

# **THE SAVINGS AND LOAN DEBACLE: A Perspective from the Early Twenty-First Century**

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## **INTRODUCTION**

The savings and loan debacle of the 1980s was a costly but important learning event for depository regulation in the United States. The origins of the debacle lay in restrictive government regulation that eventually led to financial difficulties for savings and loan institutions in the late 1970s and early 1980s. The Congress and at least three presidential administrations delayed for far too long in undoing the restrictions. When the restrictions were loosened in 1980 and 1982, safety-and-soundness regulation also was weakened at just the time when it needed to be strengthened. The debacle followed, with an eventual cost of \$160 billion.

This essay is about that experience, and about the learning that has followed from it, as well as the lessons that (unfortunately) have yet to be absorbed.

## **THE BACKGROUND**

The roots of the debacle of the 1980s can be found in the earlier debacle of the stock market crash of 1929-1933 and the banking collapse that accompanied it. Thousands of commercial banks became insolvent and failed between 1929 and 1933, as did thousands of savings and loans. The latter were state-chartered depository institutions that largely made residential mortgage loans and financed them by taking in passbook savings deposit accounts.<sup>1</sup> Reform legislation in 1933-1935 greatly strengthened the federal role in bank regulation and included the institution of deposit insurance for banks, provided by the newly created Federal Deposit Insurance Corporation (FDIC), and the

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<sup>\*</sup> This essay draws heavily on White (1991, 1993, 2002).

power (by the Federal Reserve) to set ceilings on the interest rates paid by banks to their depositors. This latter power was embodied in the Federal Reserve's Regulation Q.

Further, for the first time a strong federal regulatory presence was created for savings and loans. In 1932 the Federal Home Loan Bank Act created a system of 12 regional Federal Home Loan Banks (FHLBs) to provide liquidity and low-cost finance for savings and loans and established the Federal Home Loan Bank Board (FHLBB) in Washington to oversee the system. In 1933, the Home Owners' Loan Act (HOLA) created a federal charter for savings and loans as an alternative to state charters,<sup>2</sup> along with a regulatory regime that embraced all savings and loans (federal and state-chartered) and that was embedded in the FHLBB. And in 1934 the National Housing Act established deposit insurance for all savings and loans,<sup>3</sup> on a par with that offered to commercial banks, offered by the newly created Federal Savings and Loan Insurance Corporation (FSLIC), which was an arm of the FHLBB. As was true for commercial banks, the deposit insurance premium paid by savings and loans was a flat rate and unrelated to any risks that might be undertaken by the savings and loans; those risks were expected to be contained by the safety-and-soundness regulations established and enforced by the FHLBB.

The last major change of the 1930s was the replacement of the standard residential mortgage of the time – the five-year-maturity balloon-payment mortgage – with the long-term (20 to 30 year) fixed-rate self-amortizing mortgage. This change came about largely at the urging of the Federal Housing Administration (which was also a creation of the HOLA of 1933).

Consequently, the savings and loan industry emerged from the 1930s as a heavily regulated set of depositories that were restricted to offering fixed-rate long-term residential mortgages, which in turn were financed by short-term pass-book savings deposits (that were federally insured).<sup>4</sup> So long as interest rates stayed stable, declined, or rose only gradually, savings and loans could earn an income spread on the difference between the higher long-run interest rates that they charged on their mortgage loans and the lower short-term interest that they paid on their deposits.

Lurking in this structure, however, were the seeds of eventual disaster: If the general level of interest rates were to rise sharply,<sup>5</sup> savings and loans would be caught in a financial squeeze. They would have a portfolio of long-term fixed-rate assets that would decline in value as a consequence of the rise in interest rates, while the value of their deposit liabilities would remain relatively unchanged. Equivalently, their interest income from their portfolio of already-made fixed-rate mortgage loans would remain relatively unchanged, while their interest costs on their short-term deposits would have to rise with the rise in

general interest rates.<sup>6</sup>

Fortunately for the savings and loan industry, the first two decades of the post-war era were a favorable climate. General government policy encouraged the expansion of housing of all kinds but especially encouraged single-family suburban residences -- to be financed by the mortgages provided by savings and loans. The macroeconomic climate was benign; interest rates were stable or rose only gradually. Few savings and loans had difficulty earning adequate returns and staying solvent. The industry thus posed few safety-and-soundness problems to its federal and state regulators.

The first clouds appeared around 1964-65. The U.S. escalated its involvement in the Vietnam War, necessitating increased federal expenditures that were not matched by increased federal taxes. Inflationary pressures developed, and with them interest rates began to rise. Savings and loans began to experience the squeeze just described, and the industry asked the Congress to remedy the situation. The Congress replied in 1966 with the Interest Rate Control Act, which applied a "patch": the extension of Regulation Q's control over deposit interest rates (which previously had applied only to commercial banks) to savings and loans. The FHLBB (in coordination with the Federal Reserve) promptly began limiting the interest rates that savings and loans could pay to their depositors.

For the next decade or so, this patch worked, allowing savings and loans to pay interest rates that were below market rates and thus avoiding the financial squeeze that otherwise would have occurred. The patch worked largely because the inflationary pressures subsided and because savings and loan depositors had few good alternatives that offered comparable liquidity and safety but with market rates of interest -- since all federally insured and regulated savings and loans were similarly affected by Regulation Q's restrictions,<sup>7</sup> and so were commercial banks.<sup>8</sup>

During the 1970s at least three study groups or commissions highlighted the long-run fragility of the savings and loans' arrangements and recommended alternatives: permitting adjustable rate mortgages (ARMs) so that interest rate rises would not squeeze savings and loans; permitting the diversification of savings and loans' lending into other consumer and even commercial fields so as to allow them to diversify and reduce their interest-rate sensitivity; and ending Regulation Q. But an important ethos of Washington -- "if it ain't broke, don't fix it" -- prevailed, and no significant changes were made.<sup>9</sup>

## THE CRISIS, AND THE DEBACLE

### The Crisis

In the late 1970s, inflationary pressures again gathered steam, and interest rates began increasing rapidly -- this time into double digits. The immediate culprit was a sharp rise in the price of crude oil. But Regulation Q's patch no longer protected the savings and loan industry because better alternatives for depositors were present -- primarily money market mutual funds (MMMFs). MMMFs had come into existence only in 1972 and had grown slowly for the next five years. At year-end 1977, total MMMF assets were only \$3.3 billion. However, by year-end 1982 they had grown to \$236.3 billion.

The savings and loan industry again went to Congress. This time the Congress responded with legislation, in 1980 (the Depository Institution Deregulation and Monetary Control Act) and again in 1982 (the Garn-St Germain Act), that belatedly undertook the deregulatory actions that had been urged in the previous decade. First, savings and loans were permitted to originate ARMs. Second, they were permitted to diversify (in limited percentages) into other forms of consumer lending and even into commercial real estate and other commercial lending and direct ownership. Importantly, many states (especially in the Sun Belt) at this time permitted their state-chartered (but federally insured) savings and loans to invest in a yet wider and riskier variety of loans and assets, with fewer restrictions. Third, Regulation Q was phased out within a few years for both savings and loans and commercial banks. And fourth, the deposit insurance amount (for both savings and loans and commercial banks), which had been at \$40,000 per deposit, was raised to \$100,000.

Though belated, these actions were sensible.<sup>10</sup> But they needed to be accompanied by stepped-up safety-and-soundness regulation because the financially stressed (low capital levels) state of the savings and loan industry at the time (as a consequence of the sharp increase in interest rates) provided strong incentives for risk-taking. Unfortunately, in the deregulatory climate of the era, safety-and-soundness regulation was instead *weakened* in three important ways. First, the capital (net worth) requirements for savings and loans were decreased, which reduced the number of savings and loans that would be in violation of the capital standards and thus subject to heightened regulatory scrutiny. Second, the accounting framework (which provided regulators with the crucial information about a savings and loan's financial

position) was weakened, so as to allow more savings and loans to portray themselves as healthy. Third, the number of in-the-field examiners and supervisors was reduced.

## **The Debacle**

Between 1983 and 1985 the savings and loan industry – with its expanded investment powers, improved deposit-gathering capabilities to finance those investments (paying market rates of interest on deposits that were insured up to \$100,000), and relaxed safety-and-soundness regulation – expanded rapidly. By year-end 1985 the industry was 56 percent larger (as measured by assets) than it had been three years earlier. Not all savings and loans embarked on a path of rapid growth. But hundreds did, with many of them doubling or tripling in size over these three years, and some expanding even faster.

Rapid expansion places stresses on and induces mistakes by most enterprises, even under the best of circumstances. But the fast growers within the savings and loan industry, initiating this expansion at a time when most savings and loans were financially stressed to begin with, would be even more prone to investment errors and exaggerated risk-taking. Also, aggressive entrants, who recognized the opportunities that the expanded investment powers and deposit-gathering capabilities offered, came into the industry for the first time.

This dangerous situation was then exacerbated by three external events that eventually caused the debacle to be even worse. First, in the early 1980s the price of crude oil (after having risen sharply in the late 1970s) was expected by many (especially in the Southwest) to rise even further. Many commercial real estate projects in the Southwest were undertaken -- and financed by savings and loans -- on the expectation that oil prices would remain high or go higher, thus creating high incomes and wealth for entrepreneurs and employees in oil-related businesses in the Southwest and fueling the demand for offices, hotels, and other facilities of these projects.

In contrast to these expectations, however, oil prices peaked in 1981, drifted gently downwards for the next few years, and then fell sharply in 1986. The lower price of oil undercut the profitability and value of many of the real estate projects, generating large losses for their owners -- and for the savings and loans that had provided the financing.

Second, the Economic Recovery Tax Act of 1981 included provisions

that made commercial real estate a tax-favored investment. Much commercial real estate in the following few years was planned and financed on the expectations that this tax favoritism would continue. But the Tax Reform Act of 1986 reversed course, reduced the tax-favored position of commercial real estate, and even applied some of its more stringent provisions retroactively to income earned on pre-1986 investments. The 1986 changes again undercut the profitability and value of many investments, with associated losses for owners and finance providers.

Third, a regional enforcement office of the FHLBB (covering the states of Arkansas, Louisiana, Mississippi, New Mexico, and Texas) was moved from Little Rock to Dallas in 1983. Though the reasons for the move were sensible, the timing turned out to be inadvertently abysmal. Too few personnel moved with the office, and enforcement of safety-and-soundness regulation was seriously impaired in that district for about two crucial years (when the industry was expanding rapidly).

Thus, all of the pieces were in place for a debacle to occur. And occur it did. Much of the commercial real-estate lending and ownership that fueled the savings and loans' rapid growth of the 1983-1985 period fared badly, losing value and driving more than one thousand savings and loans eventually into insolvency. The insolvent savings and loans' assets were grossly inadequate to cover their deposit liabilities. Since the FSLIC had insured virtually all of the savings and loans' deposits and since the FSLIC's reserve funds were wholly inadequate for covering those insolvencies, taxpayer funds would eventually be required.<sup>11</sup>

## **The Cleanup**

In late 1984 the leadership of the FHLBB began to realize that things were going wrong and that a substantial tightening in safety-and-soundness regulation was needed. Gradually, over the next two years, the agency's powers and capabilities were strengthened. The number of field-force examiners and supervisors were doubled, capital requirements were raised, accounting standards were improved, and restrictions on direct ownership of commercial ventures were tightened. By late 1986 the regulatory system was far improved, as compared with 1983.<sup>12</sup>

But the damage had been done. The bad loans and investments had been made during the 1983-1985 period of rapid growth. They were irrevocably on the books of many hundreds of savings and loans, waiting to be

written down (whenever the savings and loans' accountants or the FHLBB's examiners got around to recognizing their impaired values).

Beginning in 1985, the FHLBB substantially expanded its activity in disposing of insolvent savings and loans. A few savings and loans that had little or no salvage value as going concerns were liquidated, with direct payouts to insured depositors. In most instances, however, the FHLBB could find acquirers, provided that the agency could promise an acquirer sufficient cash or other assets to bring the savings and loans back to break-even solvency. The acquirer would then be expected to provide fresh capital to the revived savings and loan (and, of course, to operate it in a safe-and-sound manner).

Because some favorable tax provisions that would reduce acquirers' costs (and thus reduce the FHLBB's costs) were scheduled to expire at the end of 1988, calendar year 1988 was an especially active year in which 205 insolvent savings and loans were disposed of, many of them in Texas (which had an especially large number of insolvent savings and loans). But the extent of the problem – hundreds more insolvent savings and loans required disposal – far exceeded the FSLIC's available funds and its ability to issue FSLIC notes (against future deposit insurance premiums and the expectation that the Treasury would make good on the FSLIC's deposit insurance obligations).<sup>13</sup>

In early 1989 the incoming Bush administration faced up to the reality that taxpayer funds would be required, and drafted legislation - eventually passed in August as the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) - that authorized an initial tranche of funds (which proved not to be sufficient); that tightened savings and loans' lending restrictions, including a ban on the holding of below-investment-grade ("junk") bonds; and that raised capital requirements, to make them commensurate with those applicable to commercial banks. The FHLBB (including the FSLIC) was abolished. In its place, the FDIC absorbed the deposit insurance function, in a fund that was (and still is) separate from the commercial bank fund; the Office of Thrift Supervision (OTS), within the Treasury, was created to carry on the federal regulation of savings and loans; the Resolution Trust Corporation (RTC) was created, under the aegis of the FDIC, to continue the cleanup process of insolvent savings and loans; and the Federal Housing Finance Board (FHFB) was created to oversee the borrowing and lending activities of the twelve FHLBs.<sup>14</sup> Also, the remaining (healthy) savings and loans were directly taxed (through higher deposit insurance premiums) and indirectly taxed (through levies on the FHLBs, which reduced members' dividends) to help cover the costs of the cleanup.

Subsequent legislation in 1991 – the Federal Deposit Insurance Corporation Improvement Act (FDICIA) – provided more funds for the cleanup

and also put into law the concept of prompt corrective action: that regulatory restrictions on banks and savings and loans should grow substantially tighter as a depository's capital fell farther below fully capitalized standards. By 1995, after yet more funds had been appropriated, the RTC was able to cease its operations and hand any remaining cleanup activities to the FDIC.

The cost of the debacle has been estimated at about \$160 billion, of which \$132 billion has been borne by taxpayers.<sup>15</sup>

## **Lessons Learned, and Not Yet Learned**

The safety-and soundness regulatory system for depositories that exists in 2002 is much improved over the one that existed in 1982. Much of this improvement and learning occurred as a consequence of the savings and loan debacle. Unfortunately, there are still some lessons that have not been learned. We will first discuss the lessons learned and then those that still need to be learned.

### **The Lessons Learned**

1. *The importance of capital.* Today, far more clearly than was true in 1982, regulators understand the role of capital as a buffer to ensure solvency and protect the deposit insurer and as a disincentive for the owners of a depository to take risks (since they have more at stake). Further, regulators recognize that levels of capital should be commensurate with the risks undertaken by the depository.

2. *Prompt corrective action (PCA).* The PCA concept of gradually tightening the restrictions on a depository's actions as its capital became thinner had been in practice at the FHLBB and the bank regulatory agencies before its enactment into law in FDICIA. But its placement in law was opposed at the time by regulators because it reduced some regulatory discretion.

The PCA idea makes good sense, since less capital exposes the deposit insurer to greater risks of loss and also provides greater incentives for the owners and managers of depositories to engage in risk-taking (e.g., through investing in risky assets), since they have less to lose. Also, the removal of the depository's owners at or before insolvency is another important part of the PCA concept. If owners (because of limited liability) can escape liability to creditors (liability holders) and the deposit insurer must bear the costs of the



insolvency, the owners' rights as to the future course of the depository should be extinguished.

PCA's placement into law both reflects and has reinforced its wider acceptance.<sup>16</sup>

3. *Safety-and-soundness regulation as protection for the deposit insurer.* As of 1982 bank and savings and loan failures had been comparatively few since 1933, and the deposit insurance funds had been more than adequate to handle the occasional insolvency. As a consequence, the crucial role of safety-and-soundness regulation as the primary protection for the deposit insurance funds against excessive risk-taking by depositories was not well understood. It is today.

4. *The importance of adequate numbers of well-trained examiners and supervisors.* The importance of in-the-field personnel to check the competency of depositories' managements, as well as to verify procedures and verify asset and liability values, is now far more clearly understood than was true in 1982.<sup>17</sup>

## **The Lessons Not Yet Learned**

1. *The importance of market value accounting.* Maintaining the true solvency of depositories, so that the values of their assets exceed the values of their liabilities, is the ultimate goal of safety-and-soundness regulation. But measurement of solvency – the measurement of capital (net worth) levels – is entirely an accounting concept. Unfortunately, the accounting system used for these regulatory purposes is the standard system that applies to all publicly traded companies in the United States: Generally Accepted Accounting Principles (GAAP). The problem with GAAP is that it is backward-looking in its orientation, focused on the historical (acquisition) values of assets and liabilities rather than on their current market values. But it is the latter – current market values – that represent (when netted) the actual available protection for the deposit insurer and thus the true effective level of capital.

By using GAAP, with its historical cost bias, regulators needlessly hamstring themselves.<sup>18</sup> It gives depositories a valuable and potentially dangerous option: to continue to value an asset at its historical value, even if its value has declined since its acquisition, while also being able to sell the asset if it rises above its historical value and thus recognize a gain. Allowing an institution to recognize gains (which may then be paid out to owners) while hiding losses is an invitation to invest in high-variance assets and a recipe for a balance sheet that in the long run is only hiding losses.

2. *Forward-looking stress tests.* As a supplement to market value accounting, safety-and-soundness regulation should require stress tests of depositories: how well (and how long) does their (market value) capital hold up under various pessimistic economic scenarios? Some stress testing is implicit in the risk modeling that is likely to be a part of the capital standards that are currently being developed by the Bank for International Settlements (BIS).<sup>19</sup> However, it is currently unclear how much stress testing will be involved, how standardized it will be, or even how many depositories will avail themselves of these sophisticated approaches (as compared to just a modification of the current standards, with somewhat modified risk weights<sup>20</sup>).

3. *The importance of long-run subordinated debt.* Long-run subordinated debt brings to the institution a set of market-based, sophisticated stakeholders whose interests are similar to (although not identical to) those of the deposit insurer. The pricing of this debt is likely to provide bank regulators with signals as to the financial markets' assessment of a depository's prospects. Unlike uninsured deposits, however, long-term debt is not "runable" and thus cannot destabilize a depository (and its peers). Also, covenants may allow the debt holders to exert some influence over management.

Unfortunately, many bank regulators continue to see subordinated debt as "debt", with obligatory interest payments that are not as capable of being deferred as are the dividend payments on equity. Also, the flotation of subordinated debt may present a scale problem for very small depositories (of which there are still many thousands in the U.S.).<sup>21</sup>

4. *The appropriate structure for a depository.* The American populist tradition of keeping banks small and limited in their powers continues to hamper the development of sensible thinking about the appropriate structure for a depository institution. Despite the passage of the Gramm-Leach-Bliley Act of 1999 and the development of large multi-function financial institutions, a safety-and-soundness based approach to depository structure – what banks should and should not be allowed to own and do – has yet to be widely accepted.

The logic of a safety-and-soundness approach would argue for the following: Anything that is examinable and supervisable – i.e., activities and assets about which depository regulators can make judgments as to the competence of the depository in managing the activity or the asset, and for which the regulators can set informed capital requirements – should be permitted within the depository.<sup>22</sup> Anything else should not be permitted within the depository but should be permitted to be located in a holding company or a separately capitalized subsidiary of the depository.<sup>23</sup> And any transactions between the depository and its holding company or subsidiary must be on arms-

length terms and subject to close regulatory scrutiny, so as to prevent the siphoning of assets out of the depository and ultimately to the owners.

## **Conclusion**

The savings and loan debacle remains as an important event in U.S. financial history, and is likely to remain so for many decades to come. It was a costly experience, but an educational one as well. Depository regulation is substantially improved today as compared with two decades ago.

Unfortunately, even more should have been learned. One can only hope that the American polity will not need another such costly experience in order to learn the remaining important lessons.

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1 Because S&Ls were so closely associated with household saving and thus with thrift, they were frequently described as "thrifts"; that term is still often used.

2 Federal charters as an alternative to state charters had been created for commercial banks by the National Currency Act of 1863 and the National Bank Act of 1864. With a federal S&L charter came required membership in the FHLB system; state-chartered S&Ls could choose whether to join.

3 Federally chartered S&Ls were required to carry deposit insurance; it was optional for state-chartered S&Ls.

4 In general finance parlance, S&Ls were borrowing short and lending long.

5 Or if, as occasionally happens, the yield curve were to invert, so that long-term interest rates were lower than short-term rates.

6 If an S&L failed to pay higher interest rates to its depositors in the higher rate environment, the depositors would withdraw their funds and redeposit them with a competitive institution that was paying higher rates. And the former institution would have to liquidate its mortgages -- at the lower sales prices that were appropriate to the higher rate environment, thus directly realizing the capital loss on the mortgages.

7 There were a number of state-chartered and state-insured banks, notably in Ohio and Maryland, that were not part of the federal system and were not affected by Regulation Q. They were not numerous enough to undermine the Regulation Q restrictions. Also, there were questions as to whether state-based deposit insurance systems were as solid as federal deposit insurance -- questions that became legitimate when both state systems experienced failures in 1985.

8 In 1970 the Treasury moved to restrict alternatives yet further by raising the minimum denomination for Treasury bills from \$1,000 to \$10,000. At the time, the

average deposit in an S&L was only \$3,045, so the larger amount effectively precluded Treasury bills from becoming an alternative for most S&L depositors. See Kane (1970).

9 The FHLBB considered changing its regulations at least twice, so as to permit federally chartered S&Ls to originate ARMs; but each time Congressional pressure caused the agency to withdraw the initiative.

10 The expanded deposit insurance amount was the subject of substantial retrospective criticism. However, this author believes that extensive deposit insurance is a worthwhile back-up for depositors against failures of safety-and-soundness regulation and thus a worthwhile protection against depositors' runs on depositories.

11 Less well known is that almost 1,500 commercial banks became insolvent in the 1980s and early 1990s; but the aggregate size of their insolvencies was substantially smaller, and the FDIC's insurance fund for covering banks was substantially larger than the FSLIC's fund had been, so that the banks' insolvencies never required the use of taxpayer funds. See FDIC (1997).

12 Also, prior to 1986, enforcement personnel may have been lulled into a false sense of security by the fact that the industry had not caused significant problems (except for the interest-rate squeeze, which was beyond its control) during the 50 years between 1933 and 1983. Industry lobbying reinforced the idea that S&L owners and managers were basically "good guys" who just needed more time to regain solvency. By 1986 any such notions that the "good guy" characterization applied to every savings and loan institution had been dispelled, at least at the agency.

13 In 1987 the Congress, in the Competitive Equality Banking Act, authorized the FSLIC to borrow \$10.825 billion, but no more than \$3.75 billion in any 12-month period. The Congress, responding to industry lobbying (especially from Texas), apparently was afraid that the FSLIC would use the funds to preemptively close S&Ls that deserved greater time and leniency.

14 Also, membership in the FHLBs was expanded to include commercial banks that undertake a significant amount of residential mortgage lending.

15 See FDIC (1997, p. 187).

16 Important advocacy of PCA can be found in Benston and Kaufman (1988a, 1988b).

17 See the discussion in FDIC (1997).

18 A flavor of this can be found in FDIC (1997), where FDIC officials observe that they knew that some banks were really in trouble but their GAAP balance sheets indicated solvency.

19 These internal (to a depository) risk modeling approaches, which are part of the new capital proposals frequently referred to as "Basle II", are described by the BIS as the "advanced" and "foundation" approaches.

20 This modification is described by the BIS as the "standardized approach to credit risk".

21 As of December 31, 2001, there were over 5,000 commercial banks and savings institutions with less than \$100 million in assets.

22 This logic is laid out in Shull and White (1998).

23 If the subsidiary is separately capitalized, the depository cannot count as an asset the net worth of the subsidiary.