How do banks lose money from bad debts?

Relayed by John Horrocks, ERA (NSW)

School Principal and Economist David Gracey often writes for Economic Reform, the newsletter published by the Committee on Monetary and Economic Reform each month. This is what he wrote in February 1998:

"Occasionally I'm asked questions by readers about previous columns.

QUESTION : If a borrower cannot repay his loans, how does the bank lose money which it created in the first place?

ANSWER:

It is important to distinguish between (private) bank credit and legal tender. Both serve as transaction money, but bank credit is ephemeral while legal tender created by the Reserve bank is permanent.

A bank makes a loan by creating a deposit for the borrower. The asset (the loan) balances the liability (the deposit) on the bank's books. But depending on the type of loan, the bank must have some backing in capital or reserves. Thus a small fraction of the loan is "secured" by legal tender.

Since the borrower has borrowed for a purpose, he will write cheques to various people or businesses. Most of those cheques will be deposited in other banks which will then have a claim on the issuing bank. Such claims are "cleared" daily and banks have to pay their debts to other banks in cash. By this process a bank could lose legal tender over time and be forced to reduce its loans or borrow from the Reserve bank.

If a loan is not repaid, the issuing bank is still responsible for those debts to other banks. That's what happened in 1991 when various debtors defaulted. The banks lost a great deal of their capital and had to reduce their loans, causing a credit crunch.

That is also what happened in East Asia. Due to careless, probably corrupt, lending practices the expansion of bank credit outran the real economy. When the bubble burst, billions of loans were defaulted, and most of the banks are now insolvent, i.e. lack sufficient capital to pay their debts. So they have to be bailed out by the IMF or their own governments (the burden of course falls on the hapless taxpayer, higher taxes to save the profligate banks). Otherwise most of them would disappear - as many banks did during the Great Depression (or, as Hixson likes to call it, the Great Liquidation - which wouldn't have happened if they had listened to Irving Fisher and Henry C Simons at the time, and later to Milton Friedman, Hotson and Pope). Thus a large chunk of the money supply vanishes (goes back to the thin air from which it came!) ■

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Muslims Take a Lead in Just Bilateral and Multilateral Trading

Reuters report, from Peter Challen KUALA LUMPUR 06.11.2002

Eight Muslim countries launched a global agency this week to set standards for an Islamic financial system that will end "debt slavery", says Malaysian Prime Minister Mahathir Mohamad. The basic principle of Islamic banking is the prohibition of usury or interest. It also outlaws investments in companies involved in gambling, alcohol or pig farming. The Islamic Financial Services Board (IFSB), inaugurated in the Malaysian capital, Kuala Lumpur, is entrusted with setting standards for Islamic institutions and ensuring they conform with principles of Islamic sharia laws.

Mahathir, in an address to about 1000 delegates from around the Muslim world, said a hallmark of the Islamic system was that risk was equally shared between lender and borrower. The international banking system stacked deals heavily in favour of lenders, he said, and some countries ended up in "debt slavery". "They are not going to lend if they cannot gain control over their borrowers in order to recover their loans, irrespective of the misery this might cause. "Clearly, debt slavery has not been abolished in the international financial system," said Mahathir, who refused to accept a bailout from the International Monetary Fund during the Asian crisis in the late 1990s, or submit to IMF policies that caused economic pain for neighbours.

Bankers attending the inauguration of the board said growing demand for ethical investments cut across religions, and non-Muslims were increasingly investing in Islamic concerns. Some Arabs who withdrew investments from the United States in fear of a backlash after the September 11 attacks were also putting more money into Islamic banks, they said. "The backlash against Muslims following September 11 is in fact helping Islamic banks," said one Malaysian banker. One estimate said about US$200 billion ($416 billion) of Muslim funds had fled the United States. A Western banker said Islamic funds run by mainstream Western banks were also attracting interest from non-Muslims riding an ethical investment bandwagon.

There are about 200 Islamic banking institutions in at least 48 countries with combined assets of about US$170 billion ($345 billion). Under Islamic laws, banks make money through profit-sharing from returns and approved investments. The Islamic banking industry, which has grown more than 10 per cent a year over the past 40 years, is expected to grow by the same rate over the next decades, says the Bahrain-based General Council for Islamic Banks and Financial Institutions.

Efforts are also underway to develop an Islamic capital market to tap the estimated US$1.3 trillion in Islamic funds that are invested in conventional markets. Mainly Muslim Malaysia has been running an Islamic banking system alongside a conventional financial system, a trend that Mahathir said would continue. Malaysia's central Bank Negara governor, Zeti Akhtar Aziz, said Islamic banking and finance had been described as a "mirror of the sea". "For until and unless we have the courage to explore its depth, we would never be able to uncover the treasures that reside within," she said.

Islamic banks in Malaysia represent about 8.8 per cent of the country's total banking assets, worth about 65 billion ringgit ($35.4 billion). In June, Malaysia completed the world's first Islamic global bond issue, lead-managed by HSBC. The IFSB's founding members are Malaysia, Indonesia, Bahrain, Saudi Arabia, Sudan, Iran, Kuwait and Pakistan. ■

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