Market Valuation and Risk Assessment of Canadian Banks

Liu, Ying (/search?f1=author&as=1&sf=title&so=a&rm=&m1=e&p1=Liu%2C%20Ying&ln=en); Papakirykos, Eli (/search?f1=author&as=1&s...

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Abstract

This paper applies the asset valuation model developed by Rabinovitch (1989) to the six largest Canadian banks. The model is an extension of the Merton (1977a) option-pricing model with the incorporation of stochastic interest rates. We then introduce a measure of distance-to default, Z-score. Our results indicate that the market value of bank assets is almost always below its book value and that Canadian banks have a very low insolvency risk over time, except for 1982 and 1983. We also find that both the market valuation of the bank assets and the z-score of these Canadian banks demonstrate similar regime switches in the late 1990s, which may be related to regulatory changes during the 1990s.

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Author(s)	Liu, Ying (/search?f1=author&as=1&sf=title&so=a&rm=&m1=e&p1=Liu%2C%20Ying&ln=en) Papakirykos, Eli (/search?f1=author&as=1&sf=title&so=a&rm=&m1=e&p1=Papakirykos%2C%20Eli&ln=en) Yuan, Mingwei (/search?f1=author&as=1&sf=title&so=a&rm=&m1=e&p1=Yuan%2C%20Mingwei&ln=en)
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