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Application of Basle Accord's regulations to the Lebanese Commercial Banks

By

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APPROVAL OF RESEARCH TOPIC

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The following professors, nominated as advisors, have approved this research topic.

First Reader:  

Second Reader:  

Signatures Redacted
I dedicate this research to my Family
for its continuous support
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# TABLE OF CONTENTS

I- Introduction

1.1- General background
1.2 - Purpose of the study
1.3 - Methodology
1.4 - Scope

II- Development of the Lebanese Banking Sector (1974-1990)

2.1 - The Lebanese banking sector up to 1975
2.2 - The Lebanese banking sector after 1975
2.3 - Troubled banks
2.4 - General causes of bank failures

III- Bank Capital

3.1 - Role of capital
3.2 - Risks affecting banks
3.3 - Bank failures
3.4 - Capital adequacy
3.5 - Banking controls
3.6 - Development of capital adequacy ratios over time

IV- Basle Committee Proposal

4.1 - General background
4.2 - The Basle Agreement
4.3 - The body of the Basle Accord
4.4 - Risk weights Assignment

V- Adoption of Basle Accord’s requirements by BDL

5.1 - Needs for adoption
5.2 - Reasons for adoption
5.3 - Measures taken
5.4 - Implementation procedure
5.5 - Capital Adequacy measurement
5.6 - Comparison criteria
5.7 - Capital adequacy ratio

VI- Conclusion & Recommendations

6.1- Conclusion
6.2- Recommendations
ABSTRACT

Development in the international economic systems has been growing at a relatively high speed as compared to that of Arab countries. The banking system in particular had been subjected to various laws and regulations over time to regulate banking activities and provide a uniform system of supervision and control.

Several years ago, attention of international banks was focused on the implementation of Basle Accord's requirements for the purpose of achieving high financial ratios to safeguard banks against possible failure. The majority of countries in the world have adopted Basle Committee's requirements eventhough over different time spans.

Today, in year 1995, we are witnessing the achievement by Lebanese banks of the financial ratios that were set by the Basle Committee hoping that this step will strengthen the external cooperation between the Lebanese and the international banking systems.
CHAPTER I
INTRODUCTION

1.1-General background

As it is generally known, the Lebanese banking sector was, before year 1975, the most important sector that brought health and wealth to the Lebanese economy. After the beginning of the war, Lebanon started to lose some of its glory and importance in what concerns its relation with surrounding countries. Its role in the business and services sectors decreased substantially.

While the banking sector tried hard to preserve its reputation and honor its claims, it has been seriously and unexpectedly shaken. Banks became undercapitalized due to the drastic devaluation of the Lebanese pound against the US Dollar. Capital adequacy levels were brought to the minimum possible level. This situation brought with it incidents of bank failures which necessitated rescue operations by Monetary Authorities to maintain confidence in the banking sector.

These failures opened the eyes of bank managements to the fact that serious efforts have to be made to return back to the period of prosperity and success. Therefore, they went into the process of analyzing, designing, and implementing a system of capital adequacy that will strengthen and stabilize the banking sector, and establish a consistent framework of analysis of bank data. This overall framework was related to the 1988 Basie agreement and its resolutions concerning optimal capital adequacy levels.
1.2- Need for the study

The majority of countries in the world have adopted Basle Committee's requirements eventhough over different time spans. Every country had established procedures of implementation that best fits its banking environment. This step was found to be very important for developed and underdeveloped countries in the process of accommodating to changes and innovations in the world and to create a fair playground for all parties in the banking business.

Today, Lebanon's turn had come to adhere to the same principles adopted by the Basle Committee within the framework of the bank for international settlements in order to prove that the Lebanese banking sector is capable, through such a commitment, to ascertain its continued conformity to the international banking developments and to recover its pioneering role in the Arab East despite all the troubles that affected the country and its economy during two decades.

In this respect, the readjustment of the Lebanese Commercial Banks with the objective of achieving a realignment of its financial ratios to satisfy the Basle Committee's requirements is a necessary step for the external cooperation between the Lebanese and the international banking system. A study will be conducted all throughout this research to assess above readjustments.
1.3-Purpose of the study.

The purpose of this research study is to analyze the economic situation of Lebanese Commercial banks prior to year 1975 to study the negative effects that the civil war had left in the structure of banks, and compare past and present performances in the light of the capital adequacy requirements that were set by the Basle Committee in July 1988. In other words, the purpose is to test whether commercial banks have been complying with BDL circular # 1114 that specified a targeted minimum capital adequacy ratio to be reached at the latest by March 31st, 1995.

1.4-Methodology.

In this research, ratio analysis was found to be the most important and useful analytical technique in banking because it is concise and facilitates comparisons. The standard of comparison to be used is the capital to risk assets of Lebanese commercial banks as was set by Basle Accord.

1.5-Scope

Chapter two starts by a historical background of the Lebanese banking sector; its troubles and remedial actions taken prior to the formulation of Basle Accord on capital adequacy.

Chapter three explains in detail the concept of bank capital and traces the development of capital adequacy ratios over time.

Chapter four discusses Basle Accord's regulations that were formulated in Basle in year 1988 with the objective of organizing the international banking activity.
Chapter five puts a light on Banque Du Liban's (BDL) decree # 5064 issued in circular # 1114 that was issued in compliance with Basle committee's regulations. Moreover, it analyses the financial statements of a sample of twelve banks and evaluates their performance in the light of this circular.
CHAPTER II
DEVELOPMENT OF THE LEBANESE BANKING SECTOR
(1974 - 1990)

To understand well how the Lebanese banking sector operates, and before going into the phase of studying the systematic procedures that Lebanese banks had developed and used in an attempt to survive and keep up with the same high performance and standards, this study begins by explaining briefly the history of the Lebanese banking sector and its most important features.

2.1- The Lebanese Banking sector up to 1975:

In the mid and late fifties, some Arab countries, namely Syria, Egypt and Iraq adopted nationalization and expropriation policies. At that time Lebanon, unlike its Arab neighbors, possessed the leading, dynamic and most flexible banking system in the Middle East. ¹ This was due to the presence of the free economic system (Laissez-faire) that Lebanon enjoyed, i.e., a free exchange system, free movement of funds, liberal taxation and a free enterprise system.

Lebanon was the doorway to the Middle East through which all the commercial trading activities with the West and the Arab World were channeled. Because it operated with no foreign controls, it provided a safe resort for incoming Arab capital. Finally, its strategic position among all Middle East countries, combined with its large free zone areas, contributed to its being a crossroads for commerce and tourism.

¹ Union of Arab banks, Conference of Arab banks facing the crisis, April 1985, P.117 (in Arabic)
With these improvements underway, banking secrecy law was promulgated in the year 1956. Under this law, bank employees were strictly forbidden to reveal the names, assets, or transactions of the bank’s clients without their prior written authorization. Only one exception was permitted, in case of legal proceedings against fraudulent enrichment.\textsuperscript{2} In other words, this law provided complete protection and strict discretion concerning client’s financial positions. Therefore, it gave investors the security they needed and induced Arab capital to take refuge in the Lebanese banking system.

Freedom in the establishment of business and financial institutions made it easier for Arab and foreign investors to establish commercial banks in Lebanon. No rules were set for the provision and maintenance of a certain limit of capital adequacy, and banks were not required, by law, to publish regular financial reports and balance sheets.\textsuperscript{3}

In 1966, the legislative authorities, conscious of the growing importance of the banking sector and its increasing role in the economy, formulated the Code of Money and Credit (CMC). It aimed at controlling and monitoring the banking sector by subjecting it to liquidity and solvency rules under the control of the Central Bank.

What was unexpected in that year was the Intra crisis of October 1966. Therefore, in November 1966, the Banking Control Commission (BCC), was created for the purpose of absorbing the negative effects of the crisis, and to avoid similar future situations.\textsuperscript{4} Its role was to supervise the activities and accounts of each bank on an individual basis with respect to the application of

\textsuperscript{2} Fadi Hariz, \textit{The performance of Lebanese Commercial banks in crisis years (1985-1989)}, MMB project - AUB, 1992, P.10
\textsuperscript{3} Mirvat K. salam, \textit{Op Cit.}, P.10
\textsuperscript{4} BDL decree Law N° 28/67 dated May 9,1967
the provisions of the CMC. It possesses large autonomy, but must collaborate with the Central Bank.

The early seventies witnessed the oil boom in the neighboring oil rich countries which provided work opportunities to Lebanese manpower. The flow of funds of those workers and of Lebanese emigrants were all channeled back into the Lebanese economy in an attempt to improve its economic situation and strengthen its structure.\(^5\) In addition, the investments that Arab investors made in Lebanon, and the fact that Lebanon was a resort for them in their leisure time, contributed a lot to the creation of a healthy economic structure.

The fact that the Lebanese economy and its markets were open to its surrounding countries was reflected in the banking sector which enjoyed solvency levels that accommodates easily to the differing requirements and conditions. In year 1974, solvency levels needed did not amount to more than 38% of the total assets of the whole banking sector. Moreover, the oil revolution in the area pushed 30 International banks to open representative offices in Lebanon. This situation increased the number of such offices to 65 in addition to the 74 Lebanese commercial banks that existed at that time. Those reasons, in addition to the cultural and educational background of the Lebanese labor force, led to the growth of the triangular trade and to the inflow of foreign capital to Lebanon.\(^6\)

\(^5\) Fadi Hariz, *Op Cit.*, P.17
\(^6\) Union of Arab banks.*Failing banks and remedial measures: Researches & debates of the conference that was organized by the Union of Arab banks, 1992*, P. 103 (in Arabic)
2.2- The Lebanese Banking sector after 1975:

The situation of the Lebanese banking system that was described therein, changed to a great extent by year 1975 when the Lebanese civil war started and took with it all the glory and triumph that Lebanon achieved in years of hard work and competition with his neighbors. The civil war that Lebanon suffered from had left serious defects in the various sectors of its economy. Among the various sectors that constituted the Lebanese economy, the banking sector was the most affected because its activities were based on people's confidence.

During the past sixteen years, confidence in the Lebanese economy was brought to the minimum possible level. Its growth was abruptly severed by the civil war and the ensuing destruction of the political stability, economic structure, and physical and demographic infrastructure. But till 1982, Lebanon was still witnessing stability in its economy. Credit to the private sector as well as private sector deposits continued to increase. Meanwhile, the banking sector experienced a period of extensive branching; 130 branches were opened throughout the country between years 1977 and 1982, and 10 new banks were established during the same period. Core capital of Lebanese commercial banks showed a real growth in the seventies and early eighties. For example, in 1970, core capital was around $ 109 million, $ 158 million in 1973, and $ 226 million in 1975. Even after the beginning of the war, core capital levels kept growing up to $ 361 million in 1981 and $ 567 million in 1982.

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7 Freddie Baz, Bilanbanques, 1981
8 Union of Arab banks, Procedures that were taken by Arab Monetary Authorities to execute Basle Committee's Regulations,1993,PP.124,125 (in Arabic)
After several years of war during which the economic and financial reserves were depleted, the eventual collapse of the different economic sectors gradually started in the mid 1980s. During that period, it became impossible for the Lebanese banking sector to acquire and adopt highly developed techniques concerning monetary instruments and improved banking services. The majority of International banks closed their representative offices which amounted to only 11 offices by year 1984. Some of the offices that were closed are: Banca Commerciale Italiana, Banque Nationale de Paris, Chemical Bank, Ste. generale de Banques, Bank Atlantiko....etc.\textsuperscript{9}

After the year 1982, and during a period of three years, core capital levels lost 63% of its real value as it decreased from $ 567 million in 1982 to reach $ 209 million in 1985, $ 50 million in 1986 and $ 231 million in 1987. In other words, we can notice that in five years core capital lost 98% of its value.\textsuperscript{10} This was due to the drastic devaluation in the value of the Lebanese pound against the USDollar as shown in table 2.1 & figure 2.1:

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|c|c|}
\hline
\hline
$\text{value at year end}$ & LL. & 3.81 & 5.49 & 8.89 & 18.1 & 87 & 455 \\
\hline
\end{tabular}
\caption{Dollar value in LL. (1982 - 1987)}
\end{table}

Source: Bilanbanques, Various issues.

\textsuperscript{9} Union of Arab banks, Failing Banks and Remedial Measures: Researches & debates of the conference that was organized by the Union of Arab banks, 1992, P.103 (in Arabic)

\textsuperscript{10} Union of Arab banks, Procedures that were taken by Arab Monetary Authorities to execute Basle Committee's Requirements, 1993, PP.124,125 (in Arabic)
FIGURE 2.1
DOLLAR VALUE IN LL.
Similarly, if we observe the trend in which capital adequacy ratio was moving, we find that this ratio decreased from 4.03% in 1974, to 3.5% in 1982, 2.33% in 1985 and then to reach 0.24% in 1988.\textsuperscript{11}

The period since late 1983 has been characterized by continuing strains in the Lebanese industry. Amid this dim economic picture, the Lebanese banking sector struggled to retain prior performance levels. However, it was not spared and had its share of the general economic downturn. The attempts of some banks to improve their performance had sometimes the opposite effect and resulted in greater operating risk levels and few cases of financial distress.

2.2.1-Troubled Banks:

A large number of Lebanese commercial banks experienced a sharp deterioration in their ability to absorb financial shocks resulting from unanticipated economic and structural changes. During that period, Arab and International companies’ Investments were transferred to other countries that enjoyed stronger and more stable economies. This situation led to several other defects such as the accumulation of bad debts due to the devaluation of the Lebanese pound and the declining economic activity (slow-down in imports and exports), despite all the gains from the difference in exchange rates. Bank collateral had become devalued, leaving loans uncovered. In addition, clients had also been unable to service loans according to agreed schedules.

One can add that, because the number of the Lebanese banks operating in Lebanon was and still is quite large relative to the size of the market, they

\textsuperscript{11} Ibid, P.10
were continuously competing for the location of safe and profitable investment outlets in the private sector. In this climate of heavy competition, a number of banks had made imprudent and unguaranteed loans, and thus had faced large losses from default.\textsuperscript{12}

Problems of adequate credit management started by the emigration of intellects, capable and specialized personnel. Substitute management destroyed the base of the banking sector and made it vulnerable to the corruption that surrounded it at that time. As a result, First Phoenician bank failed in 1984 and was having a deficit equal to all its commitments. Consequently, it was unable to continue operating. Five other banks and one financial institution faced solvency problems.\textsuperscript{13}

The Central bank, instead of deleting this bank from the list of operating banks, gave it, along with other failing banks, loans in L.L. against guarantees. Loans that were granted to First Phoenician bank amounted to US$ 100 Million. This procedure postponed the solution of the problem till 1989 and accelerated the deterioration of the economic situation.\textsuperscript{14}

Those entities were secured by The Central Bank which provided them with proper financing that was necessary to preserve the security of the whole banking sector. Due to this policy, several other banks were encouraged to fail such as Al-Mashrek bank in 1988, followed by Banque Nasr Libano-Africaine, Lebanese Arab bank, Banque Mebco, Euromed bank, Banque de credit populaire, Adcom bank, Bank of Lebanon and Pakistan, and Lebanese

\textsuperscript{12} Marwan Iskandar & Elias Baroudi, The Lebanese Economy in 1982-83, Middle East Economic Consultants, 1984, P.208
\textsuperscript{13} Salloum Abdel-Amir, The Financial, Monetary and Banking Policies in Lebanon: Problems and solutions, Beirut; Asdika’a Al-Harf, 1991, P.485 (in Arabic)
\textsuperscript{14} Ibid
prosperity bank. Moreover, Banque Tohme and Future bank were slightly affected. The Central bank was financing these banks against guarantees and collateral submitted by them.\textsuperscript{15}

It is indeed the function of the Banking Control Commission (BCC) to detect a troubled bank. It usually appraises the bank’s assets, especially outstanding loans, to test whether its capital, liquidity, and the quality of its management conform to the agreed requirements. Troubled banks are usually easy to detect when searching continuously for symptoms of trouble or failure. Bank elements that should always be monitored are:\textsuperscript{16}

a- **Liquidity ratio**: a low liquidity ratio leads to the failure of a certain bank in that it will prohibit it from meeting sudden withdrawals.

b- **Capital adequacy ratio**: Banks should always maintain sufficient capital levels to cover all kinds of business risks.

c- **Loan to deposit ratio**: This ratio shows to what extent a bank has used its deposits to meet the society’s credit needs.

d- **Current ratio**: A bank should always maintain a certain balance between his current assets and current liabilities.

e- **Management**: Regulations all over the world have emphasized the consideration of the management criteria as a basic standard in the evaluation of any bank. Factors to be considered are expertise, ethics and legal management business practices.

\textsuperscript{15} Ibid
\textsuperscript{16} Abbas M. Kesserwan, Op Cit., P.
2.2.2- General Causes of Bank Failures:  

There are three major causes for bank failures:

1- Technical mismanagement: This could made voluntarily to pass illegal transactions or involuntarily because of the lack of technical capabilities such as: * mismatching between assets and liabilities  
   * Improper lending procedures and credit analysis  
   * Disorganization between internal and external controls

2- Dressing mismanagement: In case losses are incurred in a certain bank, no corrective actions are made and management resorts to window dressing to prevent shareholders from realizing the loss situation. For example, dividends would still be paid and amounts needed would be taken from the provisions for loan losses.

3- Desperate management: When bank losses increase and become impossible to hide, management resorts to risk exposure and speculation in currencies and real estates to achieve rapid profit and to prevent a break down.

In Lebanon, several problems were thought to be the cause of banking failures. From them one can mention:

17 Union of Arab banks, Failing Banks and Remedial Measures: Researches and Debates of the Conference that was organized by the Union of Arab banks, 1992, P.112 (in Arabic)
18 Ibid, PP.105,108
1- The emergence of intruders in the banking business after year 1977: Decree number 87/1983 required that only 49% of banking institutions should be non-Lebanese. Therefore, some of the foreign and Arab banks were liquidated. And by 1990 the ownership of the liquidated banks turned into unprofessional Lebanese hands.

2- The adoption of the immunity concept in the banking sector: The Lebanese Government, through the Central bank, used to provide failing banks with loans to help them recover and rebuild their lost capital. It was thought that prohibiting bankruptcy and failure is essential to support confidence in the banking sector.

3- Inability of monetary authorities to apply monetary procedures: Central bank was unable to coordinate with the BCC concerning some monetary procedures such as:

* Prohibition of speculation transactions

* Resort to credit in L.L. to finance government deficit

4- Lack of adequate supervision: In years 1987/88 no president was elected for the BCC. As a result, corruption took place and several illegal acts were committed by members of the BCC. They permitted 3 weak banks to open new branches; Mebco(87), Prosperity bank (88), and Banque Nasr Libano-Africaine (89).

5- Fraud: Some bank managements had manipulated the Lebanese trade law which allowed shareholders to combine board and executive powers.
This denominated bank system had led to the failure of several commercial banks. In all cases one man, the owner of the bank, was the one to formulate general policies, implement them and control their execution.

In 1988, the consolidated balance sheet of banks showed a volume of LL. 3184 billion or $ 6 billion. These same figures appeared in the consolidated balance sheet of banks in 1982. This static position was due to the devaluation of the Lebanese pound as shown in Table 2.2 & figure 2.2.

<table>
<thead>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>LL/$ at year end</td>
<td>87</td>
<td>455</td>
<td>530</td>
<td>505</td>
<td>842</td>
<td>879</td>
<td>1838</td>
<td>1711</td>
<td>1680</td>
</tr>
</tbody>
</table>

Source: Bilanbanques, Various issues.

This being the case, banks were asked to increase the guarantees against their operations abroad. This led to the withdrawal of nine to ten foreign non-Arab banks from the Lebanese market in a period of 7 years, i.e., from 1981 till 1988. These banks were.

- **Toronto Dominion Bank**: sold in 1981 and was named United bank of Saudia and Lebanon.
- **First bank of Chicago**: Sold in 1982 and was named First Phoenician bank.

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19 Abdel-Amir Salloum, *Op Cit.*, P.344
20 Ibid
Figure 2.2
Dollar value/LL.

USD/LL.
- British bank of Lebanon: sold in 1983 and was named Future bank
- Bank of Fokaskotia: was erased from the list in 1986
- Standard Chartered bank: was self-liquidated
- Chemical bank: closed in 1986
- Chase Manhattan bank: closed in 1986
- Moscow Nardoni bank: closed in 1986
- Banque de credit Swisse: sold in 1988

Thus, the role that Lebanon used to play as a link between Arab and foreign countries decreased in importance since the beginning of the war. Moreover, the lack of public services and inefficient communication media pushed foreign banks to decrease the volume of their business in Lebanon and transfer them to the surrounding Arab countries that enjoyed stable economic and political situations.

It is worth mentioning here that Bahrain, Kuwait and Jordan have tried to take the place of Lebanon as a link among business men in the region. They succeeded to a great extent to achieve their aim but without any one of above countries being able to achieve it individually. This turbulent economic and political situation transferred capital and investments away from Lebanon. As a result, a shift was witnessed from using the Lebanese pound in business transactions to the US Dollar (Dollarization).

Due to inflation and large government budget deficit, the Lebanese pound began its drastic decrease in value from LL. 3.81 for one dollar in 1982 to LL. 505 by the end of 1989, LL. 842 in 1990 and LL. 879 in 1991.
2.2.3-Causes of Devaluation of the Lebanese Pound: They could be traced to the following:

1- The continuous political instability since 1975
2- Emigration of capital
3- Deficit in the balance of payment
4- Decrease of foreign reserves at BDL
5- Speculation in the foreign exchange market.
6- Chronic state budget deficit

This depreciation has led to a change in the deposit structure. If one observes the change in capital to deposits ratio, one can see that this ratio kept on decreasing from 4.76% in 1982 till year 1988 when it registered the lowest ratio at 0.29%. Even in the 1990s, namely 1991, this ratio could not reach more than 0.88% (see table 2.3 & figure 2.3)

21 Ibid., P. 144
### Table 2.3
Capital to Deposits Ratio
Prior to Basle Agreement
(In percentage)

<table>
<thead>
<tr>
<th>period</th>
<th>capital/deposits ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1974</td>
<td>5.72</td>
</tr>
<tr>
<td>1975</td>
<td>5.71</td>
</tr>
<tr>
<td>1976</td>
<td>6.25</td>
</tr>
<tr>
<td>1977</td>
<td>4.80</td>
</tr>
<tr>
<td>1978</td>
<td>4.52</td>
</tr>
<tr>
<td>1979</td>
<td>4.38</td>
</tr>
<tr>
<td>1980</td>
<td>4.42</td>
</tr>
<tr>
<td>1981</td>
<td>4.28</td>
</tr>
<tr>
<td>1982</td>
<td>4.76</td>
</tr>
<tr>
<td>1983</td>
<td>5.14</td>
</tr>
<tr>
<td>1984</td>
<td>4.59</td>
</tr>
<tr>
<td>1985</td>
<td>2.52</td>
</tr>
<tr>
<td>1986</td>
<td>1.12</td>
</tr>
<tr>
<td>1987</td>
<td>0.56</td>
</tr>
<tr>
<td>1988</td>
<td>0.29</td>
</tr>
<tr>
<td>1989</td>
<td>0.59</td>
</tr>
<tr>
<td>1990</td>
<td>0.88</td>
</tr>
</tbody>
</table>

*source: Central bank of Lebanon, quarterly bulletin, various issues.*

It is true that the capital of Lebanese commercial banks was increasing year after year starting from L.L. 2162 million in 1982 and reaching LL.7358 million in 1988, but due to the continuous decline in the value of the Lebanese pound, one notices that the above increase in capital when calculated in US Dollar indicated a great decrease from $ 557.5 million in 1982 to $ 13.88 million in June 1988. The development of capital levels in LL. and USD from 1974 till 1990 are shown in detail in tables 2.4 and 2.5 respectively:
Figure 2.3
Capital to deposits ratio prior to Basle Agreement

![Graph showing capital to deposits ratio from 1974 to 1990.]

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Capital to deposits ratio prior to Basle Agreement

![Bar graph showing capital to deposits ratio from 1974 to 1990.]

---

Period

Table 2.4
Total Capital of Lebanese Commercial Banks 1974-1993
in millions of LL.

<table>
<thead>
<tr>
<th>Period</th>
<th>Total capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>1974</td>
<td>496</td>
</tr>
<tr>
<td>1975</td>
<td>551</td>
</tr>
<tr>
<td>1976</td>
<td>583</td>
</tr>
<tr>
<td>1977</td>
<td>620</td>
</tr>
<tr>
<td>1978</td>
<td>683</td>
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<tr>
<td>1979</td>
<td>878</td>
</tr>
<tr>
<td>1980</td>
<td>1180</td>
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<td>1981</td>
<td>1663</td>
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<td>2162</td>
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<td>1988</td>
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</tr>
<tr>
<td>1989</td>
<td>15277</td>
</tr>
<tr>
<td>1990</td>
<td>33380</td>
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</tbody>
</table>

source: Central bank of Lebanon, Quarterly Bulletin, various issues.
Table 2.5
Total Capital of Lebanese Commercial Banks 1974-1993
in millions of US Dollar

<table>
<thead>
<tr>
<th>Period</th>
<th>Total capital</th>
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</thead>
<tbody>
<tr>
<td>1974</td>
<td>164.757</td>
</tr>
<tr>
<td>1975</td>
<td>226.749</td>
</tr>
<tr>
<td>1976</td>
<td>198.976</td>
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<td>1977</td>
<td>206.666</td>
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<td>1978</td>
<td>227.288</td>
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<td>1979</td>
<td>269.532</td>
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<td>1980</td>
<td>323.509</td>
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<tr>
<td>1981</td>
<td>361.822</td>
</tr>
<tr>
<td>1982</td>
<td>567.454</td>
</tr>
<tr>
<td>1983</td>
<td>542.441</td>
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<tr>
<td>1984</td>
<td>380.653</td>
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<tr>
<td>1985</td>
<td>209.005</td>
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<td>1986</td>
<td>50.609</td>
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<tr>
<td>1987</td>
<td>23.822</td>
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<tr>
<td>1988</td>
<td>13.883</td>
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<tr>
<td>1989</td>
<td>30.252</td>
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<tr>
<td>1990</td>
<td>39.644</td>
</tr>
</tbody>
</table>

Source: Central bank of Lebanon, quarterly Bulletin, various issues:

With profits under pressure, banks found it hard to raise new resources, and access to market resources of new funds had been increasingly difficult. The problem of coping with bad debts was only one of the pressures that inhibited banks from total financial recovery.\(^{22}\)

\(^{22}\) The Banker, The Bottom Line, Vol. 143, August 1993, P. 04
Figure 2.4
Total Capital (Millions LL.)

Figure 2.5
Total Capital (Millions USD)
Capital is very essential to provide a back-up when banks need to write-off bad debts, but it is in no way a sole substitute for proper credit assessment and risk management. As a result, the market view of a bank's capital has acquired greater importance in that it has become one basic reference for classifying the bank's standing vis-à-vis its competitors in the market in which it operates.

The issue of restoring capital ratios as a mean to instill greater discipline in the assessment and control of the various solvency risks has become of major priority, after the drastic decline in capital ratios of the Lebanese commercial banks since the early eighties.

This being the case, there emerged a need to find out and analyze the reasons for bank failures in Lebanon. The Lebanese authorities, especially BDL, were all aware of the problems that commercial banks were suffering from and did not ignore them. Really great efforts had to be made by supervisors in response to the need of preserving a stable, sound and competent banking sector.

2.3- Central Bank Policies for Reform:

Prior to year 1983, and in an attempt to minimize resulting injuries in the banking sector, the Lebanese Authorities, through the Central Bank of Lebanon, introduced several control devices and extremely cautious and conservative policies. On the other hand, Lebanese authorities tried their best to search for solutions that will improve the current situation and remove any feature of threat in the future. For this purpose, and before Basle Committee
published any of its reports, BDL tried to control the banking system and in specific commercial banks to improve its overall monetary management and banking practices to avoid risk of failure and collapse which could further damage Lebanon's banking reputation.

So, BDL had asked Lebanese banks, in circular N° 435/83 dated October 26, 1983 to apply new liquidity and solvency ratios in order to maintain a minimum level of economic stability. In addition, they were requested to achieve a minimum capital adequacy level (capital/total assets) of 3%. In this respect, Bank of Lebanon had moved gradually to monitor and orient monetary variables and to regulate the activities of the banking system in order to improve its position. The major activities of BDL were to stabilize the level of liquidity at high levels, and therefore to curb the rate of inflation. Furthermore, BDL had worked hard to develop strong Lebanese money and capital markets, distribute evenly bank credits to the economy, stabilize the exchange value of the Lebanese pound, and reduce foreign exchange speculation.

But this Circular was disregarded by banks which took advantage of the disorder in the economy and the absence of efficient regulations and proceeded into committing illegal acts and practices. Therefore, the application of circular N° 435/83 was postponed till July 7, 1986 after which all banks which did not apply the agreed levels were to be penalized. (Penalty was set to be equal to the same interest rate charged on the decrease in required reserves).

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23 Marwan Iskandar, Op Cit., 1982-83, P.209
24 Khalil Chammaa, Basle Committee's Requirements on Capital Adequacy and its effect on Arab Banks, Union of Arab banks, P.265
The response of the Lebanese Bankers Association to BDL's circular was that the achievement of the required capital adequacy level will never be realized in the prevailing situation without essential amendments in some basic elements that enter in the calculation of the required level. First, they suggested that items like cash at banks, required reserves, deposits at the Central bank, and Treasury Bills which are risk free to be excluded from total assets. Second, they stated that only 50% of some items like interbank deposits to be included in the total assets. Third, branches of foreign banks operating in Lebanon to be left free from applying the required capital adequacy level.\textsuperscript{25}

At that time, an agreement was reached between the Central Bank and the Bankers' Association as to the approval on the above mentioned necessary amendments but, in practice, no positive response was received from BDL concerning this subject. It was till year 1987 that a joint committee from the two sides was formed to try to formulate new capital adequacy levels that would be accepted by both parties. As a result, two capital adequacy ratios were formulated; the first in Lebanese pounds and should not be less than 7% by December 31, 1987. the second is a general capital adequacy level that was scheduled as follows: 3% by 1987, 4% by 1988 and 5% by year 1989. In addition, the Bankers' Association added that the implementation of the above formulas will not be possible if the following three points were not met:\textsuperscript{25}

1- Revaluation of fixed assets and equipment's on condition that only part of the revaluation value will be added to capital and the difference needed will have to be settled in cash.

\textsuperscript{25} Ibid, P.264
\textsuperscript{26} Ibid,P.261
2- The organization of support loans granted in US Dollars or Lebanese pounds to help achieve the level of capital required.

3- The issuance of debt bills that bank shareholders will subscribe for. And those bills will be subject to the same rules and conditions that govern the support loans.

The Banking Control Commission (BCC) gave its preliminary approval concerning the asset revaluation procedure. It proposed that only 50% of the reevaluation revenues should be added to banks’ capital, and the remaining 50% to be financed by cash. But this approval will not become finalized unless the Central Council of the Bank of Lebanon gives its decision and support.27

Unfortunately, neither circular N° 435/83 nor its related amendments were given any attention by BDL. And therefore, the capital adequacy problem remained pending and unsolved as a result of the political and economic instability which was reflected in unsecured financial and monetary markets. Despite all the above mentioned problems, the Bankers’ Association did not stop its strive for further amendments to the capital adequacy level and for the acceptance of the asset revaluation procedure. It kept directing banks and encouraging them to build up their capital levels as soon as possible.

Accordingly, and in the year 1988, eighteen banks increased their capital by a total of LL.4262 Million, and in 1989 six banks increased their capital by a total of LL.2520 Million.28

27 Ibid., p.265
28 Abdel-Amir Salloum, Op Cit., p.289
Tables 2.6 and 2.7 show a detailed list of major Lebanese commercial banks that increased their capital levels from 1987 till 1989 as follows: (in LL. & USD)

Table 2.6
Capital of Commercial banks (1987-89) in Millions of LL.

<table>
<thead>
<tr>
<th>BANK</th>
<th>1987</th>
<th>1988</th>
<th>1989</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banque Beyrouth pour le commerce</td>
<td>150</td>
<td>504</td>
<td>1200</td>
</tr>
<tr>
<td>Byblos bank</td>
<td>154</td>
<td>462</td>
<td>462</td>
</tr>
<tr>
<td>Fransabank</td>
<td>40</td>
<td>300</td>
<td>1000</td>
</tr>
<tr>
<td>Saudi Lebanese bank</td>
<td>50</td>
<td>250</td>
<td>250</td>
</tr>
<tr>
<td>United bank of Saudia and Lebanon</td>
<td>40</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Jammal trust bank</td>
<td>80</td>
<td>200</td>
<td>200</td>
</tr>
<tr>
<td>Rifbank</td>
<td>15</td>
<td>140</td>
<td>140</td>
</tr>
<tr>
<td>Syrian Lebanese commercial bank</td>
<td>25</td>
<td>100</td>
<td>300</td>
</tr>
<tr>
<td>Banque Geagea</td>
<td>5</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>Banque Joseph Lati &amp; fils</td>
<td>6</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>Bqe. de l'essor economique</td>
<td>5</td>
<td>5</td>
<td>1000</td>
</tr>
<tr>
<td>Bqe. du Liban et d'outre mer</td>
<td>200</td>
<td>200</td>
<td>1000</td>
</tr>
<tr>
<td>Bank of Beirut &amp; the Arab countries</td>
<td>-</td>
<td>300</td>
<td>800</td>
</tr>
<tr>
<td>Lebanon &amp; Gulf Bank</td>
<td>75</td>
<td>75</td>
<td>525</td>
</tr>
<tr>
<td>Allied Business bank</td>
<td>80</td>
<td>60</td>
<td>400</td>
</tr>
<tr>
<td>Banque Libano-Francaise</td>
<td>-</td>
<td>100</td>
<td>400</td>
</tr>
<tr>
<td>Banque de la Mediterranee</td>
<td>7122</td>
<td>7095</td>
<td>100</td>
</tr>
<tr>
<td>Banque de la Bekaa</td>
<td>25</td>
<td>25</td>
<td>100</td>
</tr>
<tr>
<td>Metropolitan bank</td>
<td>250</td>
<td>250</td>
<td>250</td>
</tr>
</tbody>
</table>

Source: Bilanbanques, Various issues
Table 2.7
(in USDOLLARS)

<table>
<thead>
<tr>
<th>BANK</th>
<th>1987</th>
<th>1988</th>
<th>1989</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banque Beyrouth pour le commerce</td>
<td>329,670</td>
<td>960,943</td>
<td>2,376,238</td>
</tr>
<tr>
<td>Byblos Bank</td>
<td>338,452</td>
<td>877,358</td>
<td>914,851</td>
</tr>
<tr>
<td>Fransabank</td>
<td>87,912</td>
<td>566,038</td>
<td>1,980,198</td>
</tr>
<tr>
<td>Saudi Lebanese Bank</td>
<td>109,890</td>
<td>471,698</td>
<td>495,050</td>
</tr>
<tr>
<td>United Bank of Saudia &amp; Lebanon</td>
<td>87,912</td>
<td>377,358</td>
<td>396,040</td>
</tr>
<tr>
<td>Jammal Trust Bank</td>
<td>175,824</td>
<td>377,358</td>
<td>396,040</td>
</tr>
<tr>
<td>Rifbank</td>
<td>98,901</td>
<td>264,151</td>
<td>277,228</td>
</tr>
<tr>
<td>Syrian Lebanese commercial Bank</td>
<td>54,945</td>
<td>188,679</td>
<td>594,059</td>
</tr>
<tr>
<td>Banque GeaGea</td>
<td>10,989</td>
<td>94,340</td>
<td>59,010</td>
</tr>
<tr>
<td>Banque Joseph Lati &amp; Fils</td>
<td>13,187</td>
<td>56,604</td>
<td>59,406</td>
</tr>
<tr>
<td>Bce. de l’Essor Economique</td>
<td>10,989</td>
<td>9,434</td>
<td>1,980,198</td>
</tr>
<tr>
<td>Bce. du Liban &amp; D’Outre Mer</td>
<td>439,560</td>
<td>377,358</td>
<td>1,980,198</td>
</tr>
<tr>
<td>Bank of Beirut &amp; the Arab Countries</td>
<td>—</td>
<td>566,038</td>
<td>1,584,158</td>
</tr>
<tr>
<td>Lebanon &amp; Gulf Bank</td>
<td>164,835</td>
<td>141,509</td>
<td>1,039,604</td>
</tr>
<tr>
<td>Allied Business Bank</td>
<td>175,824</td>
<td>150,943</td>
<td>792,079</td>
</tr>
<tr>
<td>Banque Libano-Francaise</td>
<td>—</td>
<td>188,679</td>
<td>792,079</td>
</tr>
<tr>
<td>Banque de la Mediterranee</td>
<td>15,652,747</td>
<td>13,386,792</td>
<td>198,020</td>
</tr>
<tr>
<td>Banque de la Bekaa</td>
<td>54,945</td>
<td>47,170</td>
<td>198,020</td>
</tr>
<tr>
<td>Metropolitan Bank</td>
<td>549,451</td>
<td>471,698</td>
<td>495,050</td>
</tr>
</tbody>
</table>

Source: Bilanbanques, Various issues.

Therefore, the capital adequacy of the banking sector as a whole started improving gradually. Slight increases were noticed as capital adequacy level increased from 0.5% in 1988 to around 1% in September 1989.\(^{29}\)

On the other hand, the Bankers’ Association (BA) played an important role in the self-control process of speculation practices in accordance with the monetary authorities. Therefore, several precautionary actions had to be done.

For example: In its circular No. 700 dated January 8, 1987, BDL amended the reserve requirement level of Lebanese banks as shown in table 2.8:

\(^{29}\) Khalil Chammaa, Op Cit., P.270
Table 2.8
Reserve Requirement levels, 1987
In percentage

<table>
<thead>
<tr>
<th>starting from</th>
<th>Reserve Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 5, 1987</td>
<td>11%</td>
</tr>
<tr>
<td>February 5, 1987</td>
<td>12%</td>
</tr>
<tr>
<td>March 5, 1987</td>
<td>13%</td>
</tr>
</tbody>
</table>

Source: Abdel-Amir Salloum, p. 272

In Lebanon, before 1974, the minimum capital requirements for existing banks were L.L. 5 million. After the year 1977, existing banks were required to have paid-up capital of L.L. 15 million, of which L.L. 7.5 million will be kept in the form of blocked interest-free deposit with the Lebanese Treasury. In 1989, banks were required to have a minimum capital for the Head Office of L.L. 200 million, and L.L. 50 million for each branch (BDL circular N° 863). In March 1991, the Central Bank issued circular N° 1013 specifying that the bank capital for the Head Office should be increased to L.L. 100 million and L.L. 10 million for each branch. In 1993, above requirements were increased to L.L. 1 billion for the head office and L.L. 100 million for each branch.30

During that period of rehabilitation, strong banks were able to accommodate to new changes and requirements. They increased their capital levels, restricted their credit operations and refrained from opening new branches until the political and security situation in the country is stabilized. On the other hand, weak banks that were dramatically undercapitalized were depicted. From here emerged the need and importance of bank mergers

30 Union of Arab banks, Conference of Arab banks facing the crisis, April 1985, p. 119 (in Arabic)
because otherwise several banks would have been liquidated or declared bankrupt.

The monetary authorities were disappointed and angry as a result of several banking shocks.\(^{31}\)

1- The shock of 1984 and that resulted in the financing of a large number of banks, (five banks and one financial institution), by more than LL. 2 billion.

2- The failure of Al-Mashrek bank in 1988 and the financing that BDL provided it with to help it pay customers' withdrawals.

3- Mismanagement of a large number of banks and the illegal operations that were done inside and outside these banks.

4- Inadequate internal and external controls that inhibited the higher banking committee from detecting all the irregularities in the banking system.

By 1990, financing by BDL of failing banks is shown in detail in table 2.9. \(^{32}\)

<table>
<thead>
<tr>
<th>BANK</th>
<th>AMOUNT IN BILLIONS OF LL.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Al-Mashrek bank</td>
<td>45.875</td>
</tr>
<tr>
<td>Lebanese prosperity Bank</td>
<td>8.441</td>
</tr>
<tr>
<td>Lebanese Arab bank</td>
<td>25</td>
</tr>
<tr>
<td>Adcom bank</td>
<td>9.334</td>
</tr>
<tr>
<td>Banque de Credit populaire</td>
<td>17.733</td>
</tr>
<tr>
<td>Mebco bank</td>
<td>14.720</td>
</tr>
<tr>
<td>Banque Nasr Libano-Africaine</td>
<td>29</td>
</tr>
<tr>
<td>Future bank</td>
<td>2.661</td>
</tr>
<tr>
<td>Banque Tohme</td>
<td>5.600</td>
</tr>
</tbody>
</table>

\(^{31}\) Abdel-Amir Salloum, Op Cit, P.293

\(^{32}\) Ibid, P.493
2.4-Bank Mergers:

In 1988, the monetary authority had made great efforts to reduce the number of Lebanese banks by resorting to voluntary or compulsory mergers. Suggestions were made concerning the formulation of a committee made up of the Central Bank, the Bankers' Control commission (BCC) and the Bankers' Association (BA). The role of this committee was the revaluation and classification of banks in order to facilitate the merging procedure which will reduce the number of banks from 88 banks and financial institutions to 15 strong and adequate banks. It was considered that bank mergers will decrease the volume of risk and improve capital adequacy and productivity levels.\textsuperscript{33}

2.4.1-Criteria for mergers:

The most important criteria that determines the volume of one entity is capital more than deposits and productivity. Undercapitalization prohibits banks from reducing costs, accelerating activities, introducing advanced technologies and attracting efficient personnel. Therefore, it is noticed that the survival of banks depend on its capital in addition to its level of capital adequacy. It is worth mentioning here that in July 1986, BDL presented a suggestion law for bank mergers.

2.4.2-Negative Sides that were Specified by the Committee.\textsuperscript{34}

1) Merger operations reduce the number of banks and legal competition in that certain banks could will be encouraged to control the market and monopolize it.

\textsuperscript{33} Ibid. P. 293
\textsuperscript{34} Ibid. P. 539
2) The absence of accurate publicized financial statements of banks hinders the merger operation.

3) Homogeneity of administration and banking operations in the merging banks is very difficult since every bank’s employees are associated with the shareholders of this bank and could not be abandoned.

4) Lebanese banks are established in the form of family ownership. So, conflicts would certainly arise in the management of the new bank concerning authority and control.

The results of the committee’s work in the process of encouraging voluntary mergers or enforcing compulsory mergers in case of inadequacy will be discussed in detail in chapter four after the analysis of banks’ capital and capital adequacy levels that necessitated any king of these mergers.

Commercial banks in Lebanon will be unable to absorb risk, sustain unexpected shocks and face still more losses and insolvency problems if they do not plan adequately for contingencies. Moreover, loan portfolio should be more diversified and analyzed carefully to meet unanticipated events. With the improvement of the political situation in Lebanon comes the process of economic restoration. The first step towards the creation of a stable economy would be to regain local and international confidence in the Lebanese banking institutions. This would be achieved by increasing capital requirement levels in above institutions to attain the international requirements. The second step would be to renew and strengthen the Lebanese banking relations with Arab and international banks.
It is worth mentioning here that such relations would never come back or exist if the Lebanese commercial banks do not try or fail to restructure their capital bases and improve their capital adequacy levels in the light of the regulations set by the Basle Agreement of 1988.
3.1 Role of capital:

Capital is the most important factor that strengthens the position of a bank and safeguards it against any possible future problems such as bankruptcy. It represents the funds invested in the Bank by stockholders. In banking, no less than in other business enterprises, survival and growth depend on capital resources and their efficient use. They are needed to protect against various forms of risk that might affect a bank's ability to service its liabilities in the face of fluctuating earnings and changes in the value of assets.

Capital is adequate when it reduces the chances of future insolvency to a minimum level. Because capital adequacy is important to sound banking performance, several factors should be taken into consideration in determining the accurate level. Such factors are operating efficiency, the prevailing and expected economic conditions of the national economy and of specific sectors served by the banks, and the competitive environment.

The level of bank capital to be considered adequate is a subjective matter which varies from bank to bank and is subject to indirect influence by the authorities. The banking business is a risky one where conflict could certainly arise between depositors, stockholders, and regulatory authorities in what concerns the rate of capital to be placed as provisions against risk and losses.
"A record of good earnings is considered extremely important because it provides reserves for contingencies and losses that may occur".  

The bank depositor favors the maximum amount of capital as a protection against the bank risky business. Capital protects the life savings of many depositors and the working capital of many business firms. Therefore, if a bank is to continue operating, its capital must inspire sufficient confidence among depositors and other creditors because bank losses affect greatly public confidence which could be directly transmitted to other segments of the economy.

The bank stockholders wish to operate with the lowest possible capital level in order to achieve maximum profitability and adequate returns. But on the other hand, adequate capital levels are important for their business because serious bank losses may involve a loss of their investment.

Capital requirements are of great importance to regulatory authorities and the adequacy of a bank's capital is one of the factors monitored during their periodic examinations. In order to prevent bank failures and to maintain a healthy, competitive banking industry, regulatory authorities have imposed minimum capital requirements for the organization of banks and have set norms and standards to ensure the adequacy of bank capital.

While it may be difficult to determine the precise amount of capital that a bank should have, the capital should be sufficient to fulfill the financing operations of a bank, provide protection to depositors and other creditors, and

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inspire confidence in those depositors and in supervisory authorities. Usually, the amount of capital funds a bank needs is directly related to the level of risk it assumes. If a bank assumes great risk in its loan portfolio, it should have more capital funds than if it were conservative in its lending policy; the higher the level of capital, the greater the protection offered.

3.2 Risks affecting banks:

Banks can increase their capital as the risks they assume increase, or else they can invest in assets that are relatively risk-free. Efficient bankers seek to identify and measure all the relevant risks that a bank may face in its daily operations in order to formulate appropriate protective strategies. The risks that most commercial banks are subjected to include: Credit risk, liquidity risk, solvency risk, and risk of theft.

a- **Credit risk**: it results from the possibility that loans will not be repaid by the counterparty.

b- **Liquidity risk**: it refers to the possibility that a bank is short of liquidity and fails to meet customers' withdrawals. In that case, the bank will be forced to sell some of its assets at a loss to meet urgent needs. To protect itself against liquidity needs, a bank must maintain an adequate level of liquid assets easily convertible into cash.

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37 Edward W. Reed, *Op cit.*, P.197
c- Solvency risks: Banks should always maintain a balance between their assets and liabilities, i.e., deposits and equity capital because of the small margin between returns on assets and cost of capital.

d- Risk of theft: Internal controls are necessary for the proper implementation of banking operations by employees. Similarly, external controls are needed to make sure that management practices are being conducted as they should be.

"It is in the interest of the Shareholder to combine profitability with safety".\textsuperscript{39} Bank customers, whether depositors or borrowers, need to be assured that their profitability is never threatened and that bank supervisors should always be working to grant them this feeling of security. They are concerned in various ways with reducing the chances of financial crisis.

The lack of diversification in banks' portfolios may affect their overall performance and can lead to above normal losses. Diversification is achieved through a logical division of assets and liabilities' portfolio and other operations into pertinent activities.\textsuperscript{40}

3.3 Bank failure:

The failure of banks is considered as a very important event because many people depend on their safety and security. When one bank fails, the

\textsuperscript{39} Howard D. Cross, Op Cit., P.68
\textsuperscript{40} Mirvat K. Salam, \textit{Capital Adequacy of Commercial banks in Lebanon}, July 1991, MBA project, BUC, P.32
soundness of other banks become suspected. Therefore, sufficient capital funds to absorb losses and to assure depositors of the safety of their funds may prevent the failure of a particular bank.

In the late 1930's, the banking holiday took place because of the lack of confidence the public had towards the banks with which they dealt. This panic was caused by the failure of few banks which the public was afraid that it will affect all other banks. In general, several important factors were depicted as serious and direct causes of bank failures. The history of failures indicated that economic conditions are an important contributing cause. In addition to unfavorable economic conditions, other causes include managerial weakness in loan portfolio management, illegal practices, and unsafe and unsound loan practices and policies. The safety of commercial banks has always been of great importance to stockholders, depositors and supervisory authorities, since bank failures have a greater effect on the economy than do failures in any other type of business.

3.4 Capital Adequacy:

The capital adequacy concept acquired great importance in the past few years as a result of the growing operations of commercial banks and its expansion in lending practices which were not accompanied with increased levels of capital backing. This situation led to the accumulation of bad debts which in turn, opened the eyes of regulatory agencies into further control and supervision in order to prevent bank failures. This induced it to develop new criteria for the assessment of bank capital adequacy.

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42 Edward W. Reed, Op Cit., P.206
Capital adequacy regulations along with liquidity regulations are adopted by regulators to ensure that banks can repay their depositors. "Adequate capital serves to keep banks open so that they may be able to absorb losses out of future earnings rather than out of capital funds themselves". In assessing the total risks of a bank portfolio, capital plays a critical role in offsetting losses to creditors. Moreover, bank's lending and investment activities are limited to the availability of capital funds to meet the requirements of supervisory authorities. For example, if a bank had made too many loans, the value of its activities could fall below the amount of its liabilities; a situation known as insolvency. If owners fail to contribute additional capital, the bank would have no possible way of repaying its depositors and other creditors. Therefore, in addition to maintaining adequate liquidity, banks must constantly guard against excessive losses from lending and investing activities.

3.5 Banking controls:

Banks can reduce credit or default risk by obtaining collateral in connection with loans, or by diversifying so that large proportions of the bank's funds are not tied up in any type of loan or to any one borrower. US commercial banks are subject to a multitude of regulations. Most of these regulations come from the Federal Reserve System, The Comptroller of the Currency, the FDIC, and state agencies charged with monitoring and regulating banking activities.

Federal Reserve regulations have been based on the objective of preserving stability within financial systems and national economies. Their

\[43\] Howard D. Cross, Op Cit., P. 69
main objective is to prevent destabilizing activities on the part of commercial banks. To prevent any discontent either from the part of the public or from that of the supervisor, both Federal and state laws, in all countries, have set a minimum level of capital that all banks have to maintain in order to reduce the risks of loss or insolvency.

As countries develop, business fields develop and new ways of control and supervision need to be searched for. Therefore, The safety of commercial banks has been greatly improved by external controls that arise outside the banking system and are the responsibility of the various regulatory and supervisory agencies. Controls are exercised by requiring periodic reports that reflect a bank's conditions and operations.

The objective of these reports and examinations are to ascertain a bank's financial progress, its solvency, its management's integrity and competence and whether unsafe banking practices and policies are being followed, so that corrections may be made. Internal controls are of equal importance in maintaining efficiency and safety. The Internal Audit department's job is to improve accounting methods and systems to produce accurate and complete records of bank transactions efficiently and in conformity with the various regulations applicable to the bank.

Banking has ever been and will always be a risky field of business since it is founded by and based on people's money. Banks could have, undoubtedly, faced serious troubles had they not been aware of this fact. Bankers were aware of the inherent risks and are, until now, cautious about developing new strategies, legislation and regulations that banks have to abide by to safeguard their business against any future threat. "There has always been a perceived
need for special protection for depositors in order to instill confidence and to safeguard them in case financial crisis occur".  

Sound management of banks gives them a high credit in what relates to the credibility and confidence of their customers. What really attracts the public to a certain bank is their confidence that their money will be safely used and that their profitability will never be threatened. This is not only the concern of the public, but also of the supervisor who is always working for the best interest of the stockholders. The existence of a system of prudential regulations applied by the Central bank carries with it, in the public mind, at least an assurance that depositors will be looked after and that banks will not be allowed to fail.

To prevent the occurrence of banking crisis in the future, a reconsideration of the minimum level of adequate capital to be maintained by banks was continuously needed. Moreover, bank management must continue to increase its alertness regarding the management of bank funds. In addition, capable and educated personnel must be attracted to banking. More strict rules and regulations were to be applied to have greater control on the banking operations.

Every decade, these rules must be amended and the levels of capital adequacy revised upward to keep up with the ever developing world. Even the capital adequacy ratio itself was developed and shaped over time to meet the growth of capital markets. Interested parties have established a set of standards and some helpful ratios that can be employed to test the adequacy of capital funds of a particular bank. Capital funds have been measured in relation to various balance sheet items such as total deposits, total assets, or

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44 Mirvat K. Salam, Op Cit., P.16
risk assets. The ratio of capital funds to these balance sheet items has been thought to indicate the extent to which a bank could suffer losses and still have enough capital to assure safety to depositors.

3.6 Development Of Capital Adequacy Ratios Over Time

For several years, Bank Comptrollers have been trying continuously to develop capital adequacy ratios that reflect the true capital status of banks. Ratios were intended to introduce greater uniformity, objectivity, and consistency in the process of assessing capital adequacy, provide direction for capital and strategic planning to banks and for the appraisal of this planning by the Agencies, and to permit some reduction of existing disparities in capital ratios between banking organizations of different size.⁴⁵ Historically, three ratios have been developed that relate capital to several balance sheet and off-balance sheet items. These ratios are: The capital/total deposits ratio, the capital/total assets ratio, and the risk-asset ratio.

3.6.1 - Capital /Total deposits ratio:

The ratio of capital funds to total deposits has enjoyed the longest use of any other ratio. It has been employed widely throughout Europe up to the present day to measure and determine capital adequacy. It was introduced by California banking law in 1909 and was recommended by the comptroller of the currency in 1914. They required banks to maintain at least one Dollar of capital funds for each ten Dollars of deposits. It is the basic and simplest tool used by both managers and bank supervisors for measuring and controlling the adequacy of their capital resources. This ratio relates capital base to an

⁴⁵ Edward W. Reed, Op Cit., P.200.
aggregate of the bank's deposits. So, if this ratio increases, the risk to which depositors and creditors are subjected would decrease. In other words, the increase in deposits beyond a specific limit of capital leads to an increase in capital risks, and thus, capital becomes insufficient to absorb potential losses for creditors.\footnote{Union of Arab bank: Basle Committee Requirements on Capital adequacy and its effects on Arab banks (in Arabic), P.20}

One important limitation to this ratio is that it excludes from the measurement of capital adequacy those off-balance sheet items that do not carry full credit risk. In addition, it does not take into consideration the nature of the different types of assets that a bank holds.\footnote{Mirvat K. Salam, Op. Cit., P.35}

3.6.2 Capital / Total assets ratio:

The ratio of capital funds to total assets came into use by supervisory Authorities in the late 1940s. A measure of capital adequacy should logically relate capital to assets and not to deposits for two reasons:

1- Losses are reflected in the bank's balance sheet by reduced values of assets.
2- capital adequacy indicates the extent to which a bank's capital can absorb loss and still protect the interest of depositors and creditors.

This is the most common method used in assessing the degree of protection offered by banks' capital.
In 1947, a maximum capital/total assets ratio of 7% was suggested by the Federal Reserve System in the US as an indication of adequate capitalization. It is worth mentioning that the precise numerical ratio which is considered by supervisors, depositors and the bank itself to be appropriate for any particular bank will vary considerably according to the nature of the business, and particularly, to the assets of banks and their profitability. The capital to assets ratio is a straight comparison of reported shareholders' equity (capital and reserves) with assets. It is therefore less refined than the risk asset ratio.

3.6.3 Capital / Risk Assets Ratio:

In the light of the defects found in the two previous ratios, and after so many reconsideration by supervisory Authorities, it was found that ratios would be more accurate if capital was divided by the volume of risky assets, of course after assigning risk weights to every category of assets. The decision on which assets to hold will have to take into account risk weights and capital requirements. The level of capital required to back bank’s activities is therefore made sensitive to the riskiness of its assets.

As banks vary in their composition, regulators recognized that the composition of banks' assets could be more important in terms of risk than in the size of assets. Off-balance sheet factors are also taken into account in determining how adequate capital holdings are for the banks.
The ratio of capital to risk assets peaked in the mid 1940s and declined until year 1974. This ratio is the ratio of capital funds to total assets less cash and Government securities.\textsuperscript{48}

This takes broad account of the differing degrees of risk associated with different types of assets by allotting weightings, ranging from zero to 100\%, to five categories of assets. It also unavoidably misses out the hidden reserves still held in a number of countries. In particular, the Japanese banks have huge holdings of stocks and other securities, worth much more than their balance sheet value, which they argue can be regarded as realizable assets if it should prove necessary to meet heavy losses.

In 1952, the Federal Reserve Bank of New York introduced six categories of assets, each of which with a different weight, to be used in the calculation of the above mentioned ratio. Assets were categorized as follows:\textsuperscript{49}

\begin{table}
\begin{tabular}{|l|c|}
\hline
Bank reserves & 0\% \\
Minimum risk assets such as secured loans & 5\% \\
Designated portfolio assets such as securities with maturities & 12\% \\
Assets that have more than normal banking risk & 20\% \\
Work-out assets such as doubtful loans & stocks & 50\% \\
Fixed assets & 100\% \\
\hline
\end{tabular}
\end{table}

It is considered that a weighted risk ratio in which capital is related to different categories of assets or off-balance sheet items, weighted according to broad categories of relative riskiness is the preferred method for assessing the capital adequacy of banks.

\textsuperscript{48} Edward W. Reed, \textit{Op Cit.}, P.199
\textsuperscript{49} Howard D. Cross, \textit{Op Cit.}, P.76
In the late 1960s and early 70s, all ratios and formulas used in previous
capital adequacy calculations were found obsolete and were abandoned.
Completely new ideas were introduced by national Bank examiners. Factors
other than capital to risk assets and to total deposits were found of equal or
even greater importance. They agreed that the character of a bank’s
management and its capacity to provide highest quality service to the public is
as important as its assets and deposit position.  

They suggested several factors to be taken into consideration by bank
supervisors. Such factors are the quality of management, liquidity of assets,
history of earnings and retention thereof, quality of operating procedures,
quality and character of ownership in addition to bank’s capacity to meet
present and future needs of its trade area, considering the competition it
faces.

In the late 1970s, comparison of selected ratios was found to be the
most efficient method for the determination of capital adequacy. All the above
mentioned approaches toward the establishment of sound, logical and
significant capital adequacy ratios were taken in an attempt to protect banks
against any probable future depression that might face the banking sector in
general. The provision of enough capital and assets is not enough. Raising
additional capital funds can, to some extent help banks to face problems, but
one should take into consideration the volume of assets that banks hold
(especially in time of crisis).

\[ \text{ibid, P.78} \]
\[ \text{ibid, P.79} \]
Attention must always be drawn to the risk of asset devaluation because, by time, such devaluation would offset any attempts made to raise additional capital funds. "Despite the strengthening of the banking sector's structure, and despite obvious improvement in the quality of bank assets, it seems that not all risks have been eliminated from the banking business". Thus, the public interest in safe banking, and the need to eliminate the emergence of banking crisis, require a conservative approach to the problem of capital adequacy.

It is important to note that bank Shareholders should show interest in providing the assurance that the banks they own will be able to survive whatever circumstances may possibly develop. Asset-risk evaluation should always be stressed upon by every bank, and it is the responsibility of each bank directors and top management to supervise capital adequacy requirements and to understand the basis of the supervisory evaluation.

\[52\text{ ibid. P.86}\]
CHAPTER IV
BASLE COMMITTEE PROPOSAL

4.0 Introduction:

Profitability in world banking was deteriorating in the late 1980s especially in Europe and Asia. In Japan and Europe profitability has been decreasing. Only big and strong banks could survive and achieve acceptable returns. In addition, capital adequacy levels tended to deteriorate greatly in the middle East and Asia-Pacific. This decrease has been prompted by the fact that asset size has become a poorer measure of the soundness, stability and performance of banks. More banks are doing business off-balance-sheet and more have been deliberately shrinking their balance-sheet footings. For many years, Total assets have been increasing faster than shareholders’ funds which are the solid foundation of a bank’s strength and soundness. The result has been a sustained deterioration in capital adequacy standards.53

Concern for the strength of the International banking system during the past years forced the banking supervisors of the group of (10) countries to achieve significant progress towards the harmonization of International regulatory standards including actions to bring national capital adequacy for banks in accordance with the guidelines issued by the Basle committee. It must be remembered that the Basle committee has already been around for a long time. Its first published efforts go back to 1975, when the initial concordat set out principles for supervision of banks’ foreign establishments.54 In 1983 this

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53 The Banker,Pillars of the Community, Vol.139,July 1989,P.38-39
54 The Banker,The Bottom line, Vol.142,August 1992,P.64
was reformulated to provide for supervision on a consolidated basis, an essential requirement to catch the overall picture of international groups.

4.1 The Basle Agreement:

In July 1988, Basle committee on banking regulations and supervision practices prepared its final report after 10 years of thorough study. The countries that endorsed the proposals were Belgium, Canada, France, Italy, Japan, Luxembourg, The Netherlands, Sweden, Switzerland, West Germany, The UK, and USA. The Central bank governors of above countries (G-10) met in 1988 and agreed on the decisions of Basle committee. They all aimed for the achievement of the same objectives.

The Basle Committee's objectives were set to help in strengthening stability in the International banking sector and to remove any feature of imperfect competition that stems from the difference in national control and supervision practices that concerns the measurement of banks' capital adequacy. A common minimum target capital standard was needed for banks operating internationally and that undertake significant cross-border business. The Basle committee's report evolves around the minimum acceptable capital adequacy ratio for international banks, and is greatly concerned with credit risks.

The Basle committee framework required that by the end of 1992, all banks with significant international business will be required to maintain a ratio of capital to assets, weighted according to risk, which is at least a standard minimum. It was also agreed upon that this standard should be set at a level
that is consistent with the objective of securing over-time soundly-based and consistent capital ratios for all international banks.\textsuperscript{55} A target standard ratio of 8\% has been agreed upon by the countries involved. By specifying a certain level of capital adequacy, the Basle Agreement’s target is to subject international banks to the control of the Central banks that had signed on the agreement of increasing their capital base.

The full period to end-1992 is available to ensure progressive steps towards the adjustment of banks whose ratios are presently below the 8\%. However, an interim target date has been set at the end of 1990 when the minimum ratio will be 7.25\%.\textsuperscript{56} This transitional period was proposed to allow for any necessary adjustments by individual banks who need time to build up their capital ratios towards the ultimate target standard. This is needed to facilitate smooth adjustment and phasing of the new arrangements within a wide variety of existing supervisory systems.

During the transitional period, and throughout all the process of capital adequacy rehabilitation, several arrangements were done and conditions were being set on a progressive basis, thus allowing small banks and banks in less developed countries some freedom and time span to catch their breath and work effectively toward the achievement of the required minimum set standards. Each country will decide the way in which the supervisory authorities will introduce and apply Basle Accord’s recommendations and regulations in the light of their different legal structures and existing supervisory arrangements. In some countries, changes in the capital regime may require lengthy procedures to be implemented. In this respect, national

\textsuperscript{55} Banking World, Playing by the same Rules, Vol.6, Jan. 1988, P.12
authorities in every country were intended to prepare papers setting out their views on the timetable and the manner in which the committee’s results will be implemented in their respective countries. Every country was left with the freedom of operating to achieve these new criteria on condition that they follow the agreed-upon accounting principles and the market conditions of each specific country. National authorities were held free to adopt arrangements that set still higher levels.

4.2 The Body of Basle Accord

Basle accord defines the capital to be included in banks’ capital base and applies a risk weighting system to each of the bank’s assets and off-balance-sheet items to determine whether the bank complies with the target or minimum standard capital ratio. Capital is a bank’s ultimate line of defense against losses and so a true measure of its strength. It provides the basis for the Basle committee’s new system of weighted-asset ratios and so brings off-balance-sheet business back into account. "It has been given a standard definition and so cuts through the ticket of inconsistent accounting practices across the world". 57

The Basle proposal defined capital adequacy ratio as capital divided by risky assets and off-balance-sheet items, and divided the capital of a certain bank into two parts; tier 1 or “core capital” and tier 2 or “supplementary capital”. In addition, it specified that at least half the bank’s capital base must consist of “core capital”, namely equity and disclosed reserves. The other half may consist of “supplementary capital” such as revaluation reserves and general provisions. This accord concentrates on relating the capital requirements of the
bank to the risks that stems from its various operations regardless whether these operations are considered as part of the balance-sheet or are off-balance-sheet items. Bank activities that are termed off-balance-sheet, in that their present form does not involve a capital demand on the bank, can still carry an element of credit risk. It is important, therefore, that such risks are captured in every capital adequacy evaluation.

Off-balance-sheet exposures are converted to equivalent on-balance-sheet assets by use of simple multiplying factors. The conversion of off-balance-sheet items into on-balance-sheet equivalents has a particularly important bearing on those banks which wish to reduce the size of their balance-sheet by securitising assets. Basle accord stated that much also depends on the quality of a bank's assets and the level of provisions a bank may be holding outside its capital against assets of doubtful value.

In calculating the capital requirements, off-balance-sheet items will be taken into account by using a credit conversion factor to establish their credit risk equivalent. Assets and off-balance-sheet exposure are to be weighted according to their degree of risk on a scale of five weightings from zero to 100%. These weightings are aimed to reflect the degree of risk involved in different types of transactions, ranging from 100% for claims on the private sector down to zero for items like cash and claims on the home central bank.58

Furthermore, in specifying a minimum level of capital to risky assets ratio, Basle agreement takes into consideration certain other factors that may lead to the improvement of this ratio; factors such as solvency, management

efficiency, and asset revaluation. Finally, it gives a general framework that will help in ranking banking operations into several categories of risk, each with different weights, in addition to numerous procedures to calculate risk. All this was set in order to attain the ultimate ratio of capital to risky assets “risk based capital ratio”.

4.3 Risk Weights Assignment

After describing in brief the main features of the Basle Accord, let me discuss how capital and assets were broken down into items of different qualities in order to facilitate the assignment of risk weights to each and every category. As a first step, and as mentioned before in brief, capital was divided into tier 1 capital (core capital) and tier 2 (supplementary capital). The core capital is considered as the only agreed-upon element among the different banking systems, and it is usually published in the final closing accounts. It is considered as a base for calculating profit margins, capital adequacy and competitiveness of a certain bank.

4.3.1 Core capital: Core capital’s two main components are.59

i. Equity capital: It is constituted of 3 sub components

   - Ordinary common stocks issued and fully paid
   - Non-cumulative preference perpetual shares
   - Legal reserves

59 Andrew Canning, Op. Cit., P.192
ii. **Disclosed reserves**: it is constituted of 3 sub components

- Share premiums
- Retained profit
- General reserves

In this context one can say that the ability of a bank's capital to absorb losses is clearly visible to potential investors through published accounts. Disclosed reserves that are not identified with any specific task also provide a suitable source of capital funds.

4.3.2 **Supplementary capital**

Supplementary capital is also important in the constitution of capital because its constituents are structured in such a manner that they are able to absorb losses in case a certain bank loses access to other funding or becomes insolvent.

It is constituted of the following items: 60

i- **Undisclosed reserves**: Secret or hidden reserves that do not appear in the final closing accounts until they are published.

ii- **General provisions / loan loss reserves**: These reserves are generally held to face any future losses. Basle Agreement has specified its percentage after the ending of the transition period (1992), not to exceed 1.25% of risky assets and it can be increased to 2% temporarily and only in case of exceptions.

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60 Union of Arab banks, Basle Committee’s requirements on capital adequacy and its effects on Arab banks (in Arabic), P.20
iii- Hybrid capital instruments (debt/equity): Under this category comes a number of capital instruments that contains several kinds of stocks and loan instruments which should be fully eligible for participation in losses.

iv- subordinated term debt: It combines subordinated debts whose maturities exceed 5 years because these instruments are not eligible for losses except in case of liquidation. Its percentage has been specified in a way not to exceed 50% of the core capital.

v- Asset revaluation reserves: They initiate from the revaluation of assets to show its current market value instead of its book value. They are subject to a discount of 55% when included in the capital.

It is worth mentioning here that there's now a growing debate over whether the potential sale value of banks' assets should be included as part of a bank's capital base. Land and Building are a potential rich source of capital for banks struggling to meet the new Basle ratios. They can sell them off to raise new resources. Disposals, whether of property holdings or other types of assets, are a perfectly legitimate way for banks to boost capital ratios. But some strong differences are emerging among the Basle signatories over including sale values in banks' capital bases. ⁶¹

In the original Basel accord of 1988 this was one of the areas where a good deal of discretion was left for countries to adapt the basic rules to their own structures and traditions. Even more controversial is the valuation of fixed assets, particularly banks' own premises. In countries where periodical

revaluations of Land and Buildings are undertaken, they are done on the basis of existing use or replacement value.

At present, revaluation reserves related to tangible fixed assets are included in tier two capital and other revaluation reserves including those related to fixed asset investments are included in tier one. The directive requires all revaluation reserves to be included in tier two capital. It is important, however, that such revaluations should be prudently and only infrequently undertaken taking into account possible future fluctuations in values as well as past experience. But banks need to remember that like investments in stock markets, property values can go down as well as up.

The core elements of capital must provide for at least 50% of the bank’s capital base. And tier two capital elements will be limited to an aggregate value equal to that of the core capital. The inclusion of tier 1 and 2 elements into the capital base is subject to several limitations and takes into account the credit risk of each item and its respective risk weight.

4.3.3. Risk Weights

In general, banking operations are subject to credit risk that initiates from the inability of the counterparty to payback, foreign exchange fluctuation risks, and risk of fluctuation in interest rates. In this context, assets were classified, according to their relevant risks, into five categories of risk: zero %, 10%, 20%, 50%, and 100%. Different asset components are assigned specific risk weights and the required amount of capital is set in relation to the sum of risk-weighted assets.
The risk weighting under Basle proposal is as follows.62

A zero% risk weighting is to be applied to the following assets:
- Cash
- Claims on domestic government
- Claims against other Governments, if denominated and funded in local currency.

A 20% risk weighting is to be applied to the following assets:
- Short term claims on banks
- Cash items in the process of collection.

A 50% risk weighting is to be applied on the following assets:
- Full secured loans on residential property
- Certain payments and accrued income.

A 100% risk weighting is to be applied to the following assets:
- Claims on private sector
- Intangible assets.

Table 4.1 shows detailed risk weight allocation of on-balance sheet items.

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62 Committee on banking regulations and Supervisory practices, International convergence of capital measurement and capital standards, Basle July 1988, P. 10
<table>
<thead>
<tr>
<th>On-Balance sheet items</th>
<th>risk weight (in %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash in vault</td>
<td>0</td>
</tr>
<tr>
<td>Central Bank</td>
<td>0</td>
</tr>
<tr>
<td>Lebanese treasury bills</td>
<td>0</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>20</td>
</tr>
<tr>
<td>Medium and long term banks</td>
<td>20</td>
</tr>
<tr>
<td>Financial institutions</td>
<td>20</td>
</tr>
<tr>
<td>Other Financial institutions</td>
<td>20</td>
</tr>
<tr>
<td>Head Office and Branches</td>
<td>20</td>
</tr>
<tr>
<td>Parent Co., Foreign sister, and Subsidiary</td>
<td>20</td>
</tr>
<tr>
<td>Checks purchased</td>
<td>20</td>
</tr>
<tr>
<td>Doubtful loans from Banks</td>
<td>100</td>
</tr>
<tr>
<td>Discounted Bills</td>
<td>100</td>
</tr>
<tr>
<td>Short term Customer loans</td>
<td>50</td>
</tr>
<tr>
<td>Medium and long term Customer loans</td>
<td>50</td>
</tr>
<tr>
<td>Loans to the Board of Directors</td>
<td>50</td>
</tr>
<tr>
<td>Loans to the public sector</td>
<td>0</td>
</tr>
<tr>
<td>Doubtful Customer loans</td>
<td>100</td>
</tr>
<tr>
<td>Debtors by acceptances</td>
<td>20</td>
</tr>
<tr>
<td>Investment Securities</td>
<td>20</td>
</tr>
<tr>
<td>Other assets</td>
<td>20</td>
</tr>
<tr>
<td>Other Debtors</td>
<td>50</td>
</tr>
<tr>
<td>Orders and Regularizations accounts</td>
<td>20</td>
</tr>
<tr>
<td>Obligatory Financial Assets</td>
<td>0</td>
</tr>
<tr>
<td>Financial fixed Assets for Investment</td>
<td>100</td>
</tr>
<tr>
<td>Non-Financial fixed Assets</td>
<td>20</td>
</tr>
<tr>
<td>Revaluation Assets</td>
<td>20</td>
</tr>
</tbody>
</table>

This method of risk classification provides equal comparison standards among different banking systems and allows the inclusion of off-balance-sheet items into the measurement procedure. Consequently, all categories of off-balance-sheet engagements will be converted to credit risk equivalents by multiplying the nominal principal amounts by a credit conversion factor. The
resulting amounts then being weighted according to the nature of the counterparty. The elements of off-balance sheet items and their correspondent credit conversion factors are: 63

* Bank acceptance guarantees and letters of credit 100%
* Performance bonds, bid bonds, warranties 50%
* L/Cs collateralized by underlying shipments 20%
* Short-term commitments 0%

In the light of all these requirements, the Basle Committee has decided to categorize world countries in groups as a base to measure risks in a way that the first group includes the OECD partner countries as well as Saudi Arabia and Switzerland. The second Group includes other non-OECD countries. As a result of this decision, the debts of Central Governments in the first group countries are given a zero% risk weight, while the debts on public sector establishments in this group, except Central Governments, will be allocated a low risk weight. As for the debts of Governments and Central banks of the second group they were given a zero% weight on condition that debts are in the local currency and are financed by same currency requirements.

Debts on all banks whose maturities do not exceed one year, were given equal risk weights of 20% while in the case of debts whose maturities exceed one year, there was a difference between banks that were established in the first group countries (20% risk weight) and banks of the second group (100% risk weight). 64

63 ibid, P.15
64 Union of Arab banks, Basle Accord requirements on capital adequacy and its affect on Arab banks (in Arabic), P.25-26
In what concerns guarantees and securities, loans secured by cash, loans secured by debt instruments issued by Central Governments in the first group countries, loans secured by debt instruments issued by a specific number of international development banks were given a zero % risk weight or a very low one.

Loans guaranteed by the banks that were established in the first group countries were given a 20% risk weight regardless of its remaining maturity. While loans guaranteed by the banks of the second group countries were allocated a 20% risk weight only when their maturity do not exceed one year.\textsuperscript{65}

As a result, one should take into consideration that the differentiation between first and second group countries will leave a negative effect on the competitiveness of banks that were established in the second group countries and on banks that have loans to the Central Governments and the public sector establishments of the second group countries.

\textsuperscript{65}ibid
CHAPTER V
ADOPTION OF BASLE ACCORD’S REQUIREMENTS BY BDL

The purpose of this chapter is to see to what extent Lebanese commercial banks have implemented Banque du Liban’s (BDL) requirements of capital adequacy that were set in the light of Basle Accord. In the first part of the chapter, the Bankers’ Association’s (BA) and BDL’s efforts in the process of capital adequacy rehabilitation are exposed. In the second part, a sample of 12 Lebanese commercial banks will be classified into four categories according to their size. Then, their capital and capital adequacy levels will be analyzed and past performances will be compared to evaluate the efficiency of the banking sector.

5.1- Need for Adoption:

Central banks of any country are in charge of securing a stable money market and a healthy banking sector because commercial banks are the recipients through which all changes in monetary market instruments will pass. In addition, Central banks are the last resort of credit, especially when confidence in the banking sector as a whole becomes suspected. For this reason, supervisory authorities and bank Governors of the Industrialized countries adopted Basle Committee’s regulations with a common concern, which is to put restrictions in the face of the enormous development in the banking sector, and to safeguard it against future risks and damages that may

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66 Union of arab banks, Procedures that were taken by Arab Monetary Authorities to execute Bsle Committee’s regulations, 1993, P. 122
threaten its existence as a result of the expansion of its operations far beyond reasonable limits.

Lebanon, in turn, wished to return to its past position as a distinguished financial and banking sector in the Middle East. Therefore, Lebanese monetary authorities found it most appropriate to adopt this new international banking criterion. The Central bank of Lebanon, in its attempt to apply capital adequacy levels that were set by the Basle Committee, did not take into consideration the same reasons that the international countries took. In Lebanon, several other and different considerations were stressed.

5.2- Reasons for Adoption:

During the civil war, several commercial banks became undercapitalized and stopped serving their customers as a result of mismanagement and of the illegal and immoral practices that were made by managers at that time. Moreover, this was the case due to the absence of adequate laws and of supervisory authorities in a period in which presence of above authorities was very crucial.

The problem that made the situation worse was that Lebanese banks were requested by law to have capital and assets in the Lebanese pound. Thus, during the war, and due to the drastic decrease in the value of the Lebanese pound against the USDollar, the capital of the Lebanese banks decreased to unacceptable minimal levels.67 (Figures were shown in detail in chapter 2 section # 2.2.3)

67 Ibid, P.124
In fact, if one studies the capital adequacy of the Lebanese banking system in depth, one feels relieved because Lebanese banks have hidden reserves in the form of approved foreign exchange positions and real estate assets that are recorded in balance sheets at historical costs. These reserves, if revalued at market prices, will no doubt increase capital adequacy to great levels. Despite this fact, it is urgent to try to improve the apparent capital adequacy of the Lebanese banking sector to improve local as well as international confidence in the Lebanese banking sector and to provide additional guarantees for depositors and investors. On the other hand, it would be unfair for the Lebanese banking sector to lag behind at a time in which all countries are heading toward the establishment of a minimum capital adequacy level set according to international common conditions.

The adoption by the Central Bank of Basle Committee’s regulations was thought to be the cure for all the disorders and disorganization in the banking sector. But it was not reasonable for Lebanese commercial banks to apply Basle requirements with the same conditions and time span specified for international banks. The implementation process in Lebanon was formulated and tailored in accordance with its special political and economic circumstances. In other words, one can see that the formulation of plans was set in 1992, at the time when all industrialized countries were supposed to have achieved the proposed capital adequacy level.
5.3 Measures Taken:

Within this framework, BDL formed in February 1992 a committee to study the solvency of Lebanese banks and to propose a new solvency ratio that conforms to the fundamental principles proposed by the Basle Committee, taking into consideration the special conditions and circumstances within which the Lebanese banking sector operates. The Committee formulated its report after five months of continuous work. This report included in it: observations, remarks, and final findings in addition to the Committee’s proposed comprehensive plan concerning the new solvency ratio.

The important reasons for which it was necessary to set new levels of adequacy in Lebanese banks were specified by the Committee to be.68

First: It would not be fair or adequate that the developed and dynamic Lebanese banking sector which was a leader in the Arab East to fail in meeting international criteria especially in what concerns adequacy.

Second: The crisis that affected a number of Lebanese banks in the last few years, proved or enlightened the importance of capital in safeguarding banks and immunizing them, and consequently providing a guarantee to protect the rights of depositors.

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68 Solvency study Committee, Report dated 25.06.92
Third: The Lebanese banking sector should not continue without a specified adequacy ratio, especially when it couldn't apply adequacy requirements that were set in 1983.

This Committee studied carefully Basle agreement and reviewed how capital adequacy requirements have been applied in countries that enjoy advanced banking systems. Then, it analyzed the status-quo of capital and its adequacy levels in the Lebanese commercial banks. Moreover, it conducted a study based on the publicized balance sheets and the Banking Control Commission's (BCC) information to find out the degree of responsiveness of the banking sector to capital adequacy requirements that fit international levels specified by the Basle agreement. What has been considered as a relief for the Committee was that the studies proved that the implementation of the proposed adequacy levels will not be so difficult.  

5.4-Implementation Procedure:

The Committee's project was subject to discussion in the Central Council of the Bank of Lebanon and with the Bankers' Association. In addition, the International Monetary Fund (IMF) had a look at it and gave its comments. As a result, the Central Council of BDL presented the final formulation of the project under decree number 5064 issued in circular number 1114 dated August 12, 1992.

In this decree, The Governor of BDL adopted the most important principles of the Basle Accord and fixed the criteria for evaluating the solvency measure of Lebanese banks on the basis of capital ratio to assets weighted by risk weights.

Ibid
and to off-balance sheet items multiplied by credit conversion factors and the risk weights of their corresponding assets. An 8% capital adequacy level was set to be applied by all Lebanese banks as of February 15, 1995. (This deadline was extended on 02/03/95 up to 31/03/95 in BDL circular number 5794)\textsuperscript{70}.

During the period from the issuance of circular 1114 till February 15, 1995, a transition period was specified during which capital adequacy level of all Lebanese banks should not fall below the following levels:\textsuperscript{71}

- 4% starting 15/02/93
- 5% starting 15/08/93
- 6% starting 15/02/94
- 7% starting 15/08/94

Moreover, capital elements were classified as follows:

**Core capital**: includes the stable monetary elements in the capital such as:
- Paid-up capital
- Legal, free and systematic reserves
- Cash contributions to capital
- Positive retained earnings

**Supplementary capital**: includes the auxiliary elements of capital such as:
- Subordinated term debts
- Asset revaluation gains
- General provisions for loan losses.

---
\textsuperscript{70} Bankers’ Association, Internal publication, Feb. 94, P. 13
\textsuperscript{71} BDL circular # 1114 dated August 12, 1992
The inclusion of supplementary capital in the core capital was allowed for banks during the transition period. A schedule was formulated in which percentages of inclusion were set according to the following time table:

- 20% at 15/08/93
- 15% at 15/02/94
- 10% at 15/08/94
- 0% at 15/02/95

In conformity with the recommendations of Basle agreement, decree number 5064 stated that in the process of calculating the capital adequacy level, core capital should be equal to supplementary capital and double the volume of subordinated loans. General risk and loss provisions level should not be more than 1.25% of the value of the denominator.\(^2\)

Lebanese banks were allowed, during the period ending March 15, 1995, to revaluate their fully owned assets in Lebanon (Land + Bldg.) except those assets that were acquired in settlement of bad debts. Proceeds from the revaluation procedure were permitted to be included in the capital of banks if three conditions are fulfilled:

- If the revaluation process is approved by the Central Board of BDL
- If banks have an 8% capital adequacy level or if they are proceeding with the revaluation process to attain this level.
- Capital to be increased in 2 ways:

\(^2\) BDL circular # 160, dated 02.03.95, P.3
a- 50% of revaluation proceeds to be added to supplementary capital

b- An equal amount as above to be added in the form of cash contributions

5.4.1-Risk weights of On-Balance sheet items:

To calculate capital adequacy level, assets were allocated different risk weights according to the level of risk each one entails (Table 5.1)\textsuperscript{73}

<table>
<thead>
<tr>
<th>ON- BALANCE SHEET ITEMS</th>
<th>RISK WEIGHTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash in vault</td>
<td>0%</td>
</tr>
<tr>
<td>Central bank</td>
<td>0%</td>
</tr>
<tr>
<td>Precious metals</td>
<td>0%</td>
</tr>
<tr>
<td>Lebanese Treasury Bills</td>
<td>0%</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>20%</td>
</tr>
<tr>
<td>Medium and Long term banks</td>
<td>20%</td>
</tr>
<tr>
<td>Financial institutions</td>
<td>20%</td>
</tr>
<tr>
<td>Other financial institutions</td>
<td>100%</td>
</tr>
<tr>
<td>Head Office and branches</td>
<td>50%</td>
</tr>
<tr>
<td>Parent Co. Foreign sister &amp; Subsidiary</td>
<td>50%</td>
</tr>
<tr>
<td>Purchased checks</td>
<td>50%</td>
</tr>
<tr>
<td>Doubtful loans for banks</td>
<td>100%</td>
</tr>
<tr>
<td>Discounted bills</td>
<td>100%</td>
</tr>
<tr>
<td>Short term customer loans</td>
<td>100%</td>
</tr>
</tbody>
</table>

\textsuperscript{73} Ibid
Table 5.1 (Continue)

Risk Weights (in percentage)

<table>
<thead>
<tr>
<th>ON-BALANCE SHEET ITEMS</th>
<th>RISK WEIGHTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medium &amp; Long term customer loans</td>
<td>100%</td>
</tr>
<tr>
<td>Loans to Board of Directors</td>
<td>100%</td>
</tr>
<tr>
<td>Loans to Public sector</td>
<td>100%</td>
</tr>
<tr>
<td>Doubtful customer loans</td>
<td>100%</td>
</tr>
<tr>
<td>Debtors by Acceptances</td>
<td>100%</td>
</tr>
<tr>
<td>Investment securities</td>
<td>100%</td>
</tr>
<tr>
<td>Other assets</td>
<td>100%</td>
</tr>
<tr>
<td>Other debtors</td>
<td>100%</td>
</tr>
<tr>
<td>Non financial fixed assets</td>
<td>100%</td>
</tr>
<tr>
<td>Orders and regularizations accounts</td>
<td>50%</td>
</tr>
<tr>
<td>Obligatory financial assets</td>
<td>0%</td>
</tr>
<tr>
<td>Revaluation reserves</td>
<td>0%</td>
</tr>
</tbody>
</table>

Off-balance sheet items were allocated credit conversion factors as follows (Table 5.2)

Table 5.2

Credit Conversion Factors (in percentage)

<table>
<thead>
<tr>
<th>Off-Balance Sheet items</th>
<th>Credit Conversion Factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non collateralized letters of credit</td>
<td>100%</td>
</tr>
<tr>
<td>Other letters of Gtee &amp; Acceptances</td>
<td>100%</td>
</tr>
<tr>
<td>Performance letters of guarantee</td>
<td>50%</td>
</tr>
<tr>
<td>Bid Bond LGs</td>
<td>50%</td>
</tr>
<tr>
<td>Collateralized letters of credit</td>
<td>50%</td>
</tr>
<tr>
<td>Currency contracts &gt; 1 year</td>
<td>8%</td>
</tr>
<tr>
<td>Currency contracts &lt; 1 year</td>
<td>4%</td>
</tr>
<tr>
<td>Interest rate contracts &gt; 1 year</td>
<td>2%</td>
</tr>
<tr>
<td>Interest rate contracts &lt; 1 year</td>
<td>1%</td>
</tr>
</tbody>
</table>

Source: BDL circular #160

These principles of the solvency study Committee were adopted by BDL without debates. Nevertheless, there appeared other issues that were controversial and that raised special debates. Some of these controversies were:

74 Solvency study committee, report dated 25.06.92, P.10
A- Basle Agreement specified in its report that subordinated term debts should be included in the supplementary capital and should not account for more than 50% of core capital. Members of the Lebanese committee demanded that subordinated term debts be included temporarily in the core capital.

B- In what concerns risk weights of assets, only one item was amended. The Lebanese Committee had put a 20% weight on commitments in favour of Governments and banks of low risk & OECD countries while Basle agreement allocated a zero% risk weight for this item.

C- The Lebanese Committee had specified a 75% risk weight for the loans that are guaranteed by assets occupied by the debtor, while a 50% risk weight was allocated by the Basle committee for this same item.

D- Off-balance sheet items were allocated more strict risk weights in this report than those allocated in the Basle agreement.

In order to know in advance to what extent the application of its requirements concerning the optimal capital adequacy level will be adopted by Lebanese commercial banks, BCC prepared an initial study in December 31st, 1991 concerning the disparity between the net book values after
depreciation and the market values of real estates owned by banks in accordance with Article number 153. The Commission requested from each bank operating in Lebanon to provide it with a list of all its real estate holdings showing, on the one hand its book value, and on the other, its market value as estimated by the bank itself.

The figures of its study were obtained from the publicized balance sheets of 70 operating banks as of December 31st, 1991, and from banks' individual estimations of the real values of their assets. The results indicated that total capital of the seventy banks amounted to LL. 160 billions distributed as follows:\textsuperscript{75}

1- Core capital: LL. 105 million
2- Supplementary capital: LL. 55 billion

The Committee found that 68 banks have real estates for LL.8.5 billion (USD 9.6 million) recorded at historical costs, while the real or market value of those assets were estimated by banks at USD 153 million. According to the study, Lebanese banks needed to provide a maximum amount of USD 100 million (25\% revaluation gain, 25\% cash contribution), during a period of 30 months.

It is worth mentioning here that decree number 4893 issued in circular 1090 dated March 30th, 1991 requested Lebanese banks to increase their

\textsuperscript{75} Ibid, P. 13
capital, before August 19, 1994 to LL.1 billion for head quarters and LL.100 million for each branch. Preliminary studies of the Committee showed that as soon as this decree is set into practice, capital adequacy level of 50% of operating banks will surpass the 8% average.

Banks that will be unable to meet the minimum capital adequacy standards will have to merge with other strong banks or will be self-liquidated. Otherwise, BDL has the right to take measures that will forbid those banks from expanding their operations by increasing credits to the community or by expanding into new branches. In that case, the IMF will authorize BDL to intervene by requiring those banks to decrease their volume of assets to match capital levels.

5.5-Capital Adequacy Measurement:

In general, the economic and banking situation in Lebanon improved a lot in the early nineties because of the political stability in the country. Development of the various sectors was accelerated as a result of the reforms that various Lebanese Authorities had undertook to bring back confidence in Lebanese capabilities. The new capital adequacy requirements that were set by BDL had posed noticeable restrictions on the operating and practical policies of banks. Small as well as large banks needed a rehabilitation process, especially in what relates to the build-up of their capital levels. Therefore,
banks needed to resort to external as well as internal financing devises to meet
the set requirements.

- **External financing:** it could be generated from issuance of common or
  preferred stocks, subordinated loans, sale of fixed assets or the lease of
  some of banks’ properties.

- **Internal financing:** it could be generated internally from the retention of
  some of the banks’ profits (Retained Earnings).\(^\text{76}\)

Large banks had no trouble in facing restrictions because they usually
have wide access to money markets abroad that facilitates the procedure of
stock issuance. On the other hand, small banks were greatly affected because
of their inability of attracting new investors by selling stocks or granting loans.
In that case, those banks found themselves obliged to generate capital funds
internally, i.e., by increasing their level of retained earnings. Table 5.3 shows the
level of retained earnings of commercial banks from 1991 till end 1993.

**Table 5.3**

<table>
<thead>
<tr>
<th>Period</th>
<th>R/E in millions of LL</th>
<th>R/E in millions of USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>4,084,017</td>
<td>4.646</td>
</tr>
<tr>
<td>1992</td>
<td>4,460,461</td>
<td>2.427</td>
</tr>
<tr>
<td>1993</td>
<td>5,121,438</td>
<td>2.993</td>
</tr>
</tbody>
</table>

Source: Freddie Baz, Bilanbanques 93, 94

The political stability which lasted since 1992, and the resulting
economic developments had a positive and immediate influence on banking

\(^{76}\) Bankers’ Association, Internal publication, Feb 95, p.31
activities and enabled a large number of banks to strengthen their financial structure. There was a significant real growth after the stagnation that characterized activity in 1988-1990. Risk weighted assets in 1992 increased from LL.3179.5 billion in 1991 to LL.7248.6 billion. At the same time, capital levels increased from LL.180 billion to LL.530.6 billion. Calculated on this basis, bank capital adequacy increased from 5.85% in 1991 to 7.32% in 1992.77

The improvement in bank capital adequacy was generally observed through the following factors:

1) The concentration of capital increased significantly. The share of the leading 12 banks in the total grew from 46.6% in 1991 to 64% in 1993.

2) In 1992, 24 out of 72 banks had a capital adequacy ratio higher than 8% while 17 only scored higher in 1991 and 29 banks enjoyed a ratio higher than the sector's average (7.32%). Finally, there were 23 banks with a ratio less than 3% in 1992 compared to 31 banks in 1991.78

In 1993, risk weighted assets increased from LL.7248.6 billion in 1992 to LL.8756.3 billion. At the same time, shareholders’ equity increased from LL.494.6 billion in 1992 to LL.713.6 billion. Accordingly, capital adequacy ratio

77 Freddie Baz, Bilanbanques, 1993, P.29
78 Freddie Baz, Bilanbanques, 1993, P.722
increased from 7.32% in 1992 to 8.18% in 1993. Thirty seven out of the 71 banks had a capital adequacy ratio higher than 8% (the limit set by Basle agreement), and 37 banks enjoyed a ratio higher than that of the whole sector (8.18%). And finally, there were 17 banks with a ratio less than 3%.

During the year 1994, improvement of economic conditions was accelerated, and the banking sector kept growing healthily so that the consolidated balance sheet of commercial banks increased from LL. 14082 billion ($ 7662 million) in 1992 to LL. 18271 billion ($ 10679 million) in 1993 to LL. 23006 billion ($ 14255 million) in Jan. 1994 to reach LL. 24285 billion ($ 14745 million) by the end of the year. This growth was noticed in the various items that constitute the balance sheet. The total level of deposits increased from LL. 15801 billion ($ 9235 million) in December 93 to LL. 20081 billion ($ 12126 million) in November 94 and up to LL. 20605 billion ($ 12510 million) by the end of the year. (see Table 5.4 & figure 5.4)

Table 5.4
Total deposits in millions of USD

<table>
<thead>
<tr>
<th>Year</th>
<th>Total deposits</th>
<th>Deposits in LL.(CV in USD)</th>
<th>Deposits in USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>4833.7</td>
<td>1572</td>
<td>3261</td>
</tr>
<tr>
<td>1990</td>
<td>4471</td>
<td>1182</td>
<td>3289</td>
</tr>
<tr>
<td>1991</td>
<td>6234</td>
<td>1978</td>
<td>4256</td>
</tr>
<tr>
<td>1992</td>
<td>6566</td>
<td>2011</td>
<td>4555</td>
</tr>
<tr>
<td>1993</td>
<td>9235</td>
<td>2773</td>
<td>6462</td>
</tr>
<tr>
<td>1994</td>
<td>12510</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Figure 5.4
Total Deposits
5.6.1- The level of Capital

The most important criteria and which requires more attention is the level of capital. From year 1992 up to this date, capital of commercial banks kept increasing to meet international levels that were set by Basle Committee and BDL's level that was scheduled to be achieved by March 31st, 1995. If one observes the change in capital levels that happened between Jan. and Dec. 94, he will feel relieved as capital increased from LL.611 billion in Jan. 94 up to LL. 676 billion in Dec. 94. An improvement in the capital adequacy was witnessed by the end of year 1994. The ratio of investment capital to total assets moved from 2.4% in 1993 to 2.8% in 1994. The rise was the result of a 68.1% growth in the banks' core capital (accounting for 90.3% of the total against 81.7% in 1993, and a 19.3% decline in the banks' supplementary capital).

Based on the above, one can notice the seriousness and effectiveness in which commercial banks in general are working toward the elevation of the whole banking sector from its dark era into an international setting capable of reflecting the true image of the Lebanese banking sector in specific and of Lebanon in general. Table 5.5 shows in detail the growth trend of capital (cor + supplementary) from 1988 to February 1995.
Table 5.5
Total capital of commercial banks
in Millions of LL. (1988-Feb.95)

<table>
<thead>
<tr>
<th>Period</th>
<th>Core Capital</th>
<th>Supplementary Capital</th>
<th>Total capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>11267</td>
<td>14409</td>
<td>25676</td>
</tr>
<tr>
<td>1989</td>
<td>21400</td>
<td>21309</td>
<td>42709</td>
</tr>
<tr>
<td>1990</td>
<td>33380</td>
<td>70552</td>
<td>103932</td>
</tr>
<tr>
<td>1991</td>
<td>63629</td>
<td>84258</td>
<td>147887</td>
</tr>
<tr>
<td>1992</td>
<td>184008</td>
<td>79557</td>
<td>263565</td>
</tr>
<tr>
<td>Sept.93</td>
<td>291694</td>
<td>93128</td>
<td>384694</td>
</tr>
<tr>
<td>1993</td>
<td>363139</td>
<td>90933</td>
<td>444072</td>
</tr>
<tr>
<td>Feb.94</td>
<td>379224</td>
<td>78329</td>
<td>457553</td>
</tr>
<tr>
<td>Sept.94</td>
<td>533684</td>
<td>66514</td>
<td>600198</td>
</tr>
<tr>
<td>1994</td>
<td>610571</td>
<td>65273</td>
<td>675844</td>
</tr>
<tr>
<td>Jan.95</td>
<td>651382</td>
<td>62462</td>
<td>713644</td>
</tr>
<tr>
<td>Feb.95</td>
<td>--</td>
<td>--</td>
<td>721600</td>
</tr>
</tbody>
</table>

Source: -BDL quarterly bulletin, various issues
- Bankers' Association's internal publications, Jan. & Feb. 95

By examining Table 5.5 carefully, one notices that banks were decreasing relatively the level of supplementary capital as compared to core and total capital. In its Circular No. 1114 dated August 12, 1994, BDL had put some restrictions to the inclusion of supplementary capital in the total capital and, as it was mentioned before, it scheduled the trend in which the above inclusion was to be achieved. The inclusion percentage decreased from 211.4% in 1990, to 132.4% in 1991, 22.3% in 1993 and 9.5% in January 1995. This diminishing trend seems very satisfactory, but if one compares it to the set schedule, one notices that further improvements are to be done. In Table 5.6 below, the above mentioned percentages will be compared to the required ones.
Table 5.6  
Percentage inclusion of supplementary capital into core & total capital

<table>
<thead>
<tr>
<th>Period</th>
<th>Required %</th>
<th>Supp.Capital</th>
<th>% of core</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>--</td>
<td>14409</td>
<td>125</td>
<td>56</td>
</tr>
<tr>
<td>1989</td>
<td>--</td>
<td>21309</td>
<td>99.6</td>
<td>50</td>
</tr>
<tr>
<td>1990</td>
<td>--</td>
<td>70552</td>
<td>211.4</td>
<td>68</td>
</tr>
<tr>
<td>1991</td>
<td>--</td>
<td>84258</td>
<td>132.4</td>
<td>57</td>
</tr>
<tr>
<td>1992</td>
<td>--</td>
<td>79557</td>
<td>43</td>
<td>30</td>
</tr>
<tr>
<td>Sept.93</td>
<td>20%</td>
<td>93128</td>
<td>32</td>
<td>24.2</td>
</tr>
<tr>
<td>1993</td>
<td>--</td>
<td>80933</td>
<td>22.3</td>
<td>18.2</td>
</tr>
<tr>
<td>Feb.94</td>
<td>15%</td>
<td>78329</td>
<td>20.6</td>
<td>17</td>
</tr>
<tr>
<td>Sept.94</td>
<td>10%</td>
<td>66514</td>
<td>12.5</td>
<td>11</td>
</tr>
<tr>
<td>1994</td>
<td>--</td>
<td>65273</td>
<td>10.7</td>
<td>9.6</td>
</tr>
<tr>
<td>Jan.95</td>
<td>--</td>
<td>62462</td>
<td>9.5</td>
<td>9.8</td>
</tr>
<tr>
<td>Feb.95</td>
<td>0%</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
</tbody>
</table>

Source: Bankers’ Association’s internal publication, Feb.95

Table 5.6 reflects the fact that commercial banks were committing real efforts in the attempt of applying BDL’s requirements especially in what concerns the compliance with specified levels of Supplementary capital that will be included in the total capital.

Finally, one can conclude that the performance of the banking sector as a whole was greatly affected by the stable political and economic conditions. This was clearly shown by the analysis that was done to several Balance Sheet items of the banking sector.
For simplicity, and to provide the ground for a relatively accurate analysis concerning banks’ capital adequacy, commercial banks will be classified into four categories according to their size (level of deposits): 79

- Alpha Group banks: deposits over $ 200 Million
- Beta Group banks: deposits between $ 50 & $ 200 Million
- Gamma Group banks: deposits between $ 20 & $ 50 Million
- Delta Group banks: deposits under $ 20 Million

The analysis procedure will be conducted by choosing from every group a random sample of three banks. Those banks will be examined, and their performance compared to the overall performance of all operating banks for a period of seven years from 1987 till 1993. In this critical time period, no recent information could be obtained from BDL, BSS, and BA because banks’ performance assessment is still in process. Moreover, Balance Sheets of individual banks are not yet finalized nor audited. Therefore this study will be limited to the above mentioned time period. This time period will enable one to compare performance of banks prior to the existence of Basle Accord, Prior to the formulation of BDL Circular N° 1114 and the aftermath of above circular.

The banks that will be examined are:

* Alpha group: Banque du Liban et D’Outre Mer, Banque de la Mediterranee, Fransabank.


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79 Freddie Baz, Bilanbanques, 1993
* Gamma Group: Jammal Trust Bank, Banque de la Bekaa, Metropolitan Bank


Table 5.7 shows the 12 chosen banks with their share capital levels, as of December 31st, 1994.

Table 5.7
Capital of commercial banks
In millions of LL.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Mediterranee</td>
<td>7122.6</td>
<td>7094.8</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>25240*</td>
<td>23434.4*</td>
</tr>
<tr>
<td>BLCM</td>
<td>200</td>
<td>200</td>
<td>1000</td>
<td>3000</td>
<td>3000</td>
<td>18000</td>
<td>30844</td>
</tr>
<tr>
<td>FransaBk</td>
<td>40</td>
<td>300</td>
<td>1000</td>
<td>---</td>
<td>5000</td>
<td>8800</td>
<td>8800</td>
</tr>
<tr>
<td>SLB</td>
<td>50</td>
<td>250</td>
<td>250</td>
<td>500</td>
<td>750</td>
<td>750</td>
<td>7594**</td>
</tr>
<tr>
<td>Leb&amp;Gulf</td>
<td>75</td>
<td>75</td>
<td>525</td>
<td>525</td>
<td>1500</td>
<td>3000</td>
<td>6000</td>
</tr>
<tr>
<td>Allied</td>
<td>80</td>
<td>80</td>
<td>400</td>
<td>400</td>
<td>400</td>
<td>1000</td>
<td>1000</td>
</tr>
<tr>
<td>Jammal</td>
<td>80</td>
<td>200</td>
<td>200</td>
<td>200</td>
<td>1000</td>
<td>1000</td>
<td>1000</td>
</tr>
<tr>
<td>Bekaa</td>
<td>25</td>
<td>25</td>
<td>100</td>
<td>100</td>
<td>600</td>
<td>600</td>
<td></td>
</tr>
<tr>
<td>Metropolitan</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>3000</td>
</tr>
<tr>
<td>SLCB</td>
<td>25</td>
<td>100</td>
<td>400</td>
<td>700</td>
<td>1250</td>
<td>2500</td>
<td>4100</td>
</tr>
<tr>
<td>Essor</td>
<td></td>
<td>5</td>
<td>1000</td>
<td>1000</td>
<td>1000</td>
<td>1461</td>
<td>2000</td>
</tr>
<tr>
<td>Joseph Lati</td>
<td>6</td>
<td>30</td>
<td>30</td>
<td>90</td>
<td>180</td>
<td>810</td>
<td>1200</td>
</tr>
</tbody>
</table>

Source: Freddie Baz, Bilanbanques, Various issues
* Of which cash contribution to capital of LL25140 million in 1992 and LL23334 million in 1993
** Of which cash contribution to capital of LL6844 Million in 1993
Table 5.8
Capital of commercial banks in USD

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$ value at year end</td>
<td>455</td>
<td>530</td>
<td>505</td>
<td>842</td>
<td>879</td>
<td>1838</td>
<td>1711</td>
</tr>
<tr>
<td>Mediterranea</td>
<td>156854066</td>
<td>13386415</td>
<td>198020</td>
<td>118785</td>
<td>113766</td>
<td>13732317</td>
<td>13696317</td>
</tr>
<tr>
<td>BLOM</td>
<td>439560</td>
<td>377358</td>
<td>1980198</td>
<td>3562945</td>
<td>3412969</td>
<td>9753254</td>
<td>18026884</td>
</tr>
<tr>
<td>FransaBk</td>
<td>87912</td>
<td>566038</td>
<td>1980198</td>
<td>---</td>
<td>5688282</td>
<td>4787813</td>
<td>5143191</td>
</tr>
<tr>
<td>SLB</td>
<td>109890</td>
<td>471698</td>
<td>495050</td>
<td>593824</td>
<td>853242</td>
<td>408052</td>
<td>4435340</td>
</tr>
<tr>
<td>Leb&amp;Gulf</td>
<td>164835</td>
<td>141509</td>
<td>1039604</td>
<td>623515</td>
<td>1760485</td>
<td>1632209</td>
<td>3506721</td>
</tr>
<tr>
<td>Allied</td>
<td>175824</td>
<td>150943</td>
<td>792079</td>
<td>475059</td>
<td>455063</td>
<td>544070</td>
<td>584454</td>
</tr>
<tr>
<td>Jammal</td>
<td>175824</td>
<td>377358</td>
<td>396040</td>
<td>237530</td>
<td>1137665</td>
<td>544070</td>
<td>584454</td>
</tr>
<tr>
<td>Bekaa</td>
<td>54945</td>
<td>47170</td>
<td>198020</td>
<td>118785</td>
<td>113766</td>
<td>326442</td>
<td>350672</td>
</tr>
<tr>
<td>Metropolitan</td>
<td>54945</td>
<td>471698</td>
<td>495050</td>
<td>290912</td>
<td>2844141</td>
<td>136017</td>
<td>1753300</td>
</tr>
<tr>
<td>SLCB</td>
<td>54945</td>
<td>186679</td>
<td>792079</td>
<td>831354</td>
<td>1422071</td>
<td>1360174</td>
<td>2396259</td>
</tr>
<tr>
<td>Essor</td>
<td>---</td>
<td>9434</td>
<td>1980196</td>
<td>1187854</td>
<td>1137667</td>
<td>794860</td>
<td>1168907</td>
</tr>
<tr>
<td>Joseph Lati</td>
<td>13187</td>
<td>56604</td>
<td>55408</td>
<td>106888</td>
<td>204778</td>
<td>440696</td>
<td>701344</td>
</tr>
</tbody>
</table>

Source: Freddie Baz, Bilanbanques, Various issues

5.6-Comparison Criteria:

The comparison criteria against which the performance of the 12 sample banks will be compared to is the capital adequacy ratio. Capital adequacy ratio prior to year 1992 differs from that of Circular N° 1114 in what concerns the components of capital and assets. Components of Basle’s capital adequacy ratio were described in detail in the first part of this chapter. For information purposes, the components of BDL’s ratio that was set in October 26, 1983 in circular N° 435 are: 50

Capital = Private funds
Total assets + engagements by signature

---
50 Abbas M. Kesserwan, The optimal level of capital adequacy of Lebanese banks, Feb 93, p. 42
Private funds consist of:

- Capital
- Reserves
- Profits carried forward
- Results of the financial year
- Less: results (loss)

Total assets + Engagements by signatures include:

- Cash
- Banks and correspondents
- Miscellaneous
- Portfolio - bills
- Loans and advances against real guarantees
- Loans and advances against personal guarantees
- Miscellaneous debtors
- Banks
- Doubtful and litigious
- Portfolio - securities
- Shareholders
- Interim dividend for the financial year
- Fixed assets
- Signature credits
- Less: Provisions for doubtful debts

It should be noted that this research will be conducted with no consideration to the changes that were made to the components of the capital adequacy ratio.

The capital adequacy ratio against which performance of the 12 sample banks will be compared to is the one that was set by circular # 1114 and that is computed as follows:

Capital adequacy ratio = capital / Risk weighted assets + Off-Balance sheet items

BDL circular # 160 that was issued on Feb. 25th, 1992 in compliance with Basle Accord's regulations described in detail the Balance Sheet as well
as Off-balance sheet elements to be included in both the numerator and the denominator of this ratio.

Capital includes: Share capital + Cash contributions + Reserves + balances carried forward + Revaluation variance + subordinated loans + Provisions for risks and expenses.

Total assets + Off-Balance sheet elements include: Cash and central Bank (0%) + Lebanese Treasury bills (0%) + Banks and financial institutions (20%) + Head office, branches, Parent & Sister (50%) + Commercial bills discounted (100%) + Loans to customers (100%) + Bank acceptances (100%) + Marketable securities (100%) + Miscellaneous debtor accounts (20%) + Regularization accounts (50%) + Financial and non-Financial assets (100%) + revaluation variance (0%) + guarantees & endorsements (50%) + Opening of confirmed credits & other engagements by signature (50%) + banks' assets given as guarantees (100%)

5.7-Capital Adequacy Ratios:

A-Alpha Group Banks:

capital adequacy ratios for the sample 3 Alpha group banks are shown in table 5.9. For Banque du Liban et D'Outre Mer, Capital adequacy ratio has
dropped from 0.30% in 1987 to 0.07% in 1988. Then it kept increasing over the years up to 5.4% in 1991 and 12.73% in 1993. This great increase in this ratio was due to an increase in capital from LL.200 Million in 1988 to LL.3 billions in 1991 and LL.30,844 millions in 1993.

For Banque de la Mediterranee, Capital adequacy ratio decreased from 9.03% in 1987 to 0.055 in 1990 and then increased up to 6.07% in 1992. This increase was caused by the inclusion of an amount of LL.25,140 Million in the capital element with the aim of achieving the 8% capital adequacy level that was set as an international criterion.

Finally, Fransabank’s capital increased from LL 5 Billion in 1991 to LL 8800 million in 1992 while its capital adequacy ratio in that same period decreased from 14.7% in 1991 to 6.84% in 1992. This downward trend can be traced to an increase in the denominator elements of the ratio that outweighed the increase in capital. It could be that the portfolio of risky assets increased or the level of loans with high risk weights increased. But in 1993 Fransabank achieved an 8.7% ratio.

B- Beta Group Banks:

Capital adequacy ratios for the sample 3 Beta group banks are shown in Table 5.10. For Saudi Lebanese bank, the capital adequacy ratio trend was inconsistent since it decreased from 0.50% in 1988 to 0.38% in 1989, increased up to 2.8% in 1990, down to 1.01% in 1992 and lately was increased in 1993 to reach 7.67%. Capital level of Saudi Lebanese bank remained the
same between 1991 and 1992 at LL 750 million and was increased to LL 7594 Million by the way of cash contributions.

Capital adequacy ratio of Lebanon and Gulf bank kept increasing from 0.17% in 1988 to 5.85% in 1993, except in 1992 in which this ratio decreased to 3% while being 3.57% in 1991.

Allied Business bank showed an acceptable capital adequacy ratio relative to the other 2 banks in its category. Its ratio surpassed the 8% level starting year 1992, i.e., around 2 years prior to the deadline that was specified on March 31st, 1995.

C- Gamma Group Banks:

The capital adequacy ratios for the sample 3 Gamma group banks are shown in Table 5.11.

What is really astonishing is that Metropolitan bank increased its capital adequacy ratio from 3.12% in 1992 up to 15.44% in 1993; far beyond the 8% target level. This was the case because of the increase in its capital from LL 250 Million in 1992 up to LL 3 billions in 1993.

Banque de la Bekaa also increased its capital adequacy ratio satisfactorily between 1992 and 1993. It increased from 3.5% in 1991 to 6.97% and 7.40% in 1992 and 1993 respectively. It should be noted that no increase in capital was effected between those 2 years.

Jammal Trust bank had a very good ratio of 10.09% in 1991. This ratio kept decreasing to reach 7.42% and 5.20% in 1992 and 1993 respectively. The
capital level in those three years was constant which means that the bank’s portfolio of risky assets and off-balance sheet items was increasing.

D- Delta Group Banks:

The capital adequacy ratios for the sample 3 delta group banks are shown in Table 5.12. The three banks that fall under this category had good performance from 1991 till 1993. As of December 31st, 1993 The Syrian Lebanese bank reached a 22.47% ratio as a result of the increase in its capital from LL.2500 Million in 1992 to LL.4100 Million in 1993.

Banque de L’Essor Economique attained nearly the ratio. Its capital adequacy ratio was 22.55% as of Dec.31st,1993 as compared to the 15.77% ratio that was attained in 1992.

Banque Joseph Lati et Fils scored last as compared to the other 2 banks, but its performance was acceptable since its capital adequacy ratio increased from 3.9% in 1991, to 7.39% in 1993 to reach 8.46% by the end of year 1993.

Table 5.9
Capital Adequacy ratio for Alpha Group Banks (in percentage)

<table>
<thead>
<tr>
<th>Year</th>
<th>Mediterranee</th>
<th>BLOM</th>
<th>Fransabank</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>9.03</td>
<td>0.30</td>
<td>---</td>
</tr>
<tr>
<td>1988</td>
<td>7.38</td>
<td>0.07</td>
<td>0.30</td>
</tr>
<tr>
<td>1989</td>
<td>0.09</td>
<td>0.91</td>
<td>0.82</td>
</tr>
<tr>
<td>1990</td>
<td>0.05</td>
<td>1.15</td>
<td>11.90</td>
</tr>
<tr>
<td>1991</td>
<td>0.21</td>
<td>5.40</td>
<td>14.70</td>
</tr>
<tr>
<td>1992</td>
<td>6.07</td>
<td>7.76</td>
<td>6.84</td>
</tr>
<tr>
<td>1993</td>
<td>4.80</td>
<td>12.73</td>
<td>8.70</td>
</tr>
</tbody>
</table>

Source:Bilanbanques (1987-1993)
Table 5.10
Capital Adequacy ratio for
Beta Group Banks (in percentage)

<table>
<thead>
<tr>
<th>Year</th>
<th>Saudi lebanese</th>
<th>Leb.&amp; Gulf</th>
<th>Allied Bus. bk</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>---</td>
<td>0.26</td>
<td>1.27</td>
</tr>
<tr>
<td>1988</td>
<td>0.50</td>
<td>0.17</td>
<td>0.42</td>
</tr>
<tr>
<td>1989</td>
<td>0.38</td>
<td>1.20</td>
<td>1.66</td>
</tr>
<tr>
<td>1990</td>
<td>2.80</td>
<td>1.60</td>
<td>7.70</td>
</tr>
<tr>
<td>1991</td>
<td>2.20</td>
<td>3.57</td>
<td>7.40</td>
</tr>
<tr>
<td>1992</td>
<td>1.01</td>
<td>3.00</td>
<td>8.48</td>
</tr>
<tr>
<td>1993</td>
<td>7.67</td>
<td>5.85</td>
<td>8.66</td>
</tr>
</tbody>
</table>

Source: Bilanbanques (1987-1993)

Table 5.11
Capital Adequacy Ratio for
Gamma Group Banks (in percentage)

<table>
<thead>
<tr>
<th>Year</th>
<th>Metropolitan Bk</th>
<th>Bq. bekaa</th>
<th>Jammal trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>2.08</td>
<td>0.51</td>
<td>0.38</td>
</tr>
<tr>
<td>1988</td>
<td>1.78</td>
<td>0.33</td>
<td>0.83</td>
</tr>
<tr>
<td>1989</td>
<td>1.57</td>
<td>0.98</td>
<td>0.78</td>
</tr>
<tr>
<td>1990</td>
<td>1.28</td>
<td>3.60</td>
<td>1.80</td>
</tr>
<tr>
<td>1991</td>
<td>4.80</td>
<td>3.50</td>
<td>10.09</td>
</tr>
<tr>
<td>1992</td>
<td>3.12</td>
<td>6.97</td>
<td>7.42</td>
</tr>
<tr>
<td>1993</td>
<td>15.44</td>
<td>7.40</td>
<td>5.20</td>
</tr>
</tbody>
</table>

Source: Bilanbanques (1987-1993)

Table 5.12
Capital adequacy ratio for
Delta Group Banks (in percentage)

<table>
<thead>
<tr>
<th>Year</th>
<th>Syrian Lebanese</th>
<th>Essor Economique</th>
<th>Joseph Lati</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>---</td>
<td>---</td>
<td>0.63</td>
</tr>
<tr>
<td>1988</td>
<td>0.64</td>
<td>---</td>
<td>1.06</td>
</tr>
<tr>
<td>1989</td>
<td>2.70</td>
<td>36.14</td>
<td>0.83</td>
</tr>
<tr>
<td>1990</td>
<td>7.30</td>
<td>30.80</td>
<td>2.80</td>
</tr>
<tr>
<td>1991</td>
<td>22.10</td>
<td>9.80</td>
<td>3.90</td>
</tr>
<tr>
<td>1992</td>
<td>16.58</td>
<td>15.77</td>
<td>7.39</td>
</tr>
<tr>
<td>1993</td>
<td>22.47</td>
<td>22.55</td>
<td>8.46</td>
</tr>
</tbody>
</table>

From this analysis of capital adequacy ratios for the sample of 12 banks, it could be clearly seen that there was a sharp drop in capital adequacy ratios from 1987 till 1988. Only two banks out of the 12 chosen showed an increase in their ratio. Those banks are Jammal Trust bank and Banque Joseph Lati et Fils. From 1989 till 1990, eight banks improved their ratio except Banque de la Mediterranee, Metropolitan bank, Banque de L'Essor Economique and Saudi Lebanese bank. Still, increased levels of capital adequacy were not satisfactory in that year because only 5 banks (41.6% of the sample population) could surpass the 3% level that was set by BDL in 1983. Real growth in capital adequacy ratios was witnessed in years 1992 & 1993 in which banks were struggling to meet the requirements of BDL circular # 1114 (decree # 5064) that was explained earlier in this chapter.

It should be taken into consideration that, as of Dec 31st, 1993, banks were still in the transitory period in which banks were required to achieve a capital adequacy ratio between 5 & 6%. From Tables 5.9, 5.10, 5.11, & 5.12 one notices that only 3 banks (25% of the sample population) had a capital adequacy ratio less than 6%. Those banks are:

- Banque de la mediterranee: 4.80%
- Lebanon & Gulf bank: 5.85%
- Jammal Trust Bank: 5.20%

Two banks had a capital adequacy ratio between 7 & 8%:

<table>
<thead>
<tr>
<th>Saudi Lebanese bank</th>
<th>7.67%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banque de la Bekaa</td>
<td>7.40%</td>
</tr>
</tbody>
</table>
Seven banks Outweighed the 8% level:

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banque du Liban et D'Outre Mer</td>
<td>12.73%</td>
</tr>
<tr>
<td>Fransabank</td>
<td>8.70%</td>
</tr>
<tr>
<td>Allied Business bank</td>
<td>8.66%</td>
</tr>
<tr>
<td>Metropolitan bank</td>
<td>15.44%</td>
</tr>
<tr>
<td>Syrian Lebanese Commercial bank</td>
<td>22.47%</td>
</tr>
<tr>
<td>Banque de L’Essor Economique</td>
<td>22.55%</td>
</tr>
<tr>
<td>Banque Joseph Lati et Fils</td>
<td>8.46%</td>
</tr>
</tbody>
</table>

It is noticed that as of Dec. 31st 1993, 58.33% of the chosen sample could easily fulfill Basle’s capital adequacy ratio that was adopted by BDL. Contrary to one’s expectations, 100% of the sample Delta group banks outweighed the 8% target level. Performance of the sample banks by category is shown in Table 5.13:

Table 5.13
Performance of banks by category
(in percentage)

<table>
<thead>
<tr>
<th>Category</th>
<th>Performance in percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alpha group banks</td>
<td>66.66%</td>
</tr>
<tr>
<td>Beta group banks</td>
<td>33.33%</td>
</tr>
<tr>
<td>Gamma group banks</td>
<td>33.33%</td>
</tr>
<tr>
<td>Delta group banks</td>
<td>100%</td>
</tr>
</tbody>
</table>

Table # 5.14 shows average capital adequacy ratios for the sample four categories from 1987 till 1993.
Table 5.14
Average capital adequacy ratio
by category (in percentage)

<table>
<thead>
<tr>
<th>Year</th>
<th>Alpha group</th>
<th>Beta group</th>
<th>Gamma group</th>
<th>Delta group</th>
<th>Whole sample</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>---</td>
<td>---</td>
<td>0.99</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>1988</td>
<td>2.58</td>
<td>0.36</td>
<td>0.98</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>1989</td>
<td>0.48</td>
<td>1.08</td>
<td>1.11</td>
<td>13.89</td>
<td>4.14</td>
</tr>
<tr>
<td>1990</td>
<td>4.37</td>
<td>4.03</td>
<td>2.23</td>
<td>13.63</td>
<td>6.06</td>
</tr>
<tr>
<td>1991</td>
<td>6.77</td>
<td>4.39</td>
<td>6.13</td>
<td>11.93</td>
<td>7.31</td>
</tr>
<tr>
<td>1992</td>
<td>6.89</td>
<td>4.16</td>
<td>5.84</td>
<td>13.25</td>
<td>7.54</td>
</tr>
<tr>
<td>1993</td>
<td>8.74</td>
<td>7.39</td>
<td>9.35</td>
<td>17.83</td>
<td>10.83</td>
</tr>
</tbody>
</table>

Source: Freddie Baz, Bilanbanques (1987-1993)

From the results of Table 5.14, one notices that the capital adequacy ratio of Alpha group banks was the lowest in 1989 (0.48%), while Delta group banks enjoyed the highest ratio (13.89%). On average, performance of the four categories increased from 1989 till 1992, despite a slow decrease between 1990 and 1991 in capital adequacy ratio of Beta & gamma group banks. As of Dec 31st, 1993, average capital adequacy ratio of the four categories showed good improvement, but only three could outweigh the 8% level while the third one (Beta) was close to the target, i.e., 25% of the sample by category needed a special attention.

From these results one can conclude that, in general, banks’ performance as of Dec 31st, 1993 was encouraging as banks were still in the mean time in the transition period. Undercapitalized banks had ahead of them 15 months to rebuild their capital levels and improve capital adequacy ratio to
Figure 5.14
Average Capital Adequacy Ratio by Category
meet international criteria that will elevate the whole banking sector and bring
back to Lebanon the glory that was lost several years ago.

As detailed information concerning banks' capital and capital adequacy
ratios were not available for the year 1994 and beginning 1995, analysis
related to this period will be limited to the enlightenment of some developments
in the banking sector in general that have been noticed at the beginning of
1995 and that are worth mentioning.

As the date specified for Lebanese commercial banks to attain the 8%
level gets nearer, several developments in banks' investments and loans
strategies were noticed: 81

1) Increase in the percentage of loans against real guarantees from total
volume of loans from 32.5% in 1992 up to 36.1% by sept.94

2) Decrease in the percentage of clean advances from total loans from
35% in 1992 to 31% by Sept.94

3) The decrease in the volume of assets (20% risk weight) from 37.6% of
consolidated balance sheet in 1992 down to 23.3% as of Jan.95

4) Increase in the volume of loans to the public sector (0% risk weight)
from 21.2% of consolidated balance sheet in 1992 up to 27.7% by the
end of Jan.95

5) Stabilization of the volume of the private sector at a rate of 35%

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81 Bankers’ Association, Internal publication, Feb.95, P.29
6) The opening of 2 representative offices: In relation to BDL circular # 5710 dated Oct. 12, 1994, 2 representative offices of foreign banks are going to settle in Lebanon. These are J.P. Morgan (America) and Commerz bank (Germany), Thus, the number of representative offices would increase to 13.

7) Increase in banks’ capital: In the beginning of 1995, 2 banks increased their capital in an attempt to improve their capital adequacy levels as follows:

<table>
<thead>
<tr>
<th>Bank</th>
<th>Old Capital</th>
<th>New Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banque de la Mediterranee</td>
<td>LL.100 Million</td>
<td>LL. 75 Billion</td>
</tr>
<tr>
<td>Universal Bank</td>
<td>LL.1 Billion</td>
<td>LL. 5 Billion</td>
</tr>
</tbody>
</table>

Source: Banker’s Association, Internal publication, Jan. 95

Finally, one concludes that the rehabilitation process of the banking sector had started with a solid ground and is proceeding as scheduled with no obstacles whatsoever. Therefore, it is hoped that improvement be brought to the various sectors of the economy in an attempt to accelerate development and try to elevate Lebanon to reach banking international levels.
CHAPTER VI

CONCLUSION & RECOMMENDATIONS

6.1- Conclusion.

The years of war, from 1975 till 1990, that Lebanon passed through had left serious effects on the various sectors of its economy. The Banking sector was the most affected because banks’ operations are based on public confidence which was decreasing year after year.

The devaluation of the lebanese Pound against Foreign currencies, and uncontrolled inflation during those years worsened the situation. Poor asset quality, weak management practices, fraud and inside abuse have contributed a lot to the incidence of bank failures, that began in year 1983 by the failure of First Phoenician bank, in addition to inadequate capital levels. Moreover, the excessive risks taken by most banks, and the weak enforcement of supervisory and regulatory Authorities added more profound problems.

From this research one concludes that despite the defects of the seventeen years of war that were seen in the various sectors of the economy, Lebanese citizens were determined to stand on their feet again. The analysis of the various elements of the banking sector proved that Lebanese Authorities needed only political stability to enforce its regulations. Therefore, in 1992, the Governor of Bank of Lebanon issued a very important decree which constitutes a significant landmark in the history of the banking sector in Lebanon, and in
particular in the history of regulating the Lebanese banking activity. This is decree N° 5064 issued in circular N° 1114 on August 2nd, 1992.

Such a decision was one of the measures undertaken by the Monetary Authorities to face the aftermath of the banking crisis in Lebanon. It obliged banks to increase their capital levels and capital adequacy ratios to reach international standards thereby increasing confidence on the foreign as well as the local levels. Decree N° 5064 specified the method and time period in which Lebanese banks are required to attain an 8% capital adequacy ratio.

As a result of the above mentioned decree, the solvency of Lebanese banks was to be measured by the ratio of capital to risk weighted assets and off-balance sheet items. This ratio was set to raise the solvency of commercial banks to the international level as specified by the Committee on Banking Regulations and Supervisory practices known as the Basle Committee. Basle Committee’s rules have focused the minds of bankers on the need to measure and provide for the risks involved in lending procedures. Furthermore, bankers have also been forced to concentrate on rebuilding eroded ratios.

The Lebanese experience in what concerns the adoption of Basle Committee’s proposals was very special in that Lebanese Authorities, BDL, Bankers’ Association and BCC, did not apply it word by word, instead, they modified them to fit Lebanon’s special economic conditions. This research studied the development of capital and capital adequacy ratios of the whole banking sector, and then concentrated on a sample of 12 banks. Analysis of
the balance sheets of those banks as of December 31st, 1993 showed that the implementation of decree N° 5064 was not so difficult if one takes into consideration that banks were still at that time in the transitory period in which banks were required to attain a capital adequacy ratio between 5 and 6%. Results showed that 58.3% of the total sample outweighed the 8% level by 1993, while 91.6% achieved the level set for that period. This was the case because banks had hidden reserves in the form of fixed assets that were recorded at historical costs. As soon as BDL allowed banks to reevaluate their assets at market prices, capital of the banking sector as a whole rose from $ 36 million in 1991 to $ 77 million in 1992 and $ 142 million in 1993.

There’s no doubt that the scientific calculation of the capital adequacy ratio is very important because it introduced the concept of relative risk in the calculation of banks’ capital adequacy. But, according to Mr. Freddie Baz⁵², the accuracy with which capital adequacy requirements were applied are not representative enough because of five considerations:
1) The risk weights allocated to banks’ assets cannot show exactly the real risk of these assets.
2) It does not take into account the risk diversification of assets
3) Experience in the banking field have shown that there’s no direct or sole relation between failing banks and their capital adequacy levels.

⁵² Union of Arab Banks, Procedures that were taken by Arab Monetary authorities to execute Basle Committee’s regulations, 1993, P.155, (in Arabic)
4) Risk weights are related to types of assets, while the real risk of these assets is determined by the characteristics of its beneficiary.

6.2-Recommendations:

Therefore, the interest of Lebanese Authorities should be to complement quantitative criteria (capital adequacy ratio) by qualitative criteria that were summarized by Central Bank of England as “CAMEL”:

- The adequacy of a bank’s Capital
- The structure and quality of its Assets
- The quality of its Management
- Its Earnings performance, and
- The Liquidity structure of the balance sheet

It is worth mentioning here that decree N° 5064 was issued along a series of circulars. The most important of these circulars are those related to the formulation of the banking reform law, the higher banking court, and the law of bank mergers. These were complementary arrangements that had put limits to the failing banks crisis that attacked Lebanon in the past few years. The majority of mergers that were effected in 1993 as a result of decree N° 192/93 dated Jan.4th, 1993, took the form of acquisitions not of consolidations;

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83 Ibid, P.156
acquisitions whereby a weak bank was acquired by a strong bank to protect it against bankruptcy. Some of the acquisitions that took place in 1993 are:

1- Banque Tohme, Sal sold all its assets and engagements to Fransabank, Sal after BDL approval dated March 10th, 1993.

At this stage of political and economic development, and in the light of the BIS Capital Adequacy requirements and the expected increase in competition among banks, it is thought that further consolidation is needed to form bank holding companies. In this case, individual bank entities will not be dissolved into another one. Each bank will preserve its management and employees as a separate entity from the Parent company. However, the Central Bank will not force any mergers. It prefers to see the banks getting together to produce better capitalized entities. Their main interest is not in seeing bigger banks but rather more liquid and better capitalized banks.

Finally, one concludes that the banking sector in general has become adequate. This could be proved by the growing interest that international banking groups are showing concerning the return to Lebanon, and the

84 BDL Yearly Bulletin, 1993
increase in the contribution of large Arab banks in its affiliates operating on the Lebanese Territories. From these groups one can mention:

- National bank of Kuwait’s contribution in Rifbank
- Contribution by Saudi National Commercial bank in its Lebanese Sister bank.

In this context, Mr. Riad Salamah, Governor of BDL, explained that Central bank’s priorities for the last few years has been focused on maintaining a stable currency, restructuring the banking sector and helping the government to curb its budget deficit. He mentioned that BDL is working to develop the right monetary and financial environment to encourage the flow of capital needed to finance the reconstruction plans. He believes that it would be possible for Lebanon to recapture its role as financial center if it develops new investment tools and instruments which already exist elsewhere.

Thus, the establishment of an efficient money market in Beirut will make it possible to attract foreign capital needed to finance the reconstruction. This will allow the Government as well as companies to obtain resources through issuing various equity or debt instruments. Moreover, the Government has explored various financing mechanisms. One of them, and which was implemented in the beginning of year 1995, was the issuance by the government of bonds denominated in USDollars to be sold in the Euromarket for international investors.

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85 Union of Arab banks, Procedures that were taken by Arab Monetary Authorities to execute Basle Committee’s regulations, 1993, P.157 (in Arabic)
86 The Banker, Top 100 Arabs, Vol. 143, Nov. 1993, P.68
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LIST OF TABLES

Table 2.1  Dollar value in LL. (1982-1987)  P.10
Table 2.2  Dollar value in LL. (1986-June 94)  P.16
Table 2.3  Capital to deposits ratio prior to Basle Agreement (%)  P.19
Table 2.4  Total capital of lebanese commercial banks 1974-1993(in millions of LL.)  P.20
Table 2.5  Total capital of Lebanese commercial banks 1974-1993(in millions of USD)  P.21
Table 2.6  Capital of Commercial banks(1987-1989) in millions of LL.  P.26
Table 2.7  Capital of Commercial banks(1987-1989) in millions of USD  P.27
Table 2.8  Reserve requirement levels-1987 (in percentage)  P.28
Table 2.9  BDL financing of failing banks (up to 1990)  P.29
Table 4.1  Risk weights of on-balance sheet items  P.57
Table 5.1  Risk weights in percentage  P.67
Table 5.2  Credit conversion factors (in percentage)  P.68
Table 5.3  Retained earnings (1991-1993)  P.72
Table 5.4  Total deposits in millions of USD  P.74
Table 5.5  Total capital of commercial banks in millions of LL.(1989-Feb.95)  P.76
Table 5.6  Percentage inclusion of supplementary capital into core & total capital  P.77
Table 5.7  Capital of sample commercial banks in millions of LL.  P.79
Table 5.8  Capital of sample commercial banks in millions of USD  P.80
Table 5.9  Capital adequacy ratios of Alpha Group Banks (in percentage)  P.85
Table 5.10  Capital adequacy ratios of Beta Group Banks. (in percentage)  P.86
Table 5.11  Capital adequacy ratios of Gamma Group Banks (in percentage)  P.86
Table 5.12  Capital adequacy ratios of Delta Group Banks (in percentage)  P.86
Table 5.13  Performance of banks by category (in percentage)  P.88
Table 5.14  Average capital adequacy ratios by category (in percentage)  P.89
LIST OF FIGURES

Figure 2.1  Dollar value in LL. (1982-1987)
Figure 2.2  Dollar value in LL. (1986-June 1994)
Figure 2.3  Capital to deposits ratio prior to Basle Agreement (in percentage)
Figure 2.4  Total capital of Lebanese commercial banks 1974-1993 (in millions of LL.)
Figure 2.5  Total capital of Lebanese commercial banks 1974-1993 (in millions of USD)
Figure 5.4  Total deposits in millions of USD
Figure 5.5  Total capital of commercial banks in millions of LL. (1989-Feb.95)
Figure 5.14 Average capital adequacy ratio by category (in percentage)