

**Public Capital, the Deposit Insurance and the Risk-Shifting Incentive
Evidence from the Regulatory Responses to the Financial Crisis in Japan**

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Abstract

Using option pricing based models, we computed the actuarially fair deposit insurance premium and the market value of assets and asset volatility for Japanese banks as implied by their stock prices. The findings based on these variables suggest that banks shift risks to the deposit insurer who charges them risk insensitive premiums. Well-designed regulatory policies in response to the crisis, however, effectively restrained banks' risk-shifting. Not only did the introduction of the prompt corrective action discipline the fully insured banks, but also large-scale public capital infusions successfully deleverage poorly capitalized banks that tended to increase risk-taking, which mitigated their risk-shifting.

Keywords: deposit insurance, blanket insurance, risk-shifting, prompt corrective action, public capital

JEL classification: G21, G28

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1. Introduction

The world has recently experienced a financial crisis of unprecedented magnitude. In response, large amounts of public capital were injected into the distressed banking system. In October 2008, just one month after the Lehman Brothers' demise, eight of the largest financial institutions in the United States were bailed out by public capital infusions under the Capital Purchase Program of the Troubled Asset Purchase Program. According to various newspaper reports, large-scale capital infusions took place in major European countries during the same month, also.

Another immediate response by the regulators was to expand the government's protection of deposits. The Federal Deposit Insurance Corporation raised the deposit insurance cap from 100 thousand dollars to 250 thousand dollars per depositor per institution. The Financial Stability Board's "Exit from extraordinary financial sector support measures" published in November 2010 reported that 46 jurisdictions adopted some form of enhanced deposit protection such as the increased insurance cap and the establishment of the deposit insurance system per se, the bulk of which was concentrated during three months from September, 2008.

International discussions promoting tougher regulations, on the other hand, lead to the fundamental reforms of current capital requirements. In September 2010, the Basel Committee for Banking Supervision (BCBS) published the draft of the Basel III, which substantially tightens capital requirements.

As Hoshi and Kashyap (2010) discuss, we can draw parallels to policy measures employed in Japan in response to the financial crisis of the late 1990s.

The deposit insurance coverage cap at 10 million yen per depositor per institution was abandoned in June 1996, transforming the deposit insurance system from a limited

to an unlimited insurance until March 2002 when the cap was reinstated.

As the financial crisis became more evident, the Japanese government decided to inject public capital into the banks, first in March 1998 and again in March 1999. Under 1998 and 1999 programs, which targeted primarily systematically important large banks, the amounts infused into the banking system totaled 1.8 trillion yen and 7.5 trillion yen, respectively.

A more rigorous regulatory action framework known as the Prompt Corrective Action (PCA) that mandates regulatory interventions into a poorly capitalized bank became effective in March 1998. The application of the PCA to domestic banks that are barred from international businesses was deferred for one year until March 1999.

The more generous insurance protection offered during a crisis is aimed at calming the fears of depositors who might otherwise panic and start a run on their viable banks to withdraw their deposits.¹ There is, however, a broad consensus that the negative side effect of the publicly run deposit insurance system is the problem of moral hazard problem, that is, the propensity for insured banks to take excessive risks.^{2 3}

The design of the modern day deposit insurance is characterized as a “flat”

¹ See Diamond and Dybvig (1983) for the classical discussion on the problem of an inefficient bank run and the role played by the publicly run deposit insurance system as a measure to prevent depositors' panic. The recent global financial crisis, however, gives us a different picture. As Ivashina and Scharfstein (2009) find, banks that were in trouble and reduced credit were those that were heavily dependent on short-term debts raised from capital markets as short-term debtors left banks when the crisis erupted. According to Shin (2009), even as for the case of Northern Rock that is often publicized as a rare event of a bank run in the recent crisis, the root cause of the bank's demise was its heavy reliance on short-term debts. Based on such empirical evidence, the increased insurance protection may not be the most desirable response to the crisis.

² For the review of the theoretical literature on the relationship between the deposit insurance system and insured banks' risk taking, see Gropp and Vesala (2004). An excellent read on this subject is Freixas and Rochet (2008).

³ “Core Principle for Effective Deposit Insurance Systems” published in June, 2009 by BCBS states, “Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net” (Principle 2).

premium design. The risk profile of the premium per unit of deposits that the public insurer charges banks is flatter than that of the actuarially fair premium that the private insurer would charge in the absence of a public insurer. Consequently, insured banks are willing to take greater risks to pursue higher returns as their greater risk taking does not cost them a larger insurance premium. This is a classic example of moral hazard.⁴

Some authors argue that an insured bank's moral hazard incentive is restrained by a strict regulator (a tougher enforcer of regulations) who successfully disciplines the banks (Grossman, 1992; Duan et al, 1992; Hovakimian & Kane, 2000). Although public capital infusions and the expansion of the deposit insurance protection are the widely employed prudential policy package to contain a financial crisis, the impact of public capital infusions on the moral hazard of banks, which are likely fueled by a more generous deposit insurance protection, is overlooked in the literature.⁵

Using Japanese bank data, we examine whether the (generous) deposit insurance induced (accelerated) banks' moral hazard and whether the tougher PCA regulatory framework restrained banks from excessive risk-taking. Our unique contribution to the literature, however, is to examine the impacts of public capital infusions on the risk-taking of banks insured by the deposit insurance. Public capital reduces a recipient bank's leverage, thereby making a bank less susceptible to insolvency. Consequently,

⁴ The studies that examine the impact of the deposit insurance on banks' moral hazard include Duan et al. (1992), Grossman (1992), Brewer and Mondschean, (1994), Brewer (1995), Wheelock and Wilson (1995), Karels and McClatchey (1999), Hovakimian and Kane (2000), Demircuc-Kunt and Detragiache (2002), Hooks and Robinson (2002), Hovakimian et al. (2003), Gropp and Vesala (2004), Wagster (2007, 2008), and Ioannidou and Penas (2010). Among them, only Keeley (1990), Grossman (1992) and Karels and McClatchey (1999) present evidence against insured banks' moral hazard.

⁵ According to Laeven and Valencia (2010), 17 of 23 countries studied incurred the fiscal cost of bank recapitalization and other restructuring costs, whereas 21 of these countries expanded the deposit protection during the years 2007 to 2009. According to Laeven and Valencia (2008a), in 8 of 42 historical financial crises, banks were recapitalized and deposits were protected under the blanket guarantee.

the deposit insurance becomes less valuable to the bank. Thus, public capital potentially mitigates the moral hazard of a bank that is insured by flat-rate based deposit insurance.

Based on the model developed by Duan et al. (1992), we test how policy measures influence the banks' risk-shifting, that is, an insured bank passes its risks on to the deposit insurer who is liable for the losses incurred by depositors if the bank fails. Using the daily stock prices and semiannual balance sheets of all listed Japanese banks, for each bank, we compute the semiannual "actuarially fair" insurance premium per dollar (IPP), which represents the value of the deposit insurance to an insured bank per unit of deposits. Our test is based on the relationship between a bank's IPP and the volatility of the market value of a bank's assets. When the actual premium is fixed, the bank is taking advantage of the flat rate based deposit insurance if a bank's actuarially fair premium increases with its overall asset risk. This is because an increase in a bank's asset risk increases the value of the deposit insurance to the bank but does not increase the premium that the bank pays to the publicly run insurer.

Our major findings are fourfold: First, banks that are insured by the flat-rate based deposit insurance are engaged in risk-shifting regardless of whether or not the insurance coverage is unlimited. Second, in aggregate, fully insured banks that were not subject to the PCA did not accelerate risk-shifting, although relatively poorly capitalized banks resorted to the "go-for-broke" policy by greatly accelerating risk-shifting. Third, the PCA was effective in moderating fully insured banks' risk-shifting incentives. Fourth and the most importantly, the 1999 public capital infusion program was effective in restraining the banks' risk-shifting through curbing leverage, whereas the 1998 public capital infusion program was ineffective. Under the 1999 program the amount of

public capital injected into each bank was linked to its capital adequacy. As a consequence, the more greatly a bank increased its asset risk, the more public capital the bank received and the less leveraged it became because an increase in asset risk was generally associated with a decrease in capital adequacy. On the other hand, under the 1998 program the amount of capital received by each bank was weakly linked to its capital adequacy.

The remainder of the paper is organized as follows: Section 2 introduces the institutional background; Section 3 discusses the empirical methodology and the relevant empirical literature; Section 4 discusses the data and empirical results; Section 5 concludes.

2. Institutional Background

The Deposit Insurance Corporation of Japan (DICJ) was established in July 1971. Deposit insurance in Japan has been characterized as a compulsory system with perfectly flat-rate pricing. All depository institutions were mandated to join the system at the cost of the fixed premium pro rated to the amount of deposits on a bank's balance sheet. The flat pricing remains today though deposit insurers in many developed countries have gradually shifted to some form of the risk-sensitive pricing.

At the establishment of the system, deposits in principal were insured up to one million yen per depositor per institution so that deposits in excess of one million yen were not covered by the insurance protection. In July 1986, the cap was finally raised to ten million yen, which shaped more or less the present system.⁶ In 1991, exactly

⁶ The insurance cap of ten million yen continues up to today, albeit the present cap pertaining to

two decades after the establishment of the DICJ, the insurance was paid out for the first time to the Iyo Bank, an Ehime prefecture based regional bank, to help the bank acquire a financially distressed Toho Mutual Bank.

In June 1996, as a temporary measure intended to contain the ongoing crisis, the insurance cap was eliminated and deposits became fully insured. This blanket deposit insurance lasted almost six years until March 2002 when the 10 million yen cap was reinstated for time deposits in principal plus accruing interests. This was a dramatic increase in the size of insured deposits. As of the end of May, 1996 -- immediately before the start of the blanket insurance for time deposits, which constituted roughly two thirds of total deposits, 57 percent of time deposits was in excess of 10 million yen in the amount of principal.⁷

As regulatory lead banks' "self assessments" of their assets at the end of fiscal year 1997 (March, 1998) were expected to unveil large capital losses, the Japanese government decided to inject a total of 1.8 trillion yen into 21 banks, 18 of which were "major banks" including city, trust and long-term credit banks (the 1998 public capital infusion program). All of the major banks except Nippon Trust Bank received public capital. Interestingly, nine city banks each received an almost identical amounts, which were small relative to the size of the recipient banks and unrelated to their capital adequacy positions (eight banks received 100 billion yen and the remaining bank, Daiichi Kangyo Bank received 99 billion yen). The amounts of injected capital under the 1998 program were not only far less than the amounts needed by participating banks,

deposits in principal as well as accruing interests and that the insurance cover of demandable non-interest bearing deposits are unlimited.

⁷ The data's source is the Bank of Japan. The data on deposits by size are publicly available only for time deposits. Note that for every deposit, the amount in excess of 10 million is uninsured so that the proportion of uninsured time deposits to total time deposits is less than 57 percent.

but also failed to reflect the capital needs of individual banks.

The failures of two major banks, the Long-Term Credit Bank of Japan and the Nippon Credit Bank in late 1998 lead to a full-fledged financial crisis. In response, the Government instigated a second round of public capital infusions in March 1999 (the 1999 public capital infusion program), at a total of 7.5 trillion yen, was far larger than the 1998 program. Fourteen of 15 recipient banks were major banks. This time, however, not only was the scale of the program larger but also the amount injected into each city bank (negatively) was linked to its capital adequacy.

The new regulatory action framework, the Prompt Corrective Action (PCA) was introduced in April, 1998, about two years after the start of blanket insurance. Domestic banks that are not allowed to operate internationally were granted a one-year moratorium so that they became subject to the PCA in March 1999.⁸ For the first time in Japan, the PCA employed the Basel risk based capital adequacy criteria as a yardstick for regulatory action. Under the PCA, a bank that falls short of the regulatory minimum standard, faces progressively tougher regulatory actions as the shortfall in a bank's capital adequacy widens.⁹

In April 2002, the unlimited coverage was narrowed to only payable deposits that are non-interest bearing, payable on demand and providing settlement services, which effectively ended the blanket insurance protection.

3. Empirical Methodology and the Related Literature

⁸ International banks adhere to an eight percent minimum standard for the risk based capital adequacy ratio whereas domestic banks adhere to a more lenient standard of four percent.

⁹ For the details of the PCA in Japan, see Allen et al. (2010).

3.1. The Option Pricing Based Model of Deposit Insurance

Under the publicly run deposit insurance system, a bank potentially has an incentive to take excessive risks to seek higher returns, as the premium is insensitive to an insured bank's asset risk. Merton (1977) shows that the (expected) payoff of the flat rate deposit insurance to an insured bank can be viewed as a put option on the bank's assets with a value of its insured liabilities as an exercise price. The value of the put obtained using the Black-Sholes formula, which represents the value of the insurance to an insured bank, is an increasing function of the bank's leverage and asset volatility (partial derivatives of the value of the put with respect to the leverage and the asset volatility are both positive).

In practice, we follow the empirical strategy of Duan et al. (1992) , which is built on Merton's theory. They give the formula for the insurance premium per unit of deposits, IPP, as follows.¹⁰

$$IPP = N\left(y + \sigma_v \sqrt{T}\right) - \frac{(1 - \delta)^n V}{B} N(y) \quad (1)$$

Where:

$$y \equiv \frac{\ln\left[\frac{B}{V(1 - \delta)^n}\right] - \sigma_v^2 T / 2}{\sigma_v \sqrt{T}}$$

$B \equiv$ a bank's total liability

$V \equiv$ the market value of a bank's assets

$\sigma_v \equiv$ the instantaneous standard deviation of the return on V .

¹⁰ Please see Appendix for the derivation of IPP.

$N(\cdot) \equiv$ the cumulative standard normal distribution.

$\delta \equiv$ the dividends per monetary unit of assets.

$n \equiv$ the number of times per period the dividend is paid.

$T \equiv$ the maturity date of the deposit insurance contract

Following the literature (Ronn & Verma, 1986; Giammarino et al., 1989; and Duan et al., 1992), we set T to be one year.¹¹ Since dividends are paid twice a year in Japan, n in equation (1) is equal to one.¹² The valuation of IPP requires estimating two unobservable variables, V and σ_V . Following the methodology of Duan et al. (1992), we obtain values for V and σ_V by solving the non-linear equation of these two variables as unknowns that involve not only the abovementioned B and T but also the bank's shareholder value E and the instantaneous standard deviation of the return on a bank's shareholder value, σ_E .^{13 14 15}

¹¹ The real world counterpart to T is the length of the interval between the regulator's examination of a bank. The assumption made in the U.S. literature is justified by the FDIC's rule to examine healthy banks that are not small in total assets annually. As for bank examinations in Japan, "major" banks including city and trust banks are examined and graded annually whereas smaller banks are generally examined and graded less frequently under the bank financial institutions examination and grading system, which became effective in April 2007 after a three month testing period starting in January of that year. As for the publicly available frequency of bank examinations in years prior to the start of the system -- except for one year periods from July, 1999 to June, 2000, and from July, 2000 to June, 2001 when approximately half of the banks were examined -- almost all banks were examined every July - June one-year period. This implies that our assumption of $T=1$ is in line with the actual regulatory practices in Japan.

¹² Although dividend payouts occur twice a year, the data on dividend payouts are available only annually. Therefore, the amount of dividend payouts is halved in order to adjust to the semiannual frequency.

¹³ When computing V and σ_V , we follow Ronn and Verma (1986), Giammarino et al. (1989) and Duan et al. (1992), assuming that the deposit insurer will declare a bank bankrupt when the value of the bank's assets falls below ρB rather than immediately after it is undercapitalized. The parameter ρ reflects what Ronn and Verma (1986) refer to as the *bail-out effect*; an insurer does not liquidate a bank immediately when its net worth ($V-B$) turns negative. Following the abovementioned studies, we set ρ to be 0.97.

¹⁴ The two equations are $E = VN(x) - \rho BN(x - \sigma_V \sqrt{T})$ and $\sigma_E = \frac{VN(x)}{E} \sigma_V$, where

3.2. Empirical Methodology

We adopt the regression equations developed by Duan et. al (1992) and Hovakimian and Kane (2000), which are later employed by Hovakimian et al. (2003) and Wagster (2007, 2008). The two equations are;

$$\Delta \frac{B_{it}}{V_{it}} = \alpha_0 + \alpha_1 \Delta \sigma_{vit} + \varepsilon_{it} \quad (2)$$

$$\Delta IPP_{it} = \beta_0 + \beta_1 \Delta \sigma_{vit} + \xi_{it} \quad (3)$$

In equations (2) and (3), i represents the i 'th bank and t represents date t . ε and ξ are error terms. Hovakimian and Kane (2000) give slope coefficients of equations (2) and (3), α and β , the following interpretations:¹⁶

$$\alpha_1 = \frac{d(B/V)}{d\sigma_v} \quad (4)$$

$$\beta_1 = \frac{dIPP}{d\sigma_v} = \frac{\partial IPP}{\partial \sigma_v} + \frac{\partial IPP}{\partial (B/V)} \alpha_1 \quad (5)$$

$x \equiv \frac{\ln\left(\frac{V}{\rho B}\right) + \sigma_v^2 T / 2}{\sigma_v \sqrt{T}}$. The first equation is based on the discussion of Black and Sholes (1973)

in which the value of the equity of a firm (bank) is represented as a call option on the value of its assets with the maturity being the same as the maturity of its debt and a striking price equal to the value of a firm's debt at maturity. The second equation is derived by using the Ito's lemma.

¹⁵ σ_E is calculated using the following formula.

$\sigma_E = \sqrt{252 \text{ var}\left(\frac{S_t}{S_{t-1}}\right)}$, where S_t is the daily price of a bank's stock price at date t . We thank

Ehud Ronn for clarifying this point.

¹⁶ More precisely, equations (2) and (3) follow specifications employed by Hovakimian and Kane (2000). Duan et al. (1992) use levels rather than changes for variables in both sides of the equations.

The risk-shifting incentive exists if β_1 is positive. This is because positive β_1 means that a bank takes asset risk so as to increase the value of IPP. As discussed in the previous subsection, $\frac{\partial IPP}{\partial \sigma_v}$ and $\frac{\partial IPP}{\partial (B/V)}$ are both positive. If α_1 is negative, β_1 becomes smaller so that the risk-shifting incentive becomes weakened. In an extreme case, β_1 could be negative when α_1 is sufficiently negative.

As Duan et al. (1992) and Hovakimian and Kane (2000) discuss, the major restraints could be regulatory pressures. The very spirit of the Basel risk based capital requirements is to request riskier banks to hold more capital and reduce leverage. We also consider the effects of public capital infusions on banks' risk-shifting incentive because public capital is injected into banks that are poorly capitalized, which are likely inherently risky lenders, reducing their leverage. To this end, we modify equations (4) and (5) so as to make slope parameters α_1 and β_1 vary across different regulatory regimes and sensitive to different types of public capital infusions in different ways. More specifically, equations (2) and (3) become,

$$\Delta \frac{B_{jt}}{V_{jt}} = \alpha_0 + \left(\alpha_1 + \sum_{j=2}^J \alpha_j D_{ijt} + \sum_{k \in K} \alpha_k PUBINJ_{ikt} \right) \Delta \sigma_{ijt} + \varepsilon_{it} \quad (6)$$

$$\Delta IPP_{jt} = \beta_0 + \left(\beta_1 + \sum_{j=2}^J \beta_j D_{ijt} + \sum_{k \in K} \beta_k PUBINJ_{ikt} \right) \Delta \sigma_{ijt} + \xi_{it} \quad (7)$$

In equations (6) and (7), j , J , k and K represent the j 'th regulatory regime, the number of regimes, public capital infusions of type k and the set of different types of public capital infusions, respectively. We assume that the effects of public capital infusions of different designs to have differential effects on banks' risk-shifting.

$PUBINJ_{ikt}$ is a measure for public capital infusion of type k for bank i at date t . In practice, we use the remaining balance of public capital of type k divided by the market value of total assets, V , as of date t as $PUBINJ_{ikt}$.

3.3. The Related Literature

Two studies using our empirical framework find that introducing tougher regulatory reforms mitigates the banks' moral hazard. Duan et al. (1992) find that banks in the United States became more restrained from risk-shifting after the introduction of numerical capital adequacy standards in 1981. Similarly, Hovakimian and Kane (2000) find that American banks became more restrained from risk-shifting after regulatory reforms in 1991, which introduced the deposit insurance premium linked to a bank's capital adequacy and the PCA.

Moreover, using a sample of banks in Milwaukee and Chicago in the 1930s, Grossman (1992) finds that insured thrifts held fewer foreclosed loans than uninsured thrifts and that the risk reducing effect of the deposit insurance was less pronounced in Chicago where regulation was lenient than in Milwaukee where regulation was strict; the evidence is consistent with demanding regulation's disciplinary effect on insured banks.

Regarding two rounds of public capital infusions in Japan targeting primarily large banks, Hoshi and Kashyap (2010) discuss that the 1998 capital infusion program was insufficient for most of the banks to restore their capital, whereas the 1999 program was sufficient because the regulator checked sufficiency of the amount of public capital for each recipient bank. Several studies examine public capital infusions on bank lending and/or borrowers of banks that received public capital. Montgomery and Shimizutani

(2009) find that public capital under the 1999 program increased total loans and loans to small and medium enterprises (SME) by international banks, but public capital under the 1998 program did not. Allen et al. (2011) find that public capital under the 1999 program or later programs increased the banks' total loans and corporate and industrial loans while public capital under the 1998 program decreased total loans. Gianneti and Simonov (2010) find that firms that borrowed from public capital recipient banks under the 1999 program increased loans whereas those that borrowed from public capital recipient banks under the 1998 program did not.

The effect of public capital on banks' risk-taking outside of Japan is mixed. While Bayazitova and Shivdasani (2010) find that banks that received TARP public capital increased total loans, corporate and industrial loans and real estate loans, Duchin and Sosyura (2010) find that TARP recipients did not increase the probability of loan approval as much as TARP non-recipients did. While Duchin and Sosyura (2010) further present the evidence that TARP recipients made riskier loans and their overall level of (bank level) risk-taking was higher, Black and Hazelwood (2010) find that TARP capital made the lending of large banks riskier but that of small banks less so. Using the German data, Berger et al. (2010) find that the capital injection into a bank by a bankers association not only contributed to reducing the bank's ratio of non-performing loans to total loans in the short run (because more NPLs were written off against injected capital) but also did so in the long run (after five years), suggesting that capital infusions made the banks' lending less risky (because less loans turned out to be non-performing ex-post).

As Bayazitova and Shivdasani (2010) mention, most of TARP recipients applied for and received three percent of their risk weighted assets, the maximum under the

program, so that each individual bank's capital needs were ignored when determining the amount of capital to be injected. What is yet to be determined is whether the virtue of the design to infuse the needed amount of capital into each recipient bank is only to save the fiscal cost or if this type of design has some perceived desirable influence on banks' lending or risk-taking behavior.

4. Data and Empirical Results

4.1. Data

We need total liabilities and dividend payouts reported in the banks' financial statements and their daily stock prices of banks to compute V , the market value of bank assets, and σ_v , the instantaneous standard deviation of the return on V . The banks' financial statements were collected from the "Financial Statements of All Banks" published semiannually by the Japanese Bankers' Association, "Financial Statements of All Mutual Banks" published by the National Mutual Bank Association and the Nikkei NEEDS databank.¹⁷ The numbers for total liabilities at interim closings before September 1997 were hand collected from hard copy versions of the "Financial Statements of All Banks" and the "Financial Statements of All Mutual Banks".¹⁸ As for the data on semiannual dividend payouts, we assume that for each fiscal year the payouts are split by half between two half-year periods because under the Japanese commercial code, a company is allowed to pay dividends to shareholders only once

¹⁷ Most mutual banks, which were licensed under the Mutual Bank Act, switched to banks licensed under the Banking Act in 1989. Thus, financial statements of former mutual banks until fiscal year 1988 are contained in the "Financial Statements of All Mutual Banks" rather than in the "Financial Statements of All Banks".

¹⁸ When necessary, the data are supplemented by financial statement reports that are disclosure reports required by the law of listed firms. These are regarded as the Japanese counterparts to the U.S. SEC filings.

during a fiscal year other than at its closing. The data on daily stock prices and the number of shares at interim and fiscal closings, which are used to calculate E and σ_E , are extracted from the Nikkei NEEDS databank.

The banks included in our original sample are 123 banks that are listed in at least one of Japan's four stock exchanges: the Tokyo Stock Exchange, the Osaka Stock Exchange, the Nagoya Stock Exchange and the Fukuoka Stock Exchange. Our semiannual sample is selected to cover the period from the second half of the fiscal year 1986 (which spans from October 1, 1986 through March 31, 1987) to the second half of fiscal year 2007 (which spans from October 1, 2007 through March 31, 2008) although the data needed to compute V , σ_v , B/V and IPP are available from the first half of fiscal year 1985. Thus, the longest time series data among sample banks encompass twenty-one and a half years. The beginning of the sample is set at the second half of fiscal year 1986 because it is during this period that deposits were insured up to 10 million yen for the first time during an entire half-year period.

Following Hovakimian et al. (2003), five banks that were in the sample no longer than three consecutive years were dropped, reducing the number of sample banks to 118. In addition, again following Hovakimian et al. (2003), observations below the first or above the ninety-ninth percentiles for at least one of the three variables of our interest -- V , σ_v and IPP -- were dropped. This sample trimming allows us to neutralize the effects of extreme values. As a result, we are left with a total of 4018 bank-date observations for our baseline sample. The sample banks cover 96.6 percent of all domestically licensed banks in terms of the market value of total assets as of March 1995 when the number of sample banks was the largest at 104 and covered 35.3 percent

as of March 2006 when it was the smallest.¹⁹ Our sample size for equations (4) and (5) with first differenced variables is further reduced to 3909.

4.2. Descriptive Statistics and Stylized Facts

Table 1 summarizes the descriptive statistics of the variables used in computing V , σ_V and IPP, computed V , σ_V and IPP as well as variables for measuring the remaining balance of public capital as a share of the market value of total assets, V , namely, PUBINJ₉₈ for the 1998 public capital infusion program, PUBINJ₉₉ for the 1999 program and PUBINJ_{OTHER} for any other capital infusions. The summary of our sample closely resembles that of the U.S. sample used in Hovakimian and Kane (2000), the only difference being banks that our sample are on average larger. Table 2 is a frequency table for sample banks with a positive balance of public capital for the 1998 and 1999 programs and of any other programs.

Figure 1 depicts aggregate trends of IPP and leverage, B/V . As a reference, the trends of the official deposit insurance premiums set by the DICJ are also displayed. Both IPP and leverage are aggregated over the sample banks with V as a weight date by date.²⁰ The aggregate IPP has almost always greatly exceeded the DICJ's premium rate, suggesting that DICJ substantially subsidizes Japanese banks by its flat rate insurance. While leverage had been consistently on an upward trend until it peaked out at the second half of fiscal year 1997, there are two spikes in IPP; the first relatively

¹⁹ The share of our sample banks is very small as of March 2006 because most of the large banks were dropped from the sample as they became unlisted subsidiaries of listed holding companies and some of their data had been discontinued. In our empirical analyses, we will test both on this base sample and the sample augmented by bank holding companies.

²⁰ The two variables are drawn only until the first half of fiscal year 2000 because it was up until this date that all the large banks, which constituted 69.7 percent of our sample in terms of V as of the end of fiscal year 2000, remained in the sample.

modest one at the first half of fiscal year 1992, and the second sharpest one at the second half of fiscal year 1997. The level of IPP at the second spike, almost one percent of the amount of deposits, stands more than six times as high as the value at the previous date and more than ten times as high as the DICJ's premium.

Apparently, Japan entered a serious financial crisis at the second half of fiscal year 1997 as both aggregate leverage and IPP reached their respective peaks.²¹ Essentially, IPP is a cover of the amount of loss incurred by a bank that would be borne by a depositor without deposit insurance. Roughly speaking, IPP is a market based measure for a bank's credit risk implied from the stock markets. It was at the second half of fiscal year 1997, particularly in November, 1997, that what is known now as the Japan premium, showed a sharp increase in Japanese banks' borrowing rates in international credit markets emerged (Peek & Rosengren, 2001). As Figure 2 shows, the Japan premium and IPP keep track each other remarkably well. This fact lends support to our method for computing IPP.²²

4.3. Empirical Results

Preliminary results

²¹ There is a broad consensus that large capital losses, which lead to the severe credit crunch, occurred at that time (Woo, 2003; Watanabe, 2007).

²² A credit default swap (CDS) is another publicly traded instrument that insures against a firm's default. The data about reference rates of CDS are publicly available through the Tokyo Financial Exchange. The historical data of CDS rates are available from late March, 2004. We calculated the correlation coefficient of IPP and the CDS rate of Mitsui Sumitomo Bank over the period from FY 2004 to FY 2010. The period was extended to include more recent dates to increase the sample size. We do not think extending our sample period for our regressions in the same manner as this would include the period of the global financial crisis when stock prices of Japanese banks as well as their CDS rates were exogenously influenced by the volatile financial markets although they were least exposed to financial instruments that incited the crisis and these market based prices were less likely to correctly imply banks' secular risk taking. We chose Mitsui Sumitomo Bank because CDS rates for only three banks are available and two other banks are ones of multiple commercial banks held by their bank holding companies whereas Mitsui Sumitomo is its BHC's sole commercial bank. The correlation coefficient is 0.931.

Table 3 presents the regression results for leverage B/V in columns 1 and 2 and the actuarially fair insurance premium IPP in columns 3 and 4, respectively, without cross products of σ_V and public capital infusion variables as independent variables. For each dependent variable, the second of the two columns shows the results for the equation in which four cross products between regulatory regime dummies and σ_V are added as additional independent variables.

The three regime dummies are: 1) a dummy variable for the period of blanket insurance without the PCA (D_2); 2) a dummy variable for the blanket insurance with the PCA (D_3); and, 3) a dummy variable for the post blanket insurance period (D_4). One advantage to using the Japanese data is that the PCA was applied to international banks one year earlier (in April, 1998) than it was for domestic banks so that we are able to identify the (pure) effect of transforming the deposit insurance from limited to unlimited insurance (without the PCA's effect) and the PCA's effect on disciplining the fully insured banks from any aggregate effect.^{23 24}

A negative and weakly statistically significant coefficient of σ_V in column 1 and a positive and significant coefficient of σ_V in column 3 of Table 3 show that, under the flat rate based deposit insurance system, although banks were engaged in substantial risk-shifting, those with riskier assets did deleverage to some extent. The sums of the coefficient of $\Delta\sigma_V$ and the cross product of a dummy variable to indicate a regulatory regime in column 4 are all positive and statistically significant, suggesting that under any regulatory regime, insured banks are engaged in some degree of risk-shifting.

²³ The regulatory regime for the blanket insurance without the PCA ended at the second half of fiscal year 1997 and at the second half of fiscal year 1998 for international banks and domestic banks, respectively. Likewise, the regulatory regime for the blanket insurance with the PCA began at the first half of fiscal year 1998 and at the first half of fiscal year 1999, respectively.

²⁴ 42 of 103 banks were international banks as of the second half of fiscal year 1997.

A negative and significant coefficient of a cross product between $\Delta\sigma_V$ and D_3 in column 2 and a negative and weakly significant coefficient of the same cross product in column 4 show that the PCA disciplined riskier banks not to seek greater leverage, which may have had some effect in mitigating the banks' moral hazard incentives. Indeed, the coefficients of the cross product of $\Delta\sigma_V$ and D_3 are statistically significantly smaller than the coefficients of the cross product of $\Delta\sigma_V$ and D_2 for both leverage and IPP regressions reported at the bottom of the table ($\alpha_3-\alpha_2$ and $\beta_3-\beta_2$ are both negative and significant.), suggesting that the PCA had a strong disciplinary effect on restraining the fully insured banks' risk-shifting incentives.²⁵

To our surprise, however, an insignificant coefficient of the cross product between $\Delta\sigma_V$ and D_2 , implies that there is no sign of heightened risk-shifting incentives by fully insured banks that are yet to be subject to the PCA. Before the period of the explicit blanket insurance, the Ministry of Finance was said to employ a "convoy system" in which the MOF would not fail any bank. In other words, even though the insurance cap was in effect, the government may have fully protected the banks' deposits regardless.²⁶

The effects of public capital infusions on banks' risk-shifting

Table 4 presents the results of the regressions with cross products with PUBINJs as independent variables.²⁷ The coefficients of the cross product with PUBINJ₉₉ are

²⁵ This suggests that Japanese banks were disciplined not only by partially insured depositors after the end of the blanket insurance as argued by Imai (2006) and Fueda and Konishi (2007) but also by the stringent regulatory framework based on the PCA.

²⁶ Several practitioners and academics pointed out the implicit full deposit protection before the removal of the insurance cap.

²⁷ None of the infusions that occurred at any time other than March 1998 and March 1999 preceded the 1999 program. When capital infusions were grouped into two, namely those under the 1998 program and others, as done in Allen et al. (2011), the results found are largely consistent with the

negative and statistically significant for both leverage and IPP regressions, whereas none of the coefficients of the cross product with PUBINJ₉₈ is significant. These findings show that, while the 1999 public capital program was effective not only in reducing leverage of riskier banks but also in curbing banks' risk-shifting incentives, the 1998 program was unsuccessful in reducing leverage of riskier banks, let alone mitigating the banks' risk-shifting.

The failure of the 1998 public capital program and the success of the 1999 program may be attributable to sharp differences in their designs. As mentioned earlier, under the 1999 program, the amount of public capital injected into each recipient bank was determined on its needs. That is, the more poorly capitalized a bank was, the more public capital the government granted to it. During the crisis period, relatively poorly capitalized banks, which were more likely to experience a larger increase in their asset risk, received a larger public capital (relative to their size) and reduced their leverage more greatly than relatively adequately banks did. Therefore, the 1999 program had the effect of strengthening the negative association between bank risk and leverage, which further moderated the positive relationship between bank risk and IPP. Under the 1998 program, on the other hand, the amount of public capital injected into each bank was not determined in accordance with its need for capital so that pre recapitalization level of leverage (capital adequacy) was not positively associated with the size of public capital (relative to the size of assets).²⁸ As far as its effect on

results reported in subsequent tables. Distinguishing three types of infusions as we do allows us not only to exemplify 1998 and 1999 programs as policies targeting large banks at the peak of the system wide crisis but also to take into account of the different designs of the two programs. For a complete list of banks that received public capital, see Allen et al. (2011)

²⁸ The correlation coefficients between the lagged leverage (pre public recapitalization level of leverage) and the amount of public capital received relative to V are 0.272 and -0.163 for 1998 and 1999 programs, respectively. Likewise, the correlation coefficients between a change in σ_V and the amount of public capital received relative to V are 0.555 and 0.300 for 1998 and the 1999 programs,

reducing the banks' moral hazard incentives is concerned, the design to efficiently allocate public capital by infusing more capital into poorly capitalized banks than into relatively well capitalized banks was important.^{29 30 31}

As for coefficients of other independent variables, the results remain almost the same as those from Table 3 where the results of regressions without public capital

respectively. These facts support our interpretations of the results in favor of the 1999 program over the 1998 program.

²⁹ We also find that the effect of the 1999 program on reducing a bank's risk-shifting had an effect beyond the date of capital infusion. When the regressions are run on the sample that excludes observations for the second half of fiscal year 1999 (the period of the 1999 program's execution) the negative coefficient of the cross product of σ_V and PUBINJ₉₉ remains significant for both leverage and IPP regressions though the magnitude of the estimated coefficient for the IPP regression is substantially smaller than the estimated coefficient reported in Table 4 and significant only at the ten percent significance level (results are not reported). This is presumably because banks were requested by the regulator to submit a Management Strengthening Plan and had to periodically report to what extent they had fulfilled the conditions of the submitted plan. Consequently, the banks were restrained from excessive risk-taking as long as public capital remained on their balance sheets.

³⁰ One fact that may be relevant to the success of the 1999 program and the failure of the 1998 program is that the regulators' duties were transferred from the Ministry of Finance to the Financial Supervisory Agency. The regulator at the time of the 1998 program was the Ministry of Finance (MOF) and is said to have been generally softer on the banks as covered by the convoy system it was said to have been overseeing. It is likely that the Financial Supervisory Agency (FSA), which was established in June 1998 as a spin off from the MOF with a mission to contain the financial crisis, gradually toughened their regulatory stance. It is this possibly tougher FSA that administered the 1999 program. The softer regulatory monitoring of publicly recapitalized banks under the MOF regime and the tougher monitoring of these banks under the FSA regime may have contributed to some extent to the ineffective 1998 program and the effective 1999 program in restraining the banks' moral hazard.

³¹ Peek and Rosengren (1995) find that banks that were subject to formal regulatory actions, which were based on the leverage ratio requirement, reduced lending faster than those that were not. In light of their finding, we examined whether there was any difference in the coefficients of σ_V in leverage and IPP regressions between banks that were enforced the PCA and those that were not. Regarding our sample, Hokkaido Bank (from May, 1999), Tokyo Sowa Bank (May, 1999), Namihaya Bank (June, 1999), Senshu Bank (September, 1999), Chiba Kyogyo Bank (April, 2000), Fukushima Bank (December, 2001) and Howa Bank (April, 2006) were enforced the PCA. We assume that the Financial Services Agency continued to enforce the PCA on the Hanwa Bank for one year and that it continued to enforce the PCA on all the other banks for three years, because it is in December 2002 that the FSA shortened the time for the improvement of capital adequacy in enforced banks from three years in principle to one year in principle. We added the cross product of σ_V and a dummy variable to indicate that a bank was under the PCA enforcement to the regressions whose results are reported in Table 4. The coefficients of this added cross product for leverage and IPP regressions are both positive and statistically significant. We decided not to report the results because the results by themselves suggest that enforced banks accelerated risk-shifting, which is puzzling. The results may well be due to the small number of observations made under the PCA enforcement.

variables are added as independent variables. The only exception is the weakly negative coefficient of the cross product between $\Delta\sigma_V$ and D_3 in Table 3, which is no longer statistically significant in Table 4. This, however, does not alter our result in Table 3 that fully insured banks became more restrained after they became subject to the PCA, as indicated by the fact that the coefficient of the cross product of $\Delta\sigma_V$ and D_3 is statistically significantly smaller than that of $\Delta\sigma_V$ and D_2 ($\beta_3 - \beta_2 < 0$).

Capital adequacy and risk-shifting

Marcus (1984) mentions that poorly capitalized banks undertake a go-for-broke policy by increasing asset risk in order to increase the value of the deposit insurance. Following Hovakimian and Kane (2000) in spirit, we divided our sample into relatively poorly capitalized observations whose leverage was relatively high and relatively well capitalized observations whose leverage was relatively low. In practice, the former sample consists of observations whose leverage in the previous half-year period was above or equal to the median during that half-year period, whereas the latter sample consists of those banks whose leverage in the previous half-year period was below the median.³²

The results are reported in Table 5. The first two columns show the results of the leverage regressions, whereas the last two columns show the results of the IPP regressions. Of the pair of columns, the first column shows the results of the sample of observations with relatively low leverage, whereas the second column shows the

³² Hovakimian and Kane (2000) interact dummy variables to indicate whether a bank's leverage in the previous quarter is below or above the median at that quarter with independent variables. We decided to split the sample because it is less straightforward to interpret coefficients of many resulting cross products. Both the method of Hovakimian and Kane (2000) and our methods produce qualitatively the same results.

results for the sample of observations with relatively high leverage.

First, in the case of Japanese banks, Marcus's hypothesis does not hold true. The point estimates of the coefficient of $\Delta\sigma_V$ for the IPP regression are larger for the sample of high-leverage observations than for the sample of low-leverage observations over all four regulatory regimes as indicated by the coefficients of $\Delta\sigma_V$ itself and the sums of the coefficient of σ_V and that of a cross product presented at the bottom of the table. Consistent with these results, highly-leveraged riskier banks deleveraged strongly before the insurance coverage became unlimited as is indicated by a negative and statistically significant coefficient of $\Delta\sigma_V$ in column 2. This may be because banks that aggressively sought risk-shifting during the real estate bubble period amassed retained profits and they ended up with lower leverage. More interestingly, an insignificant coefficient of the cross product of $\Delta\sigma_V$ and D_2 in column 3 and the positive and significant coefficient of the same cross product in column 4 indicate that poorly capitalized banks which were not subject to the disciplinary policy of the PCA did take advantage of the blanket insurance and accelerated risk-shifting while well capitalized banks did not.

The literature agrees that poorly capitalized Japanese banks in the late 1990s and the early 2000s had the perverse incentive of making rescue loans to practically defaulted firms, thus making their assets riskier (Peek & Rosengren, 2005; Caballero et al, 2008; Watanabe, 2010). This was because, as firms were able to service preexisting debt with new loans, lending banks were able to avoid classifying these loans to these firms as non-performing. The culprit accused of driving banks to what is known in the literature as "evergreening" was a loophole in the risk based capital adequacy standard: namely, the risk weight assigned to corporate loans used to calculate the risk based

capital adequacy ratio was independent of credit risk. This created an opportunity for the regulatory arbitrage between risky and safe corporate loans. Our finding that deposit insurance drove poorly capitalized banks into risky lending suggests that the deposit insurance was another institution encouraging the banks' perverse behavior.

Examining the effects of delisted banks

Recall that our data lack recent observations on the banks whose business structure was reorganized into the bank holding company system when operating banks became subsidiaries of newly established holding companies and the parent companies' shares were publicly traded while shares of the banks themselves had halted trading. Our main results regard the effects of public capital infusions on the banks' risk shifting. Because most of banks that participated either in the 1998 program or the 1999 program had exited the sample when they were delisted, we are unable to observe the recent behaviors of such banks.³³ Because most recipient banks under 1998 and 1999 programs disappeared from the sample by the second half of FY 2000, the data on the banks after they received public capital existed only for a few years and about seven years of the most recent data are missing. This may cause a serious sample selection bias, especially if risk-taking behaviors of publicly recapitalized banks have recently changed.

To resolve our concerns, we elaborate in order to reconstruct missing observations. In practice, we added the parent bank holding companies of those banks with recent

³³ As for 21 recipient banks under the 1998 program, only two banks can be observed until the end of the sample period. Among the remaining 19 banks, 17 banks became subsidiaries of their holding companies and thus disappeared from the sample. As for 15 recipient banks under the 1999 program, only one bank continues to be observable until the end of the sample period.

missing observations to the base sample and reexamined the results.^{34 35} Table 6 shows the regression results that replicate Table 4 using the data augmented by those on bank holding companies.

The results found in Table 4 remain almost unchanged. A minor change is that the coefficients of the cross product of $\Delta\sigma_V$ and PUBINJ₉₈, though their signs remain unchanged, are now statistically significant for both leverage and IPP regressions. These results may imply that the 1998 program drove banks into lending to wrong borrowers, thereby, contributing to their accelerated moral hazard. The recent literature on the efficacy of TARP public capital presents the evidence that banks which received TARP capital made riskier loans (Duchin & Sosyura, 2010, Black & Hazelwood, 2010). It so happens that the design of TARP is similar to that of the 1998 program in that the amount of injected capital was independent of each recipient's capital needs and that the TARP program may have driven risky banks into more risk-taking because of its risk insensitive design.³⁶

Alternatively, the positive coefficients of the cross product of $\Delta\sigma_V$ and PUBINJ₉₈ simply indicates that, as discussed in the literature (Peek & Rosengren, 2005; Caballero et al, 2008; Watanabe, 2010), banks that had received public capital under the 1998 program were relatively poorly capitalized and engaged in misallocation of credits

³⁴ We treat these parent bank holding companies not as direct successors of the disappearing banks but as new entities different from their corresponding banks because the earlier data on an operating bank and the recent data on its parent are not consistent.

³⁵ As we did for listed banks, we added 10 listed bank holding companies that had or have been listed at least for three consecutive years. Only one bank holding company, Ashigin Holding, which had been listed for less than three consecutive years, has been dropped from the sample.

³⁶ Note that most banks received a fixed proportion of their risk assets so that the amount of injected capital reflected the recipient's risk provided that its risk assets accurately measured its risk. We do not believe that the recipient banks' risk assets correctly measured their risk taking because it was the regulatory arbitrage to make loans and engage in transactions that cost them less risk charges than would actual risks, such as subprime mortgages and off balance transactions, more heavily, which lead to the financial crisis.

rather than received capital enabling them to misallocate credits. Either way, these results show that the 1998 program did not help the banks to discipline themselves.

Additional robustness tests

We conducted several more regressions to confirm our findings, particularly the 1998 public capital program's effect to restrain banks' risk-shifting, whose results will not be reported for reasons of brevity. First, we modified PUBINJs so that they take a positive value only at the date of infusion and zeros at all other dates. Remember that the strong risk-shifting restraining effect of the 1999 program lies in its design to replenish more capital for more capital depleted banks. Publicly recapitalized banks restored their capital immediately after receiving public capital so that the effect of the 1999 program itself emerges right at the time of capital infusion. The results of the regressions with modified PUBINJs remained qualitatively unaltered. We additionally took a one-year lead of PUBINJ₉₉ so as to examine the effect of the 1999 program that would have occurred counterfactually in March 1998. The coefficients of a one-year lead of PUBINJ₉₉ are *positive* and statistically significant for the leverage regression and the IPP regression at the ten percent significance level and at the one percent level, respectively, contradicting our earlier results that these coefficients are significantly negative.

Second, we include the cross product of σ_V and the dummy variable to indicate the second half of fiscal year 1998 (the date at which the 1999 program was executed) so as to check whether the negative and significant coefficient of $\Delta\sigma_V$ and PUBINJ₉₈ captures the unobservable shock affecting all banks' risk taking that coincides the 1999 program. The 1999 program results remain intact. The coefficient of an added cross product is

not statistically significant.³⁷

5. Conclusion

In this paper, using the data of Japanese banks that became subject to three policy measures in response to the financial crisis of the late 1990s: the blanket deposit insurance, the Prompt Corrective Action (PCA) framework and public capital infusions, we examined whether banks under the fixed (flat) premium based deposit insurance system engaged in moral hazard: excessive risk-taking by shifting their asset risk to the deposit insurer. Using the option pricing based model for valuing the deposit insurance, we examined whether banks took risks so as to increase the value of the insurance for themselves.

The deposit insurance system in Japan does induce banks' moral hazard irrespective of its coverage limit. Blanket deposit insurance when applied outside a stringent PCA regulatory framework did encourage poorly capitalized banks to engage in further risk-shifting. However it did not affect well capitalized banks' risk-taking behavior, so blanket insurance did not have a sector wide impact. The PCA was effective in restraining risk-shifting by fully insured banks under the blanket insurance. Most importantly, it was the large scale public capital infusion program of March 1999, which was executed when deposits were fully insured, that mitigated the banks' risk-shifting because this program was designed such that the more poorly capitalized a bank was, the larger amount of public capital the bank received.

These findings suggest that moral hazard incentives that are induced by publicly

³⁷ I thank Masami Imai for suggesting these additional robustness tests.

run deposit insurance can be mitigated by well-designed public capital infusions. In the context of the modern day global financial crisis, unlike in the case of the Japanese financial crisis of the late 1990s, the expansion of the deposit insurance cap in major countries was explicit, which implies that banks may have been engaged in accelerated risk-shifting under the enhanced deposit protection. Our findings also suggest that the TARP public capital infusion program which is designed not to reflect a recipient's capital adequacy on the amount of public capital it received may not have mitigated the moral hazard of banks whose deposits were covered by the expanded insurance.

Appendix: The Derivation of the IPP

In this Appendix, we derive the IPP following the model of Duan et al. (1992).

At the maturity date, T , when the deposit insurer audits an insured bank, prior to any payment from the deposit insurer, insured depositors receive the value of their deposits if the bank is solvent and a prorated fraction of the value of the bank's assets if it is insolvent. Thus, depositors receive the following amount from their bank at time T .

$$\min \left[FV(B_1), \frac{V_T B_1}{B_1 + B_2} \right] \quad (1)$$

Where

$FV(\cdot)$: future value operator,

B_1 : face value of insured deposits,

B_2 : face value of uninsured deposits,

V_T : value of the bank assets at time T

The deposit insurer pays depositors the (future) value of deposits less the amount received from their bank. Thus, depositors receive the following amount from the deposit insurer at time T . This is the value of the deposit insurance to the bank.

$$\max \left\{ 0, FV(B_1) - \frac{V_T B_1}{B_1 + B_2} \right\} \quad (2)$$

Following Merton (1977), the present value of the insurance payment expressed by

equation (2), IP, is,³⁸

$$IP = B_1 N(y + \sigma_v \sqrt{T}) - \frac{(1 - \delta)^n V B_1}{B} N(y) \quad (3)$$

Where

$$y \equiv \frac{\ln \left[\frac{B}{V(1 - \delta)^n} \right] - \sigma_v^2 T / 2}{\sigma_v \sqrt{T}}$$

$$B \equiv B_1 + B_2$$

σ_v \equiv the instantaneous standard deviation of the return on V.

$N(\cdot)$ \equiv the cumulative standard normal distribution.

δ \equiv the dividends per monetary unit of assets.

n \equiv the number of times per period the dividend is paid.

Scaling down both sides of the equation (3) by B_1 , the premium *per unit of* insured deposits, IPP, can be expressed as follows:

$$IPP = N(y + \sigma_v \sqrt{T}) - \frac{(1 - \delta)^n V}{B} N(y)$$

³⁸ All debts (insured deposits and other uninsured liabilities) are assumed to have the same maturity, which then serves as the expiration date of the option.

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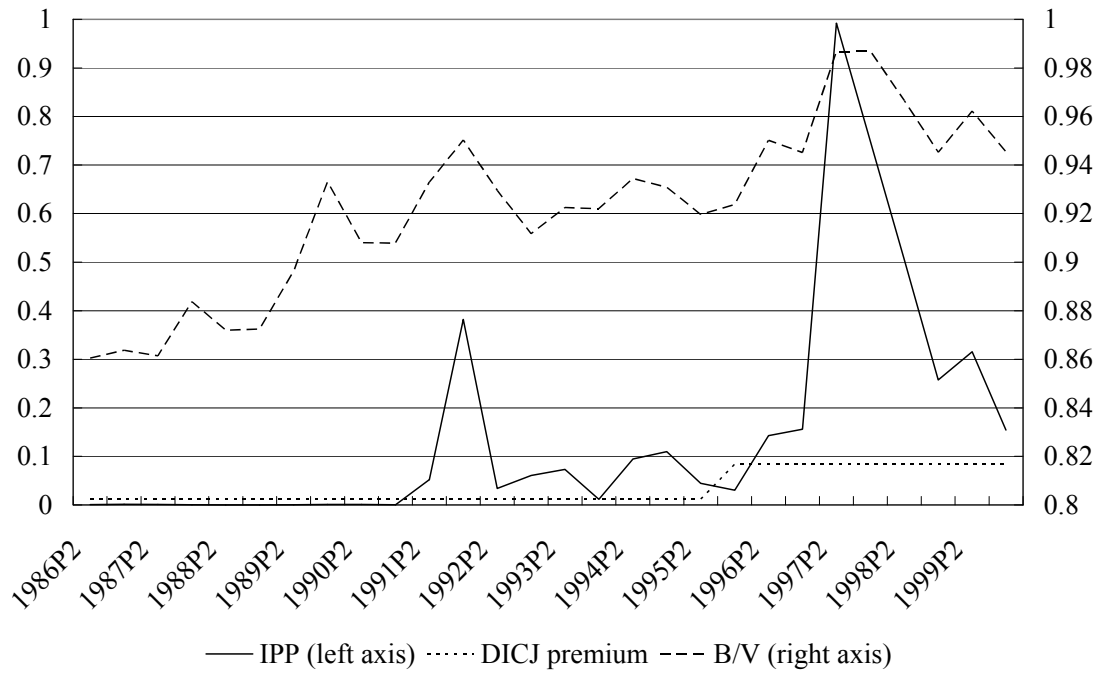
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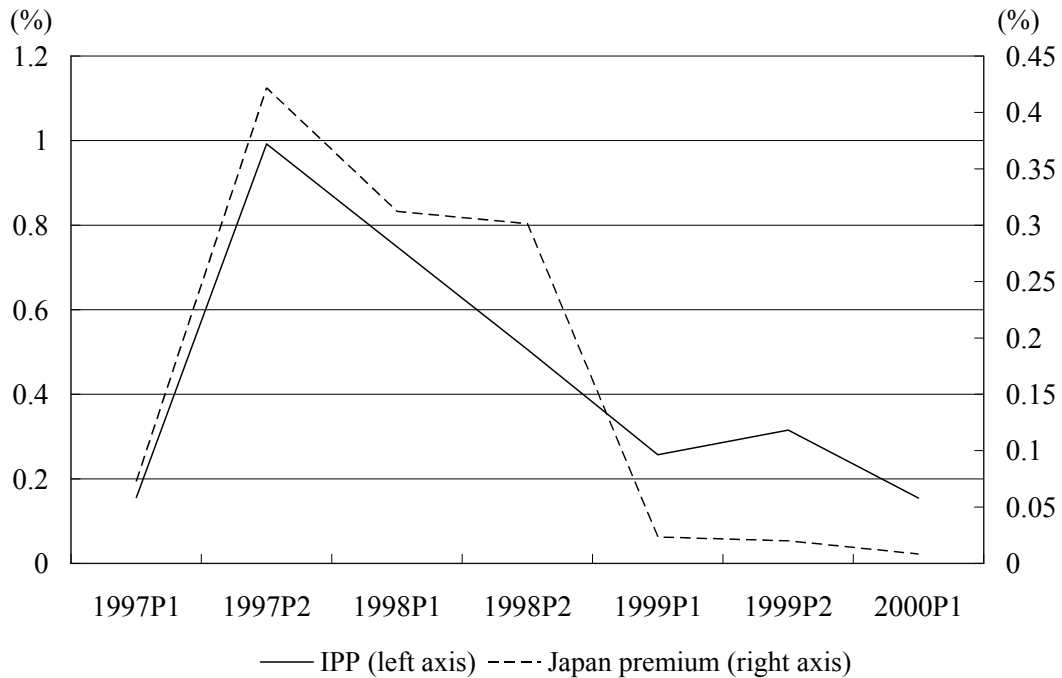
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Figure 1. Trends of IPP, the DICJ's Premium Rate and B/V



IPP and B/V are aggregated over sample banks each period using the value of V as a weight.

Figure 2. The Japan Premium and aggregate IPP



IPP is aggregated over sample banks each period using the value of V as a weight. The Japan premium is the differential between the interbank borrowing rate of Tokyo-Mitsubishi Bank and UK/US banks.

Table 1. Descriptive Statistics

	N	mean	median	standard deviation	min	max
Total liabilities, B (100 million yen)	4018	60,461	23,328	113,542	1,942	988,861
Market value of equity, E (100 million yen)	4018	5,487	1,410	12,958	85	113,178
Annualized standard deviation of rate of return on equity, σ_E (%)	4018	32.4	30.3	13.2	5.0	104.5
Annualized standard deviation of rate of return on assets, σ_V (%)	4018	2.17	1.73	1.45	0.2	11.24
Market value of assets, V (100 million yen)	4018	64,396	24,068	122,024	1,969	1,005,734
Leverage ratio, B/V (100 million yen)	4018	96.3	97.0	3.2	82.5	101.7
IPP	4018	0.1542	0.0453	0.2773	0.0000	2.9029
Public capital infused in March 1998 as a share of total assets, PUBINJ98 (%)	3909	0.0227	0	0.1572	0	2.5419
Public capital infused in March 1999 as a share of total assets, PUBINJ99 (%)	3909	0.0404	0	0.2952	0	4.5378
Public capital infused at time any other than in March 1998 and in March 1999 as a share of total assets, PUBINJOTHER (%)	3909	0.0571	0	0.3611	0	3.5932

For PUBINJ₉₈, PUBINJ₉₉ and PUBINJ_{OTHER}, since these variables are used for the regressions using the first-differenced data, descriptive statistics are calculated for the sample of first-differenced data.

Table 2. Frequency Table for the Number of Banks That Received Public Capital Injections in Each Half-Year Period

	- 1997P1	1997P2	1998P1	1998P2	1999P1	1999P2	2000P1	2000P2	2001P1	2001P2	2002P1	
a positive balance of public capital for the 1998 program	0	15	18	20	17	18	16	13	8	7	6	
a positive balance of public capital for the 1999 program	0	0	0	15	14	15	13	10	5	4	3	
a positive balance of public capital for any other programs	0	0	0	0	4	5	6	7	9	10	8	
# of obs	2061	98	104	105	98	100	100	97	90	86	82	

	2002P2	2003P1	2003P2	2004P1	2004P2	2005P1	2005P2	2006P1	2006P2	2007P1	2007P2	Total
a positive balance of public capital for the 1998 program	4	2	0	1	1	1	0	1	1	2	2	153
a positive balance of public capital for the 1999 program	3	2	1	0	0	0	0	0	0	0	0	85
a positive balance of public capital for any other programs	7	7	6	7	5	5	4	5	5	5	5	110
# of obs	83	82	81	82	80	80	79	79	80	81	81	3909

The 1998 and 1999 programs are public capital infusion programs in March 1998 and in March 1999, respectively.

Table 3. Tests of the Impacts of Different Regulatory Regimes and Public Capital Infusions on Banks' Risk-shifting

$$\Delta \frac{B_{it}}{V_{it}} = \alpha_0 + \left(\alpha_1 + \sum_{j=2}^4 \alpha_j D_{ijt} \right) \Delta \sigma_{ijt} + \varepsilon_{it}$$

$$\Delta IPP_{it} = \beta_0 + \left(\beta_1 + \sum_{i=2}^4 \beta_i D_{ijt} \right) \Delta \sigma_{vit} + \xi_{it}$$

	coefficient	standard error		coefficient	standard error		coefficient	standard error		coefficient	standard error	
constant	0.0013	0.0002	***	0.0013	0.0002	***	0.0000	0.0000		0.0001	0.0000	***
$\Delta \sigma_V$	-0.1880	0.0978	*	-0.1175	0.1190		0.0243	0.0048	***	0.2577	0.0618	***
$\Delta \sigma_V D_2$				0.1900	0.1451					0.0647	0.0742	
$\Delta \sigma_V D_3$				-0.4820	0.1704	***				-0.1294	0.0741	*
$\Delta \sigma_V D_4$				-0.3590	0.2283					-0.0630	0.1029	
R-squared		0.0296			0.0574			0.4487			0.4652	
N		3909			3909			3909			3909	
$\alpha_1 + \alpha_2$				0.0725	0.0829	*						
$\alpha_1 + \alpha_3$				-0.5995	0.1225	***						
$\alpha_1 + \alpha_4$				-0.4765	0.1947	**						
$\alpha_3 - \alpha_2$				-0.6719	0.1478	***						
$\beta_1 + \beta_2$										0.3224	0.0195	***
$\beta_1 + \beta_3$										0.1282	0.0100	***
$\beta_1 + \beta_4$										0.1946	0.0100	**
$\beta_3 - \beta_2$										-0.1942	0.0582	***

*, ** and *** indicate that values are statistically significant at ten percent, five percent and one percent significance levels, respectively. The sample covers from the second half of fiscal year 1986 through the second half of fiscal year 2007. Dummy variables, D_2 , D_3 and D_4 are variables that indicate regulatory regimes 2, 3 and 4, respectively. D_2 takes a value of 1 when the deposit insurance coverage was unlimited and the prompt corrective action (PCA) was yet to begin; from the second half of fiscal year 1996 through the second half of fiscal year 1997 for banks that the regulator allows to operate internationally (international banks) and from the second half of fiscal year 1996 through the second half of fiscal year 1998 for banks that the regulator allows to operate only domestically (domestic banks). D_3 takes a value of 1 when the deposit insurance coverage is unlimited and PCA is in effect; from the first half of fiscal year 1998 through the second half of fiscal year 2001 for international banks and from the first half of fiscal year 1999 through the second half of fiscal year 2001 for domestic banks. D_4 takes a value of 1 from the first half of fiscal year 2002 through the second half of fiscal year 2007, the end of the sample period. $\alpha_1 + \alpha_i$ and $\beta_1 + \beta_i$ are the coefficients of $\Delta \sigma_V$ under regime i . The coefficients of $\Delta \sigma_V$ themselves are those of $\Delta \sigma_V$ under regime 1 from the second half of fiscal year 1986 through the first half of fiscal year 1996. $PUBINJ_{98}$, $PUBINJ_{99}$ and $PUBINJ_{OTHER}$ are the remaining amount of the public capital injection that was received in March 1998, in March 1999 and at any other time, respectively, divided by V , the market value of total assets.

Table 4. Tests of the Risk-shifting Hypothesis under Different Regulatory Regimes when Public Capital Infusions are considered as Bank Specific Regulatory Regimes

$$\Delta \frac{B_{it}}{V_{it}} = \alpha_0 + \left(\alpha_1 + \sum_{j=2}^4 \alpha_j D_{ijt} + \sum_{k \in \{98, 99, OTHER\}} \alpha_k PUBINJ_{ikt} \right) \Delta \sigma_{Vit} + \varepsilon_{it}$$

$$\Delta IPP_{jt} = \beta_0 + \left(\beta_1 + \sum_{i=2}^4 \beta_i D_{ijt} + \sum_{k \in \{98, 99, OTHER\}} \beta_k PUBINJ_{ikt} \right) \Delta \sigma_{Vit} + \xi_{it}$$

	coefficient	standard error		coefficient	standard error	
constant	0.0013	0.0002	***	0.0000	0.0001	
$\Delta \sigma_V$	-0.1173	0.1190		0.2577	0.0618	***
$\Delta \sigma_V D_2$	0.1794	0.1436		0.0600	0.0731	
$\Delta \sigma_V D_3$	-0.4048	0.1830	**	-0.1059	0.0753	
$\Delta \sigma_V D_4$	-0.3428	0.2452		-0.0505	0.1085	
$\Delta \sigma_V PUBINJ_{98}$	9.0443	9.0071		4.0751	3.6906	
$\Delta \sigma_V PUBINJ_{99}$	-26.1113	8.6645	***	-9.0388	2.4186	***
$\Delta \sigma_V PUBINJ_{OTHER}$	-8.4878	8.4325		-5.3824	3.0902	
R-squared		0.0631			0.4726	
N		3909			3909	
$\alpha_1 + \alpha_2$	0.0621	0.0803				
$\alpha_1 + \alpha_3$	-0.5221	0.1398	***			
$\alpha_1 + \alpha_4$	-0.4601	0.2142	***			
$\alpha_3 - \alpha_2$	-0.5842	0.1585	***			
$\beta_1 + \beta_2$				0.3177	0.0390	***
$\beta_1 + \beta_3$				0.1518	0.0434	***
$\beta_1 + \beta_4$				0.2073	0.0891	**
$\beta_3 - \beta_2$				-0.1659	0.0606	***

*, ** and *** indicate that values are statistically significant at ten percent, five percent and one percent significance levels, respectively. The sample covers from the second half of fiscal year 1986 through the first half of fiscal year 2007. Dummy variables, D_2 , D_3 and D_4 are variables that indicate regulatory regimes 2, 3 and 4, respectively. D_2 takes a value of 1 when the deposit insurance coverage was unlimited and the prompt corrective action (PCA) was yet to begin; from the second half of fiscal year 1996 through the second half of fiscal year 1997 for banks that the regulator allows to operate internationally (international banks) and from the second half of fiscal year 1996 through the second half of fiscal year 1998 for banks that the regulator allows to operate only domestically (domestic banks). D_3 takes a value of 1 when the deposit insurance coverage is unlimited and PCA is in effect; from the first half of fiscal year 1998 through the second half of fiscal year 2001 for international banks and from the first half of fiscal year 1999 through the second half of fiscal year 2001 for domestic banks. D_4 takes a value of 1 from the first half of fiscal year 2002 through the second half of fiscal year 2007, the end of the sample period. $\alpha_1 + \alpha_i$ and $\beta_1 + \beta_i$ are the coefficients of $\Delta \sigma_V$ under regime i . The coefficients of $\Delta \sigma_V$ themselves are those of $\Delta \sigma_V$ under regime 1 from the second half of fiscal year 1986 through the first half of fiscal year 1996. $PUBINJ_{98}$, $PUBINJ_{99}$ and $PUBINJ_{OTHER}$ are the remaining amount of the public capital injection that was received in March 1998, in March 1999 and at any other time, respectively, divided by V , the market value of total assets.

Table 5. Tests of the Risk-shifting Hypothesis under Different Regimes when Public Capital Infusions are considered as Bank Specific Regulatory Regimes: High Leverage versus Low Leverage:

	$\Delta \frac{B_{it}}{V_{it}} = \alpha_0 + \left(\alpha_1 + \sum_{j=2}^4 \alpha_j D_{ijt} + \sum_{k \in \{98, 99, OTHER\}} \alpha_k PUBINJ_{ikt} \right) \Delta \sigma_{vit} + \varepsilon_{it}$						$\Delta IPP_{jt} = \beta_0 + \left(\beta_1 + \sum_{i=2}^4 \beta_i D_{ijt} + \sum_{k \in \{98, 99, OTHER\}} \beta_k PUBINJ_{ikt} \right) \Delta \sigma_{vit} + \xi_{it}$					
	low leverage			high leverage			low leverage			high leverage		
	coefficient	standrad error		coefficient	standard error		coefficient	standard error		coefficient	standard error	
constant	0.0032	0.0004	***	-0.0004	0.0002	*	0.0001	0.0001		0.0000	0.0000	*
$\Delta \sigma_V$	-0.0098	0.1332		-0.4673	0.0682	***	0.2916	0.0726	***	0.1339	0.0167	***
$\Delta \sigma_V D_2$	0.1408	0.1722		0.3395	0.1093	***	0.0384	0.0884		0.1446	0.0426	***
$\Delta \sigma_V D_3$	-0.4646	0.2268	**	-0.1719	0.1234		-0.1307	0.0903	*	-0.0273	0.0404	
$\Delta \sigma_V D_4$	-0.3134	0.2738		-0.3459	0.1164	***	-0.0532	0.1294		-0.0313	0.0325	
$\Delta \sigma_V PUBINJ_{98}$	9.0433	12.4249		18.8078	12.1381		4.0294	4.7081		8.8950	5.7284	
$\Delta \sigma_V PUBINJ_{99}$	-15.9979	11.9135		-32.3212	7.7753	***	-6.7712	3.1624	**	-10.9989	2.7274	***
$\Delta \sigma_V PUBINJ_{OTHER}$	-13.0467	10.3306		7.4792	12.0507		-7.6773	3.8734	**	1.0975	3.3682	
R-squared	0.0323			0.2451			0.5226			0.3243		
N	2008			1901			2008			1901		
$\alpha_1 + \alpha_2$	0.1310	0.1095		-0.1278	0.0852							
$\alpha_1 + \alpha_3$	-0.4744	0.1856	***	-0.6392	0.1032	***						
$\alpha_1 + \alpha_4$	-0.3232	0.2398		-0.8133	0.0934	***						
$\beta_1 + \beta_2$							0.3300	0.0504	***	0.2785	0.0393	***
$\beta_1 + \beta_3$							0.1609	0.05051	***	0.1066	0.0368	***
$\beta_1 + \beta_4$							0.2384	0.1074	**	0.1026	0.0279	***

*, ** and *** indicate that values are statistically significant at ten percent, five percent and one percent significance levels, respectively. The sample covers from the second half of fiscal year 1986 through the second half of fiscal year 2007. For the column labeled “low leverage”, the sample consists of bank-date observations whose leverage at the previous date is below the median at that date, whereas for the column labeled “high leverage”, it consists of the sample of bank-date observations whose leverage is above or equal to the median at that date. Dummy variables, D_2 , D_3 and D_4 are variables that indicate regulatory regimes 2, 3 and 4, respectively. D_2 takes a value of 1 when the deposit insurance coverage was unlimited and the prompt corrective action (PCA) was yet to begin; from the second half of fiscal year 1996 through the second half of fiscal year 1997 for banks that the regulator allows to operate internationally (international banks) and from the second half of fiscal year 1996 through the second half of fiscal year 1998 for banks that the regulator allows to operate only domestically (domestic banks). D_3 takes a value of 1 when the deposit insurance coverage is unlimited and PCA is in effect; from the first half of fiscal year 1998 through the second half of fiscal year 2001 for international banks and from the first half of fiscal year 1999 through the second half of fiscal year 2001 for domestic banks. D_4 takes a value of 1 from the first half of fiscal year 2002 through the second half of fiscal year 2007, the end of the sample period. $\alpha_1 + \alpha_i$ and $\beta_1 + \beta_i$ are the coefficients of $\Delta \sigma_V$ under regime i . The coefficients of $\Delta \sigma_V$ themselves are those of $\Delta \sigma_V$ under regime 1 from the second half of fiscal year 1986 through the first half of fiscal year 1996, which is before the instatement of the blanket deposit insurance coverage. $PUBINJ_{98}$, $PUBINJ_{99}$ and $PUBINJ_{OTHER}$ are the remaining amount of the public capital injection that was received in March 1998, in March 1999 and at any other time, respectively, divided by V , the market value of total assets.

Table 6. Tests of the Risk-shifting Hypothesis under Different Regulatory Regimes when Public Capital Infusions are considered as Bank Specific Regulatory Regimes: Sample Including Bank Holding Companies

$$\Delta \frac{B_{it}}{V_{it}} = \alpha_0 + \left(\alpha_1 + \sum_{j=2}^4 \alpha_j D_{ijt} + \sum_{k \in \{98, 99, OTHER\}} \alpha_k PUBINJ_{ikt} \right) \Delta \sigma_{ijt} + \varepsilon_{it} \quad \Delta IPP_{it} = \beta_0 + \left(\beta_1 + \sum_{j=2}^4 \beta_j D_{ijt} + \sum_{k \in \{98, 99, OTHER\}} \beta_k PUBINJ_{ikt} \right) \Delta \sigma_{vit} + \xi_{it}$$

	coefficient	standard error		coefficient	standard error	
constant	0.0013	0.0002	***	0.0000	0.0001	
$\Delta \sigma_V$	-0.1166	0.1192		0.2574	0.0620	***
$\Delta \sigma_V D_2$	0.1563	0.1414		0.0489	0.0724	
$\Delta \sigma_V D_3$	-0.3907	0.1769	**	-0.0996	0.0729	
$\Delta \sigma_V D_4$	-0.3983	0.2431		-0.0704	0.1072	
$\Delta \sigma_V PUBINJ_{98}$	28.4562	12.7850	**	13.5626	5.6796	**
$\Delta \sigma_V PUBINJ_{99}$	-29.6272	6.6149	***	-10.6799	1.9538	***
$\Delta \sigma_V PUBINJ_{OTHER}$	-2.0098	6.7572		-4.0520	2.6470	
R-squared		0.0714			0.4922	
N		4008			4008	
$\alpha_1 + \alpha_2$	0.0396	0.0760				
$\alpha_1 + \alpha_3$	-0.5074	0.1315	***			
$\alpha_1 + \alpha_4$	-0.5149	0.2118	**			
$\beta_1 + \beta_2$				0.3063	0.0372	***
$\beta_1 + \beta_3$				0.1578	0.0388	***
$\beta_1 + \beta_4$				0.1870	0.0875	**

*, ** and *** indicate that values are statistically significant at the ten percent, five percent and one percent significance levels, respectively. The sample covers from the second half of fiscal year 1986 through the second half of fiscal year 2007 and includes observations for bank holding companies. Dummy variables, D_2 , D_3 and D_4 are variables that indicate regulatory regimes 2, 3 and 4, respectively. D_2 takes a value of 1 when the deposit insurance coverage was unlimited and the prompt corrective action (PCA) was yet to begin; from the second half of fiscal year 1996 through the second half of fiscal year 1997 for banks that the regulator allows to operate internationally (international banks) and from the second half of fiscal year 1996 through the second half of fiscal year 1998 for banks that the regulator allows to operate only domestically (domestic banks). D_3 takes a value of 1 when the deposit insurance coverage is unlimited and PCA is in effect; from the first half of fiscal year 1998 through the second half of fiscal year 2001 for international banks and from the first half of fiscal year 1999 through the second half of fiscal year 2001 for domestic banks. D_4 takes a value of 1 from the first half of fiscal year 2002 through the second half of fiscal year 2007, the end of the sample period. $\alpha_1 + \alpha_i$ and $\beta_1 + \beta_i$ are the coefficients of $\Delta \sigma_V$ under regime i . The coefficients of $\Delta \sigma_V$ themselves are those of $\Delta \sigma_V$ under regime 1 from the second half of fiscal year 1986 through the first half of fiscal year 1996. $PUBINJ_{98}$, $PUBINJ_{99}$ and $PUBINJ_{OTHER}$ are the remaining amount of the public capital injection that was received in March 1998, in March 1999 and at any other time, respectively, divided by V , the market value of total assets.