

Federal Deposit Insurance, Regulatory Policy, and Optimal Bank Capital*

STEPHEN A. BUSER, ANDREW H. CHEN, EDWARD J. KANE

First published: March 1981

<https://doi.org/10.1111/j.1540-6261.1981.tb03534.x>

Citations: 107

† An earlier version of this paper was delivered at the June, 1979 meetings of the Western Economics Association. The authors wish to thank Edward H. Bowman, Michael Bordo, K.C. Chen, Jeffrey Fisher, Patrick Hess, E. Han Kim, Joseph Sinkey, Benjamin M. Friedman and Anthony M. Santomero of this *Journal* for helpful criticism.

ABSTRACT

This paper seeks to explain the combination of explicit and implicit pricing for deposit insurance employed by the FDIC. Essentially, the FDIC sells two products—insurance *and* regulation. To span the product space, it must and does set two prices. We argue that the need to establish regulatory disincentives to bank risk-taking is the heart of the controversy over the adequacy of bank capital and that the ability to close risky banks before exhausting their *charter value* (i.e., the value of their right to continue in business) stands at the center of these disincentives and in front of the FDIC's insurance reserves.

REFERENCES

1 Ross E. Barnett, Paul M. Horvitz, and Stanley C. Silverberg, Deposit Insurance: The Present System and Some Alternatives, *The Banking Law Journal*, **94** (April 1977), pp. 304–32.

[Google Scholar](#)

2 H. Prescott Beighley, John H. Boyd, and Donald P. Jacobs, Bank Equities and Investor Risk Perceptions: Some Entailments for Capital Adequacy Regulation, *Journal of Bank Research*, **6** (Autumn 1975), pp. 190–207.

[Google Scholar](#)

3 Roger Blair, and Arnold Heggstad, “Bank Portfolio Regulation and the Probability of Bank Failure”, *Journal of Money, Credit and Banking*, **10** (February 1978), pp. 88–93.

[Web of Science®](#) | [Google Scholar](#)

4 Andrew H. Chen, “Recent Developments in the Cost of Debt Capital”, *Journal of Finance*, **33** (June 1978), pp. 863–77.

[Google Scholar](#)

5 Federal Deposit Insurance Corporation, 1977 Annual Report, Washington: 1978.

[Google Scholar](#)

6 Benjamin M. Friedman, and Peter Formuzis, "Bank Capital: The Deposit Protection Incentive", *Journal of Bank Research*, 6 (Autumn 1975), pp. 208–18.

[Google Scholar](#)

7 Edward J. Kane, "Good Intentions and Unintended Evil: The Case Against Selective Credit Allocation", *Journal of Money, Credit and Banking*, 9 (February 1977), pp. 55–69.

[Web of Science®](#) | [Google Scholar](#)

8 John H. Kareken, and Neil Wallace, "Deposit Insurance and Bank Regulation: A Partial-Equilibrium Exposition", *Journal of Business*, 51 (July 1978), pp. 413–38.

[Web of Science®](#) | [Google Scholar](#)

9 E. Han Kim, "A Mean-Variance Theory of Optimal Capital Structure and Corporate Debt Capacity", *Journal of Finance*, 33 (March 1978), pp. 45–63.

[PubMed](#) | [Web of Science®](#) | [Google Scholar](#)

10 Michael Koehn, and Anthony M. Santomero, "Regulation of Bank Capital and Portfolio Risk", Working Paper No. 9–79 (mimeographed), Rodney White Center for Financial Research, The Wharton School, 1979.

[Google Scholar](#)

11 Alan Kraus, and Robert Litzenberger, "A State-Preference Theory of Optimal Financial Leverage", *Journal of Finance*, 28 (September 1973), pp. 911–22.

[Google Scholar](#)

12 J. Huston McCulloch, "Interest Rate Risk and Capital Adequacy for Traditional Banks and Financial Intermediaries", NBER Working Paper No. 237 (revised), Stanford, CA, July 1978.

[Google Scholar](#)

13 Robert C. Merton, "An Analytic Derivation of the Cost of Deposit Insurance Loan Guarantees: An Application of Modern Option Pricing Theory", *Journal of Banking and Finance*, 1 (June 1977), pp. 3–11.

[Google Scholar](#)

14 Robert C. Merton, "On the Cost of Deposit Insurance When There Are Surveillance Costs", *Journal of Business*, 51 (July 1978), pp. 439–52.

[Web of Science®](#) | [Google Scholar](#)

15 Franco Modigliani, and Merton Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment", *American Economic Review*, **48** (June 1958), pp. 261-97.

[Google Scholar](#)

16 Franco Modigliani, and Merton Miller, "Corporate Income Taxes and the Cost of Capital: A Correction", *American Economic Review*, **53** (June 1963), pp. 433-43.

[Google Scholar](#)

17 Sam Peltzman, "Capital Investment in Commercial Banking and Its Relationship to Portfolio Regulation", *Journal of Political Economy*, **78** (Jan. Feb. 1970), pp. 1-26.

[Web of Science®](#) | [Google Scholar](#)

18 Richard A. Posner, "Taxation by Regulation", *Bell Journal of Economics and Management Science*, **1** (Spring 1971), pp. 22-50.

[Google Scholar](#)

19 John J. Pringle, "The Capital Decision in Commercial Banks", *Journal of Finance*, **29** (June 1974), pp. 779-95.

[Google Scholar](#)

20 Anthony M. Santomero, and Ronald D. Watson, "Determining the Optimal Capital Standards for the Banking Industry", *Journal of Finance*, **32** (September 1977), pp. 1267-82.

[Google Scholar](#)

21 Kenneth E. Scott, and Thomas Mayer, "Risk and Regulation in Banking: Some Proposals for Deposit Insurance Reform", *Stanford Law Review*, **23** (May 1971), pp. 857-902.

[Google Scholar](#)

22 William F. Sharpe, "Bank Capital Adequacy, Deposit Insurance and Security Values", *Journal of Financial and Quantitative Analysis*, **13** (November 1978), pp. 701-18.

[Web of Science®](#) | [Google Scholar](#)

23 Joseph F. Sinkey, Jr. *Problem and Failed Institutions in the Commercial Banking Industry*, Greenwich: JAI Press, 1979.

[Google Scholar](#)

24 Stuart M. Turnbull, "Debt Capacity", *Journal of Finance*, **34** (September 1979), pp. 931-940.



ABOUT WILEY ONLINE LIBRARY

[Privacy Policy](#)

[Terms of Use](#)

[About Cookies](#)

[Manage Cookies](#)

[Accessibility](#)

[Wiley Research DE&I Statement and Publishing Policies](#)

[Developing World Access](#)

HELP & SUPPORT

[Contact Us](#)

[Training and Support](#)

[DMCA & Reporting Piracy](#)

OPPORTUNITIES

[Subscription Agents](#)

[Advertisers & Corporate Partners](#)

CONNECT WITH WILEY

[The Wiley Network](#)

[Wiley Press Room](#)