RECENT BANKING CRISES, REFORMS, AND RESTRUCTURING EFFORTS

The Genesis of Crises

The International financial system has been facing a number of crises time and again especially after 1970s the frequency of such crisis has substantially increased. There is not a single geographical area or a major country that has been spared the effects of these crises. In many cases the early warnings signals have proved to be ineffective in predicting the crisis. Even International Monetary Fund was unable to foresee the crises. Since mid eighties banking crisis have come to the fore of economic analysis. The stressful situation of banking, during the last couple of years, has quickly intensified and in the process has become one of the main obstacles to stability of the financial system. This brings to an uneasy feeling that there is something basically wrongs somewhere. This prompted for a call for comprehensive reform of the international financial system to help prevent the outbreak and spread of financial crisis or at least minimize their frequency and severity.

Fear of global banking crisis has afflicted banks regulators since the great depression. During the 1930s more than one-fifth of the commercial

banks in the United States suspended operations. In Europe, major bank failures or payments moratoriums were common. Withdrawals of bank loans and deposits played a major role in the balance of payment crisis of the period, particularly in Central and Eastern Europe. Johnson and Richard observe that overall the “great depression of 1930s could be defined in terms of financial collapse”.

Costs of the Crises

Estimating the cost of financial restructuring is one of the most challenging issues. There are costs both in the private and public sectors to cover losses and contribute new capital. The private costs is difficult to determine, however, the government’s gross costs for the restructuring arise from paying out guaranteed bank liabilities; providing liquidities; assisting in meeting capital adequacy requirements and purchasing non performing loans.

During Asian crisis the gross costs ranged between 15 and 45% of GDP. In Indonesia the government has issued 150 trillion Rupiah (13 percent of GDP) of indexed bonds to the central bank to compensate it for the past liquidity support. Another 100 trillion Rupiah of bonds (9 percent of GDP) is again issued to the banks to finance the first wave of bank recapitalisation. In Thailand the government was authorized to issue bonds for 500 billion Baht (10 percent of GDP) to cover losses in the Financial Institutions Development Fund, and the government has, again, announced its intention to cover additional losses in a similar way. In Korea, parliament approved the issuance of 64 trillion Won of bonds to finance Korean Asset Management Corporation (KAMCO) and Korea Deposit Insurance Corporation (KDIC) around 15 percent of GDP.

---


By the mid of 1999 Indonesia had spent $85 billions (51 percent of GDP) towards its restructuring costs. During the same period Korea had spent $46 billions (13 percent of GDP) towards its restructuring costs. Malaysia had spent 5 percent of its GDP (4 billions U.S. dollars) towards its restructuring costs. Thailand’s public cost for financial restructuring at the end of 1998 was around 34 billions of U.S. dollars that came around 25 percent of the GDP of the country. India too had lost more than Rs. 65 billion of the public exchequer towards bank restructuring by the year 2000 and now the non-performing assets (NPA) of Indian bank stood at $14 billion.6

Following table (2.1) gives the information about the costs incurred by international and other financial institutions agencies on restructuring few of the turbulent economies.

Table: 2.1
Help Provided by Multilateral Financial Institutions for Bank Restructuring
(Figures in US $ billion)

<table>
<thead>
<tr>
<th>Country/Year</th>
<th>IMF</th>
<th>World Bank</th>
<th>Regional Dev. Bank</th>
<th>Bilateral</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil, 1998</td>
<td>18.1</td>
<td>04.5</td>
<td>04.5</td>
<td>14.5</td>
<td>41.6</td>
</tr>
<tr>
<td>Indonesia, 1997</td>
<td>11.2</td>
<td>05.5</td>
<td>04.5</td>
<td>21.1</td>
<td>42.3</td>
</tr>
<tr>
<td>Mexico, 1995</td>
<td>17.7</td>
<td>04.5</td>
<td>04.5</td>
<td>31.1</td>
<td>48.8</td>
</tr>
<tr>
<td>Republic of Korea, 1997</td>
<td>21.1</td>
<td>10.0</td>
<td>04.2</td>
<td>23.1</td>
<td>58.4</td>
</tr>
<tr>
<td>Russian Federation, 1998</td>
<td>15.1</td>
<td>06.0</td>
<td>-</td>
<td>01.5</td>
<td>22.6</td>
</tr>
<tr>
<td>Thailand, 1997</td>
<td>04.0</td>
<td>01.5</td>
<td>01.2</td>
<td>10.5</td>
<td>17.2</td>
</tr>
<tr>
<td>Total</td>
<td>87.2</td>
<td>27.5</td>
<td>14.4</td>
<td>101.8</td>
<td>230.9</td>
</tr>
</tbody>
</table>


Another study conducted by Claudia and Ceyla of IMF includes a survey of 24 countries7 that have gone restructuring of their banking system after the onset of crisis. According to Claudia and Ceyla the bank restructuring

---

7 Of these 24 countries 4 are industrial, 15 developing and 5 transition economies
operations have got two main objectives; firstly, to restore the financial viability of the banking system and secondly, to restore the system’s intermediation capacity and an appropriate level of banking services relating to aggregate economic activity.\footnote{Claudia Dziobek and Ceyla Pazarbasioglu, ‘Lessons From Systematic restructuring: A Survey of 24 Countries’, International Monetary Fund, WP/97/161. December 1997.}

Table (2.2) gives the estimated costs of bank restructuring in percent of GDP in their respective countries.

<table>
<thead>
<tr>
<th>Country</th>
<th>Onset of restructuring (Year)</th>
<th>Estimated cost (in percent of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cote d' Ivoire</td>
<td>1991</td>
<td>13.0</td>
</tr>
<tr>
<td>Ghana</td>
<td>1989</td>
<td>6.0</td>
</tr>
<tr>
<td>Tanzania</td>
<td>1992</td>
<td>14.0</td>
</tr>
<tr>
<td>Zambia</td>
<td>1995</td>
<td>3.0</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1994</td>
<td>2.0</td>
</tr>
<tr>
<td>Korea</td>
<td>1993</td>
<td>n.a.</td>
</tr>
<tr>
<td>Philippines</td>
<td>1984</td>
<td>4.0</td>
</tr>
<tr>
<td>Japan</td>
<td>1995</td>
<td>n.a.</td>
</tr>
<tr>
<td>Hungary</td>
<td>1993</td>
<td>12.2</td>
</tr>
<tr>
<td>Poland</td>
<td>1993</td>
<td>5.7</td>
</tr>
<tr>
<td>Finland</td>
<td>1991</td>
<td>9.9</td>
</tr>
<tr>
<td>Spain</td>
<td>1980</td>
<td>15</td>
</tr>
<tr>
<td>Sweden</td>
<td>1991</td>
<td>4.3</td>
</tr>
<tr>
<td>Latvia</td>
<td>1995</td>
<td>n.a.</td>
</tr>
<tr>
<td>Moldova</td>
<td>1995</td>
<td>n.a.</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>1995</td>
<td>n.a.</td>
</tr>
</tbody>
</table>
Recent Banking Crises, Reforms and Restructuring Efforts

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Egypt</td>
<td>1991</td>
<td>n.a.</td>
</tr>
<tr>
<td>Kuwait</td>
<td>1992</td>
<td>45</td>
</tr>
<tr>
<td>Mauritania</td>
<td>1993</td>
<td>15</td>
</tr>
<tr>
<td>Argentina</td>
<td>1994</td>
<td>0.3</td>
</tr>
<tr>
<td>Chile</td>
<td>1983</td>
<td>33.0</td>
</tr>
<tr>
<td>Mexico</td>
<td>1994</td>
<td>12-15</td>
</tr>
<tr>
<td>Peru</td>
<td>1991</td>
<td>0.4</td>
</tr>
<tr>
<td>Venezuela</td>
<td>1994</td>
<td>17.0</td>
</tr>
</tbody>
</table>


These cost measures are limited to fiscal costs only. Costs borne by the private sector are not included. Hyperinflation in many countries substantially eroded the deposit values, which was mainly, shared by the depositors and thus are not included in the costs of these restructuring.

### A Precursor to the International Co-operations

According to Lindgren *et.al*. 73 percent of the member countries of the IMF experienced at least one bout of significant banking problems from 1980-1996. Such crisis resulted in serious bank losses. Several arguments have been raised in analytical literature like volatility in the market environment, increased leverages of banks connected lending practices and regularity forbearance, etc. Some consider financial liberalization to be the cause in an environment where financial systems of many countries are not sound as a result of improper regulation and supervision. Others felt that the ultimate cause is the bursting of the speculator bubble in asset prices driven initially by the excess of financial intermediaries.⁹

It has also been argued that the root cause of the crisis was the maturity mismatch. Short-term international liabilities were far greater than short-term assets. Many other causes including higher and growing accumulation of non-performing assets, exacerbated by weaknesses in the accounting, disclosure and legal framework were also cited as the reasons for the crises (Cooper & Fraser, 1984). Some are of the opinion that it has been the moral hazard that has largely been responsible for these economic distresses, for example, Kapstein in this regard says, "banks regulators have created for themselves a 'moral hazard' problem". As the authorities have provided systematic safeguards, they have also encouraged imprudent behaviors on the part of some financial executives. If bank depositors were more like shareholders, they would try to prevent management from engaging in careless banking practices. Kapstein further admits that unlike previous post war decades, the 1970s were characterized by a unique combination of inflation, floating and erratic exchange rates and volatile interest rates. In these circumstances the major commercial banks in the industrial countries were forced to become more active in asset and liability management. He explains that in an effort to protect both their customers and their own institutions in the face of systematic shocks, bankers responded by promoting three developments in financial markets. These were globalization, innovations of financial practices, instruments, and speculations. Accompanying and contributing to these developments was the deregulation of financial markets across the G-10 countries.

The globalization of finance meant that banks increasingly engaged in international activities on both the assets and liabilities sides of the balance sheet, blurring the distinction between domestic and international finance, with net savers in one country becoming increasingly linked to net borrowers in another.


Ibid.
The second trend innovation or financial engineering was evident in the introduction of new practices and instruments during 1970s and 1980s. Among these innovations, two of the most prominent were securitisation in which traditional bank assets, such as mortgages were transformed into marketable instruments. These included the performance bonds (which ensure that firms will perform their contractual tasks with customers or the bank will pay the penalty), note issuance facilities, foreign exchange services, letter of credit and various instruments revised to buffer financial risks including interest rate caps and swap agreements.

The third important trend was speculation, given the macro economic instability of the seventies; activities like foreign exchange trading became increasingly risky. For currency values could swing sharply on a daily basis. Accompanying and contributing to these changes in capital markets was the widespread deregulation of commercial banking. (Some details in the following pages)

The possible bad effects accompanying these changes i.e. globalization, innovations and speculation could be realized when Bankhaus Herstatt in West Germany was ordered to close in 1974. The bank had incurred heavy foreign exchange losses around $ 450 million. The main sufferers were Italian and Japanese banks. The Franklin National Bank\(^{12}\) of New York and the British-Israel Bank of London too were closed in 1970s owing to similar causes. The three failures had made the regulators realise that liquidity or solvency problems of a foreign bank or the foreign branch of a domestic bank could have serious repercussions in domestic markets besides halting the international payment system, this prompted the formation of G-10 committee on banking regulations and supervisory practices now known as Basle Committee.

An honest analysis, of the above mentioned crises might lead to several conclusions. However, one that seems to be one of the most important is surely unhealthy fiscal, monetary and exchange rate policies. This brings a number of questions. The first is about what it is that enables the continuation of macro economic imbalances, unsustainable exchange rates and unhealthy financial systems. A second related question is about why some of the countries that have followed sound fiscal and monetary policies have also faced crises and a third but equally important question is about why some of the apparently well-regulated financial systems have also faced crisis.

Abbas Mirakhor of the IMF notes that there are many analysis of financial crises and a long list of their causes but surprisingly little is said about the one under line common denominator to all of them: debt contracts that are by nature out of sync, and unrelated to, income flows that the underlying productive and capital assets of these countries can generate to serve them.13

Islamic economists see this problem from another angle they point out that conventional economic literature has not been successful in providing satisfactory answers to the above mentioned questions because, they assert, it is not an implementation problem of an honest policy rather there is a problem in diagnose itself.

Chapra, for example, is of the view that the primary cause behind these crises is inadequate market discipline. Depositors in the financial markets are assured of their return with interest which makes the depositors take little interest in the soundness of the financial institutions. And since the banks' financing largely depends upon collateral, this makes the bank takes little interest in the evaluation of the projects to be financed. Very often in the collateral based financing the end use of the finance is not the same for which

the fund is raised.\textsuperscript{14} Can the collateral be a substitute for a more careful evaluation of the project financed? No says Chapra, this is because the value of the collateral can itself be impaired by the same factors that diminish the ability of the borrower to repay the loan. The ability of the market to impose the required discipline, thus, gets impaired and leads to an unhealthy expansion in overall volume of credit, to excessive leverage, and to living beyond means. The problem is further aggravated with the reinforcement of the tax system that inherently is biased in favor of debt financing where dividends are taxable while interest payments are treated as cost.\textsuperscript{15}

In the absence of risk sharing it is possible for the financier to lend excessively and also to move funds rapidly from place to place at the slightest change in the economic environment. A high degree of volatility, thus, gets injected into interest rates and assets prices. This generates uncertainty on the investment market, which in turn discourages capital formation and leads to misallocation of resources.\textsuperscript{16} It also drives borrowers and lenders alike from the long end of the debt market to the shorter end. Consequently there is steep rise in highly leveraged short-term debt, which has accentuated economic and financial instability. IMF too acknowledges that the countries with high levels of short-term debt are "likely to be susceptible to financial crisis".\textsuperscript{17}

The heavy reliance on short-term borrowing has injected a substantial degree of instability into the international foreign exchange markets. According to a survey conducted by the Bank for International settlement (BIS), the daily turnover in traditional foreign exchange markets adjusted for double counting had escalated to $1,490 billion in April 1998, compared with $
590 billion in April 1989, $820 billion in April 1992, and $1190 billion in April 1995. The daily foreign exchange turnover in April 1998 was more than 49 times to the daily volumes of world merchandise trade (See table 2.2 and 2.3).\textsuperscript{18}

### Table 2.3

**Foreign Exchange Turnover in $ billion**

<table>
<thead>
<tr>
<th>Date</th>
<th>Turnover ($ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 1989</td>
<td>$590 billion</td>
</tr>
<tr>
<td>April 1992</td>
<td>$820 billion</td>
</tr>
<tr>
<td>April 1995</td>
<td>$1190 billion</td>
</tr>
<tr>
<td>April 1998</td>
<td>$1490 billion</td>
</tr>
</tbody>
</table>

*Source: BIS, October 1980*

### Table 2.4

**Volume of World Trade**

<table>
<thead>
<tr>
<th>Year</th>
<th>(Exports+Imports) (billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 1989</td>
<td>$499 billion</td>
</tr>
<tr>
<td>April 1998</td>
<td>$908.7*</td>
</tr>
</tbody>
</table>

* Average value of daily world trade in April 1998 comes to 830.3 billion

*Source: IMF, *International Financial Statistics*

The dramatic growth in speculative transactions over the past two decades has resulted in an enormous expansion in the payment system. Such a large volume of transactions implies that if problems were to arise, they could quickly spread throughout the financial system, Mr. Crockett, the General Manager of the Bank for International Settlements admits this “our economics have thus become increasingly vulnerable to a possible break down in the payment system”.\textsuperscript{19}

Another statistics, (table 2.5), which is instructive in this regard, show that the contingent liabilities of major banks constituted a large multiplex of

---

\textsuperscript{18} Chapra, M. Umer, “Why has Islam prohibited interest”, *Review of Islamic Economics*, the Islamic Foundation, Leicester, U K, No 9, 2000, p 16

\textsuperscript{19} BIS, *Review*, 22 June 1994, p 3
shareholders equity and in many cases longer than the banks third world total
debt exposure. By 1987 for example Citi Corporation had contingent liabilities
of $467 billion, J.P. Morgan had $203 billion and Chase Manhattan had $175
billion. They constituted more than 50 times shareholders equity for Citi
Corporation and over 40 times equity for Morgan & Chase Manhattan.\textsuperscript{20}

**Table: 2.5**

<table>
<thead>
<tr>
<th>Bank</th>
<th>Contingent Liabilities ($ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citi Corp.</td>
<td>467</td>
</tr>
<tr>
<td>J.P. Morgan</td>
<td>203</td>
</tr>
<tr>
<td>Chase Man</td>
<td>175</td>
</tr>
</tbody>
</table>

*Source: Kapstein, op cit, p 4*

One cannot undermine the fact that there is a close nexus between easy
availability of credit, macro economic imbalance and the financial instability.
Easy availability of credit makes it possible for the public sector to have a high
debt profile and for the private sector to live beyond its means to have high
debt leverage. If the debt is not used productively the ability to service the debt
does not rise in proportion to the debt and leads to a financial fragility and debt
crisis. The greater the reliance on short terms debt and the higher the leverage,
the more severe the crisis might be. This is because short-term debt is easily
reversible as far as the lender is concerned, but repayment is difficult for the
borrower if the amount is locked up in loss making speculators’ assets or
medium and long-term investments with a long gestation period.

Islamic economists, to prove that interest has solely been responsible
behind the entire crises, cite many examples like East Asian crisis to the recent
Argentinean economic crises.\textsuperscript{21} We shall not go in those details, as they are out
side the purview of our present study. Although, some other reasons put

\textsuperscript{20} Kapstein, *op cit*, p. 4.

\textsuperscript{21} See foot note one
principle for financial intermediation in the economy, are discussed in the next chapter.

There is a point to note that not only Muslims but a number of Western economists too consider the present debt based system as the root cause of financial instability and vouch for a shift to an equity oriented financial system. Hicks, for example, pointed out that, interest has to be paid in good or bad times alike, but dividends can be reduced in bad times and in extreme situation, even passed. So the burden of finance by share is less.\textsuperscript{22}

In this present study we shall not go into detail about the overall economic crises faced in different parts of the world. The analysis will be confined to banking crises and an attempt would be made to find out what cure has been done or method adopted to tackle these crises. During the last two decades more than 120 countries have experienced some kind of systematic or nonsystematic banking crisis.\textsuperscript{23} Many are of the view that interest and debt has played a pivotal role in these crises.

In the following section we would like to explore some of the international efforts in streamlining the banking sector. A brief history of Bank for International settlement (\textit{Basle Accord}) and its present efforts to deal with these banking crises is worth starting the discussion.

**The Basle Committee**

Three big failures of 1970s, the Herstatt Bank, Germany, the Franklin National Bank of New York and the British Israel bank of London, if anything, had warned the Central Bankers especially of G-10 countries that these banking crises if not contained could rapidly take on international dimensions from


crises if not contained could rapidly take on international dimensions from which all would suffer. By 1975, a new committee (the Basle Committee) on Banking Regulations and Supervisory Practices was formed by the G-10 central banks governors, to be based in Basle at the Bank for International Settlement (BIS). The first draft of the committee that came in 1975 was known as *concordat*.

The Basle Committee is made up of representatives from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. In 1981 the committee issued its first report, which since then has become an annual feature and known as “Report on International Developments in Banking Supervision.” The chief purpose of the committee is to close gaps in the supervisory net and to improve supervisory understanding and the quality of banking supervision worldwide. It has tried to pursue its objectives in firstly, by exchanging information on the operations of international banks and on national regulation policies and practices; secondly, by developing new approaches to the supervision of International banks; and finally, “reviewing the desirability of setting standards in bank capital and other areas.”

The failure of Banco Ambrosiano, Italy and the Mexican debt crisis of early 1980s hastened the processes of strengthening international payment system. Ethan B. Kapstein notes that after the bank failures of 1970s and early 1980s, the public had begun to lose confidence in the banking system. Bank portfolios were filled with dubious or high-risk loans leading to fall in banks’ profit and share prices with them. The fall in share prices eroded the ability of banks to attract equity investments to build up core capital. A vicious cycle was, thus, taking hold and threatening to undermine the major commercial banks and the internal foundation of the international payments system.²⁵


To avoid the panic, which could have easily turned into a contagion leading to collapse of the international payment system, the Basle Committee began to seek support from other international organizations like International Monetary Fund (IMF), the Organization of Economic Cooperation and Development (OECD) as well as the Bank for International Settlements (BIS). The Mexican crisis came as a timely warning to all those involved, the banks, the governments of the creditor states, the relevant international institutions as well as the debtors. The crisis threatened the international payment systems for two reasons; first, it threatened to install the trade investment and financial flows between the industrial and developing countries; second, the amount of debt was so large that if the banks were forced to write them off, they would be declared insolvent because the banks lacked the sufficient capital to absorb the losses.

The debtor countries, for their part, could not earn enough foreign exchange to meet the interest payment in their obligations. To remain current on their loans, they needed more foreign exchange from the banks, from industrial countries and from multilateral financial institutions, which were not coming following the Mexican announcement. The United States entered into the morass as American commercial banks held around half of the banks' claim on third world countries. Two pronged strategies for dealing with debt problem, consisting of “Short term crisis management and longer term stabilization, were adopted.\(^\text{26}\)

The broad purpose of the strategy was to maintain the international payment system. The short-term requirement was to inject enough liquidity to maintain its uninterrupted operation. This was to be achieved through its assistance to Mexico, bilateral agreements between developing and industrial countries, IMF stabilization credits and corresponding increase in IMF quotas

\(^{26}\) For details please see Cohen, Benjamin, J., "In Whose Interest? International Banking and American Foreign Policy". New Haven, Yale University Press, 1986.
and restructurin of existing bank debt, along with the extension of fresh loans by commercial banks.27

The US was to ask for increase in IMF quota. However, before that it asked Federal Reserve Board, Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC) to prepare a new regulatory programme for improved supervision and regulation of international lending. It contained five key elements.

1) Strengthening of the existing programme of examination and evaluation of country risk.
2) Increased disclosure of banks' country exposure.
3) The creation of special reserves against losses.
4) Supervisory rules for accounting for fees associated with loan transactions.
5) Strengthened international cooperation among foreign banking regulators through the International Monetary Fund.28

The US Senators realizing the importance of capital in banks concluded that bank capital had the quality of a "public good" in that its social benefits were greater than its private benefit; if each bank were to raise more capital, it would help to restore confidence in the international financial system as a whole; and, the imposition of tougher capital standards would ensure that shareholders would also share the burden along with the US tax payers.29

To avoid its' own bank being singled for tougher capital regulations as compared to others in the market. The U.S decided to promote these regulations at international forums. The International Lending Supervision Act (ILSA) of 1983 was the result of above-mentioned US Policy. This Act called

27 Kapstein, op cit., p 10.
29 This is the crux of whole issue towards which Islamic economists point out (1) Bank capital has the quality of public good and (2) the shareholders should share the burden. However, the difference lies in the level of dosage. The US authorities wanted increase in share, the Islamic economists wants full share capital. The US authorities wanted the shareholders to share some of the burden while the Islamic economists wants shareholders to share full burden
upon the regulators to require increased level of bank capital and it encouraged
"governments, central banks, and regulatory authorities of other major banking
countries to work toward... strengthening the capital bases of banking
institutions involved in international lending." In 1984 one of the top ten U.S.
bank "Continental Illinois, required a $6 billion infusion of the Federal
Reserve Funds to meet its immediate financial obligations. Despite the
emergency infusion of cash by Federal Reserve, the bank collapsed and a
Federal bailout followed. This event together with ILSA heightened the
regulatory supervision in the U.S. The Federal Reserve Board wanted the banks
to strengthen their balance sheets through financial market, for this, action
required on both the assets and the liability sides. On assets side Federal
Reserve examined loan quality of the banks while on the liability side it tried to
increase capital levels in the bank. For furthering its objective at the
multilateral levels the Federal Reserve Board decided to make use of Basle
Committee.

After three years of intense debate, the Basle Committee announced in
1987, that its members had reached agreement on a proposal for "International
Convergence of Capital measurements and Capital soundness". The accord
had three parts; the definition of Capital; the application of risk weights to
specific assets categories; and the treatment and off balance-sheet activities.
Peter Hayward, Secretary of the then Basle Committee conceded, "The purpose
of the capital agreement was to strengthen the capital base of the banking
system" the presumption behind this remark is that there is a direct relation
between levels of capital and bank soundness. It was agreed that banks must
have certain minimum level of capital and the banks should also assign
certain risk to each category of asset.

12 This capital was further subdivided into tier one and tier two depending on the nature of then subscription.
In 1997 the Basle Committee released a set of twenty-five basic principles for effective banking supervision, which came to be known as the Basle Core Principles for Effective Banking Supervision.

**The Basle Core principles for Effective Banking Supervision**

Endorsed by the Bank for International Settlements (BIS) these twenty-five core principles have been drawn up by the Basle Committee in close consultation with the supervisory authorities in fifteen emerging market countries including Chile, China, The Czech Republic, Hong Kong, Mexico, Russia, Thailand, Argentina, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore for adoption by all countries.

These twenty five core principles represent the basic elements of an effective supervisory system and cover preconditions for effective banking supervision, licensing and structure, prudential regulations and requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors, and the Cross Border Banking. The Basle Core principles, as it claims, are intended to serve as public reference for supervisory and other public authorities worldwide to apply in the supervision of all banks within their jurisdictions. The twenty-five core principles are setout below.

Principle: 1 Preconditions for effective banking Supervision.

Principles: 2-5 Licensing and structure.

Principles: 6-15 Prudential regulations and requirements.

Principles: 16-20 Methods of ongoing Banking Supervision

Principle: 21 Information requirements.

Principle: 22 Formal powers of supervisors.


[^33]: [http://www.bis.org](http://www.bis.org)
Preconditions for effective banking supervision

1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organizations. Each such agency should possess operational independence and adequate resources.

Licensing and structure

2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word ‘bank’ in names should be controlled as far as possible.

3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition including its capital base etc.

4. Banking supervisors must have the authority to review and reject any proposal to transfer significant ownership or controlling interest in existing banks to other parties.

5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the banks to undue risks or hinder effective supervision.

Prudential Regulations and Requirements

6. Banking supervision must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect
the risk that the banks undertake, and must define the component of capital, bearing in mind their ability to absorb losses.

7 An essential part of any supervisory system is the evaluation of the bank’s policies, practices and procedures related to the granting of loans and making of investments and ongoing management of the loan and investment portfolios.

8 Banking supervisors must be satisfied that banks established adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.

9 Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentration within the portfolio and supervisors must set prudential limits to restrict banks’ exposures to single borrowers or groups of related borrowers.

10 Banking supervisors must have in place requirements that banks lend to related companies and individuals on arm’s length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

11 Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

12 Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks.

13 Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.
14 Banking supervisors must be determined that banks have in place internal controls that are adequate for the nature and scale of their business.

15 The Banking supervisors must be determined that banks have adequate policies, practices and procedures in place including strict ‘know your customers’ rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Methods of Ongoing Banking Supervision

16 An effective banking supervisory system should consist of some form of both onsite and offsite supervision.

17 The Banking supervisor must have regular contact with the bank management and a thorough understanding of the institutions’ operation.

18 The Banking supervisors must have a means of collecting, reviewing and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.

19 Banking supervisors must have a means of independent validation of supervisory information either through on the spot site examination or use of external auditors.

20 An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Information Requirements

21 Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the
financial conditions of the bank and the profitability of its business and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

**Formal Powers of Supervisors**

22 The Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when a bank fails to meet prudential requirements (such as minimum capital adequacy ratio), when there are regulatory violations, or where depositors are threatened in any other way.

**Cross-Border Banking**

23 The Banking supervisors must practice global consolidated supervision over their internationally active banking organization.

24 A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved.

25 A Banking supervisor must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions.

**Bank Reforms and Restructuring: Some Experiences**

During the last two decades over 120 countries developed and developing have experienced banking crises in one form or the other. Whenever, the crises erupted and begun to intensify and spread the government had to intervene to restructure and recapitalize the banks in order to overcome the negative effect of the dysfunctioning banking system on economic growth and wealth. According to Charles Enoch et al, this was mainly done to
strengthen the bank capital, together with additional financial and operational restructuring of banks to restore public confidence in the banking system, reduce uncertainty, accelerate resolution of banking crisis, and promote economic recovery through reestablishing banking and payment services, and ensuring that viable businesses can fund their operations. For bank restructuring public fund was mainly needed to;

1. Make payouts to depositors of closed banks,
2. Compensate banks that agree to accept deposit transfers,
3. Facilitate an acquisition, merger, or purchase and assumption.
4. Help recapitalize banks, and
5. Restructure assets.

In the following sections we shall look into the experiences of some of the prominent countries that have faced the crisis. A sample of eight countries is chosen for analysis. Of these three; Japan, Sweden and USA are from the group of G-10 while three; Korea, Thailand and Philippines are from the former Asian tiger group and two countries China and India are taken to represent the growing economy. In selecting the country care is taken to accommodate countries following different economic ideologies.

We shall begin our discussion from Japan one of the three G-10 member countries followed by Sweden and the U.S.A. South Asian countries like Korea, Thailand and Philippines, and growing economies like China and India are followed in order.

---

15 Ibid.
16 Information of the countries mainly US, Sweden, and China are taken from various web sites of IMF, World Bank, Bank for International Settlement (BIS) and several news portals. For details please refer to bibliography.
Japan

Japan faced a full-blown systematic financial crisis in 1997 when several high profile financial institutions went into bankruptcy. Nissan Life Insurance, one of the nationwide insurance companies was ordered to suspend its operation. Sanyo Securities, a second tier securities firm filed an application for rehabilitation after it defaulted on its borrowing. Hokkaido Takushoku Bank, one of the city banks and Yamaichi securities also were ordered to suspend their operations.

In 1997, the Japanese authorities introduced the Prompt Corrective Action (PCA) under the law to ensure the soundness of financial institutions. it had two main components. It introduced a self-assessment process that held the banks themselves responsible for valuing their assets on a prudent and realistic basis, according to well-defined guidelines. By 1998, the severity of the problems faced by the Japanese banking system, and the need to use public funds to restructure it, were finally recognized. In February 1998, the Diet (The Japanese Parliament) passed two laws to amend the Deposit Insurance Law and to establish emergency measures for stabilizing the financial system. The new laws authorized the provision of 30 trillion yen (17 for dealing with bank failures and 13 for recapitalization of banks) to bail out banks and to protect depositors.37

The Financial Supervisory Agency (FSA) was established in June 1998 to take over the supervision of the banks from the Ministry of Finance and to consolidate the segmented supervisory function previously held by various bodies. It was granted considerable operational autonomy and independence. In October 1998, the Diet passed the Financial Revitalization Law and the Financial Early Strengthening Law and amended the Deposit Insurance Law to provide a broad framework for the resolution of banking problems. At the same time, the financial system was strengthened and the supervision was consolidated.

---

time the Diet also doubled the total amount of government funds set aside for the strengthening of the banking sector to 60 trillion Yen (12% of GDP), out of which 25 trillion Yen were earmarked for recapitalizing weak but solvent banks, 18 trillion Yen were earmarked for dealing with insolvent banks through nationalization and liquidation, and 17 trillion Yen were earmarked for full deposit protection of insolvent banks. The Financial Revitalization Committee (FRC) was established to oversee the bank restructuring process.

**Sweden**

The banking problems of Sweden came to light in late 1990 following which the government adopted comprehensive approach to meet the challenges.\(^{39}\)

a. A separate restructuring authority, known as the Bank Support Authority, was set up.

b. The government took steps to raise confidence in the country’s financial system. It guaranteed that the banks and all other credit institutions would meet their commitments as and when they arose.

c. The respective roles of all concerned agencies, the Ministry of Finance, the Riks Bank, the financial supervisory authority, and the bank support authority were clearly defined. There was free exchange of information between these agencies.

d. On the basis of capital adequacy and financial ratios, banks were divided into those which were viable and those, which were not. The former category was eligible for financial assistance while the banks in the latter were to be closed or merged with other institutions.

---

\(^{38}\) Ibid.

e. The support agreements contained conditions relating to change in management and improvement of internal control and risk management systems.

f. Structural reforms included strengthening of accounting, legal and regulatory frameworks and prudential supervision.

g. Separate Asset Management Companies, securum and retriva, were set up respectively for Nordbanken and Gota Bank, the two institutions, which received most of the budgetary support. These were solely funded and capitalized by the government.

**United States of America**

The 1980s and the early 1990s witnessed the most severe banking crisis in the U.S. since the Great Depression years. In this crisis, involving mainly the Savings and Loans institutions (S&Ls), or thrifts. Over 9,000 institutions were either closed or merged.

According to the U.S. News and World Report, July 9, 1984, banks were failing at a second post depression rate since the depression of 1930s. The number of troubled institutions on the “problem” list monitored by Federal Deposit Insurance Corporation (FDIC),\(^40\) soared from 217 in 1980 to 700 in 1984.\(^41\)

State and federal regulators in America closed 79 banks in 1984. During the same period another 947 were on the ‘problem’ list. Scores of Savings and Loan institutions were near insolvency. More than 21 rural banks were sucked. Even some of the largest banks, supposed symbol of financial safety and sound judgment, were also hit. To prevent a national banking crisis, the Federal Deposit Insurance Corporation engineered a US $ 4.5 billion-rescue operation.

---

\(^40\) The agency that guarantees savings and checking deposits up to Dollar 100,000
Bank of America, the second largest reported $1.6 billion loan losses in agriculture, shipping and real estates.\textsuperscript{42}

In dealing with troubled banks, the Federal Deposit Insurance Corporation (FDIC) mostly opted for the strategy of "open bank assistance" which involved preventive intervention before closure. This usually included assistance from the Federal Reserve in the form of emergency credits for temporary liquidity purposes. In the case of merger with healthier banks, FDIC entered into "income maintenance agreements", where it stood guarantee for a minimum return on the earning assets that were acquired.

The crisis brought a number of changes in the regulatory framework. The Competitive Equality Banking Act, 1987, provided for the establishment of "bridge banks" to take over the operations of a failing bank and maintain banking services for its customers. It helped "bridge" the gap between the failure of a bank and the time when the FDIC could implement a satisfactory resolution of the failing bank.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 allowed for placing temporary stewardship of problem banks with the federal authorities and in some cases allow for a temporary public equity stake when institutions are sold to the private sector. The FSLIC was liquidated and the FDIC took over insurance of thrifts. A new Office of Thrift Supervision was established to regulate thrifts. The Resolution Trust Corporation (RTC) was set up and given six years to clean up the assets of the thrift industry.

The FDIC Improvement Act, 1991, among other things, provided for rules requiring regulators to act quickly (Prompt Corrective Action) when a bank’s core capital falls below 2 per cent of risk assets and to replace management and limit the asset growth of "critically undercapitalized" banks. It also provided for restrictions on the Federal Reserve’s ability to provide credit to ailing banks and introduction of differential deposit insurance premiums.

\textsuperscript{42} Ibid.
Richard London after analyzing the American banking system concludes that “Americans, crushed under the heel of high interest rate and sky rocketing inflation... can take a lesson from the people of Islam and the banking system they have created”.

Korea

After the crisis, in November 1997, the government announced a blanket guarantee for deposits maintained with banks and other financial institutions. This was followed in December 1997 by a comprehensive reform package that included exit of unviable financial institutions, restructuring of others, and the strengthening of banking regulation and supervision.

The process of bank restructuring in Korea took the shape of voluntary mergers and foreign investments. The government to purchase Non Performing Assets (NPAs) and to recapitalise the banks provided sizeable public funds. The funds were provided through the issuance of bonds by the two government bodies, the Korea Asset Management Corporation (KAMCO) and the Korean Deposit Insurance Corporation (KDIC) which was a new agency formed by merger of all deposit insurance protection agencies and also by purchase of shares, ordinary and preferred, purchase of subordinated debt, purchases of non-performing loans and repayment of depositors.

The bad loans were purchased by KAMCO at a fixed price, 36 per cent of book value for secured loans and one per cent for unsecured loans based on historical estimates of loan recovery.

Supervision was placed with a new agency, which was also in charge of restructuring financial institutions. Regulations were tightened in the areas of

---


risk concentration, connected lending, maturity and currency mismatches, cross guarantees, and in making financial statements more transparent.

**Thailand**

Thailand’s financial sector had been facing problems since the early 1980s. The remedial measures then taken included strengthening of the legal, regulatory and supervisory arrangements, government takeovers, change in managements, mergers and closures, and financial support. The basic weaknesses, however, persisted and, in 1997, deeper structural weaknesses in the economy brought these weaknesses to the fore again.

Immediate regulatory action involved suspension of operation of 58 finance companies, which were required to submit rehabilitation plans. The Financial Sector Restructuring Authority (FSRA) and the Asset Management Corporation (AMC) were created to aid the restructuring process. The FSRA was established as an independent body under a separate Act in October 1997 to review the rehabilitation of the suspended companies and, where rehabilitation was not feasible, to oversee their liquidation.

Legal reforms were also undertaken which included amendments to bankruptcy and foreclosure procedures to ensure orderly resolution of corporate debts. Regulation was further tightened too, to bring accounting and classification of loans in line with international norms.

The FSRA assumed the responsibility of either rehabilitating or liquidating the troubled units. The most important point to note about the Thai financial restructuring programme has been that an entirely new institutional framework was created and the legal and regulatory framework was simultaneously amended to meet the requirements of the situation.
The Philippines

The problems faced by banks in the Philippines were exposed during early 1980s. The government declared a moratorium on external debt repayment. This led to a run on banks and capital outflows. By end of 1985, the Philippines National Bank (PNB) and the Development Bank of the Philippines (DBP) were declared insolvent. These banks accounted for nearly half of the banking system’s assets. Their non-performing loans formed about 70 per cent of their combined portfolios and about 21 per cent of the banking system’s assets.

The rehabilitation programmes included downsizing, transfer of non-performing assets to the Asset Privatization Trust, recapitalization, writing off of government deposits, introduction of new management, closing of branches and cost reduction programmes including significant staff cuts to the extent of nearly 25 per cent in PNB and 40 per cent in the case of DBP. In 1989, PNB was privatized up to 30 per cent and further to 57 per cent by 1996.

China

Extensive bank restructuring is being carried out in China since 1997. Four of the largest state-owned banks, viz., Industrial and Commercial Bank of China, Construction Bank of China, Agricultural Bank of China and Bank of China, are undergoing restructuring programmes aimed at improving their efficiency and increasing profits which had stagnated mainly due to huge non-performing assets estimated to be at about 20 per cent of total outstanding loans.

The series of measures taken by the government to improve management, capital and asset quality included increasing banks’ independence from local governments, setting up asset management companies, conversion of debt into equity, mergers, closures and liquidation, and direct capital injections from the central government. Between 10 and 20 per cent of total bank employees were be laid off in the process.
India

Bank reforms in India were part of the larger economic reforms initiated in the country during 1991, when country was faced with severe economic crisis. According to an estimate the public sector banks suffered losses of Rs.32.93 billion in 1992-93 and Rs.43.49 billion in 1993-94. According to a high official of the Reserve Bank of India, the factor which mainly contributed to the build-up of Non-Performing Assets (NPAs) was the lack of focused attention on the end use of funds.45

Another estimate by Standard & Poor’s and The Credit Rating Information Services of India Ltd. (CRISIL), says that India’s scheduled commercial banks require between US$11 billion-US$13 billion in new capital to support losses embedded in impaired assets.

The banking reforms specially focused on prudential guidelines, competition, merger, setting up of supervisory and surveillance mechanism and in house strengthening of banks. The implementation of prudential norms and guidelines has constituted a significant step towards introduction of transparency.

In order to strengthen the capital base of banks, the Reserve Bank in April 1992 introduced a risk weighted assets ratio system as a basis of assessment of capital for banks in India. It stipulates that Indian banks having branches abroad should achieve the minimum capital adequacy norms of 8 percent by March 31, 1995. Foreign banks operating in India were to achieve this norm of 8 percent by March 31, 1993. Other banks were to achieve this norm of 8 percent by March 31, 1996.46

---

45 Talwar, S.P., Deputy Governor of the Reserve Bank of India, ‘Emerging trends in supervision in India’ at the meeting of SAARC Supervisors in Pune (India) on 27-30/1/99.

In 1991 a committee on financial sector reform recommended following important policy measures:\(^{47}\)

1) Reduction in preemption of bank’s resources; Statutory Liquidity Ratio and Cash Reserve ratio (SLR& CRR to the minimum level).
2) Deregulation of interest rates: to reflect the market conditions.
3) Abolition of branch licensing policy: to make the entry of private sector possible.
4) Introducing new capital adequacy and other prudential norms covering Income recognition, assets classification and provisioning for bad loans.

Prudential norms were primarily introduced to serve two purposes. First, to reveal the true position of banks’ loan portfolio and secondly, to help in assessing the level of deterioration in the banking assets. The capital adequacy measure was aimed towards incentive based regulation for well capitalized and efficient banks to compete, while costs were imposed on under capitalized and poorly managed banks.

After the introduction of new prudential and accounting norms in 1992-93 most of the public sector banks were found to be undercapitalized. To cover this the government had to pump Rs. 10,9871.2 million during 1993-95, which rose to Rs. 20,0461.2 million by 1997-98.\(^{48}\) An asset would be considered substandard if it is classified as NPA for a period of not exceeding two years, doubtful when it remains NPA for a period exceeding 24 months (reduced to 18 months from 2001) and loss when it is identified as loss asset either by bank or international/external auditor but amount is not written off wholly or partly.

Banks were asked to classify their advances (Assets) into four categories i.e. standard, substandard, doubtful, and loss. Substandard, doubtful and loss assets are individually and collectively known as Non Performing Assets.

---


(NPAs). Accordingly a provision has to be made by the banks in the following manner;

Table 2.6

Assets Classification and Provisioning

<table>
<thead>
<tr>
<th>S. No.</th>
<th>Assets Classification</th>
<th>Provisioning</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Standard Assets</td>
<td>Nil</td>
</tr>
<tr>
<td>2</td>
<td>Substandard Assets</td>
<td>10 percent of total outstanding</td>
</tr>
<tr>
<td>3</td>
<td>Doubtful Assets</td>
<td>Up to one year 20%, 1 to 3 years 30%</td>
</tr>
<tr>
<td>4</td>
<td>Loss Assets</td>
<td>More than 3 years 50% then 100%</td>
</tr>
</tbody>
</table>


After the adoption of new regulatory norms there has been an improvement in banks performance, however, the cost of these banking distresses has been enormous on public exchequer as can be seen in the following table, which shows the cost incurred by the government on banking sector during 1998-2000.

Table: 2.7

Loss of Public Money in Public Sector Banks during 1998-2000 (Amount in Rs. Crores*)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Advances</th>
<th>Gross NPA</th>
<th>Maintenance Cost @ 5%/annum</th>
<th>Opportunity Cost</th>
<th>Total Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>284971</td>
<td>45653</td>
<td>31405</td>
<td>3430</td>
<td>6885</td>
</tr>
<tr>
<td>1999</td>
<td>325328</td>
<td>51710</td>
<td>35444</td>
<td>3899</td>
<td>6821</td>
</tr>
<tr>
<td>2000</td>
<td>380077</td>
<td>53294</td>
<td>34290</td>
<td>3772</td>
<td>6599</td>
</tr>
</tbody>
</table>

* 1 crore is equal to 10 million

Table 2.7 shows that during the three years period, 1998-2000, the government of India had to inject more than Rs. 203 billion of public money into the ailing banking system. This is enormous especially for a poor country like India. Moreover, it has continuously been observed that there is no end of the government support to the ailing financial institutions in the country especially banks. During the last two years few thousand crores of public money has gone to the maintenance of the ailing financial institutions in the country.

Conclusion

During last two decades more than hundred countries have some kind of financial crises. The frequency and the cost of these crises have been on increasing trend. Whenever a crises occurred government to prevent the contagion had to enter with millions of taxpayer’s money. Many times the cost of these crises has been to the tune of 45 percent of the total GDP of the country. An analysis of these crises whether national or international level reveals that there was a unanimous call for increased capitalization of the ailing institutions. In many countries regulators now believe that the capital has the public good, which is considered as cushion for unforeseen losses, capital adequacy is, thus, considered as the measure of banks’ internal strength to absorb risks.

As for the deposit insurance is concern current researches has shown that this has adversely affected the efficiency of the financial institutions apart from aggravating the moral hazard. In the words of Ajit and Bangar, “Deposit insurance is not necessarily the appropriate response to avoidance of instability. The main criticism against it is that it encourages excessive risk taking. Besides, it has been argued that since depositors are protected by insurance coverage, they have little or no incentive to monitor their banks activities.
There is moral hazard inherent in deposit insurance especially if the insurance is provided officially with implicit guarantees.\textsuperscript{49}

Some of the Western economists who claim the present system to be the most efficient have not been successful in providing convincing answers for the causes of these crises.

Islamic economists on the other are of the view that the root of the problem lie in interest based (fixed contract) system, which is pro rich and inherently biased in favor of debt capital. This system enlarges the gap between rich and poor and results in various economic evils that lead to financial crises and instability. James Robertson endorses this view in these words, 'the pervasive role of interest in the economic system results in the systematic transfer of money from those who have less to those who have more. When we look at the money system that way and when we begin to think about how it should be redesigned to carry out its function fairly and efficiently as part of an enabling and conserving economy, the arguments for an interest free inflation free money system for the twenty first century seem to be very strong'.\textsuperscript{50}

Recent researches in financial theory have shown that efficiency is independent to the capital structure rather a fixed pay system is more prone to instability and inefficiency than a system based on risk sharing. One of the famous theorem propounded by Miller Modigliani states that the value of the firm is independent of its financing decision.\textsuperscript{51} Lloyd Metzler of the University of Chicago proposed an alternative system in which contracts were based on equity rather than debt, and in which there was no guarantee of the nominal values of liability since these were tied to the nominal values of the assets.


\textsuperscript{50} James Robertson, 'Future Wealth: A New Economics for the 21\textsuperscript{st} Century'. Cassell Publications, London, 1990. p.130-1

Metzler showed that such a system did not have the instability characteristics of the conventional banking system.\(^5^2\)

The unprecedented growth in equity market during recent years in various parts of the world has also aided fuel to the thesis that as the economy marches towards advancement its reliance on fixed pay instruments decreases. Advancement in science and technology reduces the cost of information and asymmetry that makes debt based instruments economically unviable.

Islamic economists point out that the allocation of financial resources on the basis of profit/loss sharing gives more weight to the profitability of investment, whereas an interest based allocation gives it to credit worthiness. The allocation made on the basis of profitability is expected to be more efficient than that made on the basis of interest.\(^5^3\)

A number of economists (Islamic as well as conventional) have argued to shift to an equity oriented financial system on the ground that it will reduce the instability of the financial markets. It has been argued that the nominal value of deposits in conventional system is guaranteed whereas the same is not with the advances, which creates a discrepancy between assets and liabilities and ultimately to a crisis. On the contrary the profit and loss sharing system promptly cover any discrepancy on the assets side, as the nominal value is not guaranteed in this case. This will enhance the stability of the banking system. Besides, PLS system will put a check on abrupt capital flight, as it is the interest rate differential that leads to volatility in financial markets brings uncertainty and abrupt movement of capital from one to another place. As pointed out by a prominent economist at the IMF that a debt based system needs bankruptcy proceedings, debt restructuring, and workout mechanism and processes which the present international financial system lacks.\(^5^4\)


It is argued that rising interest rate spell danger not only to the western banking system but also to whole of the humanity. Higher interest rates could boost charges on most foreign loans. Economic forecasters at Data Resources Inc in Lexington, Massachusetts assert that a hike of 1 or 2 percentage point in international prime rate greatly increases the pressure for a moratorium or an outright default by a debtor country – an event that would mean steep losses for the banks involved.

Table: 2.8

Structure of Income of some Industrialized and developing Countries

<table>
<thead>
<tr>
<th>Countries</th>
<th>Interest income</th>
<th>Non interest income</th>
<th>Net Interest income (Spread)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>As a percentage to Gross income</td>
<td>As % to total Assets</td>
<td></td>
</tr>
<tr>
<td>Industrialized Countries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 USA</td>
<td>73.3</td>
<td>65.7</td>
<td>26.7</td>
</tr>
<tr>
<td>2 UK</td>
<td>65.5</td>
<td>56.8</td>
<td>34.5</td>
</tr>
<tr>
<td>3 Australia</td>
<td>61.0*</td>
<td>58.7</td>
<td>39.0</td>
</tr>
<tr>
<td>4 France</td>
<td>81.6</td>
<td>55.5</td>
<td>18.4</td>
</tr>
<tr>
<td>5 Germany</td>
<td>71.0</td>
<td>54.5</td>
<td>30.1</td>
</tr>
<tr>
<td>6 Switzerland</td>
<td>52.6</td>
<td>45.3</td>
<td>47.4</td>
</tr>
<tr>
<td>Developing Countries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 India</td>
<td>91.4</td>
<td>86.5</td>
<td>8.6</td>
</tr>
<tr>
<td>2 Mexico</td>
<td>64.2</td>
<td>78.4</td>
<td>35.8</td>
</tr>
<tr>
<td>3 Portugal</td>
<td>76.0</td>
<td>72.7</td>
<td>24.1</td>
</tr>
<tr>
<td>4 Turkey</td>
<td>49.3</td>
<td>140.7</td>
<td>50.7</td>
</tr>
<tr>
<td>5 Spain</td>
<td>81.7</td>
<td>74.8</td>
<td>18.3</td>
</tr>
</tbody>
</table>

N.A Not available, * for the year 1986, ** for the year 1988

Table 2.8 compares the structure of income of some of the industrialized and developing countries. We see that the average net interest income (spread) as percentage of total income for advanced countries is around 2.2 percent while the same for developing countries is 5.8 percent. As the country advances towards industrialization and its financial market gets diversified and matured the avenues for its income (other than interest) get enlarged. On the other hand the financial market and products of developing countries are not as diversified therefore the interest component of income in these countries are higher than those in advance financial markets. There seems to be a kind of inverse relationship between the level of industrialization of a country and the income from interest of bank in the same country. In the primitive stage banks do not have many avenues to increase their income other than normal lending operations. However, as the industrialization increases and financial markets gets mature the income avenues of the banks also increases and so the non-interest income.

Reforms and restructuring is the term often used by conventional economists to deal with any financial crises, however, Islamic economists are not content with this they call for reorganization of the system on different line. According to them, reforms and restructuring is merely a patchwork and not enough to avert the crises forever. For this, one has to reorganize the whole financial system on the basis of profit and loss sharing. At their own level Islamic economists have tried to introduce this system in some Islamic countries, which will be discussed in the coming chapters. Islamic economists call, for adopting equity based financial system, is not in the sense that debt based financial instrument would be totally prohibited rather they are of the view that debt based instrument should also be exposed to risk and be linked to the actual economic activity. They also offer some other solutions to improve the economic health, which according to them shall be fully implementable when the root cause i.e. ‘interest’ is eliminated from the economy. We shall discuss these issues in some details in the coming chapters.

****