Remarks by

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I am very pleased to be here once again to address members of the American Bankers Association. Today, I want to use the opportunity to discuss an issue that is central to banks and that consumes considerable discussion at the Federal Reserve. The topic is a timeless one because it is so fundamental—the need for adequate bank capital. I devoted some attention to risk-based capital during my remarks to your convention last year in Honolulu.

Today I do not wish to debate the details of which specific ratios or standards are most appropriate to assess capital adequacy. Rather, I want to address the broader policy issues raised by some institutions that the capital requirements we have imposed will undermine the ability of U.S. banking organizations to compete. I recognize that many institutions here today have made laudable progress to improve their capital ratios and that most of the nation's 13,000 commercial banks already exceed existing minimum capital standards. However, it is important to keep in mind that, in both relative and absolute terms, banking is a highly leveraged industry. Moreover, despite the progress many of you have made in recent years to improve your capital ratios, capital levels for the industry remain at the low end of their broad historical range.
The question of current capital levels can be addressed in two ways: first, by reviewing long term historical trends in capital ratios and other elements of bank activity, and second, by sharing the results of analyzing more recent data comparing capital ratios and returns on equity (ROEs). First, however, I want to review the principal functions of capital and stress its importance in maintaining a sound and resilient banking system.

Role of bank capital

Capital serves, of course, as a cushion for absorbing losses and protecting deposits and, as recent events have reminded us, for protecting the deposit insurance fund. In this connection, it also helps to maintain confidence—both domestically and increasingly internationally—in our banking system. Moreover, the presence of leverage restraints and the effect of capital on pricing practices help to prevent excessive or imprudent growth. Most importantly, in our system capital also represents a vested interest by private owners, who have the incentives to assert control and limit the risk exposure of their firms.

Our recent experience would seem to underscore that last point, from the standpoint of public policy, of ensuring that the owners who will profit from a depository institution's success have an appropriate amount of their own funds at risk.
Indeed, the existence of private investors with a significant ownership interest at risk is one critical element that distinguishes our free market system from governmentally owned or controlled banking systems.

While we all recognize the importance of capital, we often disagree about how much capital is necessary to encourage prudent behavior and to absorb unexpected losses. Those differences exist because of the different responsibilities and perspectives we have. I am sure we agree that the banking industry should be both efficient and competitive, and that it should be able to finance sufficient economic growth and generally meet the banking needs of the nation. It should also operate safely, while taking reasonable risks and providing adequate returns to investors. It is with these last issues that our views may begin to diverge. Bank owners have incentives to minimize their capital investments in order to maximize their returns; supervisors, on the other hand, are inclined to stress more capital in order to promote the soundness of the banking system and reduce the risks to the safety net.

It is often difficult to reconcile these differences. Growing international competition, for example, has increased pressures on banks throughout the world to reduce their capital ratios in order to compete and protect their market shares. Throughout the 1980s, in particular, different capital standards
abroad fueled this problem and hurt the market share of some U.S. banks. In large part, however, those differences in capital requirements are now being addressed. The recently adopted international risk-based capital standard was needed for two fundamental reasons: (1) to strengthen the soundness and stability of the international banking system and (2) to diminish an existing source of competitive inequality among international banks. The new standard should help the international banking community meet those goals.

**Historical trends**

In order to enhance our understanding of current capital levels, it is useful to compare them with capital levels of the past and also to try to gain some ideas about the corresponding levels of risk banks take. For that purpose, I would like first to look back to the mid-nineteenth century and identify some long-term trends.

Both the banking business and the economic environment have obviously changed dramatically since that time. Markets have become more efficient; communications, information and technology are vastly improved; the payments system is stronger and more sophisticated; a framework of prudential supervision has become well established; and management practices have changed. In addition, deposit insurance, unemployment insurance, and other social programs have tempered the damage recessions can cause, and our understanding and management of
the economy have also improved. Nevertheless, such a long-term approach, I believe, can provide some interesting historical insights and perspectives.

Although leverage was important in the past, as now, the amount of leverage historically was much less than we see today. During the 1830-1840s, bank capital ratios were around 50 percent (Chart 1). Since then, the ratios declined steadily for a century and more, with the typical fluctuations during business cycles. They generally declined when the economy was strong and loan demand heavy and improved during economic slowdowns, when loan demand would subside. That general pattern has been clearest during wartimes, including the Civil War, both World Wars, and even the Spanish-American War. In each case, capital ratios declined markedly, as banks were pressed to help finance the war.

Important events such as the creation of the Federal Reserve System in 1913 and the Federal Deposit Insurance Corporation in 1933 had a significant impact on the environment in which banks operated. The former led to a more efficient financial payments system and provided a source of increased liquidity in the banking system. The latter gave depositors greater protection for their funds and relieved pressure on banks to demonstrate their strength through higher capital ratios. Taken together, these developments introduced greater stability into the financial system and dramatically reduced the
risks the public perceived in placing their funds in depository institutions. This increased stability, in turn, created an environment in which banks could operate with lower capital positions while maintaining a high level of public confidence.

Clearly, many factors are involved whenever one assesses changes over such a long period of time. Nevertheless, from an historical perspective, the long-term trend in bank capital ratios is striking. Current levels are 1/6th the levels of the mid-1800s, and are less than one-half the level some 50 years ago.

None of this is to suggest that any particular period in the distant past should be viewed as the "good old days" that we want to repeat—despite the fact that bank capital ratios were much higher then. Not only were those higher ratios probably not all they might appear to have been, but also the financial world has dramatically changed.

**Balance sheets.** Some of those changes are reflected in other balance sheet trends. From the time of the Civil War until the depression of the 1930s, loans usually accounted for about 55 percent of bank assets, while cash and securities accounted for 20-30 percent of assets. The depression and the Second World War and Korean War years virtually reversed those shares as loan demand dropped and the banks helped finance government borrowing. Bank portfolios became loaded with
government securities, while the relative level of loans sharply declined. It was not until around 1965 that loans returned to their "traditional" level of about 55 percent of assets, where they remained as recently as 1983.

Beginning in 1984, though, this long-established relationship of loans to assets once again began to change (Chart 2). This time it increased. By that year, the loans reached 60 percent of bank assets and then climbed further to almost 62 percent at the end of 1988, the highest point since before the Civil War. Including standby letters of credit would raise the 1988 loan figure by another 5.5 percentage points.

Since long-term historical data are not available to measure asset quality, one cannot conclusively state that asset quality is either higher or lower today than it has typically been in the past. However, the historically large share of assets represented by loans, combined with the volume of off-balance sheet exposures we have recently seen, suggests that the level of risk in the industry today is certainly no lower than it generally has been in the past and is arguably higher.

In considering these broad historical trends in capital and asset composition, it is important to keep certain developments in mind. I have already referred to the advent of the federal safety net and the emergence of macroeconomic techniques for stabilizing the economy. Other factors that have
tended during recent decades to temper the risks associated with banking include broader financial disclosure, more consistent accounting practices, increased availability of information, better analytical techniques, more reliable payments systems, and improved market efficiencies.

The period from the end of World War II to the early 1970s was one of reasonable economic stability and steady growth. This was a climate that accommodated rapid domestic and overseas expansion by U.S. banks and, especially from the mid-1960s to the early 1970s, led to declining capital ratios, particularly for many large banking institutions. Focussing specifically on the period from 1947 to the present (Chart 3), the industry's average ratio of equity to assets climbed sharply through the 1950s and early 1960s, but then lost virtually all of that progress during the next ten years. The industry's latest effort to strengthen its capital base has restored only part of the loss. At 6.3 percent of industry assets, bank equity remains slightly below its average for the past 40 years.

By the late 1970s we saw rapidly increasing inflation, increased economic and financial instability, and soon thereafter, a severe recession. Since then, the overall economy has again experienced steady growth, but the business cycle and many other risks obviously remain. Given the continuing problems in certain regions and sectors of our economy, the difficulties facing some heavily indebted foreign countries, the
amount of leverage assumed by many of our domestic borrowers, and the rapid competitive and technological changes affecting the financial system, I suspect that few of you would argue that risks in banking have declined within the last decade. Indeed, the fact that more than 700 banks have failed in the past five years, alone, demonstrates that banking is far from risk-free. The many billions of dollars that this country will ultimately pay for the thrift industry also helps place in perspective the costs and market distortions that insufficient capital in financial institutions can produce.

**Relationship of Leverage and Earnings**

Considering the high capital ratios of the past, it is useful to ask how banks were able to compete for investor funds and bank customers. The large volume of relatively low cost, interest free funds and lower levels of competition and overhead costs were no-doubt important factors decades ago. Obviously, times have changed. Both businesses and consumers have become more sophisticated and demanding in the services they request; capital markets have grown; and technology and intensified competition have changed the face of the financial industry.

It is not essential, however, to have ever-increasing leverage ratios to compete. I recognize that leverage ratios affect your returns on equity and, in turn, the value of your banks. We also know, however, that there is a point beyond
which further leverage reduces the value of the firm. We must be careful not to go beyond that point.

Several factors begin to penalize any institution whose equity ratios become too thin. The most obvious one is higher funding costs. FDIC coverage may prevent a bank's insured deposit costs from rising, but eventually the cost of non-insured funds will increase. Shareholders, too, will demand more return for their increased risks and reflect those demands in stock prices. In contrast, strong bank capital ratios tend to imply financial stamina and resilience to withstand both good times and bad. Moreover, sound capital positions should help institutions attract depositors and investors who place a premium on low-risk and, in general, should help improve the institutions' competitive strength.

The fact that ever-higher leverage is not essential in order to have relatively high ROEs is borne out by a recent review of the performance of U.S. banks. While, one cannot necessarily link cause and effect between high capital ratios and strong earnings, the results demonstrate that the two are at least not inconsistent.

The review considered the performance of more than 2,300 banks whose assets now exceed $100 million and that existed throughout the period from 1975 to 1988. It placed these institutions into one of four groups based on their
average equity to asset ratios during that 14 year period. The annual compound return on equity of the banks with the highest capital ratios was higher than the compound ROE of the least capitalized banks, and the difference was statistically significant. Even among banks of similar size, that pattern held for 5 of 7 different size groups.

There is, admittedly, some potential circularity to this analytical approach. Banks with higher earnings—for whatever reason—may have higher capital ratios merely because they had more earnings to retain, while those that experienced losses necessarily saw their capital reduced. In any event, though, several conclusions seem sound. First, one does not need exceptionally low capital ratios to produce acceptable ROEs. Second, strong capital ratios do not preclude strong returns. Third, it is fundamental that, other things equal, higher capital ratios allow any organization to withstand losses better than do lower ratios. No one can know what problems lie ahead; nonetheless, banks with strong capital positions are more likely to survive periods of uncertainty than are those with weak ratios.
Conclusion

In closing, it seems fair to say that current capital requirements are not high by either short- or long-term historical standards, nor should they make it impossible for you to compete effectively. Meanwhile, a review of the composition of both on- and off-balance sheet exposures, suggests that the level of risk in banking today may, if anything, be higher than it has generally been in the recent past. The number and size of failures we have seen in both the banking and thrift industries demonstrate clearly that depository institutions must maintain sound capital positions and be able to deal with unexpected events.

Maintaining adequate capital will increase public confidence in your institutions and will strengthen your case for the expansion of new powers by ensuring that the public's interests and resources are protected. Adequate capital also provides the necessary incentives for owners to operate in a prudent and efficient way, while not exposing society to undue risks. The willingness of owners to risk their investments is the foundation of any free-market economy. It is, in the end, the key to both a sound and competitive banking system and a strong and growing economy.
Chart 1

EQUITY AS A PERCENT OF ASSETS, 1840-1988

ALL INSURED COMMERCIAL BANKS
Chart 2

LOANS AS A PERCENT OF ASSETS, 1840-1988
ALL COMMERCIAL BANKS

Percent

80
70
60
50
40
30
20
10

1840 1900 1950 1988

LOANS

LOANS + STDBY LCs