated debt goes up. The decline in deposits produces excess reserves, and if the central bank pursues a stable money supply policy, these excess reserves will be used by the bank to acquire additional assets. The increase in the demand for funds, in the form of a bank debt issue, is matched by an increase in the supply of funds, in the form of additional bank credit. The simultaneous increase in demand and supply will not, of course, occur in exactly the same sector of the credit markets.

The observation that an increase in bank capital does not absorb credit and therefore the nation's savings in the same manner as financing by nonbank businesses is reassuring. It implies that the capital needs of the banking system can be met without a drain on

the economy's scarce capital resources. Borrowing to build a plant, or a home, preempts resources from other uses. It has a social cost. Bank capital financing, in that sense, has no such social cost. Bank capital in effect is "created" like money, by the banking system.

This does not mean, however, that bank financing is costless to the private parties involved. Bank equity, and bank debt, must earn a competitive rate of return. The cost of earning this rate of return is borne by the users of bank services, primarily borrowers and depositors. The need to protect the user of bank services against bank failure thus increases the cost of the services to the users. The share of bank credit in total credit, the share of banks' time and savings deposits in total assets, and the share of bank-related payments in total payments is less than it would otherwise be.

There is an obvious inefficiency in allowing these costs and their allocative consequences to occur when, as I have noted, there is no equivalent social cost involved in the protection of the banking system through bank equity and debt. This is reflected in the familiar difference between the cost of self-insurance and pooled insurance, i.e., insurance sold by an insurance company that pools risks. Bank capital is essentially self-insurance; insurance provided by the FDIC is pooled insurance. Viewed as an insurance fund, the aggregate of all bank capital necessarily must be many times greater than the insurance fund of the FDIC, if the same degree of protection is to be provided by either route. Without meaning to comment on the relative adequacies of the two funds, I would note that the capital of the banking system exceeds the FDIC fund by more than a factor of 10.

I am sure you will not expect me to move, from this fundamental analysis, to the conclusion that we can do without bank capital because it would be cheaper to achieve one of the principal functions of bank capital by substituting deposit insurance. Full insurance of deposits would create new problems that have been discussed at the academic level for many years. I have always been skeptical of these academic proposals, because virtually riskless banking could encourage a kind of performance banking that might be very destabilizing for the economy. The technical problems involved, such as charging each bank an insurance premium proportionate to the risks assumed, and of monitoring these risks, are considerable. An attempt to institute an examination system equal to the demands of that kind of insurance system might imply less rather than more freedom and flexibility in bank operations.

What does emerge from the analysis is that there exists a trade-off of sorts between bank capital and deposit insurance. Congress has just made a moderate move along this trade-off curve, by raising the insured level of deposits from \$20,000 to \$40,000. This has raised the insured portion of total deposits in insured banks by 5 percentage points, from 61 per cent to 66 per cent. Further increases, to \$50,000, and even \$100,000, would raise the insured proportion only to 69 per cent and 72 per cent. In the course of time, this might become a useful direction in which to move. Obviously,

over time, such a policy might also call for a new look at the level and structure of FDIC insurance premiums. The possibility of substituting insurance for capital suggests that a good objective today might be to raise enough capital simply to halt further erosion of equity ratios on average. Of course, this might nevertheless mean increases for particular banks.

Lest someone should say that to protect banks via the capital route rather than the insurance route is doing it the expensive way, I would like to point out that this cost today is proportionately less than it has been in former years. So long as demand deposits were the chief source of funds for the banking system and so long as interest rates on time and savings deposits were low relative to long-term rates, the secondary function of bank capital as a source of funds was not important compared to its primary function of providing protection. Today, when time deposits have become the principal source of funds at often very high rates, this secondary function of bank capital has gained in importance. The net cost of protection is only the excess of the cost of equity or debt capital, as the case may be, over what it would cost a bank to raise the same funds by some other route. This should encourage banks whose capital ratios have been declining to undertake the job of stabilizing and where necessary increasing them.