Lecture 6: Standards of the Basel Committee on Banking Supervision (Basel-2)

- In 1999, the Basel Committee developed its agreements called Basel II in order to cover the shortcomings that exist primarily in the first agreement, taking into account the three most important banking risks, which are the loan risk (75%), the market risk (5%) and the operational risk (20%), in addition to three Primary additional columns.

- The first column is an innovative method for calculating capital adequacy to meet the various risks taken into account.
- The second column is concerned with following up on the supervisory and monitoring authorities on capital adequacy.
- The last column relates to market discipline or the obligation of banks to disclose all data related to risk assessment methods.

Basic Aspects of the Basel II Agreement In June 1999

The Basel Committee published its first proposals regarding amending the capital adequacy standard to be more precise and comprehensive

On 10th January 2001

It gave more precise and detailed suggestions about the new framework for the banking solvency standard, provided that comments and observations are sent from the concerned and competent authorities, including the International Monetary Fund (FMI), before May 2001.

In June 2004

Adoption of the final version of the agreement in June 2004 under the name Basel II, provided that the application is to be implemented until the end of the year 2006 as a maximum.

Basic pillars of Basel II

The Basel II Accord represents an important step to ensure sound and accurate management of the various risks facing the bank in a constantly changing environment characterized by technological development and financial globalization. The agreement is based on three basic pillars:

Minimum capital requirements

- New ways to manage credit risk.
- Market risk trend requirements (unchanged).

- Operational risks (new addition in Basel).

Supervisory review

- Banks have methods to evaluate capital adequacy
- Reviewing methods for evaluating capital adequacy by supervisory authorities

Mandatory disclosure of all information related to the bank to its customers

- Mandatory disclosure of all information related to the bank
- For those dealing with it
- Disclosure of the adequacy of capital to face risks.

Minimum capital requirements

In its first pillar, the agreement focuses on the need to determine minimum capital requirements for banks to manage credit risks, operational risks and market risks. What is new in this agreement is the proposal of a set of approaches or methods that remain optional for banks, from simple to more complex, to confront both credit risks and operational risks. As for market risks, it remains as in the first agreement without change.

A- Credit risk

Regarding credit risks: The new agreement made radical amendments regarding the risk weighting coefficients, so that weights were now given according to the type of the loan after it had been given according to the legal nature of the borrower (the bank, the state...) through which loans could receive a better classification and a better risk weight than others. This was given to the state in the first agreement.

The Basel II agreement proposed three methods or methods for measuring credit risk, which are:

The standard (typical) approach: In determining the credit risk weights of the bank's assets, this standard depends on the classifications given by external evaluation institutions such as (Standard & Poors) Fitch and (Moodys).

Internal classification approach: This method depends on the internal classification carried out by the bank (assessing its credit risks) and can be implemented in two ways:

*Basic method: In this method, the bank makes its own classifications of credit risks and the risk weights are determined by the supervisory authority.

* Advanced method: This method is based on the same basic method, except that banks assess their risks alone based on their experiences and expertise, as well as according to advanced programs and databases.

(BIS 2001b, p17)

B- Operational Risk: For this agreement, operational risk is a loss resulting from the failure of individuals and operations. The agreement specified three methods for calculating the minimum capital requirements:

Basic indicator: This method is based on multiplying the annual average of total income for the previous three years by 15%, and the result expresses the amount of capital necessary to cover operational risks.

Typical (standard) indicator: In this method, the bank's activity is divided into eight types or so-called business lines, which are: corporate finance 18%, trade and sales 18%, retail banking 12%, commercial banking 15%, payments and settlement 18%, services. Agency 15%, asset management 12% and retail brokerage 12%, and each business line has a percentage called (Betta) of total income, which represents the coefficient, required to cover operational risks, and it ranges between 12% and 18%, that is, simply multiplying the average The total income obtained for the last three years from each activity in its transactions, which ranges between 12% and 18%.

Advanced measurement method: Or the so-called internal approach (loss distribution approach). In this method, the bank relies on its database of operational risk losses.

C-Market risks:

It measures capital requirements for market risk, and market risk capital requirements are calculated using either the standard index or the internal approach.

Supervisory review

It includes four basic principles:

Banks must have methods and systems to evaluate the adequacy of capital to face various risks, in addition to the strategy necessary to maintain their capital levels.

- The supervisory authority evaluates the banks' internal estimates regarding the adequacy of capital and their ability to adhere to it, and takes the necessary measures in a timely manner.

- The supervisory authority expects the banks to maintain an increase in their capital and obligates them to do so.

- The ability of the supervisory authority to intervene in the early stages to prevent the capital from falling below the required level and to take the necessary measures in the event that the bank is unable to maintain the required level.

Market discipline

This pillar is considered complementary to the previous pillars (the first and second). Through this pillar, the Basel Committee saw that encouraging market discipline is achieved through a set of disclosure requirements to allow participants to evaluate the various information related to the risks that the bank faces, as well as the level of capital required to cover those risks (avoiding The problem of information asymmetry.

In general, it can be said that the new Basel II agreement establishes three basic and complementary pillars, which are considered an important step for managing various banking risks in an environment characterized by instability and the increasing emergence of new financial instruments.

- Despite all the distinctive characteristics of the Basel II Agreement, with its content representing the solidity of the financial and banking system as a whole, this did not prevent the occurrence of the major global financial crisis in late 2007, which resulted in widespread debt defaults, and this led investors and depositors to incur large and heavy losses. This led the Basel Committee to intervene quickly and introduce radical amendments to the previous agreement to enhance dealing with the economic and financial pressures imposed by the environment, whether internal or external, and to increase transparency in particular to ensure the financial stability of the bank in the long term.