

“Is DD a Good Measure in Predicting Bank Failures? Analysis of the Distance to Default”

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Abstract

This paper examines the DD of failed Japanese banks. In a related paper of Harada and Ito (2008), the DD of merged banks are examined. As the DD is a market-based measure of corporate default risk, this paper measures and analyzes the DD of failed Japanese banks. The resolution of failed banks used to be conducted under the so-called “convoy system”, or no fail policy until the 1990s. The system later totally changed.

Our results suggest that in general the DD was a helpful measure. The DD became smaller for taking longer period of time towards the failure period so was considered as a good indicator to show banks’ credit risks. In some cases, however the DD did not predict failures. The banking regulation policy as well as the supervisory system had changed several times in 1990s which must have had affected the results.

Keywords: distance to default and bank failure

JEL Classification: G19, G21.