Fourth lecture: Basel Committee Standards for Banking Supervision - Basel-1 Agreement—

After many meetings and efforts, it finally presented its first recommendations regarding the adequacy of capital capable of absorbing all potential losses and covering the bank's fixed assets to ensure the security of depositors.

Before the Basel Committee came up with its decisions related to Basel I in 1988, the supervisory authorities adopted, for many years, the leverage ratio to measure the degree of solvency of the bank or "the likelihood of the bank's insolvency," but they saw that this ratio represents a minimum for the bank's capital. Money, but it is not a measure of the degree of solvency because it does not distinguish between assets according to the degree of risk.

In 1988, the Basel Committee approved its first agreement to specify the minimum capital adequacy, or what is known as the Cook ratio, with the aim of protecting banks from potential risks, especially loan risk. It was amended in 1996 by including market risk.

The minimum capital adequacy was set at 8%, and this percentage would be applied starting from the end of 1992 (to be tested from 1990 to 1992) under the proposal of Cook, who later became Chairman of the Basel Committee, to ensure equality in the conditions of competition between international banks, and also the stability of banks through Stability in their private capital.

Advantages of the capital adequacy standard according to the Basel-1 agreement for banking supervision

The Basel-1 Agreement on Banking Supervision initially achieved great popularity among bank circles, as it helped unify and regulate supervision processes among various banks in the world through the capital adequacy standard. However, over time, it recorded several structural deficiencies, the most important of which are:

The minimum capital was imposed on banks by the Basel Committee to protect them from bankruptcy and financial crises. However, most of the banks that declared bankruptcy respected the Cook ratio, so it became necessary to add some qualitative requirements.

The volume of loans granted by banks decreased and they resorted to raising interest rates to maintain their profit margin.

An imbalance in the relationship between the bank and the customer after reducing the volume of loans granted and depriving customers or investors of achieving the greatest profit and returns, thus decreasing the proportion of investment in the country.

The process of estimating risks according to the agreement is a calculation only, regardless of the market's assessment of these risks.

This agreement focused only on credit risk and not on how to manage it.

In view of the shortcomings recorded by this agreement, the need arose to reconsider, especially the criterion of bank solvency (Cook's ratio), and to introduce some amendments to this agreement.

Amendments to Basel-1

After noting the shortcomings recorded, the Basel Committee saw the need to reconsider how capital adequacy is calculated, in order to strengthen the global banking system.

The new amendments to this agreement gave flexibility in application, leaving full freedom to the banks to choose standard models, whether complex or simplified, to measure risks, depending on the size of the banks.

It maintained the solvency ratio (8%) even though the amendment resulted in the addition of (Basel 1.5) to the components of the ratio by adding a third tranche of capital to meet part of its market risks, which is represented by two-year supporting loans.

Total Capital = Tier 1 (Paid-in Capital + Reserves + Retained Earnings) + Tier 2 (Subsidiary Capital) + Tier 3 (Short-Term Delayed Debt)

-Provided that the following conditions are met in the third tranche:

- They must be in the form of support loans with a maturity period exceeding two years, provided that they do not exceed 25% of the bank's capital (first tranche).

- It must be designated to face market risks only, including foreign exchange risks.

It is permissible to replace the elements of the second tranche with the third tranche of capital, provided that it does not exceed 25%.

-The first tranche of capital must be greater than or equal to the sum of the second and third tranches.

Therefore, the capital adequacy standard after adding market risks becomes as follows:

$$\textbf{CAPITAL ADEQUACY RATE} = \frac{\textbf{CAPITAL(First tranche + second tranche + third tranche)}}{\textbf{Risk} - \textbf{weighted assets} + \textbf{Market risk measure 12, 5}} \geq \textbf{8}$$

After the Asian crisis of 1997, the agreement authorities confirmed that the principles of the agreement (Basel I) should not depend on the financial soundness of the bank (minimum capital adequacy), but rather more attention should be paid to the stability of the financial and banking sector and how to manage various risks.

The Basel Committee saw the need to reconsider how to formulate the Cook Standard. Since 1997, many consultations began to develop these standards, so that a new agreement, or the so-called Basel Committee II Standard, appeared in June 1999, and its first form appeared in June 2001.