

Remarks by

DAVID W. MULLINS, JR.

VICE CHAIRMAN
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D.C.

before the

Brookings Institution
and
Chicago Clearing House Association Conference

Washington, D.C.

December 16, 1992

It is good to be here. I think it would be most useful to have two speakers, one giving points and the other counter points. I have some difficulty, since I tend to agree with what Congressman Leach has said on most of these issues, particularly with respect to GSEs.

So, instead of disagreeing, perhaps I will talk in a bit more detail about a couple of issues.

Let me just begin by referencing an article which I read last week and which was written by one of the most experienced and knowledgeable observers of the U.S. banking scene.

In this article he said -- and I quote -- "We are literally regulating the U.S. banking industry to death."

I thought I would begin with a brief review of the recent performance of the industry to see if we can detect whether rigor mortis has set in. Indeed, as Congressman Leach said, I think the reports of the industry's death may be a bit exaggerated. The U.S. banking industry had all-time record first-quarter profits and all-time record second-quarter profits and all time record third-quarter profits; and this, of course, aggregates to all-time record profits so far for the year.

Profits through the third quarter equaled \$24 billion. So, barring a real December surprise, 1992 set the all-time record for industry earnings, perhaps over \$30 billion for the full year. This compares with \$18 billion last year. The average in the 1980s was about \$14 billion. So far in 1992, the average return on assets is 96 basis points. Roughly two-thirds of U.S. banking institutions earned more than one percent on assets

through the third quarter. In typical years, less than half earn above one percent.

There are still asset quality problems in the U.S. banking industry: \$69 billion in non-performing loans. But one has to measure that against \$55 billion in reserves and \$257 billion in equity capital.

The industry has made impressive progress in working through its asset quality problems. Over the past four-and-three-quarters years since 1988, the industry has charged off \$123 billion in bad loans; yet increased reserves by \$5 billion and added \$77 billion in equity capital.

As Congressman Leach mentioned, the capital base has been expanded with retained earnings and large equity issues producing an average equity capital ratio of 7.4 percent now, up from 5.8 percent in the beginning of the 1980s; and, as Congressman Leach noted, the highest since 1966.

This capital is not just accounting fluff. The stock market's view of the industry has changed dramatically, as well. For the top 50 institutions at the end of 1990, the average market-to-book-value ratio was about 85 percent. Banking stocks were selling at a 15 percent discount to book value.

Today, the top 50 are selling at a 61 percent premium to book value.

So, all in all I think it is clear that 1992 is the single best year in the entire history of the U.S. banking industry.

One reaction to this performance is this: if U.S. banks are being regulated to death what a way to go!

I think this is the wrong reaction, for a couple of reasons. First, because this is actually a tale of two industries. It is the best of times for most in the industry, but, still, the worst of times for too many, representing a significant portion of the industry. Second, because I do believe that the concern over the economic damage of regulatory burden is valid and the potential damage is quite real.

While it is the best of times for most of the industry, we continue to have a near record volume of assets on the FDIC's problem bank list: almost \$500 billion. The FDIC's BIF fund remains depleted, down from \$18 billion in 1987.

It is true that bank failures have gone down in number and leveled off in size. Nonetheless, all is not well when roughly 15 percent of the industry's assets -- half a trillion dollars -- is in troubled institutions.

These firms represent the residue that has fallen to the bottom of the industry, unable to compete in an increasingly competitive financial services industry, revolutionized by technology and innovation. I won't review the sort of fundamental reform we need, but in my view we will continue to have weakness in the banking industry until we get that reform.

With the industry so traumatized by the results of last year's attempt at reform, they appear unable to enjoy even a record year. Consequently, they may be reticent to come back and

ask for fundamental reforms in the very near term; and, thus, I am not so optimistic on that front.

So, despite the profitability of the industry as a whole, we do have this weak segment. It represents an economic and in some sense political threat. Congress focuses on the threat to the taxpayer, even though the bulk of the industry is doing well.

A second reason not to celebrate too much is because of the massive increase in regulatory burden in recent years. We have seen this first hand at the federal banking agencies. Each agency had to create over 60 working groups to write the regulations to implement FDICIA.

In my view too many of the requirements of that statute represent a dead-weight economic loss, wasted resources imposed on the banking industry without measureable benefits to safety and soundness.

The cost of FDICIA has yet to show up in the industry, although some people could argue, I suppose, that, absent the increased burden, the industry may well have earned record profits in this financial environment with a lower prime rate and more lending.

But I think the real economic burdens are in the future, as next year many of these requirements will be fully implemented.

There are also healthy components of FDICIA which we must not overlook. Prompt corrective action is a step forward, as well as the foreign bank supervisory components of the act.

Nonetheless, in my judgment the rising tide of regulatory burden, in the context of an environment of intense competition in financial services, does constitute a threat to the viability of the industry.

It is useful to ask: How did this happen? What did this industry do to inspire this sort of legislative assault? The answer is simple: The U.S. banking industry got too close to the taxpayers' pocketbook.

In the wake of the S&L workout, a similar federal safety net for banks, a depleted insurance fund, and record assets in problem banks, all motivated Congress to lower the regulatory boom on the banking industry.

How can the industry reverse this trend and convince Congress to reduce regulatory burden? One way is for the industry to move away from the taxpayers' pocketbook by limiting the scope of the federal safety net.

Many in this room have fresh bruises or old scars resulting from previous attempts to try to limit the federal safety net. I won't open any old wounds with suggestions on how this might be done, but I will move on to the narrower issue of the repeal of the more notable FDICIA burdens.

FDICIA was a simple deal. Congress imposed heavy regulatory burdens, and in exchange Congress authorized, for the first time, the U.S. Treasury to set up a formal, direct, substantial funding mechanism for the FDIC insurance fund. So, for the first time, Treasury funds, that is, taxpayers' funds, would be used to fund

loses in the FDIC's bank insurance fund. The line of credit from Treasury to FDIC was raised from \$5 to \$30 billion.

Given the performance of the industry and the improved outlook for the economy, one wonders whether the industry would be willing to reverse the deal; to achieve a rollback in regulatory burden in exchange for taking Treasury out of the business of funding the FDIC, re-establishing the Treasury line as a modest liquidity backup, rather than a substantial funding mechanism and allowing the industry to once again take direct, frontline responsibility for funding the FDIC.

I will leave this question to others and turn to the question of the Basle capital standards and their role in the recent behavior we have seen in banking institutions.

In looking back to March 1989 and thinking about the Basle accord, why was it done? The basic issue was competitive equity. Foreign institutions had low capital requirements and were competing unfairly, and, indeed, these low capital requirements helped contribute to worldwide excess expansion of credit. The retrenchment from that excess credit expansion is contributing to a world economic slowdown.

The risk-based framework is consistent with the basic tenets of finance. Riskier investments should be backed by more capital. This is consistent with observed market-induced capital structures in private industry. We see firms that are risky have low debt ratios and high equity ratios. More stable firms, like utilities, tend to have high debt ratios or low equity ratios.

It is also consistent with other regulatory capital schemes. The SEC's net capital requirements are heavily risk based, although it tends to be based upon marketability risk, not credit risk.

So, the objective of a risk-based capital framework was, in part, to remove the bias toward risky investment that comes from having a single capital standard for risky investments, as well as low-risk investments.

I should note that there was controversy in 1989 about applying these standards to domestic institutions. Some felt it should be applied only to international institutions.

What was the concern? The concern was not that the Basle standards were too stringent; the concern was that they were too weak. Some feared that if we applied the Basle standards to domestic institutions, it would substantially reduce capital standards for the U.S. banking industry.

As you recall, that was a rather vigorous debate. The outcome was to retain the leverage ratio in addition to risk based standards. That debate continues.

It is a bit curious and ironic that now the allegation is that somehow the Basle standards imposed a burden on the banking industry that turned the industry away from lending and toward investment in government securities, producing a credit crunch with an alleged detrimental impact on the economy.

The alternative explanation is that the underlying economic and financial conditions induced the change in bank behavior. The recession and the dramatic trend toward deleveraging reduced

loan demand and asset quality problems motivated banks to raise underwriting standards and shore up capital ratios and liquidity.

This sort of behavior is typically associated with recessions. The severity might be related to the severe nature of the asset quality problems and excess leverage in this cycle.

I shall not settle this issue today. I am not going to present a rigorous analysis. I do think it is an important issue. It is one we are working on, but we have not yet arrived at definitive conclusions.

I do propose to raise some questions and some issues which I think are important, in the ongoing debate about the Basle capital standards.

At the outset I would acknowledge that the Basle standards have had the effect of shifting bank investment away from riskier loans and toward safer securities. That is what they were designed to do: to remove the bias toward risky investment inherent in having a single capital standard for all risk level investments.

The question is: Was the Basle effect marginal, or was it substantially responsible for the large shift from loans to securities that we have observed?

I would note several things. First, of course, the Basle standards are not now, nor have they ever been, binding on the overwhelming fraction of the industry. 98.5 percent of the U.S. banks meet the risk based standards, representing 98.8 percent of

the assets. Even in December 1990 95 percent of the industry met the standards.

The Tier One capital requirement is four percent. The average U.S. bank has 9.6 percent. This is not close. The risk-based capital requirement is 8 percent; the average U.S. bank has almost 12 percent. And, indeed, even the well-capitalized standards are exceeded by most U.S. banks -- 94 percent of U.S. banks meet the well-capitalized standards and they represent almost 80 percent of the assets of the industry. This is up from 88 percent of the institutions in December 1990 who met those standards.

Indeed, two-thirds of U.S. banks have risk-based capital greater than 14 percent against the 8 percent standard. So, the Basle capital standards have not been binding on U.S. banks nor did we expect them to be.

There is no question that U.S. banks did enter this period with inadequate capital, and they have raised capital. They felt pressure to raise capital well above the Basle standards. The pressure came not only from regulators. Banks felt real pressure from the markets. In the fall and winter of 1990, some institutions had to pay 500 basis points above the comparable Treasury rate to raise subordinated debt, and some institutions had to pay very high spreads on their money market preferred stock, and their stock prices fell as well. This was the market giving them a message to add capital. When the market does this, banks respond very quickly. Moreover, bankers also decided they

needed more equity capital in order to be able to lend on a sustainable basis.

Should one blame the Basle standards when they do not appear to be a binding constraint? There is no question that there were higher constraints imposed by the market, the regulators, and the bankers themselves.

It might be useful to look at the behavior of the least bound segment of the industry, the firms least likely to be motivated by the need to meet the Basle standards. If Basle is motivating bankers to acquire securities, that behavior should be less evident among those institutions that are least bound. But, to the contrary, the well-capitalized institutions -- the ones with risk-based capital greater than 10 percent -- account for the overwhelming percentage, the overwhelming majority of securities acquisitions over the last three years, despite the fact that they would not seem to have had to bias their investment behavior to meet the Basle standards.

What about a controlled experiment? Find a financial industry which is similar to banking but does not have risk-based standards imposed coincident with this economic cycle. I would suggest credit unions, as an example. They have traversed the same economic environment without risk-based capital standards. How have they behaved?

Well, they have behaved somewhat similar to banks, except that they have cut back on their loans more dramatically and

increased their securities more sharply than have commercial banks.

Over the past four years, commercial banks' loans as a percentage of assets have fallen from 62 percent to 59 percent. Credit unions' loans to asset ratio has gone from 66 percent down to 55 percent during the same period. And, credit unions have increased their investment in securities much more than banks. Treasury securities have risen from 10 to 15 percent of assets, and agencies or GSEs from 18 to 21 percent of credit union assets.

Though the shift is more dramatic, the pattern for credit unions, the timing, lines up precisely with the timing observed for commercial banks.

I suppose this could be a sympathetic reaction on the part of credit unions because of the imposition of Basle standards on banks. I do know that banks have no sympathy for credit unions, and I am not sure about the sentiment in the other direction.

The credit-union experience appears consistent with the view that weak demand and, perhaps, a concern about asset quality have been important factors behind the substitution of securities for loan growth; and I rather suspect that one would find similar patterns of behavior in other financial industries.

Thus, when one looks at unbound banks or unbound industries, this behavior is evident, so it seems difficult to ascribe too much of it to the Basle standards. And, of course, the timing isn't quite right either, because the standards were announced in

March of 1989 and one would expect banks to look ahead and dramatically cut lending and increase securities investment. Instead, banks continued to increase their lending as a percentage of their assets into late 1990 or early 1991. The cutback in loans seems to coincide with the economic cycle suggesting that economic fundamentals, more than Basle standards, were important causal factors.

Still, aren't banks in danger of becoming bond mutual funds? Let's put this in historical perspective. Fifty years ago the average bank had 60 percent of its assets in securities and 20 percent in loans.

Today, those percentages are reversed. The average bank has brought securities down from 60 percent of assets to 15 to 20 percent of assets.

Loans have increased steadily during this period, as banks' portfolios have, in effect, become riskier, even though their capital has not risen until recently.

Loans peaked as a percentage of assets at 62 percent in 1989 and 1990, and have fallen back to just under 59 percent. If banks are not lending enough, it can be said that they are lending more, as a percentage of their assets, than at any time in the past 50 years, and, I would suspect, any time in recorded history, except for a brief period from the mid-1980s through 1990, a period we now recognize as the tailend of a long period of overexpansion of credit.

Some of the pullback in lending is likely a cyclical response to that overexpansion of lending. Underlying this cyclical reversal is the cessation and perhaps some reversal of the long secular trend toward increased loan-to-asset ratios in U.S. banks.

Is this reversal likely to continue? Are banks likely to turn into mutual funds? It is difficult for banks to compete with bond mutual funds since banks average 400 basis points in non-interest expense. A good portion of that is intermediation costs. Mutual funds, of course, have very small intermediation costs.

Moreover, our evidence is that banks are not taking undue interest rate risk, that most of their investment is in the two-to-three-year maturity range. (I might add that the call report is misleading here because it puts all CMOs into the five years and greater maturity category even though our evidence from surveys and supervisory experience suggests banks are investing in the shorter duration tranches of the CMOs.)

A 3 percent federal funds rate and a 5 percent three year Treasury rate yield only a 200 basis point spread. I doubt that banks can recover their intermediation costs over the longer term with a strategy of investing in Treasury securities.

Compare this to small business lending: 2 percent above prime; a 500 basis points spread to fed funds with no interest rate risk but credit risk. And, of course, consumer lending, for

example credit card lending, also offers very attractive spreads compared to investing in Treasuries.

It is also true that capital disadvantage of loans can be offset -- our analysis would suggest -- with about 50 basis points in additional return.

While securities investment may be a viable short-term holding strategy, even with a highly sloped yield curve, it is difficult for banks to consistently earn profits except through lending. And, lending to segments of the market that do not have direct, cost-effective access to the public capital markets; lending where banks expertise in credit evaluation and monitoring and working with borrowers has value.

But, isn't securities investment responsible for banks' impressive profit performance this year?

So far in 1992, through the first three quarters, profit before tax in the banking industry totaled \$35 billion, while securities gains were only \$3.2 billion, less than 10 percent of industry earnings.

Of course, banks have also earned interest on their investment in securities. But when securities make up less than 22 percent of bank assets, they are destined to be only a sideshow in bank profitability. It should be clear that the source of banks' impressive profitability this year is the wider spreads on the 60 percent of their assets invested in loans.

The 300 basis point spread between prime and fed funds is near a historically high level. This is typical near the end of

a recession, although it usually lasts only several quarters. It has lasted much longer this time. And, this persistently wide spread between loan rates and overall bank funding cost is consistent with weak loan demand, producing little payoff to loan rate competition and inducing banks to reduce deposit rates sharply.

Let me give you the case example of one large institution deeply into middle market lending. Earlier this year, this bank decided to get aggressive and cut its prime rate by a quarter point. They waited patiently to be trampled by credit-starved borrowers.

It got lonely after six weeks or so. The prime cut did not generate more borrowing. The bank simply lost a quarter point on all their existing prime-based loans.

There is also ample survey evidence documenting weak loan demand from the National Federation of Independent Businesses and other sources.

Having said all this, I am not prepared to rule out the possibility that the Basle standards are misspecified and may have played more than an insignificant role in constraining lending. This is a legitimate subject for analysis. We should not shrink from rigorous, critical analysis of the Basle standards.

To do this I would suggest that one needs a firm analytical foundation to secure an analytical anchor to the entire system. Then, one can talk about relative standards.

I would propose, as the appropriate threshold question: Is 4 percent equity too high a capital requirement for investments of the risk level of C&I loans? Is \$4 behind every \$100 of C&I loans too much to ask as the Tier One equity requirement? And, one can broaden the question. Is 8 percent total capital too high, or are 6 and 10 percent excessive as well-capitalized standards?

These are important questions. We know the cost of getting these questions wrong.

Let's focus on the equity capital ratio. Is it too high, 4 or 6 percent? Well, the history of loan losses, as well as asset quality problems suggest that C&I loans are risky assets. This raises doubt as to whether 4 percent is too much to ask. And, since the average bank has an overall ratio of equity to total assets of 7.4 percent, the industry does not seem to think the standard is too high.

And, we know the distortion caused by the federal safety net and the incentive to substitute the government guaranty for private capital and the risk associated with that.

So, let's look at a similar industry without the federal safety net to see what capital structure the market induces. Commercial finance companies specializing in business loans exhibit equity capital ratios, comparable to Tier One bank capital, in the 10 to 15 percent range. These firms are generally profitable, except for the few that followed banks into

commercial real estate. They have been generally expanding their business loans during the recent period.

Moreover, there is an admittedly tenuous relationship between Tier One equity and bond ratings that would tend to suggest, that roughly a 10 percent ratio is associated with a strong investment grade bond rating. This is another market indication of appropriate bank capital structure.

Can banks be profitable at 10 percent equity? Finance companies are. Moreover, banks with the highest capital are the most profitable. There is interesting research on this relationship which I shall not explore today.

So, there is a substantial burden of proof which is associated with the proposition that the problem with Basle is that the capital standards on C&I loans are too high and that this is an inappropriate constraint on bank lending.

What about the relative calibration of these standards? How about a zero capital requirement on government securities? This ratio is inappropriate; and we are in the process, as you know, of designing interest rate risk standards to augment the basic Basle framework. In the interim the leverage ratio has been retained as a capital charge applying to all bank assets.

What about mortgage-backed securities at 20 percent weight? If \$4 in equity behind every \$100 in C&I loans is appropriate, how about behind every \$100 in mortgage-backed securities, 80 cents in equity capital, as a cushion in case anything goes wrong with \$100 in mortgage-backed securities?

There may be legitimate concerns about the relative calibration of these ratios, but we should be very careful not to allow dissatisfaction with the relative calibration of Basle ratios to lead us to the dubious and potentially very dangerous conclusion that we need to lower the absolute capital standards on risky lending.

We have been down that road before. The first few miles are quite enjoyable, but the ultimate destination is very unpleasant.

If we attempt to treat the weakness in economic growth and in loan growth with the short-term narcotic of inappropriately low capital standards on risky lending, we know from the S&L experience that that is not a life-sustaining prescription for the industry or the economy.

I am not going to review the importance of the private capital ahead of the government guaranty as a protection for the taxpayer and as a constraint on moral hazard. As a former professor, I would hope that we learned that lesson last semester. If we haven't, we will certainly learn it again next semester; the question is whether we will ever graduate.

So, while there may be a question of the relationship of the Basle components, we ought to be careful to maintain an adequate capital requirement on risky lending.

Having raised these questions, the final question is: Is there a problem here at all? Or, is all of this a natural, unavoidable adjustment process that the financial system and the economy must simply work its way through?

There is evidence of a problem here in the cumulative increase in burden on the industry. Equally important, there is troubling evidence with respect to C&I lending, small business lending, in particular.

Despite the long trend toward increased loans as a percentage of bank assets, C&I loans peaked, as a percentage of bank assets, in the late 1960s; and they have fallen during the 1980s from well over 20 percent of assets down to 15 percent.

Total loans are still almost 60 percent of assets, much larger than securities. But C&I loans have fallen as a percentage of bank assets and this started long before the Basle Accord.

In contrast, consumer debt and mortgage debt and mortgage-backed securities all rose sharply during the 1980s.

Perhaps this is a natural economic trend of securitization with the better C&I credits going directly to the markets. However, I think it warrants careful analysis. During the 1980s banks began to look less like business lenders and more like thrifts and consumer banks.

In the recent third-quarter data, bank loans increased, after six consecutive negative quarters. Though overall loans increased, led by residential mortgages and consumer installment loans and home equity lines, C&I loans, once again, fell; this time by \$6.5 billion.

There is also other evidence of tightness in business lending. Bank business loans (at U.S. offices) in late 1992

remained at about the same level as three years earlier in late 1989 -- a bit under \$600 billion. During the same period, business lending by finance companies has expanded from about \$250 billion to above \$300 billion. This suggests a substitution of finance company lending for bank lending. I doubt that this is perfect substitution because finance companies focus on asset-based lending, as opposed to the generalized lending that banks do.

So, looking at the trends, there is concern that the banking industry may be systematically retreating from small business lending in favor of mortgage and consumer loans. I have no doubt that in time, if this were true, alternative providers of finance would appear to fill the void. This may be happening. Some people would say that it might not be such a bad idea if this lending took place outside the federal safety net. However, this will take time, and there are adjustment costs to this process.

Why is small business lending so important? Because small businesses are the chief source of growth for the economy, especially employment growth. During the decade of the 1980s, Fortune 500 companies reduced employment, and yet the economy produced almost 20 million new jobs.

Small business are important contributors to economic growth and to job growth. But this segment is dependent, to a large extent, on bank financing, unlike other borrowers. Small businesses have relatively few financing alternatives, especially as a source of generalized finance.

The troubling longer-term trend in bank C&I lending suggests a couple of things. First, we need to know more about small business finance; we need more research into small business lending. Indeed, the Federal Reserve Board has approved and authorized a large sample staff research project into the nature of small business lending. This is a study focusing on the full range of financing available to small businesses, not just bank finance. This is a major research project which will take some time to complete.

As for the near term, it would be useful to carry out a systematic, rigorous analysis of the regulatory impediments to small business lending. Within the broader regulatory burden area we need to zero in on C&I lending. Then, it would be useful to launch a search-and-destroy mission to eliminate unwarranted impediments.

There may be non-capital impediments. There has been a trend, culminating in FDICIA, toward the standardization, the mechanism of supervision and regulation, with heavy emphasis on formulas, documentation and rigid rules.

This may have produced a systematic bias away from small business loans, which are often character loans, cash flow loans, requiring judgment and where the return comes from active monitoring and working with the borrower. These loans are heterogenous in nature and may not be amenable to the increasingly standardized nature of supervision and regulation.

In contrast, this trend in regulation may bias lenders toward homogenous lending product categories more easily documented, scored, and categorized, like mortgages and consumer loans.

To understand the bias, consider the work a lending officer must do to document and qualify a cash flow loan to a small business without audited financial statements. Compare that to the easier task of placing funds in standardized mortgages or in consumer installment loans, amenable to computerized credit scoring.

When one considers the difference in regulatory burden and documentation and especially the difference in examiner scrutiny between generalized small business lending and standardized mortgage and consumer lending, one wonders whether this could produce a systematic bias against business lending.

There are also fixed costs involved. A small business loan requires much the same documentation as a loan to a Fortune 500 company.

So, it is important to recognize the inherently different nature of business lending, versus the more standardized lending, and for this segment perhaps design a different regulatory process, tailored to be congruent with the nature of business lending, rather than trying to force business lending into the standardized, regulatory mold.

Indeed, the SEC has reduced and simplified registration and reporting requirements for small securities issuers in the public

capital markets. We should investigate whether there are appropriate analogs in the bank business lending area for reduced and simplified procedures.

Streamlined regulatory procedures for small business lending may cause some to worry about safety and soundness. I worry less as long as adequate capital standards are maintained for this type of lending. I would much prefer to depend upon capital standards, than rely on non-capital regulatory processes.

Of course, the capital standards themselves, I would admit, are legitimate targets in this analysis, especially the relative calibration of risk-based standards. But I believe a critical requirement of any examination or proposal to alter the capital standards should be a firm commitment to maintain adequate capital standards on risky lending. The objective should be to reduce the regulatory impediments to lending, while absolutely assuring that the banking industry is required to maintain adequate capital. It is important not just for the taxpayer but, as Congressman Leach said, for the economy. Capital standards which are too low produce over expansion of credit and asset quality problems. Then, when weakness in the economy develops, banks must pull back to build capital in bad times, exacerbating the downturn.

This pro-cyclical behavior is inherently destabilizing and damaging to the economy.

In contrast, a well capitalized banking industry is able to lend, on a sustainable basis in good times and bad, to support the economy as a counter-cyclical force in a downturn.

Banks did enter this recent period of economic weakness with weak capital and have incurred the economic cost of building bank capital in bad times. With a replenished capital base and ample liquidity, the U.S. banking industry appears now poised to support sustained economic growth.

It would be indeed unfortunate if we dissipated these hard-won gains, attracted by the transitory thrill of yet another ride on the credit expansion rollercoaster.

Let me just sum up with a couple of points.

The U.S. banking industry has made impressive progress in recent years. Weakness remains in a segment of the industry and weakness is likely to persist until fundamental banking reform is enacted. Despite the recent good performance, the rising tide of regulatory burden is a threat to the industry and ultimately to the economy. I would single out small business lending as a possible problem area, not just because of the Basle standards -- after all, the same standard applies to consumer loans and business loans -- but rather because of the longer term, troubling, down trend in small business lending. Because of its importance to the economy this is an area worthy of rigorous analysis, leading perhaps to a redesign of the regulatory approach to small business lending, consistent with sound capital standards.

Thanks very much.

5