

Book-to-Market Equity, Asset Correlations and Basel Capital Requirement

李詩政
元智大學財務金融學群

Abstract

We examine the effect of book-to-market equity (BE/ME) on asset correlations in the asymptotic single risk factor (ASRF) framework under the Basel II Accord on regulatory capital requirement. Over a sample period from 1988 to 2007, we find that BE/ME is negatively related to asset correlations after controlling for firm size, default probability, and industry effects. Decomposing BE/ME into risks of operating leverage and financial leverage according to Penman et al. (2007) reveals that higher (lower) operating risk are related to lower (higher) asset correlations. Our findings suggest that incorporating risk of operating leverage into the estimation of asset correlations may improve the measurement of a bank's regulatory capital requirement and potentially reduce regulatory capital arbitrage.