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Capital Requirements for Banks in Non-Standard Contexts

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Bâle II constitue un large éventail de règles et de lignes directrices pour la gestion du capital et du risque des sociétés financières, s'agissant de questions liées à la supervision et à la transparence. Ces règles s'adressent à des banques disposant de divers niveaux de sophistication, dans des pays à différents stades de développement de leurs marchés financiers.

Basel II is a wide-ranging set of rules and guidelines for the capital and risk management of financial firms and for related supervision and disclosure (see BCBS, *International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, Basel, BIS, June 2004). These rules and guidelines are designed to accommodate banks of different levels of sophistication and in countries with financial markets at different levels of development. For this purpose they include a number of progressively more advanced methods for setting the capital adequacy requirements for credit and operational risk as well as supervisory and disclosure requirements which correspond to the various options selected by banks. Comment on the appropriateness of Basel II has focussed on both the practical problems of implementing so complex an agreement and on its likely effectiveness in achieving its goals, especially those of competitive equality among banks and greater financial stability. Much of this comment has concerned the shortage of people with the skills needed for supervision of Basel II and for the implementation of the required internal controls within banks themselves, the problems of achiev-

ing the necessary level of cross-border supervisory cooperation, and the avoidance of unwanted competitive pressures on banks which adopt the less advanced options under Basel II and in consequence are expected to face higher capital levels and thus higher costs.

Finding a good way to accommodate banking practices

There has also been much attention to the functioning of financial markets in economies at different levels of development and to ways in which Basel II may attribute too little importance to certain features of such markets in less advanced economies with a bearing on its suitability and effectiveness. Many of these features are connected to the difficulties of obtaining the valuation of assets and liabilities required for successful implementation of Basel II when markets are still underdeveloped, and of allowing for practices of risk management which are a response to such underdevelopment. Weaknesses in accounting regimes are inevitably raised here. More concretely attention has been drawn to the basic difficulty posed for Basel II by the

Cet article aborde d'autres questions, notamment celle de savoir si le cadre conceptuel sous-jacent à l'accord de Bâle II et à son prédécesseur, l'accord de Bâle I de 1988, est approprié pour des institutions qui ont des objectifs différents de ceux des banques traditionnelles ou qui fonctionnent dans un environnement où l'autonomie des banques est limitée par leurs liens avec d'autres entreprises et par le rôle d'instruments du développement économique que leur assigne le gouvernement.

Cet article est consacré aux institutions alternatives que sont les coopératives de crédit et les banques islamiques. Aucune de ces institutions ne publie de bilan conforme au modèle bancaire habituel auquel les règles sur le capital et le risque s'appliquent traditionnellement.

frequent absence of financial markets sufficiently deep and liquid to 'validate the value of accounting capital', thus reducing capital's usefulness as a cushion for meeting losses and as an indicator of banks' soundness (Rojas-Suarez, 2004, p.23). The discussion during the lengthy Basel II consultation process of the appropriate allowance for collateralisation in setting risk weights provides another example of the problems of finding a good way to accommodate banking practices from a broad range of countries.

A different way for credit cooperatives

This paper takes up other issues related to the appropriateness of the conceptual framework underlying Basel II and its predecessor, the Basel Capital Accord of 1988, to institutions which function in accordance with objectives different from those of traditional banks or in an environment where banks' autonomy is restricted by their links to other firms and by the role accorded to them by the government as instruments for economic development.

Under the heading of alternative institutions the paper looks at credit cooperatives and Islamic banks. Neither of these institutions has a balance sheet conforming to the banking model for which rules on capital requirements for various banking risks are traditionally designed, namely one where liabilities consist of deposits, standard forms of debt, equity, and hybrid financial instru-

ments with both debt and equity characteristics, and assets are dominated by lending and other forms of debt. For both types of institution there are also different assumptions about the distribution of risk among, and the remuneration of, the holders of their obligations.

Historically the regulation of non-profit institutions such as credit cooperatives has differed in some ways from that of conventional banks and investment firms, and its implementation is not always entrusted to the same supervisory bodies. Prudential regulation has focussed more on safety for individual depositors or shareholders and not on the implications for systemic risk of the failure of such institutions.

Basel II and Islamic banking

The reasons for this difference lie in factors such as the frequently relatively small size of the alternative financial sector and the absence or limited nature of its links to arrangements for payments and settlement which are considered an important vehicle for the wider transmission of shocks throughout the financial system. Recently, however, there have been steps in the European Union (EU) to bring cooperative credit institutions inside or closer to the ambit of the regulatory regime of conventional financial institutions, including the rules for capital adequacy. The reasons for this include the belief that a standardised set of minimum rules should apply

Dans les pays non musulmans, où les banques islamiques au service de communautés musulmanes coexistent avec les institutions financières non islamiques, il existe une pression pour que la législation s'appliquant aux premières soit aussi compatible que possible avec celle des banques conventionnelles, et ceci dans le but d'atteindre un niveau acceptable de conformité avec le cadre juridique du pays.

through the region's single financial market to facilitate cross-border supervisory cooperation and to minimise regulatory arbitrage among different national jurisdictions.

For Islamic banks the payment of interest is forbidden, and the holders of their liabilities share in banking risks in accordance with different principles and rules from those applying to conventional financial institutions. Nevertheless Basel II has also been accompanied by reexamination of the legal and regulatory frameworks for Islamic banking, in particular of those parts related to the incidence and management of banking risks and the role played by capital. This reexamination seems to be driven by factors such as the wish to enhance the international standing of such banks and the increased interest in the management of financial risk generated by Basel II.

Islamic banks more exposed to changes

In non-Islamic countries, including several in the EU, where Islamic banks serving Islamic communities coexist with non-Islamic financial institutions, there is pressure for the regulation applying to the former to be as compatible as possible with that for conventional banks in the interest of achieving an acceptable level of conformity within overall legal regimes. The location in many cases of entities providing financial services according Islamic rules - in Islamic as well as non-Islamic countries - within larger banks subject

to regulation and supervision along conventional lines has probably also contributed to pressure for regulatory convergence. Moreover the increased integration of financial markets inevitably leaves Islamic banks exposed to some extent to changes in credit and market risks which are the same as for non-Islamic banks and have their origins in cyclical movements and financial instability with cross-border or economy-wide effects.

The role of state-directed financing in economic development is a vast subject with many variants ranging from cases where the banking sector is largely or completely state-owned to others where privately owned institutions follow policy guidelines from their governments on the basis of some combination of formal rules and moral suasion. The record of such intervention is mixed, though very few countries had recourse to it at some stage in their histories.

Facing financial liberalisation

Here the example chosen is the Japanese model of development financing which was designed to realise the long-term prospects of strategically selected enterprises or sectors and included as a basic feature the willingness of banks and other firms with strong links to engage in mutual support (with official backing), should this be required. The banking practices and supervisory rules associated with this model were to prove ill adapted to the different banking

Le langage de la directive européenne sur l'activité des établissements de crédit et son exercice est forcément général car il doit couvrir une grande variété d'arrangements légaux et institutionnels, dans différents pays.

La définition des ressources devant servir, comme les capitaux propres, de garantie contre les pertes des institutions financières et le manque à gagner illustre les problèmes qui peuvent surgir quand des institutions fonctionnant sur des principes différents sont soumises à une même série de règles, établies à l'origine pour assurer la solvabilité d'institutions financières conventionnelles.

risks which became more important during the country's financial liberalisation beginning in the 1980s. These risks had to be managed during the booms in the property and stock markets of that decade which were to contribute substantially to the sector's huge accumulation of bad loans. However, earlier the model was considered as contributing importantly to the country's rapid industrial development, and had a major influence on policies towards the financial sector pursued by Japan's neighbours. This gives continuing interest to the model's assumptions about credit and market risk and the valuation of assets and firms which reflected principles differing in key respects from those embedded in Basel II.

Key objectives for European credit institutions

The recitals (31- 34) of the EU's directive on the taking up and pursuit of the business of credit institutions set out the key objectives of its regime for 'own funds', a term intended to comprise not only capital but also other items serving the same function for the institutions covered by the directive (see European Parliament and Council Directive 2000/12/EC of 20 March 2000, published in *Official Journal* L126, 26 May 2000).

'Common basic standards for the own funds of credit institutions are a key factor in the creation of an internal banking market since own funds serve

to ensure the continuity of credit institutions and to protect savings. Such harmonization strengthens the supervision of credit institutions and contributes to further co-ordination in the banking sector.'

'Such standards must apply to all credit institutions authorized in the Community.'

'The own funds of credit institutions can serve to absorb losses which are not matched by a sufficient volume of profits. The own funds also serve as an important yardstick for the competent authorities, in particular for the assessment of the solvency of credit institutions and for other prudential purposes.'

'Credit institutions, in an internal banking market, engage in direct competition with each other, and the definitions and standards pertaining to own funds must therefore be equivalent. To that end, the criteria for determining the composition of own funds must not be left solely to Member States. The adoption of common basic standards will be in the best interests of the Community in that it will prevent distortions of competition and will strengthen the Community banking system.'

A language that is necessarily general

Under Article 36.1 of the directive, for credit institutions set up as co-operative societies own funds consist of members' commitments which 'shall comprise those societies' un-called capital; together with the legal commitments of the members of those co-operative societies to make

La finance islamique est basée sur des préceptes dont certains diffèrent radicalement des principes qui régissent l'activité bancaire conventionnelle. L'application de ces préceptes n'est pas uniforme, ce qui reflète les variations dans l'interprétation donnée aux concepts islamiques par les Conseils de supervision de la Charia, à l'intérieur des banques, et par les législations en vigueur, même si tous les pays musulmans n'ont pas de lois bancaires islamiques.

additional non-refundable payments should the credit institution incur a loss, in which case it must be possible to demand those payments without delay'. Moreover 'the joint and several commitments of borrowers in the case of credit institutions organised as funds shall be treated in the same way as the preceding items'. This language is necessarily general since it must cover a wide variety of countries' legal and institutional arrangements: 'All such items may be included in own funds in so far as they are counted as the own funds of institutions of this category under national law'. The specification of the resources capable of serving, like capital, as a buffer against losses for non-profit financial institutions in this extension of EU rules illustrates problems which can arise when such institutions are brought within a single set of regulatory rules originally designed to assure the solvency of conventional financial institutions. To the extent that these resources consist of accounting items classified as sources of capital for conventional institutions (and specified as such, for example, in the Basel Capital Accord of 1988 and Basel II), they do not present problems going beyond the possible need to set rules for the contributions to non-profit institutions' own funds made by categories of resources which are linked to their risks in ways that differ from conventional institutions. But the directive also refers to callable capital and to contingent obligations connected to the cooperative

credit institutions' mutual character. These are difficult to measure for the purposes of supervisory solvency ratios as well as more generally as part of the institutions' accounting. Thus under International Accounting Standard (IAS) 37 of these items would be classified as contingent liabilities since they correspond to 'a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise' (see IASB, *International Financial Reporting Standards 2003*, London, IASCF Publications Department). Contingent liabilities are not recognised in the balance sheet or income statement. They are disclosed, and under disclosure is included estimation of their financial effect where this is practicable. But no general guidelines as to measurement for this purpose are provided.

Radically different precepts in Islamic banking

Islamic banking is based on precepts of which many differ radically from those underlying its conventional non-Islamic counterpart. These precepts include the following: the return on the use of money as such (without any other consideration), *riba*, and thus interest, is not permitted; contracts linked to the occurrence or non-occurrence of uncertain future events are not allowable (such contracts include those for hedging

Une initiative a été lancée dans le but de développer un cadre conceptuel approprié aux risques des banques islamiques mais également en grande partie parallèle aux accords de Bâle I et Bâle II. Les exigences de fonds propres applicables aux banques non islamiques sont basées sur l'évaluation des risques de crédit et de marché en fonction du capital. Au contraire, les préceptes islamiques impliquent le partage du risque entre les banques et leurs clients, un lien étroit entre les transactions bancaires et les avoirs réels, et l'évitement d'activités spéculatives.

and other derivatives); transactions for purely speculative purposes are not permitted (trading or investment transactions which may lead to losses as well as profits are not included in this prohibition); transactions involving certain activities or commodities are prohibited (these include pork, pornography, conventional financial services, arms and munitions with certain exceptions, cinema, tobacco, gambling and alcoholic liquor); the asset side of the balance sheet should consist of positions only related to permitted activities: there is greater emphasis than in conventional banking on the closeness of the link between banks' assets and their backing in real economic activities - sometimes denoted by the need for a financial transaction to have a 'material finality'.

Variations in the interpretation

This set of precepts is not comprehensive, others sometimes mentioned, for example, including the principle that a financial transaction should not lead to exploitation to any of the parties to it. Unsurprisingly the application of the precepts is not uniform. This reflects variations in the interpretation given to Islamic concepts both by banks' Supervisory Sharia Boards and in legal and regulatory systems. Not all Islamic countries have Islamic banking laws. Such laws are in place in Indonesia, Iran, Malaysia, Pakistan, Sudan, Turkey, United Arab Emirates and Yemen, but not in Egypt and Saudi Arabia.

The regulatory framework in Saudi Arabia makes no distinction between conventional and Islamic banks but the latter are supposed to follow Sharia. However, the regulatory authority, the Saudi Arabian Monetary Agency, has not assumed obligations regarding compliance with Sharia. Islamic precepts have implications for both the assets and liabilities of banks. On the liabilities side they do not permit the use of interest to mobilise funds. There are various available contractual relationships for account holders, which include non-interest-bearing deposits and, much more importantly in quantitative terms, profit-sharing investment accounts (PSIA), i.e. partnerships between capital and work (*mudaraba*) under which the bank manages the funds of customers in return for receiving a share of profits from activities financed. Under a strict interpretation of Islamic precepts holders of PSIA also agree to bear losses from the investment of their funds. In practice, owing to competitive pressures on Islamic banks to match the terms on deposits in non-Islamic banks, the returns on PSIA are 'smoothed' by drawing on income which might otherwise have been attributed to their shareholders, with the result that such banks are able to offer investors accounts which closely resemble deposit or savings accounts in conventional banks. Islamic banks face risks which belong mostly to the same categories as those of conventional banking but with differences in relative impor-

Cette initiative a principalement abouti en 1999 à la *Déclaration sur le cadre de référence applicable aux banques islamiques*. Ce document propose à ces établissements une méthode de calcul du ratio de fonds propres.

tance that reflect partly differences in the banks' rules and thus in their operations and the nature of their exposures.

A different risk management

Regulation of banks operating in accordance with Islamic precepts, like that of non-Islamic banks, is generally designed to ensure that their balance sheets and management meet certain standards. For example, in Bahrain, a major centre for Islamic banking, regulation is based on the items covered by the acronym, CAMEL - Capital Adequacy (C), Asset Quality (A), Management of Investment Accounts (M), Earnings Quality and Profit and Loss (E), and Liquidity Management (L).

Under capital adequacy there has been an initiative to develop a conceptual framework which is appropriate for the risks of Islamic banks but also parallels in important respects that of the 1988 Basel Capital Accord and Basel II. Capital adequacy regulations for non-Islamic banks are based on the assessment of credit and market risk in relation to the capital. Islamic precepts by contrast involve risk sharing between the banks and holders of their liabilities, a close link between banking transactions and real assets, and avoidance of speculative activities, all of which are capable of affecting the level of banking risks incurred and their incidence between different parties. The bank is also exposed to the risk of losses due to misman-

agement and negligence (fiduciary risks), which may lead to legal liability, and to the risk of transfers from shareholders' funds for the purpose of the 'smoothing' of investors' returns mentioned above (displaced commercial risk).

Basel II closer to Islamic banks?

A major result of this initiative is the 1999 *Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks* of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). This document proposes a method of calculating a capital adequacy ratio (CAR) for Islamic banks. The numerator of the ratio consists of items classified as capital under the 1988 Basel Capital Accord and Basel II with the exception of instruments included which have debt as well as equity characteristics (and not including PSIA accounts themselves which are not considered to serve the buffer function of capital). The denominator consists of risk-weighted assets as follows: assets financed by the bank's own capital and non-PSIA liabilities plus 50 per cent of assets financed by PSIA (to cover the fiduciary and displaced commercial risks of such assets). Other approaches to the capital requirements and risk management of Islamic banks which put less emphasis than the AAOIFI initiative on features of an Islamic analogue to the 1988 Basel Capital Accord and Basel II have also been proposed by regu-

La valeur globale de l'ensemble des avoirs gérés selon les principes islamiques reste relativement faible : aux environs de 250 milliards de dollars. Ce chiffre peut être comparé aux 3'000 milliards de dollars des crédits accordés par les banques britanniques, et aux 20'000 milliards des banques américaines. Néanmoins, les avoirs des banques islamiques enregistrent une augmentation de 10% par an.

lators, credit rating agencies, and other commentators.

One approach would be to treat Islamic banks for regulatory purposes as mutual funds, whose obligation is to repay not the original sum invested but that remaining after taking account of gains or losses at the time of redemption. However, some commentators have observed that this would fall foul of account holders' own perceptions as to their deposits and investments. Mutual funds complying with Islamic precepts are already available to Muslims and are the recipients of substantial investment amounts. But there are also large sums held in PSIA, which suggest that people distinguish between the two categories of account (see A.Cunningham, 'Islamic Banks - in for a Pound, in for a Penny', *The Banker*, February 2000).

Three possible approaches

A second approach would be to structure liabilities and assets in entities designed to satisfy the differing objectives and risk appetites of account holders. In the entity intended for account holders with high risk aversion and a high requirement for liquidity their funds would be backed by asset-backed securities with low risk and easy marketability (i.e. in an entity similar to the 'narrow bank' of the theory of conventional banking - a 'narrow bank' is one whose deposits would be backed by assets with low risk and high liquidity such as various categories of government

debt; the difference in comparison with an Islamic counterpart is that the assets of the latter could not include debt, though they would require similar levels of risk and liquidity); and funds of other account holders willing to incur greater risks would be similarly placed in entities with assets chosen appropriately in the light of their investment objectives (El-Hawary et al., 2004, pp.36-38). Thus next to the entities for the most risk-averse would be entities similar to mutual funds for investors with risk appetites similar to those of investors in conventional versions of such funds. Regulation of these entities would follow lines similar to that of their conventional counterparts. A third kind of entity would be directed at the requirements of investors willing to take longer-term, riskier positions similar to investments in private equity and venture capital, which would require another type of regulation. This approach would appear to have the advantage over the first of accommodating all the different items amongst an Islamic bank's liabilities, including non-interest-bearing deposits.

A small global value of total assets

A third approach, which has some support amongst regulators in the United Kingdom, would involve a structuring of liabilities according to a system of subordination of the rights of different categories of account holder (see H. Davies, 'Regulatory Issues Facing Islamic Finan-

A la différence des dernières générations de banquiers américains, les banquiers japonais n'ont pas essayé de déterminer la viabilité d'une entreprise sur la base des rendements financiers d'un projet d'affaires spécifique. Ils portaient au contraire de l'idée que s'ils s'associaient à une entreprise, une relation se créerait sur une longue durée. Ils évaluaient donc un prêt en considérant l'entreprise dans son entier, ainsi que son avenir. Ils portaient du principe que les perspectives d'une entreprise ne dépendaient pas simplement des chiffres du bilan mais aussi de ses contacts sociaux.

cial Institutions', and M. Foot, 'The Future of Islamic Banking in Britain', contribution to the Islamic Financial Services Board (IFSB) London Summit, 19 May 2004). This would be accompanied on the asset side by an appropriate classification of risks and eventual rules on capital adequacy which take into account the actual risk experience of banks following Islamic precepts.

The global value of total assets managed according to Islamic principles is still relatively small. Approximate estimates place it at about \$250 billion. This total can be compared with one of more than \$3 trillion for the outstanding domestic credit advanced by United Kingdom banks and of about \$10 trillion for United States banks (see W. Grais, 'Perspectives for the Islamic Finance Industry', Remarks at the IFSB London Summit, 19 May 2004). However, such assets are growing at a pace well above 10 per cent annually which, if sustained, will eventually lead to amounts which are a significant proportion of global GDP.

Some accounts on the Japanese model

Major features of this system have been surveyed in several books (Coulbeck, 1984, chapter 4; Swary & Topf, 1992, chapter 6). Rather than through a summary of this literature these features will be illustrated here by drawing on accounts of historical particulars. One of these accounts is that of the rise and fall of Long Term Credit Bank

(LTCB) and its re-emergence as Shinsei by the *Financial Times* journalist, Gillian Tett, and the other is a banker's characterisation of the Mitsui group as part the decision of a major investment bank to issue its commercial paper in the United States (Smith, 1989, chapter 9). A key role in the first story is played by Katsunobu Onogi, President of LTCB at the time of its nationalisation in the autumn of 1998. Onogi's own description of Japan's 'main bank system' serves as a useful summary (Tett, 2004, pp.87, 11-12). 'At the top stood the Ministry of Finance, which exerted its control over the entire system through the practice of 'administrative guidance'. Below that was the 'main bank', which was linked to clients through the lending relationships and cross shareholding ... the real responsibility for corporate governance in Japan was balanced between the banks, their clients, and the Ministry of Finance. The only exception was when a company had fallen into such deep distress that its main bank had effectively taken control of the operations; in that situation the bank was assumed to be the 'parent' of the group, entirely responsible for corporate governance.'

Confidence in inter-enterprise relations

Inter-enterprise relations Onogi exemplified with three banks A, B, and C and three companies also labelled A, B, and C as follows: 'Although company A was the child of Bank A, it also had lending rela-

Les coopératives de crédit et les banques islamiques sont toutes deux basées sur des modèles de participation aux activités financières incorporant des cadres de référence alternatifs et des objectifs pouvant servir de miroir. Celui-ci rapporté à la finance conventionnelle, met en lumière certains principes implicites parmi les moins fréquemment examinés, notamment lorsqu'ils comportent une dimension éthique.

tions with Bank B and Bank C; similarly, the B and C companies were also linked to the other banks. The entire system existed as a complex lattice ... that connected everybody to everybody else, and it hung together because it was assumed that a parent bank would always support its child. When Bank A lent to company B, for example, it was not doing so because it had confidence in the strength of company B, but because it had confidence in Bank B playing its role. The system worked only if everybody fulfilled their duty. But if any bank failed to play its correct part, the trust that underpinned the entire matrix would shatter.'

Such a system lay behind the approach to lending found by Onogi when he was promoted to assistant loan officer a year after he joined LTCB in 1959:

'... lending decisions depended on two things. First, the bankers knew that they were supposed to be channelling their loans into companies of 'national importance', which were initially defined by the government to be ship-builders, power companies, steel, and coal mining ... Second, the bankers knew they should only give money to companies that were 'viable'. Unlike later generations of American bankers, Japanese bankers did not try to assess what was 'viable' by looking at the financial returns a specific business project would produce. Nor did they look at the cost of money over time. Instead, they assumed that when they lent to a company, they created a relationship that would last for a long period. Thus, they tended to measure

whether a loan was sensible by looking at the entire company and its future prospects. And they considered that a company's prospects depended not simply on corporate statistics, but also on social contacts: companies with a web of reliable keiretsu allies would usually survive in the Japanese system, but companies without allies could easily die'.

'Almost no equity'

'Thus, when the Japanese bankers looked at their money, they did not change the interest rate to reflect the risk of different customers, since it was the government that set the price of money ... And the concept of trying to use money to make more money, purely for its own sake, was also considered rather disloyal to the national interest. Money was seen as a means to an end, not an end in itself - and the end was the revival of Japan.'

Such a system has effects on the size and incidence of losses and thus on the creditworthiness of firms and on the balance sheets and capital requirements of banks. It is thus interesting to see how in 1969 Roy Smith, a partner of Goldman Sachs, made the case for undertaking issuance of commercial paper for Mitsui & Co., the Japanese trading house through an argument which concretely illustrates features of Onogi's portrayal and indicates how the Japanese system was intended to reduce the need for capital as a safety buffer (Smith, 1989, pp.297-298).

A member of the management committee had queried Smith's proposal.

La dimension éthique est moins immédiatement évidente dans le cas du modèle japonais de financement. Dans ce cadre, les positions de pouvoir dans les banques et au gouvernement étaient occupées par les descendants des samurai, une classe privilégiée de guerriers avec un code de l'honneur strict. La subordination de la finance au renouveau des idéaux nationaux, ainsi que le sens du devoir social caractéristique de la vision du monde de cette classe et de l'histoire récente du Japon, font partie intégrante d'un contexte où l'élément éthique est important.

'What the hell kind of business is this? It's got almost no equity - more than ninety percent of its assets are financed with debt - current assets are less than current liabilities, earnings as a percentage of sales are less than one half of one percent, and the company doesn't make anything.'

A mirror of the missing ethical dimension

Smith's reply included the following:

'The Japanese system of corporate finance is very different from ours. As capital is in very short supply, there is a lot of leverage, provided mainly by banks and suppliers. They know that Japanese companies in their system of mutual support have access to extraordinary reserves if need be. Mitsui was the brains of the Mitsui zaibatsu before the war and is again the brains of the newly constituted Mitsui Group. More than a third of its stock is owned by members of the group, and Mitsui owns stock in each of the group members too. A large part of Mitsui's assets are receivables from group companies; many of its liabilities are provided by Mitsui Bank, Mitsui Life Insurance, and other Mitsui group creditors. Other Japanese banks have sizable loans outstanding to the company too, and all of these loans are reviewed closely and periodically by the Ministry of Finance and the Bank of Japan ... Their safety net is carefully woven to permit large amounts of leverage, which is the only way they can finance the extraordinary growth that Japan has been experiencing.'

Both credit cooperatives and Islamic banks are based on models of participation in financial activity incorporating alternative frameworks and objectives which can serve as a mirror that, when held up to conventional banking, highlights some of its implicit or less frequently examined assumptions and principles, including those with an ethical dimension. In both cases practical problems posed regarding the role and measurement of capital for such institutions are related to these alternative frameworks and objectives and, as noted, have been the subject of attention on the part of those responsible for the design of regulation for financial systems which include such institutions.

The phantom of samurai

In the case of the Japanese model of national development financing there is a less immediately evident ethical dimension, and the implications for capital adequacy bear more importantly on the model's conceptual rationale than on current practical problems involving the application of regulatory rules. In this model key roles in both banks and the government were played by members of the class whose ancestors had been *samurai*, a privileged warrior class with a strong code of honour. Senior bank officials were well paid by normal standards but their remuneration fell short of the stratospheric levels which have become increasingly common in the Anglo-American financial sector.

Peu de choses sont vraiment nouvelles en finance, dès lors que la plupart des transactions et de leurs instruments ont des précédents historiques. De même, il est probablement vrai que les modèles financiers qui ont prouvé leur valeur dans certains pays et à certaines époques seront réutilisés dans le cadre des politiques de développement. Les personnes en charge des règles internationales devraient être assez flexibles pour en tenir compte.

The subordination of finance to national revival and development as well as the assumptions about firms' obligations regarding mutual support which belonged to the outlook of this class and which characterised a significant part of Japan's recent history were embedded in a framework that contained an important ethical component. During the period of its effectiveness the Japanese model was intended to generate lower levels and a better distribution of financial risks through arrangements which are at variance with the stand-alone banking model underlying Basel II.

The spectre of historical precedents

Practical regulatory problems posed by the divergence of this banking model from the stand-alone one can be handled through flexibility in the application of regulatory rules (this is the solution put forward by

one well known authority on international financial economics, Barry Eichengreen. See Eichengreen, 2002, pp.24-25, 137). But at a deeper level the divergence indicates the possibility of shortcomings in international rule design which result from conscious or subconscious reliance on assumptions as to the superiority of institutions and arrangements rooted in particular historical experiences. It is a commonplace that there is little that is really new in finance since most transactions and instruments have (frequently distant) historical precedents. Equally it is probably true that financial models (such as that just described) which have proven their worth in some countries during some epochs will be tried again by policy makers striving to achieve economic development. Those responsible for international standards would be ill advised not to include within their design sufficient flexibility to accommodate this.

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