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BASEL II: CHALLENGES AND RISKS

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ABSTRACT

Basel II will replace Basel I and it is expected that Basel II will be implemented in the U.S. by the end of 2007. However, only ten largest internationally active banks in the U.S. (core banks) will be required to use the advanced internal rating based (A-IRB) approach to calculate capital against credit risk and to use the advanced measurement approach (AMA) to calculate capital against operational risk. Other banks (non-core banks) may "opt-in" to adopt a standardized approach under the Basel II Accord or continue to use Basel I. It is expected that only a small number of non-core banks will opt-in.

Basel II explicitly requires banks to hold capital against credit risk, market risk, and operational risk. Regulators also expect the Basel II framework to provide incentives for banks to continue improving their risk measurement and management on an ongoing basis. It is also envisaged that a new securitization framework which accounts for several important risk drivers such as the credit quality, asset correlations, thickness of tranches, rating of tranche, and the underlying pool's granularity, will help determine regulatory capital requirements for securitized assets.

The study discusses the shortcomings of Basel I and outlines the reasons for the creation of Basel II. The study summarizes the three Pillars of the Basel II framework (minimum capital requirements, supervisory review and disclosure) which are recognized to be the key elements of a safe and sound financial system. The paper also discusses the advantages and some limitations of IRB approach and the regulatory capital treatment of asset securitization and raises some concerns about their potential impact on current competitive positions of banks. In addition, the study also raises some issues related to cross-border implementation of Basel II. Thus, the implementation of Basel II may have the unintended consequence of distorting competitive equity in the U.S. banking industry.

The implementation of Basel II in emerging Asia-Pacific nations will be a challenging task for both supervisory authorities and bank managers, and will have significant impact on banks.

One of the major weaknesses of Basel II discussed in the paper is that the revised standards do not address the capital requirements due to systematic risks arising from cyclical effects in credit, operational or market risk. Therefore, the future research ought to focus on an integrated approach for capital requirements that incorporates procyclical risk factors into risk measurement and management. Thus, Basel II will continue to provide many opportunities for researchers to contribute to policy debate.

SEASONALITY IN OPTION MONTH RETURNS: AN INVESTIGATION

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ABSTRACT

Securities from different US indexes for the period April 1973 to December of 2003 are studied and returns are analyzed based on calendar month to test for seasonality. Our results support the findings of the existing literature. When security returns are analyzed based on option month, we find not only the existence of seasonality but also a difference in seasonality between two types of months. Our findings contribute to the literature another dimension with which to explore seasonality and have implications for portfolio decisions. Our findings may also imply that when portfolios are hedged against market uncertainty, the choice of derivatives and the timing of these derivatives may differentiate the performance of the portfolios and may hedge portfolios differently.