

# MOMENTS IN HISTORY

ECONOMIC INSIGHTS FROM THE HISTORY OF THE FEDERAL BANKING SYSTEM

## The History of Supervisory Expectations for Capital Adequacy: Part I (1863–1983)

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As the supervisor of national banks since 1863, the Office of the Comptroller of the Currency (OCC) has placed significant importance on the quantity and quality of capital when evaluating the safety and soundness of banks. The OCC's focus on capital was apparent in the first communication by Comptroller Hugh McCulloch to newly chartered national banks in December 1863:

The capital of a bank should be a reality, not a fiction; and it should be owned by those who have money to lend, and not by borrowers. The Comptroller will endeavor to prevent, by all means within his control, the creation of a nominal capital by national banks, by the use of their circulation, or any other artificial means; and in his efforts to do this, he confidently expects the co-operation of all the well-managed banks.<sup>1</sup>

Though this advice specifically addressed the unsafe practice of a bank lending to a borrower with the expectation that the borrower would use the proceeds to purchase the stock of that same bank, thereby creating fictional capital, the point that the capital must be real would foretell of the policy debates that followed over the next 160 years. Those policy questions remain today: what are the correct elements to include in a measure of capital, and how should that capital be evaluated in the context of the bank's activities? The need for a careful evaluation of capital adequacy is virtually self-evident owing to the fact that capital<sup>2</sup>

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<sup>1</sup> Hugh McCulloch, *Men and Measures of Half a Century* (New York: Charles Scribner's Sons, 1888), 197.

<sup>2</sup> Yair Orgler and Benjamin Wolkowitz, *Bank Capital* (New York: Von Nostrand Reinhold Company, 1976); Phillip J. Hahn, *The Capital Adequacy of Commercial Banks* (New York: The American Press, 1966); George LeMaistre, "Capital Adequacy," address before the Bank Study Conference, American Bankers Association, 1974; and Federal Deposit Insurance Corporation, "Capital," in *Risk Management Manual of Examination Policies*, (2015): 2.1-1.

- absorbs unforeseen losses that exceed earnings. With capital defined as the difference between assets and liabilities, as long as the losses on assets do not aggregate beyond a level that exceeds capital, the bank remains solvent.
- protects depositors and uninsured creditors. Should a bank fail, due to insolvency or illiquidity, capital protects uninsured creditors.
- is a constraint on asset growth. A minimum capital ratio constrains asset growth by requiring assets to be partially funded by capital.

This note describes how and why regulators' thinking evolved with respect to capital. We divide the nearly 160 years of the OCC's history as the chartering authority for national banks into four intervals: 1863 to 1914, 1915 to 1960, 1961 to 1983, and 1984 to 2021.

## The Early Years: 1863 to 1914

The 1864 National Banking Act established capital requirements that were stated as dollar amounts, rather than as a requirement to maintain a specified capital-to-assets ratio. The required capital varied by the size of the town in which the bank was located.<sup>3</sup> A national bank's minimum required capital was \$50,000 if the town had a population that was less than 6,000; \$100,000 when the population was between 6,000 and 50,000; and \$200,000 in locations with a population greater than 50,000. These minimum capital levels were almost always higher than those required for a state-issued charter. As the country expanded westward in the second half of the 19th century, towns were often small and relatively far apart. To counter the slower growth in the number of national charters relative to state charters, the OCC advocated for lower minimums. In the OCC's 1896 Annual Report, Comptroller James Eckels noted that:

The proposed reduction of capital stock ... in places of less than 2,000 inhabitants would give independent banks of issue to communities in the South and West which, owing to the conditions surrounding them, can not take from their daily business needs a greater sum and invest in banking. The result is that they are deprived both of the use of foreign and local capital and the utilization of their own credits...<sup>4</sup>

This recommendation was endorsed by Charles Dawes, who succeeded Eckels as Comptroller, and the lowering of the minimum capital to \$25,000 in towns of 3,000 became law through the Gold Standard Act of 1900. As figure 1 shows, the number of national bank charters increased substantially because of this change. In 1900, there were 3,732 national banks. By 1914, the number of national banks had more than doubled to 7,525.<sup>5</sup>

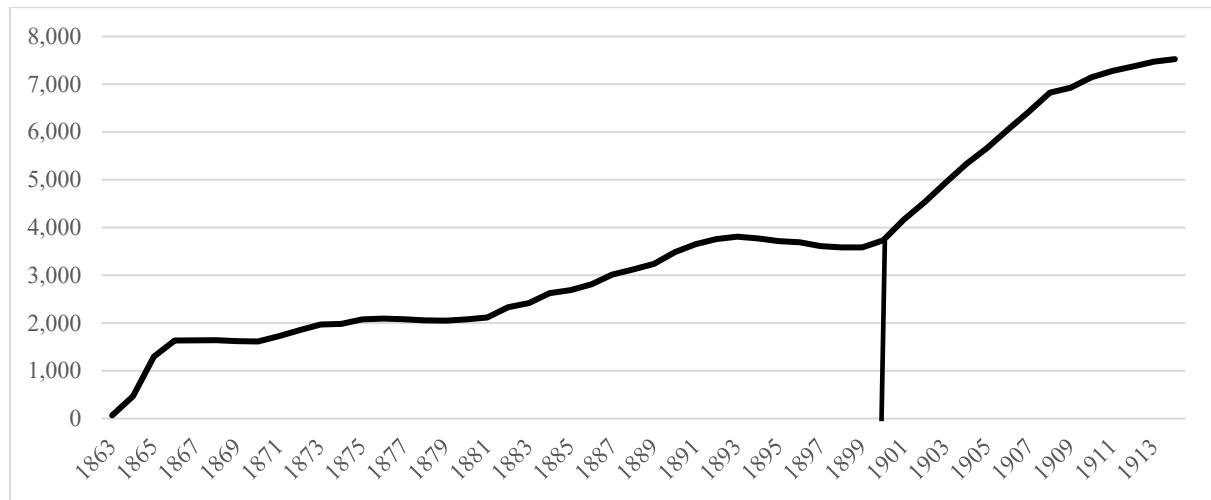
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<sup>3</sup> Ross M. Robertson, *The Comptroller and Bank Supervision: A Historical Appraisal* (Washington, D.C.: OCC, 1995), 49.

<sup>4</sup> OCC, *Annual Report of the Comptroller of the Currency* (1896), 102.

<sup>5</sup> When the depression and banking crisis struck in 1929, these small banks, which were less diversified, failed with greater frequency.

**Figure 1: Number of National Banks: 1863–1914**



Source: OCC Annual Reports

Though there was no formal minimum capital-to-assets ratio, the 1864 act required banks to hold reserves against their note issuance (i.e., the printed currency) and deposit liabilities. Later, in 1874, the reserve was required to be held only against deposits. The practical effect of a reserve requirement on deposits (a substantial proportion of the liability side of the balance sheet) was the same as though there was a limit on the capital-to-assets ratio.<sup>6</sup> Reserves in the form of gold or silver could be held in a bank's vault or deposited into a larger national bank located in one of 17 redemption cities.<sup>7</sup>

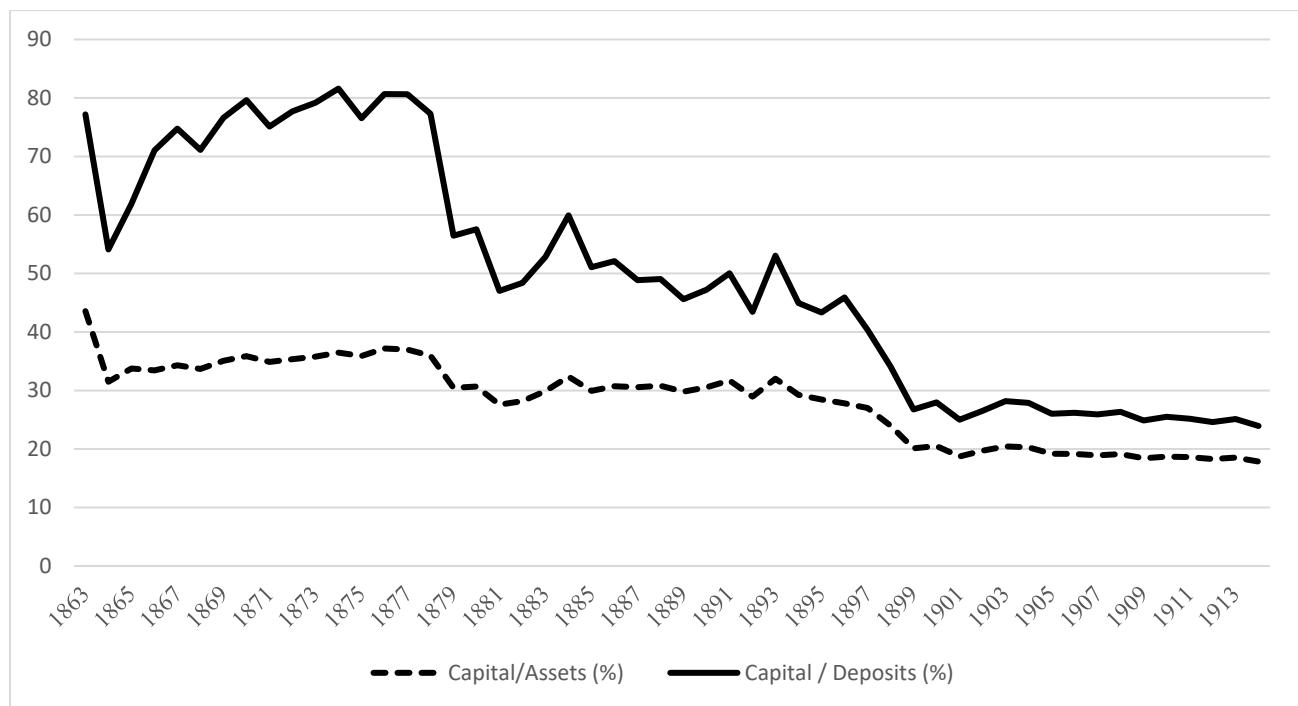
Figure 2 shows the time series of the ratio of aggregated capital of national banks to the aggregated assets of those banks, as well as the capital-to-deposits ratio.

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<sup>6</sup> Because assets on the left side of the balance sheet must equal the sum of liabilities and capital on the right side, this accounting identity means that, if \$100 of assets is supported by \$15 of capital—a capital-to-assets ratio of 15 percent—then the \$85 of liabilities is also protected by that \$15 in capital—resulting in a capital-to-deposits ratio of 17.6 percent. In figure 2, this identity does not hold exactly, because certain liabilities were excluded from the definition of deposits.

<sup>7</sup> Recall that national banks issued their own paper currency, which was collateralized by U.S. Treasury bonds held by the OCC in a vault at Treasury. The holders of this currency could present these notes to be redeemed in lawful money (e.g., gold coin). Smaller national banks were required to have this reserve on deposit at a larger national bank located in one of the redemption cities (St. Louis, Louisville, Chicago, Detroit, Milwaukee, New Orleans, Cincinnati, Cleveland, Pittsburgh, Baltimore, Philadelphia, Boston, New York, Albany, Leavenworth, San Francisco, and Washington City). Because the Civil War would not end for another two years, the 1864 act also stipulated that: “the cities of Charleston and Richmond may be added to the list of cities in the national associations of which other associations may keep three fifths of their lawful money, whenever, in the opinion of the comptroller of the currency, the condition of the southern states will warrant it.”

**Figure 2: Capital-to-Assets Ratio and Capital-to-Deposits Ratio: All National Banks, 1863–1914**



Source: OCC Annual Reports

The capital-to-deposits ratio converges to (but, by accounting, must always be higher than) the capital-to-assets ratio. This suggests that, over the last 10 years of the 19th century and the first 14 years of the 20th century, deposit banking became dominant. That is, when a bank made a loan to a borrower, the bank would credit that borrower's checking account, against which the borrower would write drafts. This is in contrast to the bank handing that borrower an envelope with the bank's printed paper currency that would then be used to make payments.

The capital-to-deposits ratio was the focus of the OCC's attention. Over this entire period (and beyond to 1935), bank shareholders were subject to double liability in the event of a bank's closing. Double liability meant that if the OCC placed a bank into receivership, the then-current shareholders could be assessed an amount that was equal to their investment in the par value of that bank's shares. Thus, an insolvency would not only extinguish the value of the invested capital but would also subject the listed shareholders to an additional loss equal to the amount of their investment (i.e., double the original shareholder liability).<sup>8</sup> This double liability shareholder assessment was a significant factor in lessening the losses suffered by depositors. It was not until 1933, with the creation of the Federal Deposit Insurance Corporation (FDIC) and its mandate to directly protect depositors from loss, that supervisory attention shifted focus to the capital-to-assets ratio. Prior to the 1933 FDIC Act, the focus on the capital-to-deposits ratio was so ingrained at the OCC that, in 1914, Comptroller John Skelton Williams advocated changing the law to establish a minimum capital-to-deposits ratio:

The view is held by many practical bankers and experienced economists that it is not sound banking for an active commercial bank to be allowed to receive deposits in excess of ten times its capital and surplus. I am firmly impressed with the correctness of this view, and respectfully recommend to the

<sup>8</sup> Roger Tufts and Graham Tufts, "Shareholder Double Liability and Depositor Losses in Failed National Banks: 1865–1935," OCC *Moments in History* (November 23, 2021).

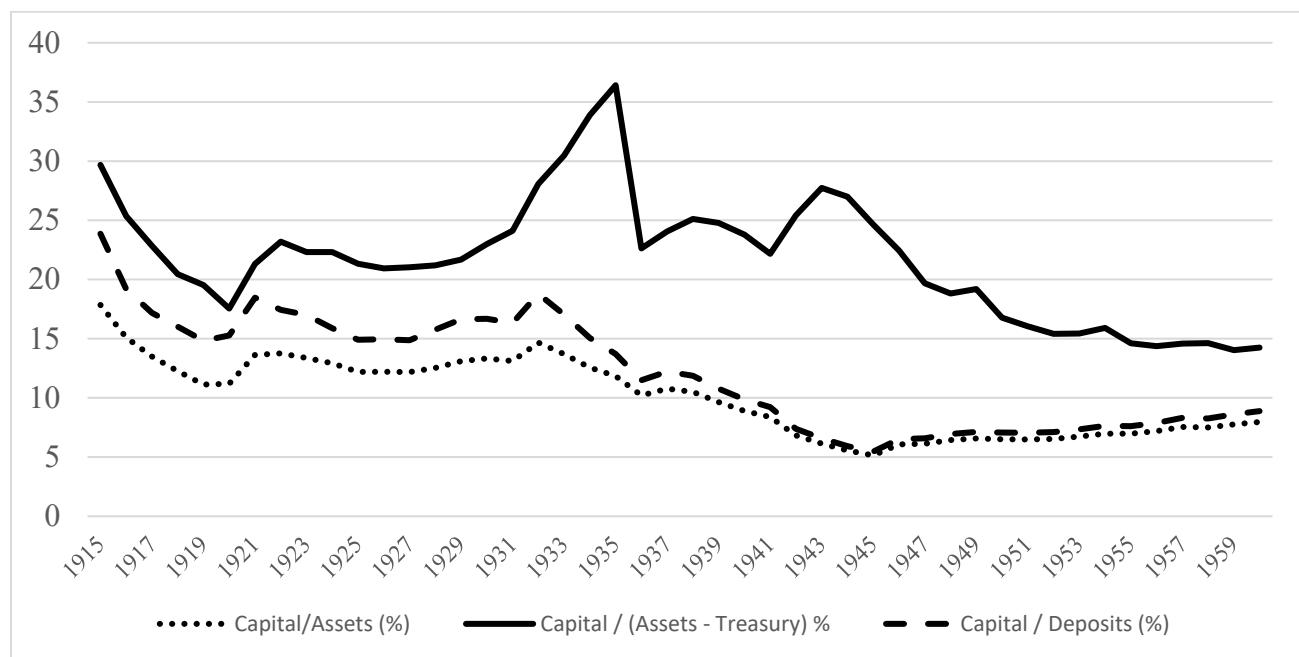
Congress that the national bank act be amended so as to provide that no national bank shall be permitted to hold deposits in excess of ten times its unimpaired capital and surplus.<sup>9</sup>

This constraint implies a capital-to-assets ratio of roughly 9.1 percent, which would be quite a high requirement compared to the minimum requirements that will prevail in later decades.<sup>10</sup>

## Years With Two World Wars: 1915 to 1960

In addition to the capital-to-deposits ratio and the capital-to-assets ratio for the years 1915 to 1960, figure 3 shows a third ratio: the capital-to-risk assets ratio. This ratio is similar to the capital-to-assets ratio, but the calculation excludes assets with very low credit risk, specifically cash items and obligations of the U.S. government, from the denominator.

**Figure 3: Capital-to-Assets, Capital-to-Deposits, and Capital-to-Risk Assets: All National Banks, 1915–1960**



Source: OCC Annual Reports

From 1915 to 1931, the ratios are generally consistent, with the capital-to-deposits ratio always a few percentage points higher than the capital-to-assets ratio. Similarly, the capital-to-risk assets ratio was higher over this interval, when cash and Treasury obligations were roughly 40 percent to 45 percent of assets. Such large amounts of these low-risk assets substantially decrease the denominator, thereby increasing the ratio.

In 1930, the effects of the banking crisis and onset of the Depression are pronounced, as evidenced in figure 3. From 1930 to 1935, aggregate national bank capital and surplus fell by more than 20 percent,

<sup>9</sup> OCC, *Annual Report of the Comptroller of the Currency* (December 7, 1914), 20.

<sup>10</sup> If a bank had \$10 in capital and \$100 in deposits—the maximum suggested by Williams—then the capital-to-assets ratio would be roughly \$10 divided by \$110, or 9.1 percent, if the definition of deposits included all non-capital liabilities.

from \$3.88 billion to \$3.09 billion. Over that interval, aggregate assets rose by \$1.9 billion. However, the increase in cash and Treasuries was \$4.8 billion. Figure 3 depicts the substantial decrease in the capital-to-assets ratio from 13.3 percent to 10.2 percent from 1930 to 1935, while at the same time, due to the large increase in Treasuries, the capital-to-risk adjusted assets ratio rose from 23 percent to 36.4 percent. Then, in 1936, total assets grew by \$5 billion (19 percent over the year) while risk-free assets slightly decreased. This resulted in a substantial decrease in the capital-to-risk adjusted assets ratio.

As the deposits of national banks became insured in 1935, while at the same time, the double liability of shareholders of failed banks ended, this started a continuous decade-long decline in the aggregate capital-to-assets ratio. Writing in 1955, John Kenneth Galbraith noted that:

Federal insurance of bank deposits, even to this day, has not been given full credit for the revolution that it has worked in the nation's banking structure. With this one piece of legislation the fear which operated so efficiently to transmit weakness was dissolved. As a result, one grievous defect of the old system, by which failure begot failure, was cured. Rarely has so much been accomplished by a single law.<sup>11</sup>

That deposit insurance nearly eliminated depositor losses is evident in the data that immediately follows the creation of the FDIC. By mid-year 1934, roughly 97 percent of all commercial bank deposits were covered by insurance. Table 1 indicates that depositor losses in this first year of the FDIC's existence were 1/100th the losses in the system one year earlier. In 1935, depositor losses were 1/10th the losses of 1934. By 1940, depositor losses were effectively zero.<sup>12</sup>

**Table 1: Bank Closings and Depositor Losses, 1933–1937**

Year	Number of banks closed	Estimated losses by depositors (\$1,000s)	Estimated depositor losses per \$100 of deposits as a % of all commercial bank deposits
1933	4,000	\$540,396	2.15
1934	61	6,502	0.02282
1935	31	600	0.00180
1936	72	185	0.00049
1937	82	155	0.00039

Source: Friedman and Schwartz, *A Monetary History of the United States, 1867–1960*

Thus, by 1935, two important policy changes greatly changed the banking environment and the mindset of bankers and depositors. First, the creation of deposit insurance, as a practical matter, fully protected most depositors. Second, the shareholders of banks no longer needed to worry about a possible subsequent assessment being made against them. With depositors no longer imposing a discipline that might prevent banks from pursuing lower capital ratios and bank equity owners confident that they could lose no more than their investment, it is not surprising that aggregate national bank capital-to-assets ratios started a downward trend that would last until the end of World War II. In addition, even though it was not then widely required by the banking agencies, the capital-to-risk assets ratio remained much higher due to the very large increase in government bonds during the war. Remarkably, by June 1945, just a few

<sup>11</sup> John Kenneth Galbraith, *The Great Crash 1929* (Boston: Houghton Mifflin Harcourt, 1955), 191.

<sup>12</sup> Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867–1960* (Princeton: National Bureau of Economic Research, 1965), 436–438.

months before the end of the war in the Pacific, national bank holdings of U.S. Government securities and guaranteed obligations were 58 percent of their total assets.<sup>13</sup>

In the 1950s and 1960s, the banking agencies increasingly focused their attention on their own variants of a risk-based capital ratio.

## The Federal Reserve's Approach

In 1956, the Federal Reserve developed its analyzing bank capital (ABC) ratio. Though revised over the years, the 1972 version was used as an identifier of banks that warranted a closer review of capital adequacy. The ABC ratio, in addition to looking at the liabilities for the purpose of evaluating liquidity risk, assigned multiplicative credit and market risk factors to the assets, as well as a capital measure for trust activities. The sum of these amounts of recommended capital were then compared to the amount of the bank's adjusted capital, where adjusted capital was equal to total capital minus classified assets. The difference between the recommended capital and the bank's actual adjusted capital was the gauge of capital adequacy. This calculation has the appearance of leading to a simple yes or no answer to the question "Does the bank's level of capital exceed the recommended levels?" However, despite the precision and complexity of the weights and calculation, the ABC measure did contemplate subjective elements being important factors. The notes section of the form includes the qualifying statement highlighting the role of subjective judgment:

The requirements indicated by the various items on the form are essentially 'norms' and can provide no more than an initial presumption as to the actual capital required by a particular bank. These 'norms' are entitled to considerable weight, but various upward or downward adjustments in requirements may be appropriate for a particular bank if special or unusual circumstances are in fact present in the specific situation.<sup>14</sup>

## The FDIC's Approach

The FDIC adopted a different approach. In 1939, the FDIC was the first agency to switch its emphasis away from the capital-to-deposits ratio. The logic for doing so was simply that the assets of the bank, not the liabilities, is the cause of an insolvency and the concomitant actions of the FDIC to make depositors whole. The Chair of the FDIC, Leo T. Crowley, wrote:

The Corporation believes that every bank should have a minimum net sound capital equal to at least 10 percent of the appraised value of its assets... The capital structure of a bank may be regarded as inadequate, however, even though it meets this minimum standard, if other adverse circumstances exist.<sup>15</sup>

The FDIC's measure of net sound capital equaled the sum of equity, capital notes, debentures and reserves minus assets classified as loss or doubtful. Bond depreciation was also subtracted.<sup>16</sup> We note that the FDIC's inclusion of debentures, being a claim on the bank in receivership that was subordinate to the

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<sup>13</sup> OCC, *Annual Report of the Comptroller of the Currency* (1945), 6.

<sup>14</sup> Orgler and Wolkowitz, 87.

<sup>15</sup> Federal Deposit Insurance Corporation, *Annual Report* (1939), 12-13.

<sup>16</sup> Federal Deposit Insurance Corporation, "[A Brief History of Deposit Insurance](#)," International Conference on Deposit Insurance (September 1998): 34.

FDIC, was ahead of its time. It was not until 1962 that Comptroller Saxon included subordinated debt in the definition of capital for national banks.

Unlike the Federal Reserve, the FDIC did not advocate applying differential weights on assets in calculating the ratio. “The Corporation does not believe it desirable, in establishing supervisory rules and principles, to differentiate among types of assets ... To give preference to a particular type of asset by means of supervisory rules would encourage banks to go into that type as against some other type of asset. In the eyes of the Corporation a good loan is as good as cash.”<sup>17</sup>

## The OCC’s Approach

As noted earlier, the OCC advocated a capital-to-deposits ratio in 1914. However, by the 1940s, the OCC position was that no single capital ratio was all-important. Rather, the *Comptroller’s Manual* listed the factors considered. This included quality of management, liquidity of assets, earnings history, quality and character of ownership, occupancy expenses, and volatility of deposits. However, the OCC did use ratios as a guideline for identifying problem banks. For example, to determine the need for additional supervisory scrutiny, the OCC used the ratio of classified assets (i.e., substandard, doubtful and loss) to total capital, where total capital included equity, loss reserves, and long-term debt.

Though the FRB developed its ABC ratio in 1956, the OCC was the first to operationalize a measure that recognized the differences in the credit risk of assets. In his 1948 Annual Report, Comptroller Preston Delano noted the OCC’s shift away from the capital-to-deposits ratio:

In order to expedite our procedures and perform our duties as efficiently as possible, we have adopted certain rules-of-thumb for preliminary screening. One of the most useful of these is a ratio of capital funds to loans and investments other than United States government securities.<sup>18</sup>

## Years of Rapid Change and Turbulence: 1961 to 1983

The 22 years from 1961 to 1983 was a period both of rapid change in banking and macroeconomic stress, with Comptroller James Saxon an influential, as well as controversial, figure during his five years leading the OCC (November 1961 to November 1966). Among his many interpretations that loosened the constraints on banks was his decision in 1963 to widen the range of instruments that would count as bank capital for national banks.

A significant change was instituted in the official recognition accorded alternative means of raising capital. The use of preferred stock, subordinated notes, and convertible notes, had been discouraged by the Office to such a degree that virtually no national bank had issued such securities since the 1930’s ... Apparently, this attitude stemmed from the fact that the Reconstruction Finance Corporation had purchased preferred stock and capital notes from banks during the depression, so that the issuance of such securities was viewed somehow as a reflection on the banks’ soundness. We rejected this reasoning and issued an opinion that it was both legal and appropriate to raise capital by these means ... ”<sup>19</sup>

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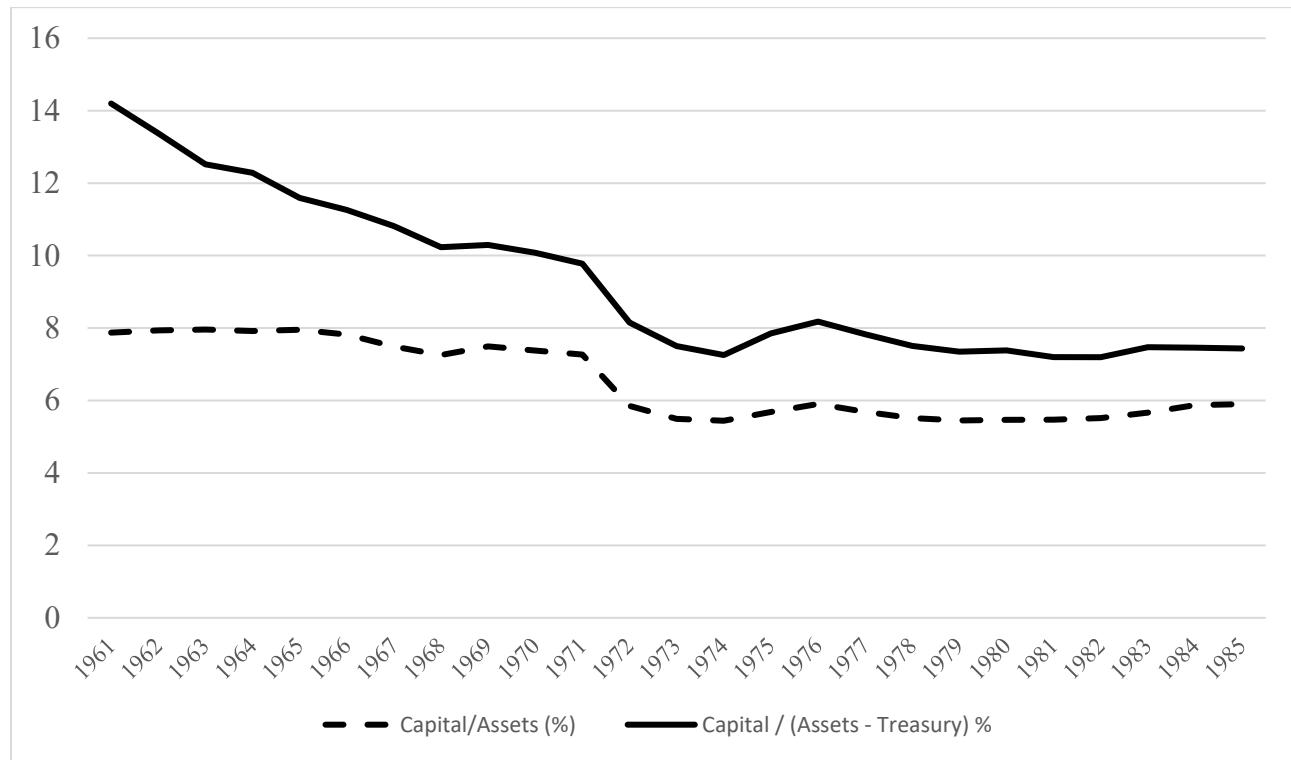
<sup>17</sup> Federal Deposit Insurance Corporation, *Annual Report* (1939), 12.

<sup>18</sup> OCC, *Annual Report of the Comptroller of the Currency* (June 10, 1949), 4.

<sup>19</sup> OCC, *Annual Report of the Comptroller of the Currency* (1963), 19.

Yet, Comptroller Saxon would disrupt the status quo even more, by further distancing the OCC's practices in examining capital adequacy from the ABC ratio used by the Federal Reserve. As seen in figure 3 and figure 4, by 1962, there was a clear downward trend in the risk-asset ratios used by the Federal Reserve Board and OCC.

**Figure 4: Capital-to-Assets and Capital-to-Risk Assets, All National Banks, 1961–1985**



Source: OCC Annual Reports and OCC Integrated Bank Information System

In December 1962, Comptroller Saxon abandoned those ratios as the primary determinants of capital adequacy. Instead, eight factors would be considered:

- The quality of management
- The liquidity of assets
- The history of earnings and the retention thereof
- The quality and character of ownership
- The burden of meeting occupancy expenses
- The potential volatility of deposit structure
- The quality of operating procedures
- The bank's capacity to meet present and future financial needs of its trade area, considering the competition it faces<sup>20</sup>

And yet, within 10 years, this list would be omitted from the 1971 revisions to the *Comptroller's Manual*. Instead, the capital section simply read:

<sup>20</sup>Orgler and Wolkowitz, 70.

The question frequently arises regarding the importance of ratios in determining capital adequacy. In an average bank, with average management, the capital to risk asset ratio, when it goes beyond reasonable bounds, is important in deciding that additional capital is necessary, even though existing assets problems are relatively minor. The relative degree of quality in a bank's loans, bonds and other risk assets, is a valid argument in relationship to capital needs up to a certain point, but its validity decreases rapidly and disappears when the sheer volume of such assets completely overshadows the capital structure ... In other words, ratios alone are not conclusive, and they always must be integrated with all other pertinent factors.<sup>21</sup>

However, over the next 15 years, events would substantially change the OCC's view regarding the relevance of capital ratios as determinants of capital adequacy.

In October 1973, the United States National Bank (USNB) of San Diego failed. As the 86th largest bank in the United States, and 14 times larger than any other bank failure since the Great Depression, the OCC faced substantial criticism for not having addressed the insider dealing that had been going on for more than a decade. An important capital-related result of the failure of USNB of San Diego was the policy change in the interpretive ruling that required standby letters of credit, which are credit guarantees that are not recorded as an on-balance sheet asset, to be included in the calculation of the limit of credit exposure to a single borrower.<sup>22</sup>

The following year, in October 1974, Franklin National Bank of New York failed. Though Franklin had been the 20th largest bank, its rapid growth was substantially funded by the Eurodollar deposits generated by the London office it had opened in 1972. Unfortunately, the bank was paying more for the deposits than the interest earned on the assets back in New York that were funded by those deposits. Comptroller James Smith wryly noted that the substantial maturity mismatch between assets and liabilities at Franklin was the "first encounter of LIBOR (London Interbank Offered Rate) funding and Long Island pricing."<sup>23</sup>

These two prominent failures and the unflattering portrayal of the OCC's examination practices they suggested were overshadowed one year later. On January 11, 1976, the headline and lead sentence of *The Washington Post* read, "Citibank, Chase Manhattan on U.S. 'Problem' List ... Two of the three largest banks in the United States have been placed on a super-secret list of problem banks by the U.S. Comptroller of the Currency ... after bank examinations disclosed 'inadequate' capital ..." Just over a week later, on January 20, the OCC's Robert Bloom, First Deputy Comptroller of the Currency for Policy, testified before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Government Operations Committee on the use of a capital ratio in identifying weak banks:

There is no magic formula or ratio which is capable of identifying banks for special supervision with any degree of accuracy. As a practical matter, however, we have used in the past a quantitative formula based on examination report data which identify those banks to be given further analysis at all staff levels. All banks with criticized assets . . . aggregating 65 percent or more of adjusted capital funds . . . are given special analysis and attention by this office.<sup>24</sup>

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<sup>21</sup> OCC, *Comptroller's Manual* (March 1973), 17.

<sup>22</sup> OCC, *Annual Report of the Comptroller of the Currency* (1974), 17. In addition, national banks were required to report the total amount of their outstanding standby letters of credit in a footnote to their financial statements.

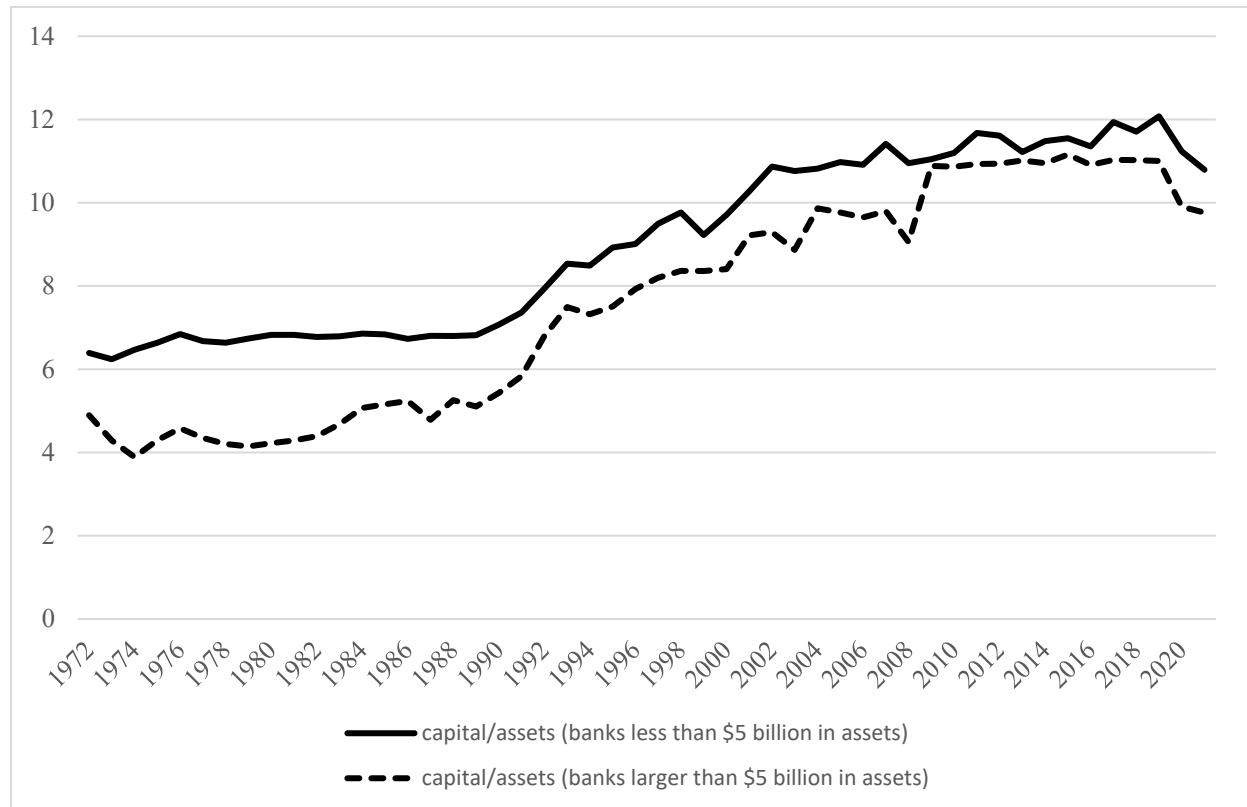
<sup>23</sup> Eugene N. White, *The Comptroller and the Transformation of American Banking, 1960–1990*, OCC (October 1992), 28.

<sup>24</sup> Testimony of Robert Bloom, in *Annual Report of the Comptroller of the Currency* (1976), 189.

Referencing *The Washington Post* article and reiterating the role of strength of management, earnings, liquidity, and the other factors noted above, Bloom said, “the labeling of every bank with a ratio of criticized assets to capital of 65 percent or more as a ‘problem bank’ is a misstatement and oversimplification.”<sup>25</sup>

Shortly after *The Washington Post* article, Sen. William Proxmire held hearings on problem banks where he highlighted the decreasing trend in the capital-to-risk assets ratio. The decline (as shown in figure 4) was pronounced from 1960 to 1975. The decline was especially apparent at the largest banks.<sup>26</sup> Figure 5 shows the capital-to-assets ratios for two groups of national banks, those with assets greater than or equal to \$5 billion each year, and those with assets less than \$5 billion.

**Figure 5: Capital-to-Assets Ratio, all National Banks (1972–2020)**



Source: OCC Integrated Bank Information System

The 1974 year-end data that was available for the Proxmire hearings shows that the aggregated large banks’ capital-to-assets ratio of 3.89 percent was 2.58 percentage points lower than the 6.47 percent ratio for smaller banks. This differential, though now smaller, persists today.

Aggregating over all national banks, the capital-to-assets ratio fell from 14.2 percent in 1961 to 7.8 percent in 1975. To put the trend into context, Comptroller Smith noted:

<sup>25</sup> Ibid.

<sup>26</sup> U.S. Senate Committee on Banking, Housing and Urban Affairs, 94th Congress, Second Session (February 5, 1976), 3.

The United States is now emerging from the severest economic recession since the great depression of the 1930s. Not surprisingly, these serious economic conditions weakened many of the businesses upon which our economy depends. In view of this fact, it would be unrealistic to expect that these major economic problems would not affect the Nation's banks, especially those larger institutions which are the principal credit sources for regional and national businesses. Indeed, I might say, Mr. Chairman, that if the problems of the U.S. economy businesses and U.S. borrowers were not reflected in the loan losses of America's largest banks, then we would have a remarkable event, one deserving of the most searching inquiry and the most indignant editorials from our Nation's major dailies.<sup>27</sup>

Though the Comptroller was correct that macroeconomic conditions of the mid-1970s reflected a period of sustained inflation, relatively high unemployment, and large loan losses, his main point was that banks were nonetheless profitable and sufficiently profitable that losses were covered by earnings. Figure 4 also shows that, for national banks, the decline in the capital-to-risk assets ratio was greater than the decline in the capital-to-assets ratio. Simply stated, Treasury securities and cash assets were becoming a smaller proportion of the balance sheet in the 1960s and 1970s.

Though Congress' focus on capital ratios in 1976 was important, it was the outcome of a case brought before the U.S. Court of Appeals for the Fifth Circuit that was the catalyst for the formal specification of a minimum regulatory capital requirement. On May 28, 1981, the OCC issued a cease-and-desist order to the First National Bank of Bellaire, Texas, asserting that "contrary to safe and sound banking practices, the Bank has been operating with inadequate capital." The OCC asserted the bank needed a capital-to-assets ratio of at least 7 percent. After considering all the factors presented, including the bank's earnings and asset quality, the Court explained its decision to find in favor of Bellaire.

The Comptroller's finding was unreasonable because there is no rational relationship between the evidence, when looked at in the whole, and the finding. There is evidence in the record which, on its face, supports the Comptroller's finding. When this evidence is looked at in light of the entire record, however, it becomes clear that this evidence is not substantive. The Comptroller acted unreasonably in relying on these bits of evidence in light of the entire record.<sup>28</sup>

The court's ruling set the stage for the significant change in the law that led to the modern era of capital regulation. In Part II, we will discuss the nearly 40-year history of capital adequacy during which all banks are subject to a regulation specifying a minimum capital ratio.

## Conclusion

Well before the creation of the OCC in 1863, the importance of bank capital in maintaining the soundness of a bank, and thereby providing protection to depositors, was well-understood by bankers, depositors, investors, and the many federal and state regulators. Yet, over the 120 years of OCC supervision, 70 years of the Federal Reserve System, and 50 years after the creation of the FDIC, there had been no agreed-upon, straight-forward, quantitative measure of capital sufficiency. As described above, capital as a percentage of deposits, capital as a percentage of assets, and capital as a percentage of risk assets each had periods of general favor by a regulator. Then, in 1983, after 120 years of the OCC, the Federal Reserve System, and the FDIC applying judgment and rules of thumb as the starting point for evaluating a bank's capital adequacy, the court's ruling in the Bellaire case was the impetus for a significant change in the law that led to the modern era of capital regulation. Part II will discuss the nearly 40-year history of capital

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<sup>27</sup> Ibid., 7.

<sup>28</sup> *First National Bank of Bellaire v. Comptroller of the Currency*, 697 F.2d 674 (5th Cir. 1983).

adequacy during which all banks have been subject to an enforceable regulation specifying a minimum capital ratio.