

# The Impact of Basel (I) and (II) Accords On the Distribution of Credit in the Egyptian Commercial Banks (1999 – 2014)

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**Abstract:** The banking system has recently witnessed a lot of developments and was the focus on a great deal of attention due to its significance and the effective role it plays in the world economies. In addition, it works on consolidating the economic stability and mitigating the cases of default suffered by many banks. Both governments and authorities in charge are exerting efforts to avoid the occurrence of banking crises through internal monitoring committees on banks through such as the Basel I and II Accords related to the Bank of International Settlements. On the Egyptian part within the framework of the banking reform scheme the importance of applying the decrees of Basel II lies in the purpose of providing sufficient and appropriate levels of capitals that match the volume and quality of risks. This study aims at casting light on the Basel Accords II through the presentation of its definition, objectives and focal points. In order to shed light on such subject and its treatment, the researcher of this study has formulated the following problem: Are the indices of Basel Accords in conformity with the banking systems existent in both the developing and the developed countries? What are the drives behind changing the decrees of Basel Accords I and II? Both questions shall be answered by this present study.

**Keywords:** Impact of Basel (I) and (II) Accords On the Distribution of Credit in the Egyptian Commercial Banks.

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## I. THE RESEARCH PROBLEM

Despite the fact that the standards of Basel Accords represent one of the most significant standards applied to the banking system, and they are globally accepted due to the dominant conditions of the banks within several financial systems as well as the total economic impacts that may cause serious risks resulting from the instability of the banks, however, there are but a few evidences regarding the relationship between the compliance with the basic rules of Basel Accords and the performance of the banking system. The paper shall attempt to investigate the relationship between the performance of the banking sector as measured by the main rules of Basel Accords, thus, this study is working on analyzing the decrees of the committee of Basel II that were applied and then comparing them within the Egyptian banks. The research problem of this study focus on the following major question: Does the compliance with the main rules of Basel Accords II create an organizational and supervisory environment the help improving the performance of the commercial banks in Egypt ? In addition, what are the drives behind changing the decrees of Basel Accords I, II and III?

## II. THE HYPOTHESES OF THE STUDY

1. There are evidences that the banks working in Egypt apply the decrees of the Basel Accords II that are related to internal control.
2. There is a huge positive impact of the performance of the banks sector in case of complying with the Basel decrees due to the increase of supervisory and monitoring process over the banks.

### III. THE TEMPORAL AND GEOGRAPHICAL SCOPE OF THE STUDY

The present study deals with the impacts of the decrees of Basel Accords on the distribution of credit in some Egyptian banks during the period from the year 1999 till 2014, whereas the territorial scope includes Egypt and the European Union.

### IV. THE SIGNIFICANCE OF THE STUDY

#### **The Scientific Significance of the Study:**

The scientific significance of this study is based on the fact that it deals with a subject that is highly important and very closely related to the banking industry, which is the Basel Accords I and II in addition to the capital adequacy in order to maintain the depositors' funds and to safeguard the commercial banks against credit risks.

#### **The Practical Significance of the Study:**

The present study gains its practical significance from its potential to contribute to laying down an integrated and comprehensive framework for solving the credit problems in the Egyptian commercial banks along with identifying the main objectives and aspects of Basel Accords which must be considered and implemented by the commercial banks.

### V. THE STUDY APPROACH

The approach adopted by the researcher of this study is the analysis of the various aspects of the banking systems (inputs, outputs, transformation, feedback and the surrounding environment) as such approach can be utilized in regard to the subject of this study through considering the Basel Accords, how they lay down certain conditions and rules that are derived from their decrees, what are the reasons behind the stipulations of such rules and how they are used by the European commercial banks in order to implement such laws on the European level as well as what may be the results of the noncompliance therewith in addition to the outcome of such policies and the valuation there of.

### VI. DATA RESOURCES

The collection of the academic data for the subject matter of this study depends on all the primary resources of reference works which include the Basel decrees, the laws of European Monetary Union, the international reports, the theses, documents, and also the secondary resources that include written works on the subject matter of this study of reference works and previously published texts, academic journals, newspapers, magazines, as well as works published on the Internet as they present the most updated and recent academic papers that provide information on the most recently published books that are relevant to the subject matter.

### VII. INTRODUCTION

Banks represent the mainstay of the economy of all societies and the major pillar of nations' advancement. As certain economic crises occurred, some banks became in default on global level, especially within the European Union, such incapability resulted in the fact that a committee of the Central Banks through their CEOs, the specialists and bankers held regular meetings since 1974 in order to find certain effective solutions aiming at preventing the failure of such banks, and such meetings took place until the year 1988. The regular and annual meetings led to certain solutions that were appropriate for the banking system, which resulted in the emergence of Basel Accords I in the year 1988, thus, both Basel Accords I and II were the gateway to a new era of banking cooperation on global level. These Accords also helped improving the overall situation through the introduction of quantitative and technical standards in addition to coordinating the banking monitoring, organization, and the standards of capital adequacy throughout many of the other emerging market economies. Even when Basel Accords were accurately implemented in full, they might be misunderstood for leading to decrease the cash flows to the emerging markets based on the fact that they cause large volumes of risks. On the contrary, their implementation shall lead to increase the credit worthiness of banks operating in emerging markets, thus increasing both the cash flows and the foreign investments even if they were not actually implemented, such accords shall increase the level of credit worthiness of banks operating in the economies of the emerging countries. It was hoped that the outcome and the results of such accords shall lead to stability on long term in the banking sector in many

countries all over the world .Nevertheless, most third world banks, especially in Egypt have not finished the implementation of Basel Accords II yet.

### 1. THE DEFINITION OF BASEL COMMITTEE I (1988):

This committee was established and formed of a group of governors and CEOs of the Central Banks in the major ten industrial countries in 1975, i.e. thirteen members (Italy, Belgium, Germany, Switzerland, Luxemburg, the USA, the Netherlands, Canada, Spain, Sweden, Britain, Japan and France)<sup>1</sup>within the framework of the Bank of International Settlements in Swiss city of Basel that lies on the Rhine River.

On the light of the aforementioned, the researcher defines both the Basel Accords I and II as the outcome of the meetings held by the Basel Committee formed of the group of the eleven industrial countries within the period from 1974 till 1988, following the dissolution of Herstatt Bank in order to accommodate the banking standards and regulation within all the member countries in the committee. Their aim, as stated in the incorporation agreement of the Basel Committee, was "the extension of the organizational coverage scope and promoting the appropriate banking monitoring and to make sure that there no foreign banking institution that is not subjected to supervision and control". In order to achieve such objective, the member states, i.e. France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the UK, the USA and Luxemburg, held a meeting in Swiss city of Basel for the purpose of forming a committee formed of the group of the central banks in every country and the representative of the general authority of banking supervision, whereas the authorities of the states allowed the discussion of the current status of the global banking system and proposing the common standards that may help the committee achieve its objectives, however, it was up the member states themselves to decide for the implementation and application of the Basel Committee recommendations as the incorporation agreement explicitly stipulated that the Basel Committee cannot pass a law or a standard that are obligatory for application by banks in any country. It is worth mentioning that the committee is only advisory and not based on any agreements that oblige banks to actually implement them in a practical manner. The committee convenes regularly on quarterly basis each year in the headquarters of the Bank of International Settlements in the Swiss city of Basel. It also has about 80 technical work groups to prepare the general recommendations and guidelines as well as the monitoring standards regarding the best supervisory practices of the general banking practice<sup>2</sup>.Although it has no legal resources to comply with the implementation thereof, the Accords has received certain global acceptance as it contains some positive points and advantages that help promote the banking industry on global level. Up to this date it is already implemented in more than 100 countries worldwide and it holds a forum to exchange the viewpoints in its headquarters that is located in the Bank of International Settlements in Basel, Switzerland<sup>3</sup>.Since the establishment of Basel Accords I in 1988, it stipulated a unified standard for the capital adequacy. Such standard defines the minimum limit of capital that should be maintained by banks at 8 % based on the relationship between capital and assets as well as the risky liabilities. Although such agreement is not globally binding, it granted a great deal of strictness to some countries which are willing to comply with higher than 8 %.The capital requirements are calculated based on the following formula<sup>4</sup>:

$$\frac{\text{Total Capital}}{\text{Credit Risks Weighted Assets} + 12.5 \times \text{Capital Required to Cover Market Risks}}$$

### 2. THE OBJECTIVES OF BASEL COMMITTEE I (1988):

Shortly after the establishment of Basel Committee, the eleven member states started discussing and considering a unified official standard to guarantee the stability of a sound and strong banks' capital, especially for the banks operating internationally. In addition, it gave way for the banks to be able to "merge" through making use of the geographical borders inherent in the legislations of the national banks. Furthermore, such agreement encouraged the globally operating

<sup>1</sup>Bank of International Settlements (BIS) (2000), "New Capital Adequacy Framework"; A Consultative Paper issued by the Basel Committee on Banking Supervision, p 1.

<sup>2</sup>Daniel K. Tarullo, "Banking on Basel: the Future of International Financial Regulation" book, Peterson institute for international economics, Washington DC, August 2008, p 2.

<sup>3</sup>Ibid.

<sup>4</sup>Patrick Van Roy, "The impact of the 1988 Basel Accord on Banks' Capital Ratios and Credit Risk Taking", international study, European Centre for Advanced Research in Economics and Statistics (ECARES), Université Libre de Bruxelles, Brussels, Belgium, 25 July 2005, p 6.

banks to head for the baseline, where the less strict countries are, upon the end of the petrodollar leap and the following banking crises – that was earlier in the year 1980. It emerged from the purpose of having common banking capitalism, the matter that came on top of the agenda of the member states which represent the Basel Committee. After six years of negotiations in 1988, they reached a final agreement which is the mutual approach of the capital standards which is unofficially known as "Basel I". But first, it is worth mentioning that Basel I aimed at promote and adopt the organizational regulations and the standards of capital adequacy within the member states of Basel Committee and the developed markets by most – if not all - of the international organizations, thus, laying down unified standards for capital adequacy through Basel I was especially tailored for the banks operating in such markets. As the agreement explicitly stipulated that Basel I was not meant for the economies of the emerging markets, we must not consider the anxieties of individual risks in the economies of the developing countries, such as the emerging banking market as it shall be subjected to banking reform. In brief, Basel I grants a wide scope and a great opportunity before the viewpoints of the central banks to consider the local currency, the debts, the deeds and the securities that are more appropriate and stable, as the higher the deposited insurance is, the less the risks are along with the usage of the maximum limit of casting volumes of risks in favor of the lowest requirements of capital adequacy which are appropriate only for the economies of the developed countries. It is never considered as safe if applied in the economies of the emerging markets or in the banking sector of an emerging economy. They may new risks that are not identifiable by their banks.

It is also worth mentioning that Basel Accords came to existence only to provide the sufficient capital against risks to guarantee the credit worthiness of banks. We find that Basel I did not consider the other risks such as market risks and fluctuations risks of foreign currencies as well as the changes in the interest rates and total economic recession due to the huge discrepancy of such risks in the various countries.

Where upon the Basel Committee decided to formulate the general rules of such risks, however, they were based on the evaluation of each separate case within the member states of the G-10. As the Basel Accords I explicitly stipulated the proposal of the minimum requirements of capital only on global level, while it calls for the sovereign authorities and the central banks alike to be cautious regarding the banking systems. Furthermore, it warns against considering the financial isolation of the capital adequacy percentage as the final decision regarding the bank's solvency. The basics of Basel Accords I, which reached after the meetings in Basel city since the nineties of the 20<sup>th</sup> century and the beginning of the 21<sup>st</sup> century, strive from their beginning for the compliance of the countries with a set of policies and standards within the banking systems, which lead to achieve the stability of banks and the organization of control processes thereon in addition to enabling the banks to be more cautious and rational regarding the investment of their capitals and resources through investing them in assets that are less exposed to risks as well as profitability balance<sup>5</sup>.

The main objectives of Basel Accords in 1988 were the following:

1. To help strengthen and stabilize the international banking system, especially the banks operating on global level among them<sup>6</sup>.
2. To eliminate a significant source of unfair competitiveness among banks in the various countries<sup>7</sup>.
3. To work on finding mechanisms to adopt with the global banking changes, especially the financial globalization emerging from the financial liberalization and the separation of capital markets from banks in addition to the legislations, regulations and barriers that limit the expansion and deepening of the banking activity of banks all over the world through the technological and informational revolution<sup>8</sup>.
4. To facilitate the technical methods of exercising control over banking practices and to also facilitate the process of exchanging information on such methods among the various executive authorities<sup>9</sup>.

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<sup>5</sup>Mohamed Raef Mosad Abdou and Hasan Ahmed Ebaid, *An Introduction To Funds, Banks and International Economy*, The Faculty of Economics and Political Sciences, Cairo University, p. 75. [in Arabic]

<sup>6</sup>Daniel K. Tarullo, *"Banking on Basel: the future of international financial regulation"* book, Peterson institute for international economics, Washington, DC, August 2008, p 72.

<sup>7</sup>Ibid, p. 75.

<sup>8</sup>Tarek Abdel-Ail Hamaad, *The International Developments and Their Reflections On The Banks' Activities*, The University Publisher, Alexandria, 2008, p. 126.[in Arabic]

<sup>9</sup>Ibid, p. 128.

### 3. THE BASIC DRIVES OF BASEL COMMITTEE I (1988):

#### The Economic Circumstances That Led To Hold Basel Convention:

Warding off risks was the main motive for holding Basel I in the year 1988. In this respect there were two concerns, i.e. the stability of the international financial system and safeguarding banks against lower levels of capital, especially for those banks operating on global level as well as the elimination of unfair competitiveness among banks. Such concerns made the interaction with Basel Accords I a kind of mixture between the international trade negotiations and practicing the organizational banking activities. Despite such concerns, the national competitive ability became the dominant one over the time. We find that Basel Accords I did not exclude the assumption of increasing the percentages of capitals regarding the globally active banks. The execution of Basel Accords I was for the purpose of achieving the objectives thereof<sup>10</sup>. The same legislation that was enacted in the year 1983 which charged the US Congress with the capital standards of a group of US banks was the same one that charged both the Federal Reserve Council and the Ministry of Treasury with obtaining an international agreement on the standards of capital adequacy. It was not long before the US Congress recognized through the labor of auditing that the US banks were in a position that allowed them to stop legislations regarding capital adequacy. US was in the middle of the crisis of Latin America debts, of which the USA was also affected, most of the senators in the US Congress did not accept objections to increasing the capital levels although they might be costly and unnecessary in regard to the US banks or the huge multi-national banks.

They were more responsive to complaints that the strict organization of capital stipulated by the Congress may cause great harm regarding the competitive position of such banks. Nevertheless, it could be in other countries foreign banks may be allowed to maintain lower level of capital than the levels determined for capital in the US banks. The Japanese banks were highly competitive as they managed to strongly break through the European and Western banking markets, a matter that may be the main second reason behind the European eagerness to determine a minimum of banking capital adequacy as it is known that the Japanese banks provided their services with very low profit margins since they can yet achieve an additional profit percentage for the shareholders due to the low level of their capital in the first place. The capital percentage in the most Western banks is not lower than 4 % and in some cases it reached 6 %. In addition, the percentages proposed by Basel Committee 1988 were actually achieved in the British banks. This was one of the reasons that led banks to adopt and work on implementing the decrees of Basel Committee in order to achieve fairness and equality among the globally active banks.

In the West the Japanese banks had made an incredible expansion exactly as the Japanese exports of commodities, whereas the Japanese banks became on top as being the largest banks in the world at the late Seventies and the beginning of the Eighties of the former century, thus, in the year 1987 the volume of deposits in the Japanese banks exceeded that one in the US banks due to the fact that the exchange rate of Yen was higher than the US Dollar. The share of Japanese lending against the against the US Dollar in the international market increased from 10% in 1985 to reach 18% in 1987, while the United States maintained its share at 13%. In addition, the banking assets portfolio in Japan was better than the American banking portfolio, especially since the United States has been involved in bad debts of countries in Latin America, Africa and Asia. The yen's share in the global bond issues increased from 4% in the early eighties to 10% in the year 1987, and to 12% at the end of the year 1989<sup>11</sup>.

In order to achieve the liberation of monetary markets from the relevant constraints in addition to the creation of methods to safeguard them against exchange rates risk and interest rates, there was an urgent and necessary need to direct the active global banking system to adopt the decrees of the Basel Committee. The collapse of the globally operating banks in 1970 and the collapse of the Continental Bank in 1984 constituted the fundamental cause and the definitive evidence that the collapse of the global and international banks will totally affect the banks that operate their activities on domestic level. It was also the reason that made countries resort to adopting the standards Basel Accords I in addition to the fact that there was a common motivation between the United States of America and Great Britain to complete the pursuit of competitive equality and strongly push increasing capital ratios within the local banks.

<sup>10</sup>Daniel K. Tarullo, "*Banking on Basel: the future of international financial regulation*" book, Peterson institute for international economics, Washington, DC, August 2008, p 45.

<sup>11</sup>Tarek Abdel-Ail, *The International Developments and Their Reflections On The Banks' Activities*, The University Publisher, Alexandria, 2008, pp 126-128. [in Arabic]

On the Egyptian local level all the standards of Basel I and II must be applied due to their beneficial effects for banks that are the backbone of the national economy, especially because Egypt is now undergoing economic critical juncture as a result of the revolution that occurred in January 2011, and the subsequent unrest in the country of as a result of individual and collective claims, have negatively affected the local economy as a whole. It has already affected the banks' activities, and led some other banks to go out of business and be sold in addition to the withdrawal of some of the major companies from the Egyptian market. Some banks have been exposed to the risks of financing and market risks, such as the increase in the exchange rates of foreign currencies. Along with the decline in their profits in varying proportions of not less than 10% because of the repercussions of the political events in Egypt after the January 25<sup>th</sup> revolution, which reflected its impacts on all sectors of the economy, the matter that led to the suspension of the economic activity.

The decrease of the profits of the banks operating in Egypt, especially the Arab banks, is due to the deterioration of the economic situation in the country during the last period and the cessation of the economic activities funded by these banks in addition to the rising of the loan provisions and the increased person encloses as well as the losses of the substitution of the financial instruments that are available for sale. The economic disorder experienced by the country after the January 25<sup>th</sup> Revolution has severely affected the business sector and capital markets, which greatly influenced the decline in profitability and liquidity.

**Thus, the Basel Accords included a set of the following key motives:**

1. Deepening the interest in the quality of assets and the adequacy of the reserves that must be formed as there was a greater interest in the quality of assets and provisions that should be formed for the assets or the doubtful debts. In addition to the other provisions, since it cannot be imagined that the capital standard at one of the banks is the determined minimum, while it has no adequate provisions at the same time. It is necessary to form sufficient provisions in the first place, and then comes the application of the standard of capital adequacy.
2. Maintaining the depositors' funds and the solvency of the bank at the same time.
3. Focusing on credit risks. The agreement aims at calculating the minimum capital taking into consideration the credit risks in addition to possibility of lowering that minimum to a certain extent; however, the capital adequacy standards stated in the Accords in 1988, did not include the methods of dealing with other risks such as:

**A. Interest rate risks:**

- They are the current or future risks that have a negative impact on the bank's earnings and capital arising from the adverse changes in interest rate. Although the huge risks of the interest rate could constitute a major threat to the base of profits and capital for the bank. The main objective of the interest rate risk management is to maintain certain levels that are acceptable for the Bank.
- The Basel Committee has worked on the treatment of the interest rate risks by providing clear policies and necessary procedures to reduce interest rate risks at banks. Furthermore, a stress testing must be performed in order to determine the conditions that can influence the Bank as a result of changes in the interest rate in addition to the existence of information systems capable of providing the management with the necessary reports in a timely manner. Provided that they have control systems to ensure the credibility of the interest rate risks management thereof. And that such systems constitute an integral part of the overall control system at the bank.

**B. Exchange rate risks:**

- They are the current and future risks that may affect the bank's earnings and capital due to the adverse changes in the exchange rate movement. - The probability of loss is represented in the result from the revaluation of a position in the local currency against the foreign currencies.
- The board of directors and the management of the bank are responsible for the bank's exposure to such risks and thus the bank should be provided with clear policies in order to control such activities. Moreover, the policies must also include the limits accepted by the board of directors regarding such type of risks.
- The measurement of exchange rate risks is of a high degree of importance for understanding of the potential losses to which the bank might be exposed, and thus the bank's management should undertake that the exchange rate losses, if any, shall not have the a devastating impact on the bank's profits.

– As a matter of fact, it is necessary to provide information systems in order to manage the exchange rate risks and to ensure the compliance with the limits acceptable for such type of risks. These risks must also be monitored by the internal control systems in the bank.

### C. The Risks of Investing in Securities:

In general, investments risks are divided into types:

**1. Systematic risks:** They are the risks resulting from the factors affecting the securities in general, and their impact is not limited to a particular company or sector. These factors are related to the economic, political and social conditions. Since the prices of all securities are affected by these factors in the same way, but at varying degrees. The degree of the systematic risk is higher in companies that produce basic industrial commodities as well as the companies whose activities can be described as seasonal, i.e., in general, the companies that are most vulnerable to systematic risks are those whose sales and profits are affected, and thus their shares prices, by the level of the economic activity in general, as well as the level of activity in the stock exchange market.

**2. Unsystematic risks:** They are represented in the risks resulting from factors related to specific company, or particular sector and they are independent from the factors affecting the economic activity as a whole. The companies that are largely characterized by a high degree of unsystematic risks whereas the sales of such companies do not depend on the level of the economic activity north estate of the stock exchange market. The degree of the unsystematic risk of particular company is influenced by the change in the nature or the components of the assets of such company. It is also affected by the increased competition of activity, the end of certain contracts or the occurrence of a fundamental change in its management. Thus, the unsystematic risk can be reduced through diversity, i.e. forming a capital investment portfolio that is distributed over various assets in order to enable the investor to avoid the risks associated with each asset separately.

**3.** Dividing the countries of the world into two groups, in terms of the volumes of credit risks, whereas the Basel Committee Decrees were based on of the division of the world into two groups, one of low-risk and the other of high-risk. The first group (i.e. of low-risk) includes the following two subgroups<sup>12</sup>:

**A.** The member states in the Organization for Economic Co-operation and Development in addition to two countries:(Switzerland and the United Kingdom).

**B.** The countries that have prepared certain borrowing arrangements, especially with the International Monetary Fund, i.e.(Australia, Norway, Austria, Portugal, New Zealand, Finland, Iceland, Denmark, Greece and Turkey) whereas the committee has modified that concept during the year 1984in order to exclude any countries from this group for five years had they rescheduled their external public debt. While the second group of high-risk countries include all the countries of the world except those referred to in the first group.

### 4. THE BASEL ACCORDS I (1988):

The Basel Accords I are divided into four pillars or foundations, namely: The first pillar, known as the constituent bodies of capital, includes all types of capital reserves and the amount of each type of capital. Capital is divided into two levels, the firestones the capital of the first layer, which is composed of two types of capital that are the core Capital and the supporting or reserve capital. It consists of the capital paid-up from the sale of bank stocks, securities and preferred stocks, and the capital of the second layer which is specifically created to cover loan losses that includes the declared adnoun-declared reserves and the holdings of the subordinated debts, debts, equity and potential earnings gained from the sale of assets that were purchased through the sale of the bank's shares. In order to apply the Basel Accords, banks must maintain the same amount of capital in US Dollar regarding the first Tier and the second Tier of the bank's capital. The second pillar or foundation of the Basel Accords I is the probability of risks, whereas Basel Accords I create a comprehensive system for measuring risk-weighted bank assets, or in other words, the loans portfolio. The weights or five categories of risk include all the assets stated in the balance sheet of the bank.

1. The first category of the risk-weighted asset is 0%, describing these assets effectively as "risk free", that is how they are defined by Basel I and bank funds, sovereign debts ,financing in local currency, and all debts in the group of

<sup>12</sup>Ibid, p. 129.

countries for Economic Cooperation(OECD),as well as the other claims from the central governments in the member states of the(OECD).

2. The second category of risk-weighted assets is at 20%, which shows that the deeds of such category are of low risk. The securities of this category include the multilateral debts of the Development Bank in addition to the bank debts created by the banks which are stated in the non-OECD banks with a maturity of less than one year, as well as the cash items in all banks, and the loans guaranteed by entities related to OECD in the public sector.
3. While the third category, i.e. the "moderate risk" category includes only one type of residential assets, mortgages and the weights of such assets are at 50%.
4. The fourth category, among the probable weights, is the one of "high-risk" category at 100% of the value of the asset. It includes the claims of all private sector banks, non-OECD as well as the debts that fall due within a period of more than one year, and the claims of non-OECD, debts in US Dollars or bonds in Euro, stocks and assets held by the bank, and all other assets.
5. The fifth category, which includes the category of "variable" claims from the local public sector institutions, whose value may reach 0, 10, 20, or 50% depending on the evaluative authority of the Central Bank.

As for the third foundation(the second aspect), its objective is represented in unifying the first and second pillars of Basel Accords I .It provides a unified global standard where the bank's capital ratio of reserves must be  $\geq 8\%$  of risk-weighted assets of the Bank by the first bracket or the capital of the first Tier (1) and the capital of the second Tier (2). While the fourth pillar or (fourth aspect) is represented in the implementation and the transitional stages, therefore it paves the way for the implementation of Basel Accords I. Furthermore, the central banks in each country were asked to create a strong control or strong monitoring department within the central bank or each bank separately in addition to the creation of the mechanisms for implementing the Accords and to ensure the execution of the transitional stages in order to provide the banks supporting Basel Committee with the opportunity to adjust themselves over the course of four years in order to apply the standards of the Accords.

##### 5. THE VALUATION OF BASEL ACCORDS I (1988):

Although Basel Accords I have many positive aspects, they could not fill all the gaps ;the matter that led to having motives for change and searching for alternatives, new proposals or adding some recent developments that cope with the present and technology along with the modern developments in the markets and the existence of the difference between the economic capital and the regulatory capital. Furthermore, they did not cover all kinds of risks to which banks are exposed. As they were limited to the credit risks only, and they did not indicate at all to the market risks and operational risks, in addition to the fact that there are gaps in the coverage thereof and that the opportunities that have been created as the regulatory arbitrage gradually became more serious, such as blending the activities of banks and turning them toward securitization and under writing in derivatives along with many financial products and instruments in the most internationally operating banks<sup>13</sup>.

The harshest criticism that was leveled at Basel I came from four main sources, namely:

1. The first of such criticism comes from the fact that the Accords have only covered credit risks and they are aimed at the group of the major eleven industrial countries, the so-called G-10; in addition, Basel's view is narrow in scope to ensure achieving the stability of the global financial system. They also disregarded the principle of market discipline in order to limit the unfair competition between the various directions between countries and banks.
2. While the second group of criticisms dealt with the way in which Basel (I) was published and the method of their implementation by the banking authorities. Such criticisms included the inability of the authorities to translate their commendations of Basel I correctly which, in its turn, created a false presentation of Basel I, and the basic and final agreement was binding for each country to be implemented in order to achieve the stability of the banking sector

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<sup>13</sup>Daniel K. Tarullo, "*Banking on Basel: the future of international financial regulation*" book, Peterson institute for international economics, Washington, DC, August 2008, pp 8-9.



therein. They would lead the large private banks to affect the manner by which the economies in emerging market shall be demanded to pursue Basel I.

3. The third criticism focuses on the fact that Basel I granted the banks misleading incentives and fluctuating standards for measuring risks and absolute freedom to risk weights. The matter that resulted in the fact that the banks put a lot of risk weights when carrying out such lending process, which has not had expected by the major industrial countries which laid down the accords. The matter became clear based on two mechanisms:

#### A. Securitization Mechanism:

A new financial instruments a tight financial institution has mobilized a group of heterogeneous debts which are secured as assets, and put them in the form of one debt enhanced by credit, and then presenting it to the public through specialized entity for under writing in the form of securities, in order to minimize risks and to ensure the continuous flow of liquidity to the bank. Thus, the term "securitization "is represented in the transformation of loans into tradable securities, i.e. transferring debts from the primary lender to other lenders or in other words: The banking securitization is a transfer of the financial rights which represent a group of real estate debts and transfer red to securities that are guaranteed by those tradable debts. It is in fact a sale of debts to others. The financial institutions in developing countries suffer from the lack of the ability to borrow on long-term from the international financial markets, due to the sovereign low rating of these countries. Some financial institutions intentionally aimed at securitizing some of their assets as a means of improving their credit rating. Thus, the Credit Bank in Peru managed through the securitization of the revenues obtained from credit cards to gain a rating of (AAA) from Standard & Poor's Corporation against a sovereign rating from Peru of (BB). This type of processes has also given way to secure housing loans to low-income families in the absence of the state's ability to finance them and in the light of the reluctance of the financial institutions due to the high risks of such type of loans, as such rating is applied regardless of the status of the actual debt of the debtor, since the government belongs to the states of the (OECD), which is characterized by a lower credit rating that is cheaper to finance than a debt that is directed to a commercial borrower with a credit rating of (AAA), as in such case it is supposed that the borrower shall be committed to a percentage of 8% for capital adequacy. The banks' ability to manipulate the capital requirements through innovative financial products such as derivatives, has introduced additional problems upon application. Through the innovative monitoring arbitrage of capital, some banks managed to attract the capital requirements specified in accordance with Basel Accords, which include the securitization techniques of debts, derivatives and the similar financial products and instruments<sup>14</sup>. Securitization represents an important tool and that can play an effective role, not only in providing banking and non-banking institutions with liquidity, improving capital adequacy rates through the sale of the loans portfolios related to the non-liquid financial assets, and reducing the credit risk of the assets. It also leads to decrease the cost of debt and the expenses associated with the establishment of debt in addition to paying the wages of the bank employees and the costs of the accounting, legal and tax consulting, as well as playing an effective role in attracting domestic savings and directing them toward investment<sup>15</sup>.

Although the securitization of assets may be a method that is competent in the field of the redistribution of credit risk to other banks and to non-bank investors, the Basel Committee's concerns were increasing with respect to the banks' usage of these structures, which aims to reduce the capital that matches their exposure to these risks, thus, they prepared a consultation paper that includes the operational requirements, disclosure and minimum capital requirements that were set to achieve a higher degree of economic compatibility between the treatment of securitization, according to the approach based on the internal classification and the other forms the entrance to mitigate credit risk.

**B.** The mechanism for selling and transferring the fewer assets to the weighted risk securities is what makes the bank's assets more likely to actual risks. Moreover, through securitization, gained profits can be added to the banks' assets reserves and allowing these banks to obtain loans, which is a manner that creates banks on paper only, in addition to properly protecting themselves against credit risks, but in fact, they are classified on a much higher degree of risks than the risk weights of Basel I.

<sup>14</sup>Ikhlas Baqer El-Nagar, "A Reading of Securitization Terminology", Political Sciences Journal, No. 23, Volume 6, 2009.[In Arabic]

<sup>15</sup>Khalil Mohamed Hasan El-Shamaa, The Comprehensive Role of the Bank in the Capital Market Development, Arab Banks Federation Magazine, No. 158, Vol. 14, Lebanon, 1994, p. 39 [In Arabic]

The ultimate source of the criticism leveled at Basel (I) is limited to the application processing the emerging markets.

Although Basel I was never intended to be applied in the emerging market economies, the application thereof to these economies under the pressure from the international business and political activities created expected and unexpected malformations in the banking sectors of the economies of the industrial nations. First, as outlined in the Basel Accords themselves, when considering the local currency and the sovereign debt are more confident and appropriate than assets, and that the deposited insurance works on reducing the risk of significant negative effects on the emerging economies .in countries that are exposed to fluctuations in the exchange rate of high risk foreign currencies. The settlement of sovereign debts to reduce the deficit risks resulting from the settlement of credit based on banking assets. This, in turn, created a sort of retardation on the scope of the system in the banking sectors of the emerging markets when it became clear that all the banks had excessive risks, and when it was revealed that the central banks in such countries want to borrow to rescue some or part of the banking sector, but that was not enough, in addition to the negatives points expected from Basel (I) in the emerging markets, and many of the unexpected effects of Basel have also made the Accords less desirable in the recent manufacturing(newborn) economies. The unexpected side effects were for example:

1. The method of risk weights as a result of the risk of bank debt for the non-members of the organization on the short term since the banking debts that are risk-weighted within the relative risk are less than the long-term debts.
2. Basel (I) encouraged the international investors to move from the contract of a long-term bank debts of the emerging market to the contract of the market instruments in the developing countries on the short term. The matter has led to the inflation resulting from the risks of the flow of funds into the emerging markets, and created a lot of fluctuations in currencies exchange rates in the emerging markets. This unexpected effect of Basel (I) came out from the difference between sovereign-weighted risks and the debts of the private sector since sovereign debts are considered in the emerging markets as of less risk than private debts.
3. Finally, the lack of deeply-rooted markets and liquid capital in the emerging markets created an insufficient confidence in capital adequacy ratios in the economies of the emerging markets since it is often the case that the stocks prices, debts and weighted risks of these bonds are not correctly estimated in regard to exchanges in the emerging markets. In addition, the inclusion of such deeds and bonds in the account of capital adequacy ratio of the bank leads very often to the presentation of positions capital adequacy in an unclear and incorrect manner to a great extent in relation to banks operating in the emerging markets.

Thus, solutions and proposals had to be found in order to cope with the spirit of the age. Such proposals had to include imposing insurance on all the types of risks, whether they were related to credit, market, or operation. However, among the criticisms leveled at Basel Accords I (1988) was the fact that it divided risks into four categories only, a matter that was considered as deficient and insufficient to fill all the risks gaps. It did not provide a precise and comprehensive illustration of the quality of the bank's assets in addition to the services introduced to the banking operations whose main objective was avoiding and mitigating the negative effects of Basel Standard I (1988). Despite what Basel Committee achieved, i.e. increasing the level of the banks worldwide within the last years, the financial developments resulted in risks that were not covered by Basel Standard I (1988), whereas the Accords became less binding and a mere general step that should be followed to avoid being exposed to financial crises and being in default in banking operations.

Hence, Basel Accords I (1988) work on broadening the effective control in order to guarantee the stability of the financial system as a whole, and not only to guarantee the going concern of a bank and the efficiency of its management. In addition, during the period from July 1999 to June 2004, Basel Committee issued a lot of recommendations that were represented in directing Basel Accords I (1988) toward such recent development.

The matter led to some previously mentioned gaps and negative points until the Basel Committee decided to adopt the following key approach:

**A.** The Basel Committee for Banking Supervision issued a number of the supervisory proposals related to the implementation of Basel Committee Standard through the inclusion of the market risks encountered by the banks in April 1995, where market risks can be defined as<sup>16</sup> the risks of being exposed to banks' losses that are either related to the

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<sup>16</sup>Ibid, p. 61.

balance sheet or off balance sheet as a result of the fluctuations of the market prices or as the banks' losses resulting from the decrease in the value of the commercial or investment securities<sup>17</sup>, and they include the following four standards: stock exchange prices, interest rates, foreign currencies exchange rate, commodities prices. These proposals were introduced to the banks and the parties participating in the market, where the main focus of such groups was represented in a planning scheme of Basel Accords for capital adequacy in July 1988. The Basel Committee laid down a plan for allowing the banks to provide internal models for determining the sufficient amount of capital that is necessary to cover market risks, a matter which may differ from one bank to another. Furthermore, an accompanying bulletin to illustrate the method by which the supervisory bodies are planning to be used in making comparisons, obtaining the standard results and the actual performance in relation to the systems of risks measurement in the banks as a basis for applying the principle of capital adequacy.

**B.** The target of using such amendment of the capital agreement is represented in providing explicit and definite capital guarantees against prices risks to which banks are exposed, especially those resulting from their commercial activities in relation to the currencies exchange rates, interest rates or commodities prices.

**C.** The main feature of the Basel Proposal in the year 1995 is represented in responding to the request of the parties of the banking industry in order to allow the banks to use internal models of market risks measurement as an alternative for the option of the unified framework that was laid down in the year 1993 which was proposed for implementation in all bank. However, the discussions and observations that took place within Basel Committee resulted in allowing banks to determine the amount of capital necessary to cover market risks based on internal statistics forms and in order to guarantee a minimum level of cautiousness, diligence and transparency that is appropriate to the conditions related to capital on the level of all banks, where the Committee proposed some quantitative and qualitative standards in order to be used for the banks that are desirous of using internal ownership forms. Among the aforementioned was the necessity to calculate the daily risks along with confidence coefficient  $\geq 99\%$ , to use a low pricing package that is equivalent to ten days of trading, and that the form must include a dated monitoring period of at least one year. In that case the capital burden in relation to the bank that uses an internal form shall be represented in the value of the risks in the previous day, and what is equivalent to the triple of the value of the daily risk in relation to the foregoing years<sup>18</sup>.

On the other hand, the Committee's proposals included stereotyped statistical methods for the calculation of capital in relation to banks dealing with derivatives contracts on a large scale, among of such methods what is called the derivatives contracts risks measure, and in the year 1999, the Basel Committee laid down certain guidelines related to governance in the banking and financial institutions, which are represented in the following:

1. The goodwill of the company, codes of ethics for proper actions, and other appropriate actions and systems through which the application of such standards can be achieved along with laying down properly prepared strategies for the bank, whose overall success can be measured as well as the individuals' participation in such matter in addition to the sound distribution of the institutions and the decision-making center in a typical and hierarchical manner in accordance with the requests provided by the individuals to the board.
2. Laying down a mechanism for the effective cooperation among the board of directors, the auditors and the senior managements along with providing a strong internal control system that includes the internal and external reconciliation tasks in addition to a risk department that is independent from the work activities along with taking into consideration that the authorities must be in conformity with the responsibilities.
3. Special monitoring for the risks centers located in the sites where a conflict of interests existed including the business relationships with the borrowers that are connected to the bank, the senior shareholders, and the senior management or the extensive key decision-takers in addition to appropriately recording the information whether on internal or external level.

<sup>17</sup>Kevin Roebuck, *Basel II High Impact Strategies - What You Want To Know: Definitions, Adoptions, Impact, Benefits, Maturity, Vendors*, Lightning Source UK, 2011, p 33.

<sup>18</sup>Tarek Abdel-Ail Hamaad, *The International Developments and Their Reflections On The Banks' Activities*, The University Publisher, Alexandria, 2008, pp 156.[in Arabic]

Furthermore, the financial and managerial incentives must be supported for the senior management which carry out the business activities in a sound manner as well as for the managers and the employees, whether in the form of compensations, promotions or any other forms.

## 6. BASEL ACCORDS II

In response to the banking crisis of 1990 and the above-mentioned criticisms that were leveled at Basel I, the Basel Committee provided in 1999 a more comprehensive proposal for this agreement, which is officially known as the New Agreement for Capital Adequacy and the International Convergence to Measure Capital Adequacy Standards, and informally as "Basel II", which led to largely expanding the use of advanced technology on fairly large scale as well as deepening of the original Basel Accords. In 2001, the Basel Committee submitted more specific and detailed proposals about the modified framework of bank solvency, and asked for feedback from the concerned parties, the specialists, the relevant bodies and the International Monetary Fund before the end of the month of May 2001, and it was expected that the Committee shall issue the final version of this agreement before the end of 2001, which finally resulted in the issuance of the final document of the decrees of Basel II in June 2004 along with maintaining the "pillars" of the framework of Basel I. However, each pillar shall be largely expanded in Basel II in order to cover new approaches to credit risks, and to adapt to the securitization of bank assets, market risks, operational risks and the interest rate risks as well as the inclusion of supervisory control over the market. Consequently, the banks were granted a period of time to adjust their positions until the end of the year 2004 and the implementation thereof was to take place as of the beginning of the year 2007.

**Basel II focused on the three main pillars.**

## 7. THE THREE MAIN PILLARS OF BASEL II

Basel II was based on three main pillars, which work on achieving the bank's commitment to the financial rules and decisions according to capital adequacy as follows:

### 1. The First Pillar:

It is represented in the minimum requirements of capital adequacy to achieve a higher degree of proportionality between the bank's capital and its significant assets through a flexible manner. In this regard, the new standards include several alternatives that substitute the unified standards stated in Basle Accords I of 1988 in conformity with the risk borne by the banks enabling them to control the risks of credit, securitization and credit derivatives and where the reduction focuses on the value of risks measurement Hence, the capital adequacy ratio is to be calculated according to the new decrees as follows<sup>19</sup>:

Capital in its Comprehensive Concept

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Credit Risks Weighted Assets+12.5 X Capital Required to Cover Operation  
and Market Risks

Thus, we find that reaching such rate requires not only the measurement of credit risks, but also requires the measurement of market risks and operational risks as Basel II (2004) had defined the method for measuring both of them, which will be mentioned in detail in the second section (capital indicators), according to Basel Accords II.

### 2. The Second Pillar:

It is represented in the supervisory examination of the capital adequacy, the provisions and the control of the monitoring bodies over credit risks to make sure that each bank has sound internal systems that are appropriate to estimate the conformity of its capital with credit and risk assessment. The Commission considers that the control auditing process as an integral part of the framework of the capital of the internationally operating banks as well as an integrated element of capital requirements, whereas the purpose behind the bank's capital review is represented in the need to ensure that the bank has a strong position and the ability to overcome any economic setbacks<sup>20</sup>.

Within this context the Basel Committee provided the following proposals:

<sup>19</sup>Basel Committee on Banking Supervision "A NEW CAPITAL ADEQUACYFRAMEWORK", Consultative paper, 1999, p. 12.

<sup>20</sup>Ibid, p. 16.

1. The regulatory authority in the country which is characterized by volatile economy must impose a minimum of capital adequacy ratio that is higher than the limit set in the other countries.
2. Claiming from some banks the commitment to a minimum of capital adequacy ratio that is higher than the minimum determined for the rest of the banks in the country based on several factors, including: The nature of capital components (the bank), the nature of its business activity, its ability to provide additional capital and the extent to which the senior shareholders thereof support such aspect.
3. The banks are required to have a comprehensive assessment system of capital adequacy in relation to each market and each activity of the bank.
4. The regulatory authority must intervene in early stages in order to prevent the deterioration of the bank's capital below the required limit.
5. The observers must expect banks to practice their operation on the level of the minimum ratios of the statutory capital.

### 3. The Third Pillar:

It is represented in the market discipline and disclosure through strengthening the two elements of transparency and disclosure of the bank's capital and risks, the accounting policy and the strategy of dealing with risks in order to provide a center of information for market participants that help them in the assessment of the capital adequacy of the banks. Thus, we find a clear discrepancy and variation between Basel I and Basel II, and that market discipline has the ability to promote and regulate capital, as well as the efforts to enhance the safety and stability of the banks and the financial systems<sup>21</sup>.

It was represented in the addition of operational risks as a key factor for calculating capital adequacy ratio and the second and third pillars along with expanding the scope of applying the accords as Basel (I) was a draft in 1988 and was brought into implementation in 1998, while Basel II was a draft in 1999 and was brought into implementation in 2007.

### 8. THE MOST SIGNIFICANT PROPOSALS APPROVED BY BASEL COMMITTEE II:

Although the proposals suggest that the framework of Basel (II) regarding capital requirements was specially prepared for major countries, the risks application process is more accurate by adjusting the asset classes according to the risks of each type, which makes the process of assets applying more sensitive in spite of the difficulty of identifying the criteria according to which the assets risks categories will be measured, therefore, obligations on governments, banks and companies are applied within the six risk categories<sup>22</sup>, which are: (zero %, 20 %, 50 %, 100 %, 150 %, and 200 %) according to the evaluation of the international application institutions that require specific standards for a minimum credit risk, and as a result thereof the framework of Basel II granted two options to determine the risks of obligations on banks, namely:

A. Depending on the application of the countries in which the bank is registered or the credit rating of the bank itself.

Therefore, the framework of Basel (II) provides treatment of the problem of high-risk rating for the countries outside the Organization for Economic Co-operation and Development (NON- OECD), known as G-8, which leads to the increase in the cost of lending, thus, such countries greatly benefit in terms of reducing the cost of their resources which they obtain through lending according to the proposed risk weights. The Basel Committee allocated some risk ratios for some assets, however, it tended to increase the percentage to 100 % for some other assets that are exposed to a consecutive decline in their value, an example of which is the weight of the risk at 150 % on assets, and the fact that the low rating by global credit rating institutions in the field of assets securitization leads to the re-distribution of risks and thus reducing them as well as emphasizing the continuing review of the regulatory actions regarding capital adequacy whereas capital adequacy is considered as an essential guarantee for banking stability. Hence, Basel II emphasizes the necessity that each bank must possess good internal systems that monitor its capital adequacy.

<sup>21</sup>Ibid, pp 17-18.

<sup>22</sup>Magda Ahmed Shalaby, "Banking Supervision In Light Of The Global Economic Transformations And Standards Of The Basel Committee," Paper presented at the Conference of the legislations of banking operations between theory and practice in the Faculty of Law in collaboration with the Faculty of Economics and Administrative Sciences, Yarmouk University, Amman, Jordan, June 2009, p. 30. [In Arabic]

There is no doubt that these systems will vary from one bank to another according to the size of the bank and its business activities, and the necessity that the observers in the bank must review and provide capital adequacy using a method that is more accurate than the method existing in this field, and the purpose of this review is to ensure the strength of the internal control of the bank. It is also necessary to encourage the regulatory authority to review the control procedures and to take the appropriate methods to intervene along with the corrective actions and avoiding the occurrence of banking crises. The availability of disclosure and transparency system leads to improving the assets and liabilities management at banks, attracting customers and gaining their trust, the matter which strengthens the capital adequacy resources and the process of supervisory review in terms of the risks to which the bank might be exposed as well as its ability to continue as a going concern and to ensure the publication of the most accurate information and their soundness on specific dates and in adequate quantities that enables those who deal with the bank to have good knowledge of its financial position. Taking into account the existence and the inclusion, for the first time, of new types of risks within the capital requirements such as (operational risks, loss resulting from personnel errors and inefficient systems) as well as losses resulting from unexpected events, it had been determined that such risks shall constitute about 20 % of capital requirements. However, the lending process carried out by banks was not dependant on the borrower's instructions only, but it also accommodates and includes the provision of the bank to the borrower (Single Borrower) in particular, and the sector in which it operates in general. Although the framework of Basel II focuses on the globally operating banks, the principles and foundations on which the Accords are based are considered as appropriate for application to all banks, regardless of their levels of development, which means that the Basel Accords II are applicable to the banks that deal with operations of borrowing and local deposit as well as the banks that perform local and foreign activities. Thus, we find that the framework of Basel II provides standardized options for banks, as mentioned earlier, when assessing their risks, including methods that rely on internal applications of banks if they had internal systems that were capable thereof or methods that rely on the application of the external rating institutions. Therefore, each bank individually applies Basel II to the holding companies of the Egyptian group separately.

## 9. AN ANALYSIS OF THE MOST SIGNIFICANT ASPECTS OF THE PROPOSALS OF BASEL II:

Whereas credit risks constitute the main reason for most of the default cases of banks and the financial crises that took place, the Basel Committee (II) brought about control over banks through monitoring the banks on international level, and within its framework it proved that credit risks represent the most serious risks to which banks are exposed worldwide.

1. Banks must implement the decrees of Basel Accords II in order to ensure that the credit policy is an appropriate policy that sets the bank apart from the risks to the maximum extent possible, due to the fact that many of the principles, to which the Committee indicated, represent an integrated package, therefore, any system to control risks and to guard against them must be based on identifying, managing and dealing with all types of risks. Hence, an integrated analysis of all the risks encountered by default banks must be mandatory for banks and observers, therefore, the committee maintained the relative aspects of capital as stated in Basel Accords I and II, however, we find that the amendment focuses on the risks as the Committee aimed at the necessity that capital must cover all types of risks and not to be limited to one type of risks along with granting incentives to the banks which manage their risks efficiently and effectively. Despite the fact that the framework of Basel II that is related to the requirements of capital adequacy standard was appropriate for globally operating banks, the Committee has prepared the principles and bases to accommodate all banks at various levels of development, i.e. the new system is applicable to banks that deal with the local operations of lending and depositing in addition to those banks that carry out local and external business activities at the same time. The framework of Basel II represents standardized options for banks when assessing their risks such as the method of internal classification and the methods of classification of external rating institutions. Furthermore, it provides two options for determining the risks of lending in banks, either relying on the classification of the state in which the Bank is located or on the classification of the bank itself. The proposed framework addresses the problem of high risk classification outside the Organization for Economic Co-operation and Development, which leads to an increase in the cost of lending. Hence, these countries largely benefit from covering the cost of their resources that they obtain through lending. In addition, the Basel Committee has reduced some of the risk ratios for some assets according to some proposed risk weights; however, it tended to increase their value ratios, for example, the application of the risk weight of 150% to assets with low classification by the global rating institutions.<sup>3</sup> Therefore, the framework of Basel II takes into account the fact that the process of securitization of the assets leads to the redistribution of risks, thus reducing them, and the emphasis on continuing as well as reviewing the regulatory actions related to capital adequacy based on the fact that capital adequacy

constitutes an essential protection to ensure banking stability, therefore, it is necessary that each bank should possess good internal systems that monitor the bank's capital adequacy.<sup>3</sup> Undoubtedly, such systems will vary from one bank to another according to the bank's size and volume of its transactions as well as the importance of having the observers of the bank reviewing and evaluating the capital using one or more methods. The primary purpose of this regulatory review is to ensure the strengthening of all the regulatory actions of the bank and to encourage the regulatory authority to review the control procedures and the use of the essential methods to intervene as well as to take the proper actions to correct and avoid being exposed to banking crises.

2. The availability of disclosure and transparency system help increasing customers' trust, the matter that supports capital adequacy and the process of the regulatory review along with the need to disseminate accurate and correct information at specific times, and to the extent that makes dealing with the bank is based on a clear knowledge of its position, especially in terms of the risks to which the bank is exposed and the extent of the bank's ability to continue as a going concern<sup>23</sup>.

Despite the a positive aspects and proposals of the Basel Committee II, the officials of laying down the banking rules and regulations in the ten major industrial nations, especially from the United States, Japan, and Europe asked the Basel Committee for Banking Supervision to grant them enough period to study the proposals of Basel II for capital adequacy, i.e. a longer period of time to study the agreement due to the uncertainty of some of the points in addition to the criticisms leveled at these points by some bankers on global and local levels. The points of criticism leveled at Basel Accords II are represented as follows:

**A.** Operational risks are considered among the most important criticisms in this regard, as the accords did not clearly specify the operational risks. The accords stated that what is meant by operational risks are the direct and indirect losses which can result from the inefficient internal operations and the poor performance of the employees and the implemented systems in addition to the direct and indirect losses resulting from the external environment. Such definition did not clearly state what is meant by indirect losses, making it difficult to measure accurately on quantitative level, in addition, such definition must be expanded to include the operational risks that cause great harms which may damage to goodwill of the bank.iii. Major banks also believe that the proposed percentage of the bank's capital to cover the operational risks at 20% is considered a very high ratio, a matter that is confirmed by the fact that banks already insure a large part of operating risks through insurance companies. Examples of risks against which banks place insurance are those related to the use of computers in forgery and fraud.iii. Capital brackets must be decreased to cover operational risk. Furthermore, the capital brackets allocated to cover those risks for banks in countries with emerging economies must be reduced when compared to their counterparts of banks in countries with developed economies.iii. The matter is based on the fact that the banks in countries of emerging economies apply technological methods, set-off systems, and settlement of payments that are simpler and less developed compared to banks operating in countries of advanced economies, whereas relying on the assessment of the international credit rating institutions as one of the key determinants to determine the relative weights used to encounter the risks of the banks' assets was exposed to several criticisms that are represented in the fact that the institution of international credit rating may be able to estimate the risks of the credit extended to the private sector in the emerging economies accurately. Moreover, it is better to assess those risks through local or regional credit rating institutions in these economies.iii. It is noted that most of the emerging economies are limited to the existence of credit rating institutions, and on the other hand, there are concerns about the manner of achieving market discipline through strengthening the two aspects of transparency and disclosure, which represent the third pillar of Basel Accords II.

**B.** It is supposed to the disclosure standard includes a detailed explanation of the manner of the internal evaluation systems work in the banks. It should also include the necessity to disclosure the credit risks to which the banks may be exposed, and the regulatory bodies must not bear such burden alone, but there must be an effective participation of the credit rating institutions, such as Moody's Investors Services and Standard and Poor's, especially after the poor performance thereof in many cases of predicting credit risks of banks, a matter that may lead to worsening the economic activities cycle, where those in charge of the process of assessment inside banks work on granting credit on favorable terms in the case of having an economic recovery, while adopting strict rules against granting credit in cases of recession; therefore, allowing to perform internal evaluation processes is criticized based on the difficulty of reaching a judgment and accuracy in relation to the soundness of the standards that will be applied by the various banks within the same

<sup>23</sup>Ibid, p. 12.

country due to the lack of unified standards for evaluation. It becomes increasingly difficult when comparing between the standards that will be applied by banks in different countries where the incorporation and regulatory systems vary, and laying down decrees that regulate the banks' capitals is not related to what the banks actually avoid, e.g. having their funds as capital reserve, whereas banks with cautious management do not need the advice of the regulatory bodies with respect to maintaining reserve capitals against credit risks due to the fact that cautiousness leads them to avoid the reserves at the expense of reducing the profits they achieve, and on the other hand, the new proposals will not exist without the fact that banks circumvent the existing decrees in the same manner as the major US banks, which bore, heavy losses that do not match the size of the capitals that were set aside to encounter those risks when they indulged in huge debts in Latin American countries<sup>24</sup>. Although this framework leads to unifying and standardizing the methods of determining the capital requirements and make them fairer, it connects the fate of the banking sector with a limited set of credit rating institutions, which are not subjected to any regulatory organization, and whose neutrality cannot be assured. In case of the applying the proposed framework, it is expected to establish new credit rating institutions, particularly local rating institutions, the matter which requires providing tight control over the performance of local and foreign credit rating institutions working in the local market along with the rationalization of granting licenses for the establishment of credit rating institutions in accordance with specific controls and standards. In case of applying Basel II framework, there will also be a necessity for more incentives to push banks to adopt internal systems and procedures that are more advanced for risks assessment, such as credit risks, market risk and operational risks.

**C.** Determining the risk weights according to Basel II is based on the credit rating of the debtors specified by the credit rating institutions specialized in such field, which are widely spread in the developed countries, unlike the case in developing countries, the matter which leads to increase commitment risk weight imposed on the governments of the developing countries to 100% as they are not subjected to evaluation by credit rating institutions regardless of the quality of the commitment, if any.

**D.** Basel Accords II state that banks must have a system for assessing capital adequacy for each market or activity associated therewith, and the matter requires the availability of new technologies that are not available in most banks in the developing countries.

**E.** Basel Accords II require that in order for the debtor bank to obtain a risk weight that is less than 100%, the regulatory authority of the country in which such bank is registered must apply the core principles in order to achieve effective banking control, the matter which raises the question about the body which decides on the availability of such condition, and the scope of achieving the effectiveness of control. It is likely that the high cost resulting from capital increase leads to a weak competitive position of banks against the other financial institutions that provide banking services and are not subjected to the same rules and standards. It is possible that risk may reoccur; because determining the appropriate amount of capital through gathering all risks may eventually lead to require banks to fulfill a minimum of capital that does not take into account the impacts of the different risks on each other, the matter which leads to the reoccurrence of risks.vii. In order to fulfill the standard ratio of capital adequacy, banks will be forced to retain a high percentage of profits for the purpose of capital increase to encounter the increase in risks, which means that profits shall not be distributed to the shareholders.vii. The increase in the cost of one unit of the banking services as a result of the high cost of obtaining funding sources and the increase in the size of the allocations as a result of the higher weight of risks related to the bank's assets in addition to being exposed to losses due to mandatory liquidation of some assets before their maturity dates for the purpose of decreasing the risks of the assets portfolio. One of the criticisms that have been articulated by those standards is that they do not allow, unlike the 1988 standards, for one standard for comparison between credit risk ratings for the various banks.vii. In addition to the extent of the appropriateness of allowing banks, which possess efficient systems applied in the field of risk assessment and management, to freely determine the minimum capital that must be held to encounter employment risks. However, expanding such activities of that kind of proposal may lead the mentioned banks to maintain amounts of capital that are less than the appropriate minimum that must be retained to encounter the risks.vii. In addition, all banks, especially the European ones, must reduce the capital bracket that must be

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<sup>24</sup> Daniel K. Tarullo, "Banking on Basel: The future of international financial regulation", book, Peterson institute for international economics, Washington, DC, august 2008, p 46, paragraph, 2.



retained by the bank in order to meet the lending risks to small and medium enterprises<sup>25</sup>. Furthermore, the bank's commitment to this bracket may cause the bank to be obliged to lend these projects at a high cost, which may largely weaken their abilities to fulfill their financing needs. It is likely to reduce capital bracket for each of the lending risks as well as the operational risks. The transfer of banks' capitals in some countries, such as the emerging economies, to the high-level capital bracket that is to be retained by banks to meet the risks of lending to emerging economies may lead major banks to stop lending the poorest countries. It is worth mentioning that the implementation of Basel Accords in this regard may result in increasing the interest rates on loans granted to countries such as Brazil and India and that is estimated at 100%<sup>26</sup>.

## **The Practical Challenges Encountered the Application of Basel II:**

### **1. The Strategy and Objectives:**

The main challenge in the implementation of Basel II is represented in the goals, due to the fact that in most cases the Basel II initiative is purely of supervisory and regulatory nature and is non-binding for banks. Because of the absence of the general and basic strategy of the banks, which were not considered as a priority and were not granted an adequate level of importance along with the lack of clarity of the ultimate goal of the project due to the lack of a model for the operation process. Due to the lack of budget and the enforceable priorities in relation to addressing these issues, the bank may need to establish a model for the operation that has clear and specific goals to achieve a minimum of compatibility.

### **2. Programs Management, Communications and Reporting:**

The application of Basel II requires competent staff, skills and strong management for the projects and the infrastructure as well as the allocation of resources. In most cases, Basel Accords are not managed in accordance with the determined schedule because in most cases there are complex sub-projects that cannot be centrally controlled. To overcome such challenges, the project manager must fill these major gaps through the evaluation of preparedness and developing plans to get rid of them. And there must be units to treat and facilitate business units on a large scale.

### **3. Credit Risks:**

It is clear that Basel II is more powerful and sophisticated than Basel I due to the great cautiousness of dealing with credit risks in terms of the approach, the data requirements and the use of information technology. Dealing with the new requirements often imposes challenges for the implementation of Basel II. The typical challenges include the following: (Loss of credit risk database, the lack of the required skills, and the probability of default in line with multi-exposure to risks). The application of Basel II requires the calculation of such gaps through the assessment of such needs and the development of plans to get rid of them. There is also a need for the skills and capacity building as well as the continuous training to be treated.

### **4. Operational Risks:**

Regarding Basel II, it's likely that the challenges may rise due to the lack of a central database to calculate the losses resulting from operational risk and the weakness of the self-assessment of data requirements because of the policies and procedures of the varying business activities. Such challenge can be overcome by identifying a wide range of self-assessment procedures through work units.

### **5. Data and Operations Model:**

The data and information systems come on top of the list of challenges encountered by the Basel II .as many banks lack the data models and a clear and comprehensive structure in the light of the required data. In order to overcome those challenges, banks are required to take advantage of the models derived from Basel II to calculate the daily business journal, to identify the gaps in the data, and to plan for the elimination thereof.

<sup>25</sup>Magda Ahmed Shalaby, "Banking Supervision In Light Of The Global Economic Transformations And Standards Of The Basel Committee," The Electronic Guide to Arabic Law, pp 38-39, Word File on (<http://www.arablawnf.com>) [In Arabic].

<sup>26</sup>The Economic Bulletin, Banque Misr, "On the New Framework of Capital Adequacy (Basel Committee's Proposals), year Forty-Four, Nos. 1 and 2, Cairo 2001, pp 117-118.

### VIII. CONCLUSION

It is necessary to select the new standards in the event of the application of the two Accords to the Egyptian banks in conformity with the local banking sector, especially when taking into consideration that the implications of the global financial crisis on the Egyptian banks were less influential than on their counterparts in the European countries and the United States. Basel Accords I and II are working on strengthening global capital standards and contribute to the financial stability. Furthermore, they shall protect the banks against serious transactions through the most restrict regulations contained in the two accords. The time period granted for the implementation of these accords constitutes a significant reason to eliminate fears a sit grants the banks adequate opportunity to adapt themselves along with re-planning their fiscal policies according to the recent developments on global level. It may be a right opinion to increase the banks' capitals in order to protect them from risks and to grant them a greater deal of abilities to promote the steps of creditworthiness.

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