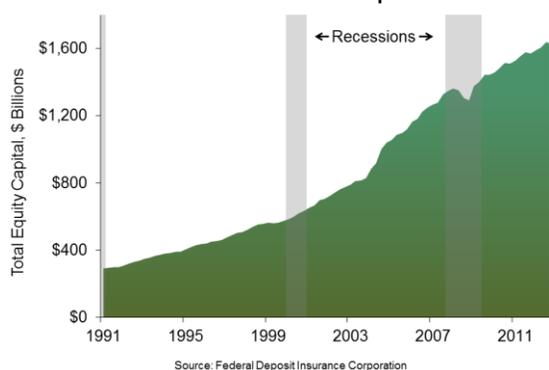


## High Capital Requirements Have Consequences

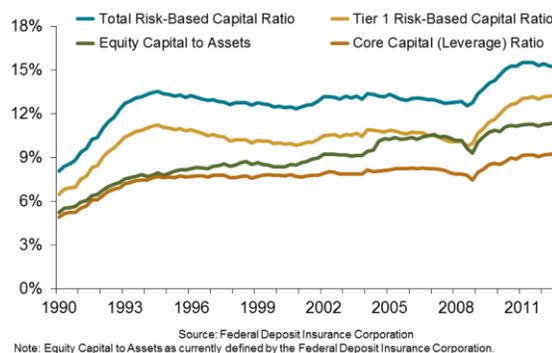
Recent proposals<sup>1</sup> advocate for substantially higher tangible capital-to-assets ratio for the banking industry, arguing that such standards would have made the financial crisis less severe and costly to the public. Higher capital levels, it is argued, would have prevented many banks from failing.

Certainly, there is general agreement that more capital would have helped banks weather losses with less stress and may have made the secondary impact less severe (such as the reduction of loans and other assets). In response to market and regulatory pressure since the crisis, banks have significantly increased both the dollar amount of capital and capital-to-asset ratios. Now both are near or at record levels.

### Banks Have Record Capital Levels



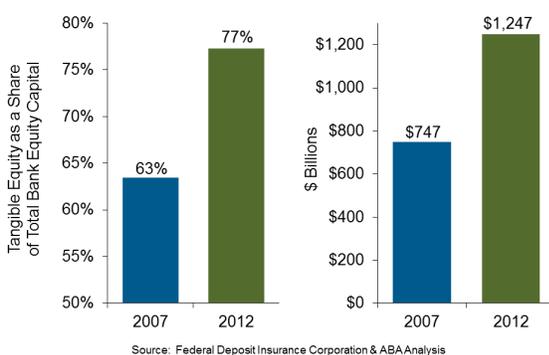
### Capital Ratios Near Record High Levels



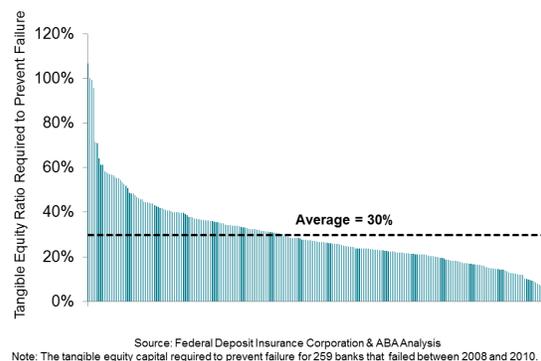
Recent proposals have focused on capital measurements using a form of tangible equity, i.e., a more conservative form of capital that is immediately available for paying off creditors in the event of a failure or other unforeseen difficulty. Tangible equity capital is understood to be a higher quality of capital—even beyond the high standards of Tier 1 capital. Banks have increased not only the level of total capital but also the quality of the capital by raising the level and share of tangible equity capital.

It is also the case that while strong capital levels are essential to running a healthy bank, they do not ensure the bank's survival. In fact, excessive risk-taking can result in a failure regardless of the level of capital held. For example, an institution whose tangible equity to tangible assets ratio was as high as 35.4 percent in 2008 had losses so severe that it failed.<sup>2</sup> ***Over half of the institutions that failed between 2008 and 2010 would still have failed if they had had a tangible equity capital ratio of 25 percent in 2008.*** Moreover, of the banks that failed in this time period, 32 percent already held tangible equity capital exceeding 10 percent, some vastly so. If all banks that failed from 2008-2010 had held 10 percent tangible equity capital in 2008, 95 percent would have failed anyway.

### Banks Raise Quality and Quantity of Capital



### Capital Required to Prevent Failure

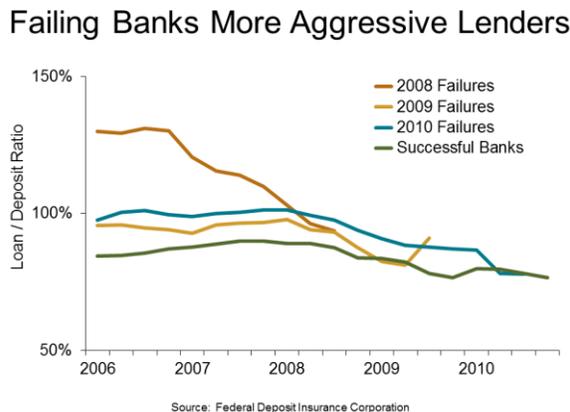
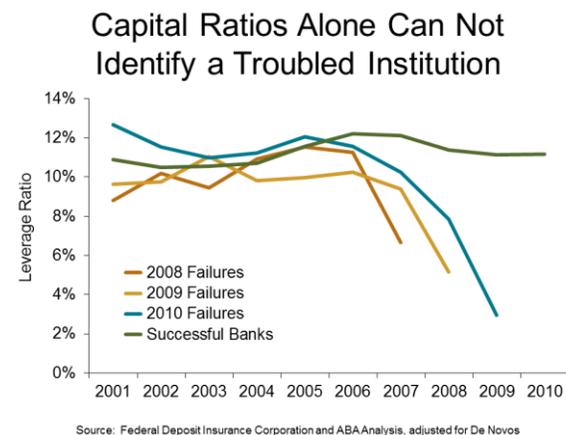


<sup>1</sup> For example, FDIC Vice Chairman Tom Hoenig advocated such a proposal in a November 30, 2012 speech "[Financial Oversight: It's Time to Improve Outcomes](#)" to the AICPA/SIFMA FSA National Conference in New York.

<sup>2</sup> The tangible-equity to tangible-asset ratio is calculated by taking the value of the bank's total equity and subtracting intangible assets, goodwill and preferred stock equity and then dividing by the value of the company's tangible assets. This ratio is a more exclusive, extreme version than current capital measures.

Simply put, the majority of failed institutions failed because the losses were so great that no reasonable level of capital would have been enough to absorb them.

Prior to the crisis, capital levels did little to distinguish banks that would go on to fail with those that remained healthy. As a group, the failed banks were more aggressive lenders with significantly higher loan-to-deposit ratios coming into the crisis than surviving banks. Once economic conditions deteriorated, losses overwhelmed capital and led to failures.

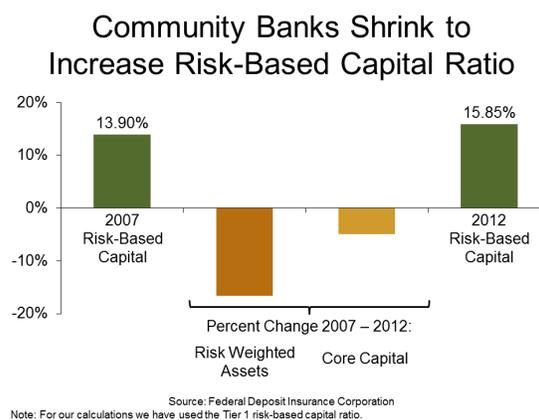
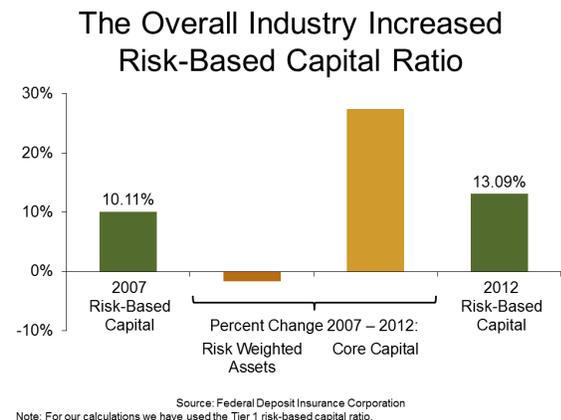


### Higher Mandated Capital Levels Have Significant Costs to Banks and Communities

Raising capital levels to arbitrary levels would be costly for both banks and the economies they support. In order to meet rising capital-to-asset ratios banks need to either secure additional capital from outside the institution or shrink their business (assets). Due to the current market conditions, many banks—particularly smaller community banks—have very limited access to outside capital, meaning that institutions would need to shrink to meet raised capital standards. This would mean a decrease in lending to the economy, just as it did during and just after the financial crisis and recession.

Risk-based capital-to-asset ratios for the industry have increased significantly over the last few years. However, community banks, with limited access to sources of new capital, had little choice but to shrink their asset size in order to raise their capital-to-asset ratio. Raising capital for community banks is much more challenging than for larger banks that have direct access to capital markets.

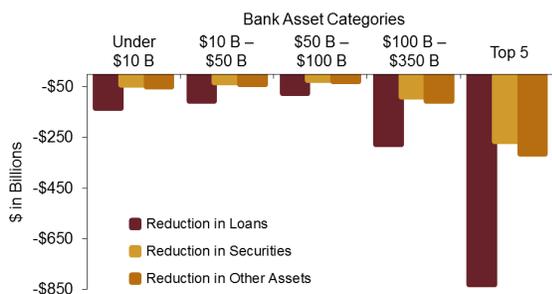
To illustrate this, the industry as a whole did raise its Tier 1 risk-based capital ratio from 10 percent in 2007 to 13 percent in 2012—increasing capital ratios by nearly a third. Capital for the industry rose 27 percent over this 5-year period (see the Chart below on the left). However, the capital increase was largely from institutions with assets greater than \$1 billion. Looking only at community banks under \$1 billion, core capital fell by \$7.5 billion over the period. This meant that in order for the risk-based capital ratio to rise—as it did from nearly 14 percent to almost 16 percent—risk-weighted assets of community banks had to fall dramatically: by \$181 billion (see the Chart below on the right). The bottom line is that smaller banks with more limited access to outside capital had to shed assets and hold back lending, all of which created more stress for their local economies.



Suggestions for significant increases in minimum tangible equity capital ratios will have very negative impacts on communities. For example, the 10 percent tangible equity capital levels suggested by FDIC Vice Chairman Hoenig, would require \$242 billion of new capital (a 15 percent increase over current capital levels). Smaller institutions would more likely shrink. If the increased minimum ratio was met solely by reducing assets, ***it would require the banking industry to shrink by nearly 17 percent, with assets falling by over \$2 trillion.*** This shrinkage would come primarily from loans, which would fall by \$1.4 trillion or more. Securities and other asset holdings of banks would also fall, creating large distortions in other markets.

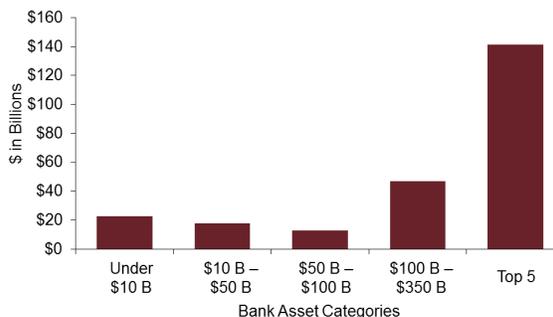
The impact would be felt across banks of all sizes, and therefore, across all their customers (see tables on page 4). Businesses (large and small) and individuals would have fewer credit options and higher costs to borrow. Neither is a path that supports economic growth.

**Shrinking Assets to Reach 10% Tangible Equity/Assets Ratio**



Source: Federal Deposit Insurance Corporation and ABA Analysis  
 Note: Reductions calculated using 20-year averages.

**Additional Capital Required to Reach 10% Tangible Equity/Assets Ratio**



Source: Federal Deposit Insurance Corporation and ABA Analysis Note: Analysis is holding all else equal.

As large as the adverse impact would be of a 10 percent tangible equity capital ratio, the negative consequences naturally are significantly higher for higher minimum levels, such as 13 percent to 16 percent which have been mentioned by some commentators. The industry would need between one-half trillion and \$1 trillion dollars in new capital; community banks (with assets less than \$10 billion) would need an additional \$85 billion to \$163 billion in capital. In the alternative, assets would shrink by more than one-third, i.e., \$4.7 trillion to \$6.4 trillion. Obviously, any combination of new costly capital or reduced lending at these levels would slow economic growth severely.

Although strong capital levels are important to a healthy banking sector, arbitrarily high capital levels do little to ensure further safety. Bank capital continues to grow and remains near record levels. It is important to remember that bank capital has increased throughout the financial crisis and is now 25 percent higher than 2008 levels. Further raising capital will do little to stop losses at poorly managed and high-risk institutions and comes with too great a cost.

**Impact Associated with 10 Percent  
Tangible Equity to Tangible Assets Ratio Requirement**

**Additional Capital Required\*:**

\$B, as of December 2012 Asset Category	to Reach 10%	Percent of Current Capital
Top 5	\$141	22%
\$100 B - \$350 B	\$47	15%
\$50 B - \$100 B	\$13	8%
\$10 B - \$50 B	\$18	10%
Under \$10 B	\$23	7%
Total Industry	\$242	15%

**Change in Assets Required\*:**

\$B, as of December 2012 Asset Category	to Reach 10%	Percent of Current Assets
Top 5	(\$1,412)	22%
\$100 B - \$350 B	(\$470)	19%
\$50 B - \$100 B	(\$126)	10%
\$10 B - \$50 B	(\$178)	12%
Under \$10 B	(\$227)	8%
Total Industry	(\$2,413)	17%

Source: Federal Deposit Insurance Corporation and ABA Analysis

\*Holding all else equal

**What Does a Shrinking Asset Base Mean**

\$B, as of December 2012 Asset Category	Shrinking of Assets to Reach 10% Tangible Ratio			Total Shrinking
	Reduction in Loans	Reduction in Securities	Reduction in Other Assets	
Top 5	(\$831)	(\$266)	(\$315)	(\$1,412)
\$100 B - \$350 B	(\$277)	(\$89)	(\$105)	(\$470)
\$50 B - \$100 B	(\$74)	(\$24)	(\$28)	(\$126)
\$10 B - \$50 B	(\$105)	(\$33)	(\$40)	(\$178)
Under \$10 B	(\$133)	(\$43)	(\$51)	(\$227)
Total Industry	(\$1,420)	(\$454)	(\$538)	(\$2,413)

Source: Federal Deposit Insurance Corporation and ABA Analysis

Note: Reductions are calculated using 20-year averages.