Testimony by Bert Ely
to the
House Financial Institutions Subcommittee
at a hearing entitled
TARP Oversight: Is TARP Working for Main Street?
March 4, 2009

Mr. Chairman Gutierrez, Ranking Member Hensarling, and members of the subcommittee, I very much appreciate the opportunity to testify today about TARP and whether it is working for Main Street.

I have appended to this testimony two recent Wall Street Journal op-eds of mine pertaining to bank lending, headlined "Banks Don't Need to be Forced to Lend" and "Don't Push Banks to Make Bad Loans" as well as my resume. I also have appended to this testimony my answers to the eight questions posed in the letter of invitation to testify today. As will be readily evident from my answers, I am not a great fan of the TARP. Further, I greatly fear that the TARP will become a vehicle by which Congress will impose credit-allocation policies on TARP investees. Such policies would be very destructive to the American economy.

Harking back to resume, my early consulting experience is especially relevant to the subject of this hearing as for over a decade I consulted to small and medium-sized businesses on a broad range of financial matters, including obtaining bank credit. I often worked with business insolvencies, including serving as the operating trustee of a company in Chapter 11 bankruptcy, as a consultant to companies in Chapter 11, and as a bankruptcy examiner. Those experiences brought home to me the importance to small businesses of having sufficient equity capital on which to <u>safely</u> leverage bank credit.

As I discussed in my Wall Street Journal op-eds, lending standards clearly are returning to earlier, prudent standards from the excessive laxness of recent years. That return to prudent standards is crucial, both for the recovery from the current recession as well as for the longer-term health of the American economy. This is absolutely the wrong time for Congress to force banks, whether through TARP rules or otherwise, to launch a new round of imprudent lending, whether to small businesses or homeowners or whomever.

With regard to lending to small businesses it is important to realize that the primary reason why a business cannot obtain the credit it believes it needs is that it lacks sufficient equity capital and/or it cannot demonstrate to a lender that it can profitably employ the credit being sought. It is vitally important to realize that credit is <u>not</u> a substitute for equity capital. Rather, credit can only be <u>reasonably</u> leveraged off a sufficiently strong equity-capital base. In this regard, non-financial businesses are no different than banks, except that for good reason non-financial businesses cannot operate with as much leverage as banks and other financial intermediaries. Because lending standards are returning to normalcy, businesses of all types cannot operate with as much leverage as they could a few years ago, nor should they try.

The underlying cause of insufficient credit for businesses, including small businesses, is inadequate equity capital. Rather than beating on banks to lend more, Congress should address the tax disincentives working against equity-capital accumulation within businesses. To put this another way, the Internal Revenue Code is the principal underlying cause of the current financial crisis. I address the tax laws and ten other public-policy causes of the crisis in an article which will appear shortly in the Cato Journal. I would be glad to submit that article for the record when it appears in print later this month.

While there are many aspects of the tax laws which fueled the housing bubble and the gross overleveraging of the American economy, working together they encouraged businesses and individuals to overleverage by incenting overspending and undersaving, thereby discouraging the accumulation of capital denominated as equity. That is, rather than encourage saving, which builds equity capital on a balance sheet, the tax laws actively discourage savings and equity-capital accumulation through the relatively heavy taxation of profits, for profits represent the generation of equity capital. At the same time, the tax deductibility of interest expense by businesses and homeowners encourages borrowing, and therefore overleveraging.

When the pre-tax cost of equity capital is easily 15% or more and the Prime Rate is 3.25%, as it is today, it is an apparent no-brainer for a business to finance as much of its balance sheet as it can with debt capital and as little as possible with equity capital. In addition to funding a portion of a business's balance sheet, equity capital also serves as its loss cushion, the same role equity capital plays in bank balance sheets. That loss cushion becomes vital to a business's survival during a recession, for it is equity capital, not debt capital, which must absorb any business losses and serve as the foundation on which borrowing during tough times must be based. Far too often, I have seen business owners seduced during good times by seemingly cheap debt, only to suffer losses during the tough times that exhaust their too-thin equity-capital foundation.

I will close this portion of my testimony by posing this thought experiment. What would be the condition of the American economy today, and the availability of credit for businesses of all sizes, if interest was not a tax-deductible business expense and business profits were not taxed at a business level? I strongly suspect that America would not be in recession and that it would enjoy a much more profitable and much less leveraged business sector than it has today.

I will close by discussing a threatened loss of bank capital, and therefore a reduction in bank lending capacity – the 20-basis-point deposit insurance special assessment that the FDIC has proposed to levy on the nation's banks and thrifts this coming September 30. This assessment represents a $15 billion tax on bank capital and would occur as the government is trying to boost the banking industry's capital and lending capacity. As FDIC chairman Sheila Bair has admitted, this assessment would be procyclical, yet she is determined to levy it. I recommend that the Financial Services Committee express its opposition, in the strongest possible terms, to this most untimely attack on bank lending capacity. As the banking industry demonstrated in the 1991-96 period, it has the capacity to rebuild the Deposit Insurance Fund back to its statutory minimum, but that rebuilding process should wait until the economy and the banking industry have begun to recover.

Mr. Chairman, I thank the Subcommittee for its time this afternoon. I welcome your questions.

Responses to questions posed in the Subcommittee's Letter of Invitation

1 – In general, have TALP and TALF funds/actions had measurable positive effects on the credit markets? If so, to what extent? If not, or if the positive effects have been *de minimis*, to what factors do you attribute these shortcomings?

> It is not possible to specify the effect of TARP on the credit markets, for two reasons. First, TARP investments represent an addition to bank and thrift capital, as shown in the lower right hand corner of the accompanying illustration of a typical bank balance sheet. Because of the leveraged nature of bank and thrift balance sheets, capital is <u>not</u> a major source of bank funding – deposits and borrowings provide most of the funding with which banks and thrifts make loans and investments. According to FDIC data, bank equity capital (common and preferred) accounted for just 9.4% of total bank and thrift funding at December 31, 2008, while deposits provided 65.2% of bank and thrift funding and borrowings provided another 19.9% of that funding.
>
> Second, because cash is fungible, the cash a bank or thrift receives when Treasury makes a TARP investment in the institution (not a gift, but an investment), it is impossible to trace the flow of the TARP investment into specific loans or investments or other bank assets. Therefore, it is impossible to draw a direct link between TARP investments and changes in bank and thrift lending to any class of borrower.
>
> It is important to recognize that the primary purpose of bank and thrift capital, including TARP investments, is to serve as a loss cushion, to protect bank liabilities, and notably deposits, from losses. Therefore, TARP investments potentially enhance the credit markets, and specifically bank and thrift lending, by increasing the <u>capacity</u> of banks and thrifts to lend to all classes of borrowers.

2 – Generally, have the TARP recipients used the funds in responsible ways and consistent with Congressional intent? (Assuming that Congressional intent was to unfreeze the credit markets, freeing-up capital for lending.)

> Banks and thrifts have used TARP investments responsibly as these investments have strengthened their capacity to lend, and lend they have in the face of an economy sliding into a potentially long and severe recession and declining loan demand because of that recession.
>
> As the accompanying page from the most recent Federal Reserve compilation of commercial bank assets and liabilities shows, bank lending to the non-financial sector of the U.S. economy (line 5 minus line 15) has held up amazingly well. The amount of these loans actually rose 1.8% from its September 2008 average to February 18, 2009, and has declined only 1.2% from the December 2008 average to February 18. During the first year of the present recession (January 2008 to January 2009), bank lending to the non-financial economy increased quite robustly, by 3.9%. It is patently not the case that banks have stopped lending – not only are they lending, but the ratio of their loans to GDP has steadily increased since the recession began.

It also is important to note that the bank lending reported by the Fed is net of loan-loss reserves, as footnote 4 to this Federal Reserve report states. That is, the amount of loans actually outstanding has been reduced by the amount the banks have reserved for losses on those loans. Banks and thrifts have dramatically increased their loss reserves in recent months; for Fed reporting purposes, those increases offset loans, leading to an understatement of bank loan growth. For example, during the fourth quarter of 2008, banks and thrifts increased their loan-loss reserves by $16.5 billion; during all of 2008, they boosted their loan-loss reserves by $70.5 billion.

3 – Have TARP recipients increased business lending? Small business lending? If so, to what extent?. If not, what are the obstacles to lending (e.g., decreased demand, regulatory and capital requirements, inability to leverage, bank mismanagement)?

Business borrowing demand will decrease during a recession as business working capital needs (principally accounts receivable and inventories) shrink, due to lower sales volumes, and as capital outlays (new equipment, building expansions, etc.) are trimmed or postponed. Despite an expected drop-off in business loan demand, due to the recession, the accompanying Federal Reserve data show that bank lending to businesses (commercial and industrial loans, line 6) increased $111 billion, or 7.7%, from January 2008 to February 18 of this year.

Unfortunately, data on bank and thrift lending to small businesses is collected just once a year, on the June 30 Bank Call Reports and Thrift Financial Reports. That data will not be available until early August. It will be most interesting to see what changes in the volume of bank lending to small businesses will have occurred between June 30, 2008, and June 30, 2009.

4 – In order to increase business lending, especially small business lending, should the Treasury Department funnel more funds into the larger banks or should TARP funds be directed to smaller regional and community banks and Community Development Financial Institutions? Which would seem more effective?

As explained above, it is impossible to link any type of bank and thrift lending to TARP investments.

5 – Could you suggest a way to accurately measure whether or not banks have increased lending as a result of accepting TARP funds?

No, I cannot nor can anyone offer a credible way to measure a link between an institution's receipt of a TARP investment and the institution's lending.

It is extremely important to note that bank lending absolutely cannot be measured by the amount of new loans extended by a bank or thrift as much of that lending is merely a rolling over of previous loans. For example, a mortgage refinance for the same amount as the old mortgage does not increase the aggregate amount of mortgage credit outstanding.

Likewise, a business which draws $200,000 under a bank line of credit and then pays down that line of credit nine days later when it receives a payment from a large customer has not changed the amount it has borrowed from its bank even though the $200,000 draw on its line of credit technically would count0 as a new loan. The amount of credit that a bank, or the banking industry overall, has supplied to the economy, can only be measured by the amount of credit outstanding at any one time.

6 – Did the Treasury Department makes its initial TARP investments in the large banks in a manner that was likely to motivate the fund recipients to lend? If not, how should those investments have been made and what can be done to correct past errors?

As noted above, no linkage can credibly be drawn between a TARP investment in a large bank and its lending. Additionally, large banks, like all banks, are in the lending business, for extending credit is the principal way that banks earn profits.

Because of subsequent changes in the rules governing the recipients of TARP investments, notably executive compensation limits, and the prospect of future rules, specifically lending mandates, TARP investments are becoming increasingly unattractive to banks. Not surprisingly, more and more banks which accepted a TARP investment are now preparing to buy back the preferred stock they issued to the government when they received a TARP investment. Right from the beginning, I have strongly recommended to banks and thrifts that they not seek a TARP investment because I could foresee that the rules would make a TARP investment increasingly unattractive. My prophesy unfortunately has come true.

7 – Do you believe some of the large bank TARP recipients are insolvent? If so, how should the regulators deal with those institutions?

Any good accountant should be able to demonstrate that (1) all the large banks are insolvent or (2) all of them are solvent – it is just a matter of the assumptions the accountant makes. This is especially the case with determining the value accorded to investment securities under the fair-value accounting rules.

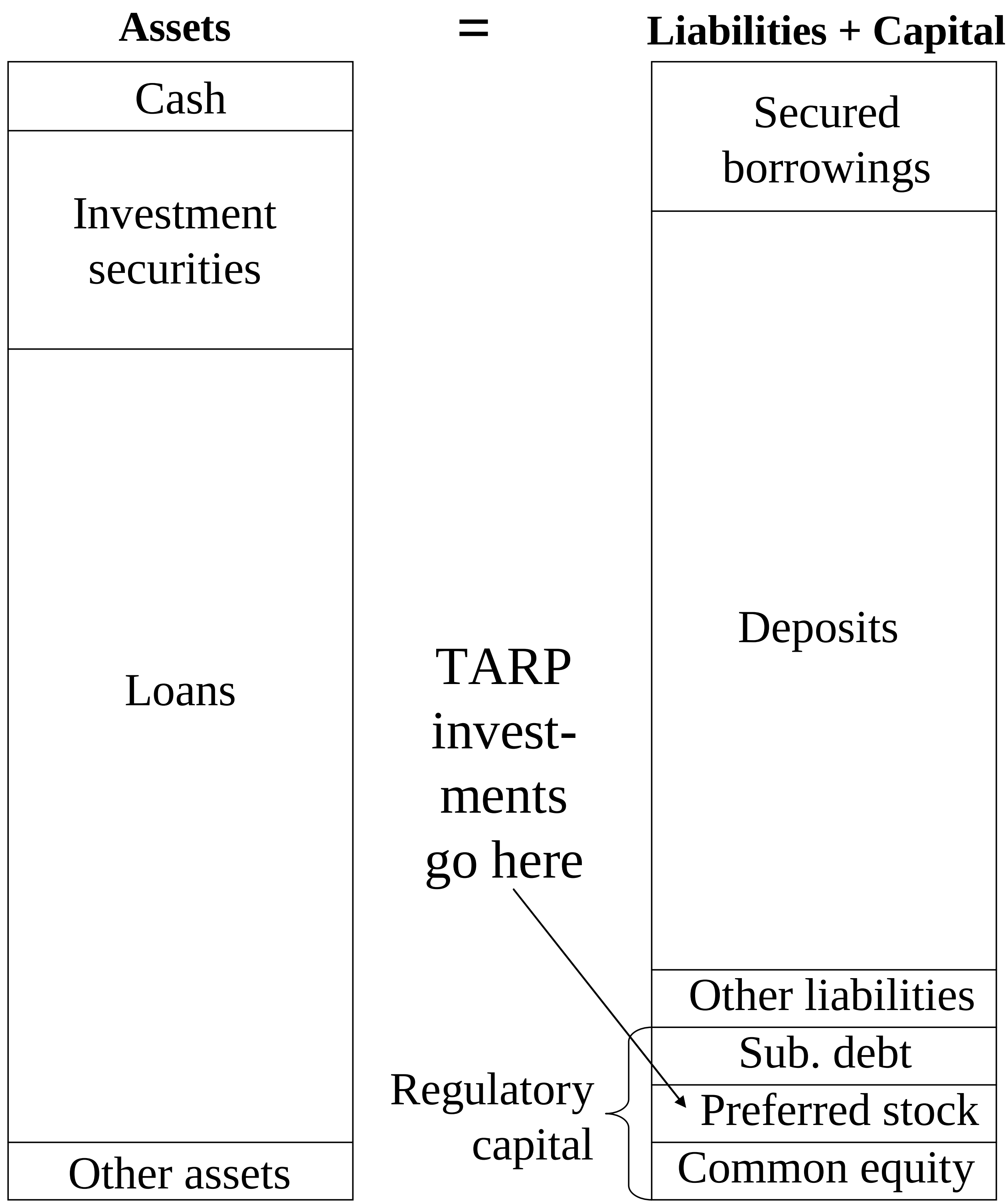
There also is a second question which must be addressed: Is the solvency test aimed at the holding company which owns the large bank or the large bank itself. Given the existence of "double leverage" (holding company debt invested in the subsidiary bank as equity capital), it is conceivable that a large bank holding company is insolvent, but that its subsidiary bank, which has more book equity capital than its parent holding company, is not insolvent.

8 – If the Treasury Department's proposed stress tests reveal that banks are undercapitalized, should those banks receive more TARP funds or would TARP funds be better spend on stronger banks?

As an accountant, I can produce whatever outcome is desired from the proposed stress tests – it is simply a matter of the assumptions that I make. That said, the Treasury Department and the regulators must make judgments about which banks cannot survive on their own. Weak banks should be encouraged to merge with stronger banks while clearly insolvent banks should be taken over by the FDIC under its well-established procedures for dealing with failed banks.

Typical bank balance sheet

(not to scale)



Assets and Liabilities of Commercial Banks in the United States[1]

Not seasonally adjusted, billions of dollars

February 27, 2009

	Account	2008 Jan	2008 Jul	2008 Aug	2008 Sep	2008 Oct	2008 Nov	2008 Dec	2009 Jan	Week ending Jan 28	Week ending Feb 4	Week ending Feb 11	Week ending Feb 18
	ASSETS												
1	Bank credit	9,352.2	9,377.4	9,400.5	9,596.6	9,995.0	9,972.3	9,998.0	9,859.2	9,814.7	9,830.4	9,811.1	9,762.7
2	Securities in bank credit	2,427.6	2,488.4	2,477.3	2,525.5	2,709.6	2,740.0	2,769.1	2,721.5	2,704.5	2,661.1	2,643.4	2,664.9
3	Treasury and Agency securities[2]	1,091.0	1,126.3	1,139.9	1,152.0	1,217.6	1,260.8	1,238.5	1,261.5	1,263.9	1,260.7	1,240.9	1,264.0
4	Other securities[3]	1,336.6	1,362.1	1,337.5	1,373.5	1,492.0	1,479.1	1,530.6	1,460.0	1,440.5	1,400.4	1,402.5	1,400.9
5	Loans and leases in bank credit[4]	6,924.6	6,888.9	6,923.2	7,071.2	7,285.4	7,232.3	7,228.9	7,137.7	7,110.3	7,169.3	7,167.6	7,097.9
6	Commercial and industrial	1,453.0	1,505.7	1,511.6	1,544.3	1,611.1	1,607.8	1,590.8	1,574.6	1,574.5	1,578.7	1,565.6	1,564.2
7	Real estate	3,621.7	3,623.2	3,627.3	3,669.8	3,831.0	3,833.6	3,823.6	3,797.2	3,797.6	3,816.4	3,826.1	3,804.5
8	Revolving home equity	491.0	522.8	527.3	541.6	581.5	586.2	592.0	595.3	595.2	595.0	595.6	595.8
9	Other residential	1,515.6	1,427.9	1,423.7	1,438.5	1,516.3	1,511.4	1,496.1	1,477.0	1,477.5	1,499.2	1,507.9	1,487.8
10	Commercial	1,615.2	1,672.5	1,676.3	1,689.7	1,733.2	1,736.1	1,735.6	1,725.0	1,724.9	1,722.2	1,722.6	1,720.9
11	Consumer	828.4	833.7	844.8	854.8	866.5	877.0	891.8	912.9	919.6	911.7	907.7	910.4
12	Credit cards and other revolving plans	361.9	348.4	356.8	364.2	378.4	390.1	403.1	411.0	410.3	401.4	398.9	405.1
13	Other	466.5	485.3	488.0	490.6	488.1	486.9	488.7	501.9	509.3	510.3	508.8	505.3
14	Security[5]	288.8	275.5	288.7	323.3	302.2	270.8	256.4	224.0	202.9	244.3	254.7	200.2
15	Fed funds and RPs with brokers	229.0	225.1	237.2	260.3	238.9	219.1	211.5	182.3	162.2	205.3	216.0	161.7
16	Other	59.8	50.4	51.5	63.0	63.3	51.7	44.9	41.6	40.7	39.0	38.7	38.5
17	Other loans and leases	732.6	650.8	650.7	679.0	674.6	643.1	666.3	629.0	615.7	618.2	613.6	618.5
18	Interbank loans	448.0	426.8	428.5	463.2	445.6	355.3	375.0	441.4	458.7	438.5	441.1	445.3
19	Fed funds and RPs with banks[6]	366.7	350.4	352.4	391.2	366.0	277.9	309.9	377.4	393.6	376.2	379.4	384.2
20	Other	81.3	76.4	76.1	72.0	79.6	77.4	65.0	63.9	65.1	62.3	61.7	61.1
21	Cash assets[7]	313.6	296.9	290.5	371.7	585.9	890.5	1,041.6	1,019.1	936.3	847.2	790.4	900.6
22	Other assets[8]	968.4	1,013.5	1,010.4	1,047.5	1,096.4	1,129.0	1,141.6	1,104.3	1,101.6	1,108.5	1,122.7	1,096.1
23	TOTAL ASSETS[9]	**11,000.3**	**11,003.2**	**11,015.9**	**11,359.6**	**11,994.3**	**12,215.4**	**12,422.9**	**12,283.6**	**12,172.7**	**12,080.2**	**12,021.6**	**12,061.4**
	LIABILITIES												
24	Deposits	6,714.1	6,857.6	6,869.5	7,072.4	7,161.4	7,132.9	7,343.7	7,364.9	7,297.1	7,350.8	7,320.8	7,322.4
25	Transaction	627.2	602.5	585.2	624.3	660.2	701.0	801.9	719.4	732.2	670.8	642.3	676.1
26	Nontransaction	6,086.9	6,255.2	6,284.3	6,448.1	6,501.2	6,431.9	6,541.8	6,645.5	6,565.0	6,680.0	6,678.4	6,646.4
27	Large time	2,050.4	2,097.0	2,105.5	2,150.2	2,074.6	1,952.8	1,989.9	1,999.1	1,983.3	1,970.1	1,954.1	1,936.0
28	Other	4,036.5	4,158.2	4,178.9	4,297.9	4,426.6	4,479.2	4,551.9	4,646.4	4,581.7	4,709.9	4,724.4	4,710.4
29	Borrowings	2,281.8	2,332.1	2,373.3	2,447.2	2,653.6	2,637.5	2,495.2	2,423.1	2,445.7	2,425.7	2,421.8	2,443.7
30	From banks in the U.S.	487.5	466.6	470.1	479.2	453.1	404.5	384.7	435.2	443.0	423.1	415.6	432.8
31	From others	1,794.3	1,865.5	1,903.2	1,968.0	2,200.5	2,232.9	2,110.5	1,987.8	2,002.8	2,002.7	2,006.2	2,010.9
32	Net due to related foreign offices	122.9	-26.3	-77.2	-65.6	181.6	399.5	460.7	447.3	390.5	341.5	273.0	295.1
33	Other liabilities	700.5	661.1	666.5	707.8	806.9	860.5	932.9	857.8	843.2	764.5	793.6	777.4
34	TOTAL LIABILITIES	**9,819.3**	**9,824.6**	**9,832.1**	**10,161.8**	**10,803.5**	**11,030.4**	**11,232.5**	**11,093.1**	**10,976.5**	**10,882.6**	**10,809.2**	**10,838.6**
35	Residual (assets less liabilities)[10]	1,181.0	1,178.6	1,183.8	1,197.8	1,190.8	1,185.0	1,190.3	1,190.5	1,196.2	1,197.6	1,212.4	1,222.8

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OPINION

JANUARY 6, 2009

Banks Don't Need to Be Forced to Lend

The last thing we need is Congress setting business models.

By Bert Ely

Tomorrow, the House Financial Services Committee will hold a hearing to "discuss priorities" for the Obama administration's use of Troubled Asset Relief Program (TARP) funds. Those priorities could include lending and other directives to financial institutions receiving TARP investments. These directives could be disastrous for taxpayers and the economy if they force banks to engage in unwise lending, or keep weak, troubled banks from being absorbed by stronger banks.

TARP has two major shortcomings. The first is a lack of political support. Congress did not explicitly authorize capital investments in financial institutions when it created the $700 billion program three months ago. The Treasury originally was supposed to buy troubled assets of banks and other financial institutions. It quickly realized that this was unworkable due to challenges in determining asset prices. It then decided to invest TARP funds in the institutions, to increase their capital. But the lack of congressional consent for these investments has understandably stoked controversy about their purpose.

Second, there is widespread confusion about the role capital plays in bank balance sheets, which has exacerbated this controversy. That confusion is evident in comments such as "banks should be forced to lend the TARP monies the government has given them."

Treasury invests TARP funds by purchasing preferred stock in a bank, which adds to the bank's capital. Bank capital, which also includes common stock and retained earnings, serves as a cushion to absorb losses from loans and other bank activities; it is not loaned out directly. Most bank lending is funded by customer deposits and borrowings from third parties (such as the Federal Home Loan Banks).

Potentially, a bank could use its increased capital from TARP to absorb losses from loans and investments already on its books, to acquire banks too weak to remain independent, or to increase its lending. The higher capital boosts a bank's lending capacity because it enables the bank to safely increase its deposits -- and thus its loans -- without increasing its risk of insolvency.

Unfortunately, Treasury has poorly explained the legitimacy of those uses. Congressional debate about TARP may further muddy the waters. A review of these uses show why none should be mandated or barred.

First, even well-managed banks are suffering loan losses as collateral values shrink and the recession deepens. In normal times, a bank would raise new capital to offset those losses. However, the capital markets are not functioning normally, with many sound banks now unable to raise fresh capital.

TARP investments, which increase a bank's capital, therefore serve as a bridge to when normality returns to the capital markets. Because of restrictions accompanying TARP investments, and a jump in the TARP dividend rate after five years to 9% from 5%, banks will have an incentive to raise private capital to finance a buyback of their TARP preferred stock. Taxpayers will profit from these TARP investments because of the dividends paid by the banks on the preferred shares the Treasury purchased.

Second, weak banks need to be acquired by well-managed banks rather than being propped up by TARP investments, for weak banks are not good lenders. The continued existence of weak banks will impede the economic recovery.

However, an acquirer needs to realistically account for losses buried in the other bank's balance sheet even though this accounting will reduce its own capital. The TARP investment should therefore ensure that the merged bank is well capitalized. Eventually, that bank would raise capital to retire its TARP stock.

Third, while a TARP investment increases a bank's lending capacity, lending mandates -- such as that a bank must increase its outstanding loans by some multiple of its TARP investment -- could force banks to make new bad loans.

Unfortunately, banks accepting TARP investments must, under the contract governing Treasury's investment in the bank, agree that Treasury can "unilaterally amend" the agreement "to comply with any changes . . . in applicable federal statutes." Through this provision the new Congress can impose on banks with TARP investments lending mandates or other obligations and restrictions, such as barring the use of TARP funds to acquire weak banks. Even worse, Congress may legislate credit allocation, such as directing that a certain percentage of a mandated lending increase must go to a favored class of borrowers.

Banks are in the lending business: They do not need to be forced to lend. And contrary to popular and political opinion, banks have not stopped lending. Despite the recent financial market turmoil, a declining GDP, and an increase in loan-loss reserves, commercial bank lending actually grew $336 billion, or 4.9%, from August to Dec. 24, according to Federal Reserve data. While lending dictates or other restrictions may be tempting, the Obama administration must discourage Congress from imposing them on recipients of TARP investments.

Mr. Ely, the principal in Ely & Co., Inc., is a financial institutions and monetary policy consultant.

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OPINION

FEBRUARY 2, 2009

Don't Push Banks to Make Bad Loans

Contrary to myth, commercial bank lending is up. So are standards.

By BERT ELY

There is a widespread belief that banks are now refusing to lend as much as they should, and that Congress should pressure them to extend more credit to consumers and businesses.

In reality, banks as a whole increased their lending during 2008 -- the notion they haven't is based on a misunderstanding of U.S. credit markets. Pressuring banks to lend more could backfire.

Lost in too many discussions of the financial sector is that banks and other depository institutions account for only 22% of the credit supplied to the U.S. economy (down from 40% in 1982). "Shadow banking" -- notably asset securitization and money-market mutual funds -- now supplies 33% (up from 14%). Insurance companies, other financial intermediaries, non-financial firms and the rest of the world provide the balance.

As far as commercial banks go, Federal Reserve data released last week show that their lending increased 2.36% during the last quarter of 2008. For all of 2008, commercial-bank lending rose by $386 billion, or 5.63%, even as the economy slid into recession. Over that 12-month period, business lending jumped $152 billion, or 10.6%, real-estate loans were up $213 billion, or 5.9%, and consumer lending rose $73.5 billion, or 9%. Other categories of bank lending such as loans to farmers, broker-dealers and governments, declined $53.2 billion, or 5.4%.

Fed data also show that during the first three quarters of 2008, the total amount of credit supplied to the economy increased $1.91 trillion, or 3.8%, with $540 billion of that amount coming from foreign lenders.

Nevertheless, Treasury recently demanded that the 20 largest recipients of government capital investments start providing detailed monthly reports about their lending and investment activities. This new requirement could lead to government lending mandates. That would not be a good idea.

In the first place, the drop in stock-market and house prices has made millions of families feel poorer and led them to save more than in recent years. It has also encouraged them (especially Baby Boomers approaching retirement) to pay off debt. They don't need more debt.

More broadly, many of the most creditworthy neither need to nor want to borrow right now. Richard Davis, CEO of U.S. Bancorp, recently said that he is seeing the demand for loans diminish at his and other banks "from people and businesses spending less and traveling less and watching their nickels and dimes."

Lenders moreover have tightened lending standards, correcting an excessive laxness that contributed to our financial mess. Zero or very low down-payment mortgages are out, as are "covenant light" corporate loans. Likewise, lenders have trimmed credit-card limits and cut the amount of money available under home equity lines of credit as home values have declined.

And contrary to the "lend more" message broadcast from inside the Washington Beltway, bank examiners are criticizing weak loans and forcing banks to tighten lending standards. Bankers are caught in a vise between politicians and examiners.

A lot of the credit tightness is a reflection of the near-collapse of loan securitization. Recent Fed plans to buy asset-backed securities may help revive asset securitization, but bankers have no control over the fate of that initiative.

The economy is in recession and working off the consequences of a housing bubble fed by excessive mortgage credit. Given that loan demand typically falls during a recession, it's amazing that bank lending increased as much as it did last year. It was essentially flat during the 2001 recession.

Bankers should always lend prudently, as they are now doing. If they are jawboned or worse by Washington into reckless lending, the U.S. will set itself up for another debt crisis, even before the present mess has been cleaned up.

Mr. Ely, the principal in Ely & Co. Inc., is a financial institutions and monetary policy consultant.

Biographical sketch for Bert Ely

Bert Ely has consulted on deposit insurance and banking structure issues since 1981. In 1986, he became an early predictor of the S&L crisis and a taxpayer bailout of the FSLIC. In 1991, he was the first person to correctly predict the non-crisis in commercial banking.

Bert continuously monitors conditions in the banking industry as well as monetary policy. In recent years, he has focused increased attention on the GSEs, notably Fannie Mae, Freddie Mac, and the Farm Credit System. He has co-authored a monograph on how to privatize the three housing-finance GSEs. Currently, Bert is focusing his attention on banking problems, the crisis in housing and housing finance and the entire U.S. financial system, and the resolution of the Fannie and Freddie conservatorships.

Bert has testified on numerous occasions before congressional committees on banking issues and he often speaks on these matters to bankers and others. He is interviewed by the media on a regular basis about banking and other financial issues.

Bert first established his consulting practice in 1972. Before that, he was the chief financial officer of a public company, a consultant with Touche, Ross & Company, and an auditor with Ernst & Ernst. He received his MBA from the Harvard Business School in 1968 and his Bachelor's degree in economics in 1964 from Case Western Reserve University.

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