The Regulatory and Practical Application of the Lender of Last Resort Doctrine in Pakistan

By

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Abstract

This thesis is divided into four main parts. This thesis examines the operation of the lender of last resort (LOLR) in Pakistan. In order to deter financial crisis, the Central Bank (CB) plays the role of LOLR by taking necessary steps. The operations of LOLR by the Central Banks of the United Kingdom and the United States of America are used as examples to present reforms for the system of Pakistan. Firstly, the research evaluates the significance of the banking industry and examines the importance of LOLR in Pakistan. The thesis further examines the causes of financial crises and evaluates the factors that made LOLR an integral part of the responsibilities of CBs. Secondly, it explains the progression of the role of LOLR along with the emergence of CBs as a financial policy regulator of the State. Furthermore, this thesis analyses the classical and modern theories of LOLR.

Thirdly, the case study of KASB bank from Pakistan is used to identify the problem in the current regulatory system. In order to determine if LOLR can be effectively regulated in Pakistan; Northern Rock, Lehman Brothers, and AIG are used as examples. Fourthly, this thesis examines the current laws which regulate LOLR in Pakistan and evaluates its limitations. There are currently two types of banking systems operating in Pakistan, which are commercial and Islamic banks. The latter operates on interest-free banking, which could limit the effectiveness of the LOLR mechanism. Notwithstanding, this thesis mainly addresses the commercial banking sector of Pakistan. The thesis concludes by recommending reforms to the financial system of Pakistan according to the lessons learned from the illustrations of the UK and the USA. It also provides an analysis of the recommended reform proposals.

Chapter 1: Thesis Introduction

1.1 Introduction:

Lender of last resort is one of the fundamental duties of the Central Bank. In the modern financial system, it is the responsibility of the CB to maintain stability in the system and strengthen financial institutions against financial crises. The main aim of this chapter in this research is to provide a comprehensive rationale behind selecting this topic for research. It provides a brief argument on the contemporary significance of the topic of research. Furthermore, two figures are also used in this chapter to demonstrate that there are loopholes that will be addressed in this research. This particular chapter further contributes to this study by providing the research question, research aims, and limitations of this research. A complete layout of this research is also provided in this chapter.

1.2 Rationale

Lending liquidity to financial institutions that are in need of liquidity has been in practice for over 200 years.[1] From the outset, many policymakers and even Central Banks were against the existence of a lender of last resort (LOLR) and believed that its presence will lead to a fragile domestic banking system.[2] The rationale behind the existence of LOLR was nothing more than imparting liquidity to the financial institutions facing a shortage of liquidity thereby deterring a financial crisis. Furthermore, the survival of the banking industry rests upon the trust of its

[1] Robert E. Keleher, Thomas M. Humphery, "The Lender of Last Resort A Historical Perspective", (1984) Cato Journal, Vol.4, No.1, Page No. 275

[2] Paul Kosmetatos, The 1772–73 British Credit Crisis, (Springer, 2018), Page No.191, ISBN: 978-3-319-70907-9

creditors.[3] Therefore, a financial panic among the creditors can increase the demand for liquidity and create a situation in which it becomes impossible for the banks to deter a financial crisis.[4]

The presence of LOLR assures the creditors that in the time of financial need, the CB would intervene and rescue the financial institutions by imparting liquidity. This provides stability, in the financial institutions by allowing them to overcome a liquidity shortage/shortage of liquidity. The principle set by the early academics that the Central Banks should only provide liquidity support to the financial institutions which are capable of providing collateral and this facility of liquidity should also be charged on the high-interest rate.[5]

However, there are certain discretionary powers attached to the function of LOLR which the Bank of England (BOE) has used in the best interest of its financial system during financial crises.[6] It lent liquidity to the financial institutions even on a lower interest rate and has denied operating as a LOLR in certain cases.[7] For example, the BOE adopted an uncommon approach and nationalised the Bank of Northern Rocks instead of imparting liquidity to it. The decisions of the BOE were quite helpful in protecting financial institutions from a collapse during the financial crisis of 2007-2008 and enhanced the functions of LOLR in the UK.[8]

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[3] Robert E. Keleher, Thomas M. Humphery, "The Lender of Last Resort A Historical Perspective", (1984) Cato Journal, Vol.4, No.1, Page No. 275

[4] Paul Kosmetatos, The 1772–73 British Credit Crisis, (Springer, 2018), Page No.191, ISBN: 978-3-319-70907-9

[5] See Chapter two (Walter Baghot and Honery Thornton)

[6] Gayane Oganesyan, "The Changed Role of LOLR: Crisis Responses of Federal Reserves, European CB and Bank of England", (2013) Institute for International Political Economy Berlin 19/2013, Accessed: March 30, 2018.

[7] Mike Anson, David Bholat, Miao Kang and Ryland Thomas, "The Bank of England as Lender of last resort: new historical evidence from daily transactional data", (2017) The Bank of England 691/2017, Accessed: April 10, 2018

[8] Robert E. Keleher, Thomas M. Humphery, "The Lender of Last Resort A Historical Perspective", (1984) Cato Journal, Vol.4, No.1, Page No. 275

Similarly, in the United States, the Federal Reserve played an imperative role in strengthening its financial institutions during the financial crisis of 2007-2008.[9] The liquidity support was provided to the financial institutions which were capable of providing adequate collateral.[10] The Federal Reserve rescued AIG and refused to extend liquidity support to Lehman Brothers because the bank was not complying with the rules set by the Federal Reserve.[11]

The State Bank of Pakistan (SBP), which was established on the model of BOE,[12] has however struggled to maintain stability in the financial system of Pakistan. The powers of the SBP to act as a LOLR are also based on the principle of Walter Bagehot which provides that it should only lend to the financial institutions that can provide sufficient collateral. Furthermore, frequent political interference and continuous engagement of the SBP in LOLR's operations have created uncertainty in the financial system of Pakistan.[13]

The International Monetary Fund (IMF) played the role of international LOLR for Pakistan because a continuous engagement of the SBP in rescuing the national and financial institutions made it difficult for the SBP to survive without the intervention of an ILOLR. The LOLR operation of the SBP in the case of KASB bank is one of the most recent cases which is examined and discussed in detail in chapter six of this study. However, the involvement of the IMF could not bring stability to the financial system of Pakistan.[14]

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[9] Stanley Fischer, "The Lender of Last Resort Function in the United States" (2016), International Finnace, Vol. 2 Page No. 239-60.
[10] Paul Kosmetatos, The 1772–73 British Credit Crisis, (Springer, 2018), Page No.191, ISBN: 978-3-319-70907-9
[11] Hansjörg Herr, Sina Rüdiger & Jennifer Pédussel Wu, "The Federal Reserve as Lender of Last Resort During the Subprime Crisis–Successful Stabilisation Without Structural Changes" (2016) Berlin School of Economics Accessed: April 01, 2020.
[12] C.A.E. Goodhart (1999), "Myths about Lender of Last Resort," (1999) *International Finance,* Vol. 2, Page No. 339-60
[13] Muhammad Farooq Arby, "State Bank of Pakistan: Evolution, Functions and Organization", (2009) MPRA Paper No. 13614), Accessed: June 10, 2018
[14] Ibid

To this end, the thesis aims to evaluate the doctrine of LOLR and appraise the financial regulatory framework in Pakistan in order to determine whether the reform is essential in relation to the function of LOLR. Furthermore, the study evaluates the practical application of the doctrine of LOLR in the UK and the USA in order to draw lessons from its operations and provide recommendations beneficial to Pakistan.

It is important to understand that the rationale behind the existence of LOLR is not only to lend liquidity in tough conditions but to maintain the stability in the financial system. An apprehension among the investors about the stability of the financial system rapidly increases the demand for liquidity which is the most annihilating factor for a system and ultimately resulting in its collapse. Nonetheless, the assurance of the CB that it will play the role of LOLR and address the issue eliminates the panic which decreases the demand for liquidity.[15] Usually, to address the issue of liquidity, the financial institutions sell their illiquid assets and handle the issue whereas the absence of a LOLR raises the demand and compels the financial institutions to sell their assets swiftly. A rapid sale of assets mostly deteriorates their value and makes the situation more difficult to handle for financial institutions.[16] Imparting liquidity is not the only mandate the LOLR has; the CBs can purchase the illiquid assets of the financial institutions to provide liquidity.

To further illustrate the research problem, two tentative charts are used to show the operational system of the financial system in the UK and Pakistan.

[15] Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.

[16] Marc Dobler, Simon Gray, Diarmuid Murphy, and Bozena Radzewicz-Bak "The LOLR Function after the Global Financial Crisis" (2016), IMF working paper No. 16/10, ISBN: 9781498355995/1018-5941,Assessed: May 17, 2017.

Figure 1: Tentative Figure of Financial System of a Developed Country (UK, USA):

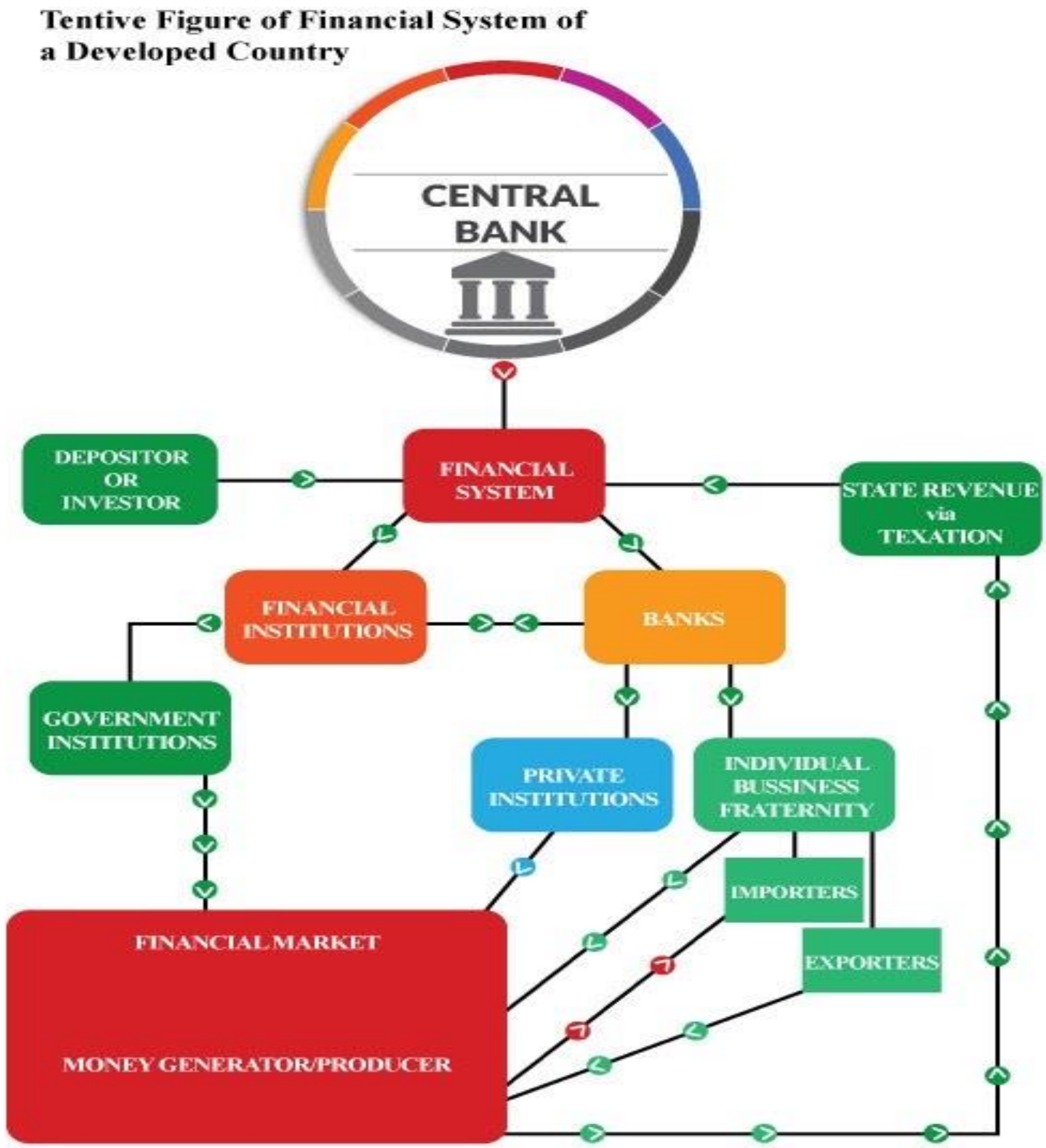

Figure 1: Tentative Figure of a developed country (UK, USA)

Figure 1 explains the financial system of the UK. It further illustrates that the Central bank injects liquidity into the financial system which includes banks. Depositors also invest their money in the financial system and play an imperative role in maintaining stability in the economic system of a country. The main acumen behind having an efficient system of LOLR is not to inject liquidity during financial unrest but to ensure the trust of the depositors in the system. If a financial system loses the trust of its depositors, it enhances the demand for liquidity and makes it difficult to prevent a recession. Thereby, the trust of the depositors is required to maintain stability in the financial system of a country. This is why, in the developed countries i.e., the UK and USA financial regulators pay heed to ensure the trust of the depositors in the financial system. Banks lend liquidity to the companies and business groups for commercial ventures. Financial bodies put their money into the financial market and earn more money through their business activities. The State helps them by providing the facilities, such as law and policy, to carry out their business. The State, on the other hand, recovers money via direct and indirect taxation. However, if the financial institution is faced with any liquidity crisis, the Central Bank intervenes and imparts liquidity which strengthens these financial institutions to overcome the liquidity crisis.[17] The ability of the Central Bank to inject liquidity during any financial unrest prevents the financial situation from further escalation. Thus, the strength of a financial system rests on the trust of the creditors in the system.

[17] Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.

Figure 2: Tentative Figure of Financial System of Pakistan

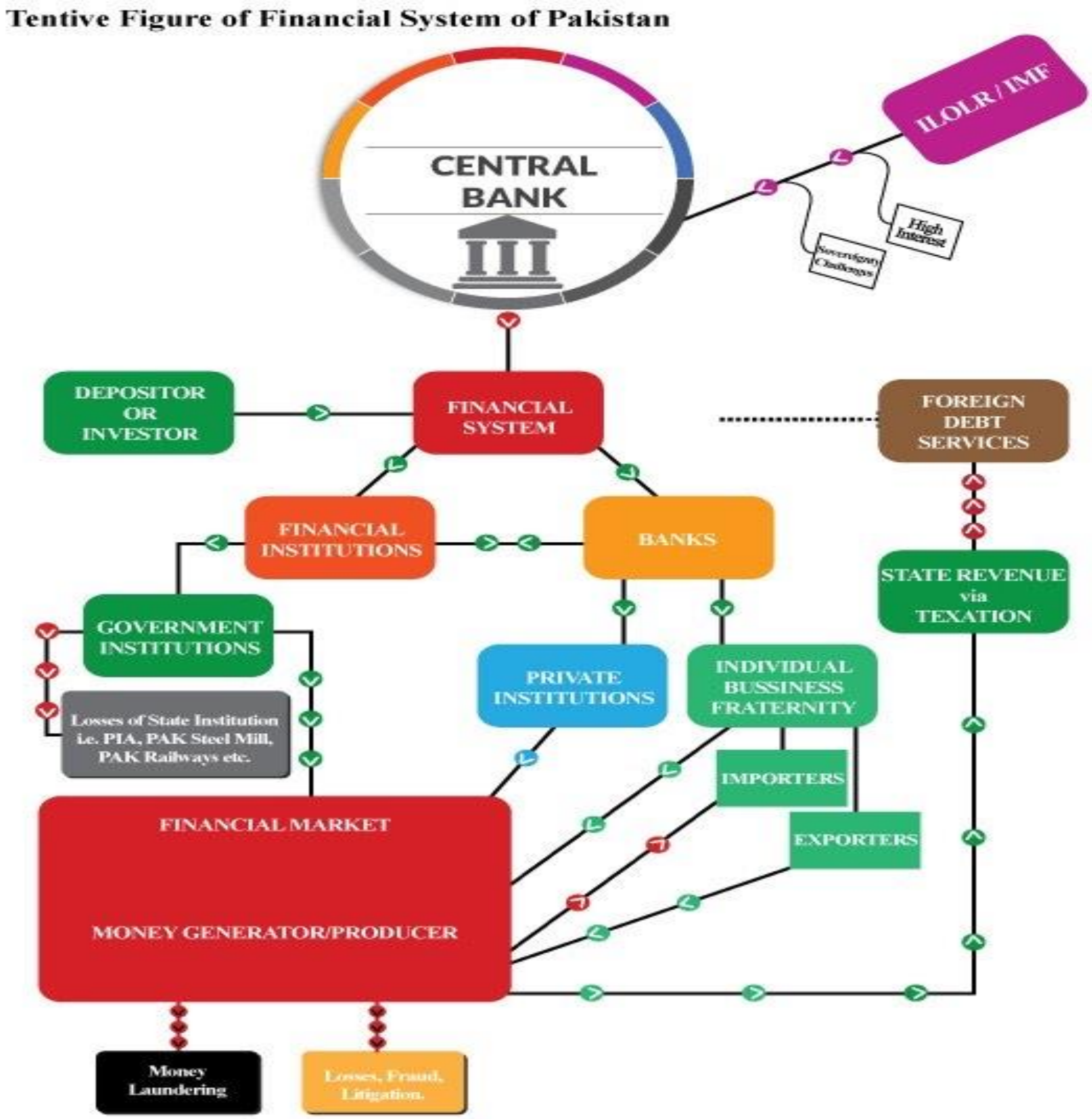

Figure 2: Tentative Figure of Financial System of Pakistan

Figure two explains the financial system of Pakistan and its problems. The figures portray the current financial problems and explain how an effective regulatory framework will be able to address these issues. Furthermore, figure two depicts the reasons why SBP is incessantly involved in the rescue operations of financial institutions. It further explains the problems of the financial system in Pakistan. The logic behind the operation of LOLR is to rescue the financial system against the financial crisis and bring stability. The SBP has lost money through this process and this is partly caused by the gaps in the regulatory framework (see Chapter 5) and hence the need for regulatory reform. The law regulating LOLR is found in section 17 of the State Bank of Pakistan Act, 1956. It states that:

"17G. Lender of last resort. – Where the circumstances so warrant and a scheduled bank approaches the Bank for the financial facility to improve its liquidity and where the bank in the opinion of the Bank, is solvent and can provide adequate collateral to support the financial facility, the Bank may provide the financial facility, in accordance with the regulations made by the Bank in relation thereto."[18]

Based on Figure 2, the Central Bank lends liquidity to financial institutions and banks. Financial institutions that include government institutions utilise this money for business purposes. Banks and businesses invest money into the financial market, and a large amount goes out for the payment of imported goods and money lending. In order to create a balance in maintaining the flow of the liquidity, the State imposes more direct and indirect taxes which curtail the margin of profits. The figure further explains that in such situations, the Central Bank can request the

[18] The State Bank of Pakistan act, 1956, Section 17G

intervention of the ILOLR/IMF to maintain the flow of liquidity.[19] This raises several questions regarding the LOLR and its operation in Pakistan.

This thesis aims to examine the regulatory and practical application of the lender of last resort doctrine in Pakistan. In doing so, it will appraise the financial systems in the UK and USA and draw lessons that will eventually be used for my recommendation for Pakistan. Above mentioned figures are used to identify the problems in the financial system of Pakistan in the context of LOLR.

[19] Edwin M. Truman, "The IMF as an International Lender of Last Resort", (October 12, 2010) Peterson Institute for international Economics, Accessed: February 04, 2018.

1.3 Research Question:

This thesis seeks to answer the following research question;

1. To what extent is Pakistan's approach towards the regulation of Lender of last resort effective?

1.4 Research Aims:

In order to answer the research question, the following aims will be achieved;

a) To evaluate the financial regulatory framework in Pakistan in order to determine whether reform is necessary for the function of lender of last resort.

b) To draw lessons from the UK and USA on the operation of lender of last resort in order to propose a suitable framework for the financial system in Pakistan.

c) To recommend the befitting reform proposals for the legislative and procedural structure of Pakistan.

1.5 Research Objectives:

a) Identify the gaps in the current regulation of lender of last resort in Pakistan.

b) Critically evaluate the lessons learned from the financial systems of the UK and USA on the regulation of lender of last resort and propose viable reforms for Pakistan.

c) Critically examine the reforms proposed through this research and evaluate their viability.

The SBP is empowered to act as the Central bank through the State Bank of Pakistan Act, 1956. Unlike the BOE, the SBP was not empowered to act as LOLR for the domestic financial institutions during financial unrest. There was no provision in the State Bank of Pakistan Act, 1956 which is the governing regulation for the bank regarding LOLR until 2015. In 2015 the SBP was empowered to act as LOLR for the domestic financial institutions during financial unrest. However, due to the lack of independence and proper legislation the SBP is unable to benefit the domestic financial market by acting as LOLR. In the case of KASB bank, the SBP failed to exercise its duties of a LOLR which is discussed in detail in Chapter six of this thesis. The research question and aim of this research are mainly focusing to identify the problem in the current legislation and recommend reform proposals. Furthermore, the research question is set to identify if there is a mere legislative problem, or the system is suffering due to other procedural gaps as well.

1.6 Methodology:

The thesis adopts a qualitative methodology. The doctrinal methodology is used because the research focuses on case law, statutes, and other legal sources. Normally, this method is used to enable the researcher to assess documents, beyond case law and statutes, to develop a narrative around the research problem. The documentary research methodology is also a commonly used method in such legal research. Furthermore, it is used to evaluate the reliability of the documents. Due to the non-availability of the official documents, this was used to evaluate the secondary documents.

In a study regarding contentious issues especially concerning the performance of a State institution, the use of a comparative research methodology is imperative to draw lessons from other jurisdictions. The comparative method is also used from the examples of the LOLR operations of the UK and the USA. To gather empirical data requires in-depth information to support the existence of such a problem. Thus, the case studies from Pakistan are applied in chapter 6 to evidence the research problem.

Chapter three explains in detail why these research methodologies were selected and how the researcher intends to apply these methods in the research. Additionally, the chapter provides reasons why other methods were not used for this study.

1.7 Findings:

After a critical examination of LOLR and getting the empirical evidence from the case studies and examples, this study finds that frequent engagement of the CB in the operation of LOLR without addressing the moral hazard problems could harm the financial system. Furthermore, the research finds that the diverse banking system of Pakistan is still struggling to frame a policy of LOLR for Islamic banking and examines the challenges of the existing system of commercial banks. Additionally, the rescue operations of the SBP for commercial banks also require transparency and befitting regulation. This study also finds that to reduce the challenges caused by the moral hazard problem, the high-interest rate is charged as a penalty. Nonetheless, the Islamic banking system still operates on an interest-free basis. Similarly, the SBP while playing the role of LOLR for Islamic banks, can use the option of nationalisation or imposing conditions on the business activities of these banks and require a more than usual share from their profits. The nationalisation of a bank is not unprecedented as evidenced by the example of the bank of Northern Rock.

1.8 Originality:

This study contributes to the literature on LOLR in the context of Pakistan. It examines the key factors which have contributed to the evolution of the role of LOLR and makes it an imperative part of the functions of the CBs. This study critically examines the regulation of LOLR in the UK and the USA, and the findings are used to inform the reform process in Pakistan. This study envisages lessons for policymakers in Pakistan on the gaps in the current regulation of the LOLR function. To remain impartial, while carrying out this research, the examples from the UK and USA and relevant theories are utilised for empirical purposes instead of relying on the researcher's opinions.

1.9 Limitations:

This study mainly focuses on the LOLR role to maintain stability in the financial system. There are many other factors than liquidity shortage and insolvency of the financial institutions which contribute to causing a financial crisis. However, this study is limited to the functions of LOLR. The scope of this study being limited to LOLR does not imply that all contemporary financial problems currently in Pakistan are because of the absence of an efficient regulation for LOLR. Furthermore, there are several CBs that are playing the role of LOLR for their domestic institutions, but this study only uses the systems of the UK and USA as models to obtain lessons for the regulatory reforms in Pakistan. Furthermore, there are two types of banking models working in the financial system of Pakistan (Commercial & Islamic Banks). Although, this thesis addresses the working of Islamic banking and its weightage in the financial system of Pakistan it does not extensively address the LOLR doctrine in the context of Islamic Banking. It explicates the repercussions of not having an efficient system of LOLR for Islamic Banks and argues on its needs. Nonetheless, LOLR for the Islamic banking sector is not addressed because this thesis aims to address the issue of LOLR in the context of the commercial banking sector of Pakistan.

1.10 Thesis Layout

To this end, the research is divided into eight main chapters and each chapter has further sub-sections. Chapter one provides the rationale behind the research on the doctrine of LOLR in the context of Pakistan. It further provides the research question, research aims, and research objectives. Furthermore, it explains the significance of research methodologies and briefly discusses their usage in this research. The findings and limitations of this research are also discussed in the last part of this chapter.

Chapter Two explains the evolution of the role of LOLR. It further discusses the LOLR operations in different jurisdictions. It also examines the significance of the role of LOLR at the domestic and international levels. Finally, it explores the moral hazard problems pertaining to the presence of LOLR.

Chapter three reviews the existing literature on LOLR and explains the significance of this topic with regard to the modern financial system. This chapter is divided into six main parts. It starts with a review of the literature which elaborates on the progression of LOLR and the role which CBs play in deterring a financial crisis. Furthermore, it reviews the literature on operations of LOLR during the financial crises and provides different approaches used by the BOE and FRB to maintain stability in the financial system. The literature which explores the approaches taken by the Federal Reserve while playing the role of LOLR for Lehman Brothers and AIG is also reviewed. The academic debate on the role of FRB during the recent financial crisis of 2007-2008 is also included. The research further reviews the literature which explicates the contemporary significance of LOLR and highlights the challenges which the financial system would face in its absence. Additionally, it evaluates the literature on the role of LOLR played by the Bank of England, Federal Reserves, and the State Bank of Pakistan. Finally, the literature on the moral hazard problem which can harm the financial system is also reviewed. This chapter, therefore, examines the contribution of important academics and highlights the limitations of the current literature. It also provides evidence on the contribution of this study to literature.

Chapter four critically examines research methodologies and the importance of selecting appropriate research methodologies in a research study. It examines the topic of the research and explores various relevant research methodologies. LOLR is a legal doctrine and doctrinal research methodology is used for this study to address legal views and perspectives. The documentary research methodology is equally explained along with its scope and relevance to this research. Additionally, the choice of using comparative research and a case study approach is clearly explained. It elucidates the significance of case studies in legal research and explains the salient features of this research method. Finally, the historical and conceptual research methodologies and their limitations are explained. This chapter further explains why the doctrinal and comparative research methodologies are preferred over historical and other methods and what the rationale behind not using the latter was. The authenticity of all the resources which are used to carry out this research is discussed as well.

Chapter five examines the banking sector of Pakistan, the inception of Islamic banking, and the current position of the Basel Accord in the financial system of Pakistan. The chapter is divided into five major parts. The significance of the banking system in the contemporary financial system is explained in the first part of this chapter. This thesis also explains the progression of the banking sector and elaborates on the effects of the policy of the nationalization (the 1970s) and then privatization (1990s) of the banking sector of Pakistan. Furthermore, the inception of the Islamic banking system (2002) is briefly examined. The second part of this chapter analyses the key factors which have been established to be the main causes of a financial crisis and the reasons for the instability of the financial system of Pakistan. The third Part evaluates the Banking Companies Ordinance, 1962 (LVII of 1962) which regulates the banking sector. It also explains the powers and duties of the SBP to maintain stability in the financial system. The fourth part explores the causes of the failure of the banking system and elucidates salient features of the Basel Accord. It evaluates the causes of the failure of Basel I and II and discusses the potential of Basel III to deter the collapse of the banking system. The implementation challenges of Basel III in Pakistan are also explained. The last part of this chapter expounds on the importance of LOLR in Pakistan and highlights the challenges if any, of having LOLR for an Islamic banking system.

Chapter six of this thesis identifies the problem in the regulatory system of Pakistan in the context of LOLR. The chapter also answers the research question of this research. It provides a detailed discussion on the operation of LOLR by the SBP to identify the problem. It argues that the power of acting as LOLR is allocated to the SBP after the financial crisis of 2007-2008. The SBP is empowered to act as LOLR through an amendment in the State bank of Pakistan Act 1956 in 2015. The Section is examined in this chapter. Furthermore, a case study of the KASB bank is examined to identify the problem. The establishment of the KASB is discussed besides the functioning of the bank until the merger took place. Furthermore, the legal formalities which were required to fulfill in the amalgamation of the KASB into the BankIslami are appraised. The chapter concludes by arguing that although there are loopholes in the regulation, the main problem lies in transparency while conducting the LOLR operations. It is examined in this chapter that the SBP’s role as a financial regulator was not transparent while intervening in the

KASB bank. The bank sought the intervention of the court to get the information regarding its takeover which is a legally determined right of the said bank. However, its right was denied which raised several questions on the impartiality and transparency of the role of SBP.

Chapter Seven critically evaluates the role of LOLR in the context of the Bank of England, Federal Reserve, and the State Bank of Pakistan. This chapter has five main parts, the first part focuses on the functions of the role of LOLR and explains its importance in the modern financial system to deter the financial crisis. The second part discusses its role before the recent financial crisis of 2007-2008. The third part extensively examines the approaches which were used by FRB, BOE, and SBP while playing the role of LOLR. The fourth part critically examines the laws in detail which empowers the CBs of the US, UK, and Pakistan to operate as a LOLR. It further compares the systems of LOLR in Pakistan with the UK and US to draw lessons to propose a suitable legal framework for the financial system in Pakistan. This part has three main sub-parts. The first part explores the emergence of the Bank of England as a CB. The second part focuses on the journey of CB in the US. The establishment of the Federal Reserve System is comprehensively examined. Its role in the recent financial crisis (2007-2008) and the salient features of the Dodd-Frank Act, 2010 are also explained in this part. The third part appraises the operation of BOE and FRB by using the examples of Northern Rock, Lehman Brothers, and AIG.

Chapter eight provides a reform proposal in light of the lessons learned from the examples of the LOLR operations of the UK and the USA. It further evaluates the proposed reform proposal. This chapter concludes by providing a comprehensive conclusion. Moreover, it evaluates the rationale behind this research in light of the research questions.

1.11 Conclusion

This first chapter of this research is incorporated mainly to provide a rationale for research on this topic. The role of LOLR is elaborated and examined in this chapter. Furthermore, a detailed argument is provided to demonstrate the importance of this research. Research of this level requires a solid basis, therefore; the first part of this chapter extensively argued and briefed on the reasons for researching this topic. The research question which will be answered in this research is also provided. Limitations of this research are also discussed besides the research aims and objectives. A short depiction of the research methodology is also provided. The layout of the entire thesis is provided to give an idea of this research.

Chapter 2: Conceptual Underpinning of the Lender of Last Resort

2 Introduction

The main purpose of this chapter in this research is to explain the role of LOLR in detail at the domestic and international levels. The former chapter of this research provided the significance and reasons for this research. However, this chapter starts by providing a brief introduction to the legal system of Pakistan and its contemporary financial issues. Furthermore, it provides a comprehensive argument on the evolution of the doctrine of LOLR. This chapter also talks about the emergence of the IMF as an international LOLR. Further to the importance of this research which is discussed in the former chapter, it talks about the significance of LOLR in a modern financial system. This chapter concludes by arguing the potential moral hazard problems pertaining to the role of LOLR.

2.2 Conceptual Underpinning

Pakistan gained its independence from Britain in 1947 and the country's legal system derives its roots from English common law. Pakistan is the fifth largest country in the world.[20] The state bank of Pak was established on the model of the bank of England on 1st July 1948 by the founding father of Pakistan, Muhammad Ali Jinnah.[21] Aside from the commercial banking system, Pakistan also has an Islamic banking system.[22] The State Bank of Pakistan played the role of lender of last resort (LOLR) for its financial system several times since its establishment. The country has been rescued by the International Monetary Fund (IMF) over eighteen times.[23] This study aims to identify the gaps in the regulatory framework of Pakistan to propose a suitable

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[20] World Population Review, Accessed, 10 November 2019.
[21] A Journey towards Professional Excellence. http://www.sbp.org.pk/70/his.asp accessed: 10, Feb 2020.
[22] Muhammad Mahmood Shah Khan, Bushra Shafiq, Farrukh Ijaz, "An Empirical Analysis of Banking Sector in Pakistan: Islamic Versus Conventional Banks", (2017) International Journal of Islamic Economics and Finance Studies, Vol: 3, Issue: 1, Page No. 61
[23] Sara Cheema, "The IMF: Pakistan's History and Future with the LOLR", (2017) Eurasia Review, April 21, 2018.

framework for LOLR, using the financial systems of the UK and USA to draw lessons for the financial system in Pakistan.

LOLR has been defined as an operation that injects liquidity into the financial market to avoid a recession.[24] Prior to the present times, its main function was to lend liquidity on demand. Thus, all-natural and legal persons who possessed sufficient liquidity and were capable of lending were considered eligible to play the role of LOLR.[25] Today, the CB holds the resources of the State and is generally empowered to release new notes hence; Sir Frances Baring (1797) argued that the CBs are the main operators of the role of LOLR for the financial system.[26] The impartation of liquidity by the private institutions to each other does not cover the entire meaning of LOLR. Private institutions are not bound to adhere to the goals of LOLR because they lend liquidity for business or personal motives. Nonetheless, the CB is under an obligation to support the growth of the financial system and protect it from any financial crisis.[27]

In a financial system, it is unsurprising for a financial institution to face liquidity problems and be unable to address the issue by using its resources. Therefore, CBs intervene and lend liquidity to financial institutions. The operation of CBs is not to protect an individual institution, but it works for the protection of an entire system.[28] Many economists have argued that injecting liquidity into the financial system is not a solution to deter a financial crisis rather it leads to

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[24] Paul Kosmetatos, The 1772–73 British Credit Crisis, (Springer, 2018), Page No.191, ISBN: 978-3-319-70907-9

[25] Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.

[26] Robert E. Keleher, Thomas M. Humphery, "The Lender of Last Resort A Historical Perspective", (1984) Cato Journal, Vol.4, No.1, Page No. 275

[27] Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.

[28] Michael D Bordo, "Rules for a Lender of Last Resort: An Historical Perspective", (2014) Journal of Economic Dynamics and Control, Vol 49, Page No. 126.

depletion of resources. The current role of LOLR does not prevent financial institutions from imparting liquidity to each other.[29]

However, CBs cannot lend liquidity without following certain principles. If the CBs provide complete assurance that they will back all financial institutions in times of crisis, it could create moral hazard problems. Thus, to curtail moral hazard problems, it is necessary to implement a financial policy regarding LOLR which can only be done by CBs.[30] Like domestic financial institutions, it is also possible that a CB starts enduring liquidity problems therefore the IMF is playing the role of international LOLR. Notwithstanding, there are several principles regarding the operation of LOLR which explain why only CBs are capable of being regarded as a LOLR for the system. These principles are extensively examined in the next section.

2.2 Evolution of LOLR Domestically

The role of LOLR has been through an intense evolutionary process. In 1797, the word "dernier resort" was used for the CBs by Sir Francis Baring in his book "Observations on the Establishment of the Bank of England".[31] It was not only the CB that could play this role, but the financial institutions were also capable of lending liquidity for business or personal interests.[32] Imparting liquidity to the financial institutions facing a liquidity crisis was considered as being the sole role of LOLR. This move was criticized and did not get the attention of the policymakers. Therefore, any institution or private individual who would lend liquidity was considered as the LOLR which was justifiable in those times.[33] Afterward, Henry Thornton

[29] Paul Kosmetatos, The 1772–73 British Credit Crisis, (Springer, 2018), Page No.191, ISBN: 978-3-319-70907-9
[30] Mikko Niskanen, "Lender of Last Resort and the Moral Hazard Problem", (2002) Bank of Finland 17/2002 Accessed: August 10, 2017.
[31] See Chapter two (Sir Francis Baring)
[32] Robert E. Keleher, Thomas M. Humphery, "The Lender of Last Resort A Historical Perspective", (1984) Cato Journal, Vol.4, No.1, Page No. 275.
[33] David Grad, Perry Mehrling, Daniel H. Neilson, "The Evolution of Last-Resort Operations in the Global Credit Crisis", (March 2011), Accessed: May 20, 2017.

(1802) argued that moral hazard problems are inseparable from LOLR.[34] Additionally, he argued that private financial institutions are obliged to safeguard the interest of their customers. Therefore, lending liquidity for other financial institutions against interest rates is a business activity for them. However, CBs owe wider obligations hence; they must ensure the trust of the investors in the economic system which prevents the financial institutions from aggregated demand for liquidity.[35]

Walter Bagehot (1873) took the ideas of Henry Thornton regarding LOLR and further argued that the CB will only play this role when the existence of the entire economic system comes under threat. The CB comes under the obligation to strengthen the financial institutions against a crisis through the role of LOLR.[36] Bagehot extended the sphere of LOLR merely from lending liquidity to the protector of the system by arguing that CB can take any decision to earn the trust of depositors instead of merely imparting liquidity.[37] Furthermore, he argued that CB should follow certain principles while acting as LOLR because it cannot let any financial institution waste public money. He suggested that CB should lend freely and make its policy clear and state the grounds for supporting LOLR. Bagehot also tried to address the moral hazard problems which Henry Thornton had highlighted and argued that if these problems remain unaddressed, LOLR will be unable to protect the system against a crisis.[38]

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[34] C.A.E. Goodhart (1999), "Myths about Lender of Last Resort," (1999) *International Finance*, Vol. 2, Page No. 339-60

[35] Michael D Bordo, "Rules for a Lender of Last Resort: An Historical Perspective", (2014) Journal of Economic Dynamics and Control, Vol 49, Page No. 126.

[36] David Laidler, "Central Bank as the LOLR- Trendy or Passe", (2004) University of Western Ontario, Economic Policy Research Institute 20048: Accessed: May 20, 2017.

[37] Thomas M. Humphrey "LOLR: The Concept in History", (1989) FRB Richmond Economic Review, Vol. 75, No. 2, Page No. 8

[38] David Laidler, "Central Bank as the LOLR- Trendy or Passe", (2004) University of Western Ontario, Economic Policy Research Institute 20048: Accessed: May 20, 2017.

According to Bagehot, the CB should charge a high-interest rate on its liquidity support.[39] He was also of the opinion that CBs should also lend only against worthy collaterals. Nonetheless, there are no principles to determine the solvency of the institutions and it is still a discretionary power of the CB.[40] However, there are certain cases when CBs were coerced to protect some financial institutions because their fall would subsequently affect the entire economic system. This, in turn, defeated the idea of demanding good collateral from financial institutions before lending liquidity. All the arguments by these philosophers revolved around lending liquidity or preventive steps to overcome the financial crisis.

However, the role of LOLR is still emerging in developing countries and many countries are reluctant to authorise their CBs to play this role because of moral hazard problems. As stated earlier, one of the research aims is to examine the nature of LOLR in Pakistan and propose a regulatory framework for it.

2.3 The Emergence of the IMF as an International LOLR

In the domestic financial systems, the support of liquidity to financial institutions has been occurring even before the existence of CBs. In the United Kingdom, it was Sir Francis Baring (1797) who argued while explaining the characteristics of CBs that it is a LOLR for domestic financial institutions.[41] In the United States, before the establishment of Federal Reserves (1913), the financial institutions were playing this role individually.[42] The banks were mainly playing

[39] See Chapter two (Walter Baghot)
[40] Thomas M. Humphrey "LOLR: The Concept in History", (1989) FRB Richmond Economic Review, Vol. 75, No. 2, Page No. 8.
[41] Denis O. Brien, "The LOLR concept in Britain", (2003) History of Political Economic, Volume 35, No.1, Page 1-19.
[42] Jerome H Powell, "America's Central Bank: The History and Structure of the Federal Reserves", (2017), Accessed: April 20, 2018.

this role and it was a business activity for them to lend liquidity and charge an interest rate to earn money.

Different countries played this role based on their interest or political affiliations and rescued the economic system of other countries by providing liquidity. The countries on mutual understandings and mainly due to political relations lend liquidity to each other. There are several cases where one country lent liquidity to another country without charging any interest. However, this was happening purely on the basis of diplomatic relations, but the emergence of global financial systems and the nature of crises raised the need for an international LOLR.[43] The Bank of England and the Banque de France played this role in the early nineteenth century to stabilise the world economic system.[44] However, domestic LOLR paved the way for the organization of an institution that is capable enough to play this role with all of its essential characteristics. Currently, the International Monitoring Fund (IMF) is playing this role. The IMF also faces several operational challenges i.e. it cannot lend liquidity to personal relations.[45] However; it can play the role of a consultant.[46] The countries who are playing the role of LOLR for each other were not following any principles to lend liquidity and made their rules for it.[47] IMF is not seen to ask for worthy collaterals to impart liquidity like the CBs, but it asks for a viable plan to return the money.[48] To curtail moral hazard problems, the IMF also charges high-

[43] Stanley Fischer, "On the Need for an International LOLR", (1999) The Journal of Economic Perspectives Vol.13, No.4, Page 85.
[44] Mark Traugott, "The Mid-Nineteenth-Century Crisis in France and England" (1983) Theory and Society, Vol. 12, No. 4, Page 455
[45] Camila Villard Duran, "The International Lender of Last Resort for Emerging Countries: A Bilateral Currency Swap?" (2015) The Global Economic Goverance Programme University of Oxford, Page No 1-33.
[46] Jean-Pierre Landau, "International LOLR: Some thoughts for 21st century", (2014) Bank for International settlement No 79, Page No. 119.
[47] Forrest Capie, "Can there be an International Lender of Last Resort?" (2002) International Finance, Wiley Blackwell, Vol. 1, Issue. 2, Page No. 311.
[48] Jean-Pierre Landau, "International LOLR: Some thoughts for 21st century", (2014) Bank for International settlement No 79, Page No. 119.

interest rates.[49] Notwithstanding, the role of the IMF as a LOLR in the last two decades has become controversial which is evident from the way it deals with developing countries. Instead of assisting the borrowing countries, the IMF is seen trying to apply its influence.[50]

The insight behind the establishment of the IMF was not to make them an international LOLR.[51] CBs have several powers to act as LOLR and they can intervene at any stage to protect the financial institutions without their permission. However, the IMF cannot intervene unless the government of the State asks for assistance. Before the Latin American Crisis (1982), the IMF was lending liquidity for the short term, but it started lending for a longer period afterward.[52] The rationale behind the establishment of the IMF was to curtail poverty in the world.[53] Thus, in 1999 Poverty Reduction and Growth Facility, (PRGF) eliminated the role of Enhanced Structural Adjustment Facility (ESAF) which was used to provide long-term liquidity on an appropriate interest rate to the poor countries.[54] IMF reformed its functions and started lending liquidity to the countries which were facing financial crises. It was significant for the global economic system to have a neutral institution that can play the role of ILOLR for all countries.[55]

In this modern era, international laws and institutions have become indispensable elements for the survival of the global world. The global financial crisis coerced economists to realize that in

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[49] Camila Villard Duran, “The International Lender of Last Resort for Emerging Countries: A Bilateral Currency Swap?” (2015) The Global Economic Goverance Programme University of Oxford, Page No 1-33.

[50] Sara Cheema, The IMF: Pakistan’s History and Future with the LOLR”, (June 19, 2017), Accessed: April 21, 2018.

[51] Fischer, Stanley. 1999. "On the Need for an International Lender of Last Resort." Journal of Economic Perspectives, 13 (4): 85-104.

[52] Curzio Giannini, “The IMF and LOLR Function: An External View”, (1999), Finance & Development, Vol 36, No.3, Page 1.

[53] Giancarlo Corsetti, Bernardo Guimaraes, Nouriel, “International Lending of Last Resort and Moral Hazard: A Model of IMF’s Catalytic Finance”, (2006) Journal of Monetary Economics, Vol. 53, Issue. 3, Page No. 441.

[54] International Monetary Fund (1999a) for a description of the mandate in Poverty Reduction and Growth Facility. For a discussion of the evolution of the IMF's activities over time, Boughten (1998), Krueger (1998), Vasquez (1999), Overseas Development Council (2000) and International Financial Institution Advisory Commission (2000). Accessed: March 15, 2018.

[55] Camila Villard Duran, “The International Lender of Last Resort for Emerging Countries: A Bilateral Currency Swap?” (2015) The Global Economic Goverance Programme University of Oxford, Page No 1-33.

case of the collapse of an international economic system, the endurance of the domestic system is nothing more than an illusion. The framework offered by Walter Bagehot in the Nineteenth century, in which the operations of LOLR were proposed against good collaterals was basically for the domestic role of LOLR.[56] It became inevitable at the domestic level because of numerous reasons. Similarly, the existence of an international LOLR also becomes inevitable because a CB can also face a liquidity crisis as require the support of ILOLR. However, the importance of the role of LOLR paved the way for the organization of a proper institution that is capable enough to play this role with all of its essential characteristics. Therefore, currently, the International Monitoring Fund (IMF) is playing this role. The IMF also faces several operational challenges and it cannot lend liquidity to personal relations. It cannot give financial policy for the country, which is taking assistance from it, however; it can play the role of a consultant.[57]

2.4 Contemporary Significance of LOLR

In the modern economic system, the role of LOLR has become a vital part of the functions of CBs. It was not a part of major policy debates before the financial crisis of 2007-08. It was argued that the assurance of having an institution that will eventually provide liquidity to handle the crisis allows the financial institutions to take a plunge in the risky act without bothering about the consequences.[58] Its presence eliminates the role of investors to put an eye on the business activities and compels the administrators not to involve in such ventures. It will allow the financial system to ruin the public money injected into it by the CB while acting as LOLR. However, it holds several benefits and strengthens financial institutions against any crisis. In this

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[56] Curzio Giannini, "The IMF and LOLR Function: An External View", (1999), Finance & Development, Vol 36, No.3, Page 1.
[57] Jean-Pierre Landau, "International LOLR: Some thoughts for 21st century", (2014) Bank for International settlement No 79, Page No. 119.
[58] Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.

modern era when multinational companies are working in financial markets and they are using various currencies for their businesses, there are many reasons which can put even a solvent institution into a situation where it would face liquidity problems. Mere liquidity issues can escalate the demand for liquidity because of the apprehensions of the crisis. Thus, the presence of a LOLR can handle the situation by lending liquidity.[59] It is important to understand that the rationale behind the existence of LOLR is not merely to lend liquidity in tough conditions but to maintain the stability of the financial system.

A dread among the investors rapidly increases the demand for liquidity which is the most annihilating factor for a system to collapse. Nonetheless, the assurance of the CB that it will play the role of LOLR and address the issue eliminates the panic which decreases the demand for liquidity.[60] Usually, to address the issue of liquidity, the financial institutions sell their illiquid assets and handle the issue whereas the absence of a LOLR raises the demand and compels the financial institutions to sell their assets swiftly. A rapid sale of assets mostly deteriorates their value and makes the situation more difficult for financial institutions to handle.[61] Imparting liquidity is not the only mandate the LOLR has; the CBs can purchase the illiquid assets of the financial institutions to provide liquidity. The presence of LOLR is inevitable for modern financial systems. Notwithstanding, there are several moral hazard problems pertaining to this role that needs to be addressed.[62] Moral hazard problems are extensively described in Chapter 5 of this research. The benefits of having a LOLR can be seen in the recent financial crisis

[59] Kathryn Judge, "The Role of a Modern Lender of Last Resort", (2016) Columbia Law Review, Vol.116 Page No. 843.
[60] Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.
[61] Marc Dobler, Simon Gray, Diarmuid Murphy, and Bozena Radzewicz-Bak "The LOLR Function after the Global Financial Crisis" (2016), IMF working paper No. 16/10, ISBN: 9781498355995/1018-5941,Assessed: May 17, 2017.
[62] Mikko Niskanen, "Lender of Last Resort and the Moral Hazard Problem", (2002) Bank of Finland 17/2002 Accessed: August 10, 2017.

however, it is important to implement the principles while playing this role. There was criticism on this role because of the apprehensions of wasting the public money but strong regulations are capable of addressing the moral hazards. Thus, in contemporary financial issues, LOLR is regarded as a strong tool to address them.[63]

In the modern economic system where the CBs are playing the role of LOLR and strengthening the financial institutions against recession, it is also possible that CB itself starts facing a situation that is difficult to handle.[64] Although the CB of a State has the power to emit new notes but issuing new notes can cause inflation. However, in such a situation where the CB is facing liquidity problems, there must be an international LOLR that can rescue the economy of that country. Contemporarily IMF is playing the role of an ILOLR. In the globalized economy, the collapse of a domestic economy can harm other systems hence; the ILOLR is as important as a domestic LOLR.[65]

2.5 Moral Hazards Pertaining to LOLR

The impartation of liquidity support to the financial institutions experiencing the shortage of liquidity will be futile if the inseparable moral hazard problems are not properly addressed.[66] The moral hazards problems are the main reasons for curtailing the benefits of LOLR, therefore, it is befitting to identify the reasons which are causing these problems and address them.[67] For

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[63] Marc Dobler, Simon Gray, Diarmuid Murphy, and Bozena Radzewicz-Bak "The LOLR Function after the Global Financial Crisis" (2016), IMF working paper No. 16/10, ISBN: 9781498355995/1018-5941,Assessed: May 17, 2017.

[64] Frederic S. Mishkin, "The International Lender of Last Resort: What are the Issues?", (2000) Graduate School of Business, Columbia University and National Bureau of Economic Research, Page No.1.

[65] Giancarlo Corsetti, Bernardo Guimaraes, Nouriel, "International Lending of Last Resort and Moral Hazard: A Model of IMF's Catalytic Finance", (2006) Journal of Monetary Economics, Vol. 53, Issue. 3, Page No. 441.

[66] Kathryn Judge, "The Role of a Modern Lender of Last Resort", (2016) Columbia Law Review, Vol.116 Page No. 843.

[67] Marc Dobler, Simon Gray, Diarmuid Murphy, and Bozena Radzewicz-Bak "The LOLR Function after the Global Financial Crisis" (2016), IMF working paper No. 16/10, ISBN: 9781498355995/1018-5941,Assessed: May 17, 2017.

instance, the purchase of illiquid assets prevents the depreciation of the assets. However, the assistance of the CBs through purchasing illiquid assets does not stop the financial institutions from investing in risky ventures. Frequent purchases of such assets can create a situation where the position of the CB to handle the crisis will be compromised.[68] Any sort of assistance in the operations of LOLR without addressing the issue of moral hazard problems will cause inefficiency and expedite the dependency of the financial system on the CB which will create a frailer economic system.[69] To curb the moral hazard problems, CBs must stipulate that no financial institution will be eligible to seek liquidity support if it cannot provide worthy collateral. CBs should penalize these financial institutions by charging a high rate of interest on their support.[70] Bagehot also emphasized that a frequent involvement of the CBs in rescue operations will make it difficult for the CBs to maintain stability. Thus, the backing of the LOLR in the form of impartation of liquidity of illiquid assets should only be offered to illiquid but solvent institutions.[71]

Notwithstanding, there were no parameters offered by Bagehot and Thornton to evaluate if the financial institutions are just illiquid or insolvent. The example of the Bank of Bulgaria is important. The Bank of Bulgaria applied Bagehot's principles and rescued the solvent institution and refused to extend its support to a bank that was insolvent in their view.[72] This approach was used to minimize the effects of moral hazard problems. However, it was later established that the

[68] Vittorio Corbo, "Financial Stability in a Crisis: What is the role of the Central Bank?", (BIS Paper No.51), Accessed: April 4, 2018.
[69] Avinash Persaud, "How can Central Banks avoid another Financial Crisis?", (August 21, 2014), World Economic Forum, Accessed: April 4, 2018.
[70] Mikko Niskanen, "Lender of Last Resort and the Moral Hazard Problem", (2002) Bank of Finland 17/2002 Accessed: August 10, 2017.
[71] Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.
[72] Michael Berlemann, Kalin Hristov and Nikolay Nenovsky, "Lending of Last Resort, Moral Hazard and Twin Crises Lessons from the Bulgarian Financial Crisis 1996/1997, (2002), William Davidson Institute Working Paper No. 464 Accessed: February 10, 2018.

evaluation of the CB was wrong in determining the solvency of the institutions, as it rescued an insolvent financial institution instead of rescuing a solvent bank.[73]

A domestic system works with the alliance of all of the financial institutions in the country and their existence is dependent on each other. The collapse of a financial system can escalate panic among investors and create financial unrest. Similarly, in the modern global economic system, the collapse of the economy of a country can create an international financial crisis like that of 2007-2008.[74] International LOLR has played its role in the recent financial crisis and strengthened the global economic system against the financial crisis. However, it also faces moral hazard problems like domestic LOLR.[75] The IMF in the current era has emerged as an international LOLR and has lent liquidity to more than 50 countries.[76] The dealing of IMF is with the CBs of the States, that is why it cannot lend liquidity directly to the financial institutions. At the international level, when a CB realizes that it is incondensable to avoid the financial crisis with its resources, it decides to seek assistance from the IMF.[77]

2.6 Conclusion

This chapter explains the duties of CB in deterring a financial crisis. It further argues that the role of LOLR and examines the principles of playing this role. The need for the LOLR, its evolution process, and contemporary significance is discussed in detail. The importance of an international LOLR in the modern financial system and its evolution and role of IMF as an ILOLR is examined briefly. Finally, moral hazard problems pertaining to the presence of LOLR are

[73] Ibid

[74] Paul Kosmetatos, The 1772–73 British Credit Crisis, (Springer, 2018), Page No.191, ISBN: 978-3-319-70907-9

[75] Robert E. Keleher, Thomas M. Humphery, "The Lender of Last Resort A Historical Perspective", (1984) Cato Journal, Vol.4, No.1, Page No. 275.

[76] Jean-Pierre Landau, "International LOLR: Some thoughts for 21st century", (2014) Bank for International settlement No 79, Page No. 119.

[77] Camila Villard Duran, "The International Lender of Last Resort for Emerging Countries: A Bilateral Currency Swap?" (2015) The Global Economic Goverance Programme University of Oxford, Page No 1-33

evaluated in this chapter. Furthermore, how important it is to address the issue of moral hazard to make the role of the LOLR beneficiary is also discussed. The parameters that would be helpful to curtail the moral hazard problems are discussed in chapter seven of this research.

Chapter 3: Literature Review

3.1 Introduction

The substantial contribution of the noteworthy scholars to the literature of lender of last resort is reviewed in this chapter of the research. This part of the research enunciates that the conception of this research possesses empirical substance. It appraises the existing literature of LOLR and highlights the gaps in it. Thus, it paves the way to contribute to the literature and provides an insight to identify if it has contributed to the literature. This chapter holds vital importance in this research because it evinces the importance of this study and provides scholarly work to conduct qualitative research.

This chapter is divided into six parts and each part has further split in it. First, it reviews the scholarly work on the evolution of the conception of LOLR. The financial crises at different times compelled the policymakers to pay attention to it. The second part explains the progression in its operations because the role of LOLR was considered nothing more than imparting liquidity to the financial institutions during the crisis. The third part describes its importance and suggests reforms to deal with contemporary financial issues. The fourth part unfolds the importance of an international LOLR and explains how the IMF has emerged as an ILOLR. The fifth part consists of the approaches of the CBs of different jurisdictions. It also explains which laws allow the Bank of England, Federal Reserves, State Bank of Pakistan, and the Central Bank of Europe to act as LOLR for their domestic financial systems. Finally, it explains the issue of moral hazards which are pertaining to this role and explains how these problems can be curtailed. It also highlights the loopholes in the existing literature and provides an outline of the contribution of this research to the literature.

3.2.1 Sir Francis Baring (1797)

Although the liquidity support of the financial institutions to each other during times of financial unrest is a common practice over the centuries. Nonetheless, Sir Francis Baring is regarded as the first economist who had attributed this duty to the Central Bank by using the word *"the dernier resort"* in his book "*Observations on the Establishment of the Bank of England"*.[78] He was born on 18 April 1740 in Exeter, Devonshire, England. He established his business firm which was regarded as one of the most influential business firms of the United Kingdom of his time.[79] He was among those who played a vital role in establishing the East India Company (1763). He remained the head of this company between 1792-93 where due to his excellence he was rewarded with a baronetcy.[80] Between 1815-60 his business firm was financing US trade and also involved in marketing US bonds. On his death, he was regarded as the most talented and opulent merchant in Europe.[81]

Furthermore, he has contributed to the literature on the banking system. He has argued in his book that the CB must act as a LOLR for financial institutions during the financial crisis domestically.[82] The financial institutions are not prevented from baling out each other on mutually agreed conditions but the CB must act as an official LOLR for the financial system. According to him the CB of a State in most of the countries holds the assets of the State and is empowered to emit new notes. Therefore, it should be the duty of the CB to inject liquidity into

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[78] Robert E. Keleher, Thomas M. Humphery, "The Lender of Last Resort A Historical Perspective", (1984) Cato Journal, Vol.4, No.1, Page No. 275.

[79] Adam Augustyn, "ENCYCLOPÆDIA BRITANNICA", Sir Francis Baring, 1st Barnet British Financier and Marchant, (April 14, 2019), <https://www.britannica.com/biography/Sir-Francis-Baring-1st-Baronet> Accessed: March 10, 2020.

[80] Ibid

[81] Ibid

[82] Sir Francis Baring, "Observation on the Establishment of the Bank of England, and on the paper circulation of the country", (2nd Edn, Minerva press 1797).

the system to strengthen the financial institutions against a financial crisis.[83] The attribution of the role of LOLR to the CB started a contention among economists regarding its pros and cons. In his book, he argued why it should be the duty of the CB to play the role of LOLR. He further argued that it is one of the duties of the CB to inject liquidity into the financial system to deter the financial crisis. Nonetheless, no rules were suggested to carry out bail-out operations during the financial panic. Moreover, the role of LOLR was narrowly defined as a mere facility of liquidity during times of financial unrest. He proposed that the CB must act as LOLR but had not defined the domain of this role. It is imperative to understand that the conception of LOLR was emerging during this time and it was not regarded as one of the vital roles of the CB, although Sir Francis Baring is credited among the early economists who worked on the doctrine. The contemporary role of LOLR is admittedly much wider and quite different now from the role discussed by Baring and while he articulated several pros of the role, its cons (in the form of moral hazard problems) were not identified or addressed by Baring.

3.2.2 Henry Thornton (1802)

Henry Thornton is regarded as one of the earliest economists who made significant contributions to financial theories. He was born on 10 March 1760, elected to the parliament from Southwark in 1782, and regarded as one of the finest economists, bankers, and philanthropists of his time.[84] On financial matters, he was regarded as an authority by his peers in the parliament. Being a monetary theorist, he has significant contributions to the banking sector. His most noteworthy contribution is the identification of the difference between nominal and real interest rates.[85]

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[83] Ibid

[84] Melissa Petruzzello, "ENCYCLOPÆDIA BRITANNICA", Henry Thornton British Economist, Banker and Philanthropist, (March 6, 2020) <https://www.britannica.com/biography/Henry-Thornton> Accessed: March 10, 2020.

[85] Ibid

His book *An Inquiry into the Nature and Effects of the Paper Credit of Great Britain* is regarded as a significant contribution to monetary theory. He argues that the Central Bank must act as a lender of last resort for the domestic financial system to prevent a financial crisis. He has suggested the principles for the rescue operations of LOLR by the CBs.[86] He argues that the CB must not rescue insolvent institutions, it should rather rescue the financial institutions by injecting money that is facing liquidity problems. The CB is only meant to maintain stability in the financial system, its support should not be offered to private individuals for personal interests.[87] The liquidity support should be restricted to the institutions which are capable to provide worthy collaterals. To curtail moral hazard problems high-interest rates should be charged for providing liquidity support. Finally, he argues that it would be a befitting financial strategy to deter a financial crisis if the CB will promulgate its policy of acting as LOLR.[88]

Furthermore, he was the first one who identified moral hazard problems pertaining to the role of LOLR.[89] The role of LOLR will be barren if the problem of the moral hazard remains unaddressed. Notwithstanding, many economists expressed their concerns reading the viability of the principles suggested by Thornton in the context of LOLR.[90] In the modern era, his principles of performing the role of LOLR cannot be followed due to the intricate contemporary financial institutions. He suggested liquidity support should only be for the institutions which are capable of providing worthy collaterals. However, no mechanism was proposed to determine if the collaterals were worthy or not. Also, his principle is of less use in situations where a financial institution's collapse could harm the entire system, but the institution is unable to provide

[86] Henry Thornton, An Inquiry into the Nature and Effects of the Paper Credit of Great Britain (1802), (Friedrich von Hayek 1939).
[87] Ibid (Chapter XI)
[88] Ibid (Chapter XI)
[89] Henry Thornton, An Inquiry into the Nature and Effects of the Paper Credit of Great Britain (1802), (Friedrich von Hayek 1939).
[90] See Chapter 3 (Paul Tucker, Michael D Bordo)

satisfactory collaterals. There are some clear gaps in Thornton's understanding of LOLR as currently conceived due mainly to the more complex financial system of the modern era. Nevertheless, Thornton suggested some principles to make the role of LOLR effective and hazard-free which were appropriate at the time even if it would be inappropriate to strictly follow these principles today.

3.2.3 Walter Bagehot (1873)

In the evolution process of the LOLR when it was not considered as a plausible solution to deter financial crisis Walter Bagehot was among those who were advocating that the CB must act as LOLR. He was born on February 03, 1826, in Langport, England. He was a political and economic analyst who is regarded as one of the most influential journalists of his time.[91] He worked for Stuckey's Bank for several years and also participated in politics. However, he could not succeed in politics and was defeated in all of his elections.[92] In 1873 he published *Lombard Street* in which he argued about the control of the Bank of England over central reserves. This research largely influenced the modern theory of central banking.[93]

Furthermore, he argued on the capacity of the CB to play the role of LOLR during the financial crisis. He advocated the presence of LOLR and considered it a useful tool in deterring a financial crisis.[94] According to him, moral hazard problems can be curtailed hence CBs must not abstain from playing the role of LOLR domestically. The absence of LOLR will make a vulnerable financial system where minor liquidity issues can be converted into a detrimental financial

[91] Patricia Bauer, "ENCYCLOPÆDIA BRITANNICA", Walter Bagehot British Economist and Journalist, (March 20, 2020) <https://www.britannica.com/biography/Walter-Bagehot> Accessed: March 30, 2020
[92] Ibid
[93] Ibid
[94] Walter Bagehot, "Lombard Street: A Description of the Money Market" (3rd Edn, Henry S. King & Co 1873).

crisis.[95] Furthermore, he endorsed the principle that the CB must demand good collaterals before lending liquidity and charge a high-interest rate. However, the experience of several financial crises since 1873 demonstrated that the CBs could not establish a standard to evaluate the collaterals. He argued that the CB must lend liquidity to all the financial institutions which are facing liquidity crises and are capable of providing collaterals. Moreover, the assurance of the CB that it will recuse the financial system can help minimise the panic among the creditors. Providing liquidity to the financial institutions during the crisis is not the aim behind having a LOLR but it must take all preventive measures to ensure stability in the financial system. Although Bagehot's insights contributed to the evolution of the role of LOLR, they do not adequately address the contemporary issues pertaining to this role which are discussed below. He endorsed the principles proposed initially for the LOLR doctrine. However, no clear consideration was provided to comprehend the moral hazard problems pertaining to the operations of LOLR. Also, no mechanism was suggested to address the situation in which a financial institutions like AIG or Northern Rock are unable to provide collaterals. The doctrine of LOLR emerged through crisis when economists encountered new challenges and realised that the principles which were proposed by earlier economists were unsuitable to address the problems of modern financial systems.

3.2.4 Thomas M. Humphery 1975

In the research *"Lender of Last Resort: The Concept in History," Thomas M. Humphery* argues that the Central Banks are obliged to avert the anxiety of a financial crisis. Humphery divulges his insight regarding the LOLR that a mere proclamation of the CB to stand by the system would

[95] Ibid

be sufficient to rekindle the faith of people in the system.[96] To evince his stance, he further argues that panic among creditors of being deprived of their money can cause more devastation in the system than any other loss. It further identifies the vigorous characteristics of the role of LOLR and explains why it could not prevent the financial system of the UK from the financial crisis in 1866.[97] This paper examines the frame-work of the LOLR and finds out how this role can work effectively to deter a financial crisis. The CB must not bother the failure of insolvent institutions, it should rather stand by solvent institutions. The liquidity assistance should be offered to the financial institutions which are capable to provide worthy collaterals. The author endorsed the idea of charging a high-interest rate for liquidity support. The policy of the CBs regarding liquidity support should be clear ahead of a crisis.[98]

This paper also explains the process of the evolution of LOLR. The author argues that the journey of its evolution started when in 1797 *Sir Francis Baring* used the word "*the dernier resort*" in his book *Observations on the Establishment of the Bank of England*. Notwithstanding, the actual recognition of the concept of LOLR is given by *Henry Thornton.*[99] This research further elaborates the contributions of Thornton and argues, the echo of LOLR went into the parliament through his orates and the distinguished role of the Central Bank of England as a LOLR was recognized by the report of "*An Enquiry Into the Nature and Effects of the Paper Credit of Great Britain (1802.)*[100] The author argues that the role of LOLR cannot benefit a financial system if the moral hazard problems remained unaddressed. This paper further explains the distinguishing characteristics of CBs and argues why only a CB can play the role of LOLR. It

[96] Robert E. Keleher, Thomas M. Humphery, "The Lender of Last Resort A Historical Perspective", (1984) Cato Journal, Vol.4, No.1, Page No. 275.
[97] Ibid Page 276
[98] Ibid Page 278
[99] Ibid (Page 280)
[100] Ibid Page 280-282

argues that all the reserves of the State are vested in the hands of CB in most countries thus; not only it can lend liquidity to financial institutions, but it can also issue new notes to enrich the system with sufficient liquidity. Additionally, this paper critically evaluates the views of Thornton in detail that the CB owes the duty to play the role of LOLR and how befitting it would be if the CB acts as a LOLR.[101]

The second part of this research evaluates the classical theories of the above-mentioned scholars and identified the gaps. The author argued that rather than making hard rules for the operations of LOLR that will let the insolvent institutions collapse and charge high-interest rates to curtail moral hazard problems, the CB must be empowered with discretionary powers and it must act according to the situation.[102] Furthermore, the author discussed why the role of LOLR should be played by the CB. This research discussed the evolution of LOLR and evaluates the contributions of the former scholars and is clearly situation in the era in which it was written and outside of the current era of international global markets.

3.2.5 Charles Goodhart (1989)

C Goodhert born on 23 October 1936 served at numerous distinguished positions during his glittering career. At LSE[103] he served not only as a professor of banking and finance but served as deputy director between 1987-2005. For seventeen years he worked as a financial advisor of the Bank of England until 1980. BOE established a monetary policy committee where he has served as an outside independent member between 1997 and May 2000.[104] He has largely contributed to the literature on central banking and its role during the financial crisis and

[101] Ibid Page 11
[102] Ibid
[103] London School of Economic
[104] Flexi-Grant, "The British Academy", Professor Charles Goodhart FBA, (April 2015), <https://www.thebritishacademy.ac.uk/fellows/charles-goodhart-FBA> Accessed: March 20, 2020

monetary policy. He is among those scholars who are of the opinion that a financial system can remain steadfast during a financial crisis in the presence of a LOLR.

In his book *Money, Information, and Uncertainty (2nd Edition)* he appraised the role of LOLR and argued that a financial system is more vulnerable in the absence of a LOLR. The essential measures which a CB should take before offering liquidity support are discussed. He endorsed that no CB should rescue insolvent financial institutions rather the institutions which are complying with the monetary policies of the CB should be bailed out.[105] His book *The Central Bank and the Financial System* also explained the role of a CB as a LOLR. In this book, the author discussed the issue of moral hazard problems pertaining to the role of LOLR. More than injecting liquidity into the financial system the CB must ensure the trust of the credits because a panic among the credits can harm the system more than the issue of the shortage of liquidity.[106]

Furthermore, in his book *The Regulatory Response to the Financial Crisis* which was published after the recent financial crisis of 2007-2008 he argued that the earlier principles to hold operations of LOLR are not sufficient to address contemporary issues. A CB can no longer rely on the principles that it will impart liquidity to the financial institutions which are capable to provide good collaterals. Additionally, the liquidity support will be against high-interest rates because the CBs cannot maintain stability in the financial system with these classical approaches.[107] Regulatory response to the financial crisis is explained. He concluded that during the time of financial panic banks must hold sufficient liquidity to pay their debts when due. Also, banks must hold enough capital to absorb losses. To Goodhart, these two steps could help the banks to deter the crisis. Moreover, he explained the factors which contributed to the financial

[105] Charles. A.E. Goodhart, "Money, Information and Uncertainity, (2nd Edn, Red Goble Press 20 May 1989).
[106] Charles. A.E. Goodhart, "The Central Banking and the Finnacial System", (MIT Press 1995).
[107] Charles. A.E. Goodhart, "The Regulatory Response to the Finnacial crisis", (Edward Elgar Publishing 2009), **ISBN:** 9781848444515

crisis and argued how these issues can be fixed to prevent a further crisis. The role of the credit rating agencies besides deposit insurance is also discussed in detail.[108] Goodhart's work inevitably addresses the financial systems of developed countries and hence lacks critical evaluation of the position of under developed countries. Equally, while his work analyses different concepts of the LOLR doctrine, he, like writers before him, does not propose an adequate mechanism to address the issues of moral hazard problems.

3.2.6 Michael D Bordo 1990

Another substantial academic contribution regarding the growth of lender of last resort came in the research *"Rules for a Lender of Last Resort: An Historical Perspective"* by *Michael D Bordo.* Scholar explains the phases of its evolution and explicitly analyses the hedges which came its way. The researcher argues that the origin of LOLR is inseparable from the origin of the central banks. However, the LOLR is the most controversial part of the duties of CB to date.[109] Michael further examines the principles of LOLR suggested by early scholars. The most significant part of this research is the appraisal of the origin of LOLR in England and the USA. Furthermore, a comparison of the approaches of BOE and the Federal Reserve regarding the LOLR is provided. The emergence of the Federal Reserve as being LOLR is examined albeit; the Federal Reserve Act 1913 never spelled out if it would act as LOLR.[110] The primary ethos behind its advent was mainly to avert the banking panic nonetheless; its failure to prevent the banking panic in the 1930s resulted in the form of the worst recession.[111] The financial crisis brought the flaws of the FSA[112] at fore hence; it was reformed which maintained financial

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[108] Ibid
[109] Michael D Bordo, "Rules for a Lender of Last Resort: An Historical Perspective", (2014) Journal of Economic Dynamics and Control, Vol 49, Page No. 126.
[110] Ibid (Page 2)
[111] Ibid
[112] Federal Reserve Act 1913.

stability for the next 40 years.[113] In the 1970s and during the subprime mortgage crisis of 2007-08 the Federal Reserve acted out of the traditional approach of LOLR and resolved the issue abruptly. It further argues that this financial crisis highlights the gaps in the legislation hence; led towards the legislation of the Dodd-Frank Act 2010.[114]

Furthermore, this research provided a chronological order of famous scholars who contributed to the evolution of the role of LOLR. To Michael D Bordo, Sir Francis Baring for the first time in Eighteenth-century attributed the role of LOLR to the BOE[115] then Henry Thornton (1802) reinforced the doctrine by arguing that the CBs should dispel the financial panic through lending liquidity against collaterals.[116] Bagehot's (1873) rules of lending freely, high penalty rate, against sound collaterals, and lend only to solvent banks came aftermath. Humphrey (1975) and Bordo (1990) added to Bagehot's rules that CB should make it clear to all financial institutions that it will lend in crisis on certain stipulations.[117] Instead of lending liquidity directly to the banks, BOE opted to lend in the market anonymously. However, Capie (2002) criticised the approach of the BOE by arguing that it will help the institutions that can provide good collaterals nonetheless; it will not serve the institutions which hold relatively weak collaterals.[118]

Furthermore, this research appraises the growth of the Federal Reserve as a LOLR. The failure of central banking attempts of 1791 and 1816 made the way to the advent of Federal Reserves. The formation of banks was in the hands of States which created a fragile system. Thus, the necessity of a uniform system was inevitable. This research is remarkable to gather significant information

[113] Michael D Bordo, "Rules for a Lender of Last Resort: An Historical Perspective", (2014) Journal of Economic Dynamics and Control, Vol 49, Page No. 126.
[114] Ibid
[115] Bank of England
[116] Michael D Bordo, "Rules for a Lender of Last Resort: An Historical Perspective", (2014) Journal of Economic Dynamics and Control, Vol 49, Page No. 126.
[117] Ibid
[118] Ibid (Page 132)

for the progression of LOLR in England and the US. However, the research does not really address the particularities of EU states or developing countries. Hence, to address those issues the research of further scholars is considered below. Bordo's contribution mainly lies in covering the issues raised by the US not having a CB and thus the absence of the LOLR doctrine.

3.2.7 Forrest Capie (2002)

In the research of *"Can there be an International Lender of Last Resort?" Forrest Capie* appraises if the consequences of the recent global financial crisis have changed the accustomed approach of LOLR. Henceforth, it divulges the magnitude of the Great Depression of 1930 and compares it with the recent crisis of 2007-2008. He argued that deterrence against financial crisis and addressing contemporary financial issues have evinced that the LOLR has emerged as an efficient tool against recession.[119] Modern interpretations of LOLR are evaluated to figure out the evolution of its functions from the traditional theories of early scholars. Protecting money stocks and ensuring stable money growth is not the entire duty of CB as a LOLR. The CB must eliminate the panic of the creditors. He argued that panic can be minimised by adopting the preventive measures suggested by economists. (See Thornton and Bagehot)

Furthermore, Cappie argued that the assistance of LOLR should be open to all financial institutions and the stakeholder should also be assured that CB will intervene in case of financial instability. This theory was presented at the time of the Gold Standard which is why the high penalty rate was the befitting option to secure national gold reserves.[120] Moreover, the author argued that the high-interest rate would curtail moral hazard problems and compel the financial institutions to return their loan swiftly once the crisis ends. He further endorsed the principles of

[119] Forrest Capie, "Can there be an International Lender of Last Resort?" (2002) International Finance, Wiley Blackwell, Vol. 1, Issue. 2, Page No. 311.
[120] Ibid (Page 312)

lending to financial institutions should be against good collaterals. According to him a mere willingness to repay the loan and penalty is not enough hence the financial institutions must provide worthy collaterals that will ensure that the CBs resources are secured from going into the drain.[121] Finally, according to this doctrine, liquidity support should be offered to the illiquid nonetheless; solvent institutions. Finally, he concluded by stating that the policy regarding the LOLR must be flexible and subject to modification according to the needs of contemporary issues.

This research further describes the operations of the IMF and Bank of England. He argued that in the recent crisis the traditional approach remained unhandy to deter the crisis. Therefore, unconventional methods were used by the IMF and BOE to address this issue which played a vital role in extending the functions of LOLR.[122] Furthermore, the approach of the Bank of England to deter the crisis in the case of Northern Rocks (2007) is not applauded by him. To Cappie, the BOE emphasized not to engage in risky activities and esteemed it a rational approach to prevent future crises. Theoretically, this methodology can be a tool to curb the panic of crisis. Nonetheless, in the modern economic system, the traditional approach of LOLR will not be helpful.[123] Like BOE the ECB approach towards the LOLR was also limited and it faced serious legal implications. Articles 123 and 125 of the Treaty on the Functioning of the European Union 1957 prohibit financing in government deficits and bailouts respectively.[124] This paper explains the functions of LOLR and analyses its operations during the crisis. However, it does not clearly provide a way forward. The role of the CBs is analysed to the extent that loopholes are identified but no principles are suggested to address the gaps. The principles suggested by earlier

[121] Ibid (Page 313)
[122] Ibid (Page 315)
[123] Ibid (Page 317)
[124] Ibid (Page 321)

economists are criticised but no alternative solution is proposed. (See the Chapter of Reform Proposals).

3.3 Operations of LOLR

3.3.1 Marc Dobler, Simon Gray, Diarmuid Murphy and Bozena Radzewicz-Bak

In the research *"The Lender of Last Resort Functions after the Global Financial Crisis"* by *Marc Dobler, Simon Gray*, *Diarmuid Murphy*, and *Bozena Radzewicz-Bak* depicts the role of the lender of last resort and enlightens its significance in the modern economic world. This research finds that the recent financial crisis rekindled the fiction of emergency liquidity support and argued that the criticism of having a LOLR is not judicious. Furthermore, it is stated that fragile procedures of conducting the operations of LOLR are incapable of comprehending the current financial issues. Additionally, it explores various approaches that can be used to conduct these operations and argues how they could be more fruitful. This research spotted perilous issues that played a vigorous role to cause a financial crisis. The central banks do not have any option in certain circumstances but to lend liquidity to financial institutions for the survival of the financial system. If financial institutions are facing a shortage of liquidity which restraints them from economic activities the CBs conducts Open Market Operations (OMOs)[125] to lend liquidity. Merely, lending liquidity is not the only way to strengthen the banks against financial crisis, but CBs can directly retaliate to the cause which has escalated the demand of liquid assets and prevent the financial market from disruption.

It further describes the idea of bilateral lender of last resort at the domestic level nevertheless, it can be denied by the CB in exceptional circumstances. This research argues about the need for a LOLR that financial institutions can lend liquidity to each other on mutually agreed conditions in

[125] OMOs are undertaken at the initiative of the CB, while SFs are automatic and provided at the initiative of individual banks. See Gray and Talbot (2006) for a longer discussion of this point.

the time of difficulty. An escalation in the demand for liquid assets leads towards the swift sale of illiquid assets and results in gigantic losses hence, CBs are obliged to step in and protect the financial system from annihilation. Before the financial crisis, economists were reluctant to pay heed to LOLR nonetheless; it grabbed their attention afterward. This paper further explains the ideas to carry out the rescue operations that under the stipulation of good collateral CBs must lend freely however, it should be on the high-interest rate. It explains several ways to conduct the operations of LOLR in the financial crisis and highlights its importance to deter financial anguish. It also explains how the role of LOLR emerged and how vulnerable an economic system would be if this role is omitted from the duties of CBs. Eligibility of the institutions which can seek help from CBs during the financial crisis and methods of preventing the fire sales of the assets in crisis is discussed.

There are many challenges of the operations of LOLR and queries to address that the lending of liquidity will be for the short term or long term. Ostensibly, the demand for good collaterals which is suggested by the authors seems handy nonetheless, which parameter will be used to determine good collateral and who will supervise the working of financial institutions at domestic and international levels is yet to be answered. Most of the challenges which a CB faces while conducting the operations of LOLR are discussed in this research paper. The research mainly examines the hurdles which a CB faces while playing the role of LOLR. Also, it discusses the repercussions if the CB does not act as LOLR during the financial crisis. However, moral hazard problems that are almost inseparable in the existence of LOLR are still not discussed in this paper.[126]

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[126] Marc Dobler, Simon Gray, Diarmuid Murphy, and Bozena Radzewicz-Bak "The LOLR Function after the Global Financial Crisis" (2016), IMF working paper No. 16/10, ISBN: 9781498355995/1018-5941, Assessed: May 17, 2017.

3.3.2 David Laidler (2004)

The role of the CBs in the recent financial crisis as a LOLR was quite helpful to enhance the sustainability of the institutions against the crisis. *David Laidler* has conducted commendable research on it and explains in his research work "*Central Banks as Lender of Last Resort – Trendy or Passe?*" that the CBs have used many different approaches to conduct the rescue operations. The first part of this research examines the evolution of LOLR and appraises the principles suggested by economists. He further argued that the theory of Bagehot regarding the role of LOLR and Central banking has played a vital part in the development of the modern banking system. Furthermore, according to him, it is not unnatural that each commercial banking was holding its gold reserves. In Britain, however, the BOE has emerged as the holder of the entire gold reserves of the country and emitter of the currency which at the same time extended its responsibilities towards the financial system.[127] He argued that the responsibility of the CB regarding the financial system is wider than merely earning profits.

Additionally, he argues that the principles which Bagehot has suggested are not viable in the modern economic system because they do not cover the whole rationale of the role of LOLR (see Bagehot's part). The CB which is empowered to issue more notes, therefore, has the responsibility to prevent any financial panic. Domestic banking requires time and assistance of liquidity from the CB to get rid of the illiquidity crisis which demands the CB to maintain huge reserves.[128] Moreover, he argues that in the apprehension of an internal crisis, CB should lend freely to the illiquid but solvent financial institutions at a high-interest rate. Finally, he emphasises that it is more important for the CB to ensure the trust of the financial system and the

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[127] David Laidler, "Central Bank as the LOLR- Trendy or Passe", (2004) University of Western Ontario, Economic Policy Research Institute 20048: Accessed: May 20, 2017.
[128] Ibid (Page No.5)

inhabitants that it would back them in the time of financial unrest.[129] In the financial system no institution can impart liquidity but the CB thus, it is regarded as the "Lender of last resort". It is difficult to figure out the difference between illiquid and insolvent banks. The Bank of Canada rescued two commercial banks that were being encountered in financial difficulties, but it was eventually proved that both of them were insolvent.

On the other hand, the Bank of Canada refused to extend its liquidity support to a bank based in British Columbia which was then being taken over by another bank. The work describes the principles laid down by Ralph Hawtrey on how the CBs should react to the crisis of liquidity.[130] To him rather than imposing a high-interest rate on all LOLR operations it should be imposed after evaluating the quantity of the liquidity support which is imparted. In this research, the progress of the concept of central banking is analysed along with the role of LOLR in the crisis. The work also identifies the gaps in the traditional theories regarding LOLR operations and suggests how they can be addressed. Nonetheless, it does not suggest any technique to reform the system to comprehend the needs of contemporary banking which are addressed below. (See 3.3)

3.3.3 Michael Berlemann, Kalin Hristov and Nikolay Nenovsky

To handle the crisis of illiquidity the operations of LOLR by the CBs are being conducted for the last 200 years. It is discussed in the major financial debates of the world that the existence of LOLR is inevitable to make a strong system. However, this role will be futile if the moral hazard problems remain unbeckoned. *Michael Berlemann, Kalin Hristov, and Nikolay Nenovsky* extended the debate on the issues of moral hazards in their research of "*Lending of Last Resort, Moral Hazard and Twin Crises Lessons from the Bulgarian Financial Crisis 1996/1997".* This research explains the financial crisis of Bulgaria and appraises the role of LOLR which was

[129] Ibid (Page No. 8)
[130] Ibid (Page No.13)

unable to prevent the crisis because of the systematic moral hazard issues. It further explores that the policymakers of Bulgaria have addressed the moral hazard issue by empowering their CB to act as a LOLR on strict conditions which enabled them to establish a less vulnerable financial system.[131] The major financial crisis of the European exchange rate crisis (1992-3), the Tequila Crisis (1994-5), the Brazilian crisis (1998-9), and the most recent financial crisis urged the economists and the public to take this issue seriously. Numerous financial theories are developed to enunciate the reasons behind these crises and how the economic crisis of one country can harm the other and even the international financial system.[132]

Bulgaria is a small economy thus; its financial instability did not bother the world's community because it does not create any tornado in the global financial system like Europe and other big countries. Financial crisis usually occurs due to the depreciation in the value of the currency and banking sector. It discusses the different approaches of the CB to curtail the apprehensions of the crisis. It is argued by economists many times that the insurance of the CB to rescue the system at the time of crisis causes moral hazard problems. It provides enough courage for financial institutions to invest in risky activities without considering the consequences.[133] It allows investors to invest in ventures where the probabilities of success are less. The probity behind such behavior is that they know the losses will be divided nationwide nonetheless; if these risky investments will be successful they are the only partners in the profits.[134] The depositors are also careless about the risky investment of the institutions because they will be compensated by the CBs. All these factors enfeeble a financial system and cause severe moral hazards. Daiz

[131] Michael Berlemann, Kalin Hristov and Nikolay Nenovsky, "Lending of Last Resort, Moral Hazard and Twin Crises Lessons from the Bulgarian Financial Crisis 1996/1997, (07 May 2002), Accessed: 10th February 2018.
[132] Ibid (Page No.2)
[133] Ibid (Page No.12)
[134] Ibid (Page No.13)

Alejandro was the first one to highlight the issue of moral hazard problems in 1985 however, in the rhetoric of the need and benefits of having a LOLR this issue was neglected.[135]

Furthermore, the author argues that the repercussions of neglecting the issue of moral hazard problems compelled the policymakers to fix this issue otherwise the stability of the system cannot be perpetual. This research uses the example of the Bulgarian banking system where the issue of illiquidity was resolved by the operations of LOLR. Nonetheless, the neglect of moral hazard issues caused a more severe financial crisis. This research rightfully analyses the impact of moral hazards on the financial system but does not propose a solution that can help small countries to understand the intentions of international investors and to curb the problems surrounding moral hazards. This research aims to find solutions to the problems that domestic and international LOLR faces and proposes a regulatory framework to make this role more effective. (See the part of reform proposals).

3.4 LOLR in Contemporary Financial System

3.4.1 Paul Tucker 2014

Paul Tucker is an American scholar who appraises the tentative journey of LOLR in the research of *"The Lender of Last Resort and Modern Central Banking: Principles and Reconstruction".* Central Banks (CBs) due to their imperative role in the financial system are often venerated and castigated for their actions and omissions. The engagements of the CBs with insolvent institutions through injecting liquidity were regarded as overstepping of the jurisdictional fences.[136] However, the financial crisis of 2007-2008 has transformed this role. It was not a part of policy debates and more or less was regarded as a relic of the past. Not only the assurance of

[135] Ibid (Page No.14)

[136] Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.

liquidity support but the need for central banking was also questioned. Hence, the endorsers of LOLR faced accusations of being partisan. Notwithstanding, forthcoming financial tornados realized the significance of LOLR.[137] More than the challenging existence of LOLR, the criticism was on its operational approach because the insolvent institutions were also rescued.

To Paul, Bagehot's theory is incapable to address the technical and operational challenges which came to the fore during the financial crisis of 2007-2009.

a) Which formula will be used to evaluate the worth of the collaterals?

b) Can non-banks seek liquidity assistance from the CB?

c) What are the parameters of LOLR if the liquidity shortage is in foreign currency?[138]

This literature addresses above mentioned questions and argues that the traditional doctrine of LOLR needs vital updating to counter the stability issues of the vague financial system. It proposes precepts for the legislatures to counter the criticism of the legitimacy of the functions of LOLR. Primary legislation or a statutory body should determine its operational jurisdiction and objectives.[139] The operations of LOLR should be free from any political jurisprudence and the legislatures at the time of law-making need to be clear regarding the challenges of the financial crisis. This research largely emphasises the clarity of the principles surrounding LOLR notably in times of financial crisis. It is noted that a financial system cannot retaliate against a financial crisis if the creditors are uncertain of the intervention of CB.[140]

Paul criticised the principles proposed by the earliest economist Bagehot however, a mechanism is yet to be established that can determine the solvency of an institution by appraising its

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[137] Ibid
[138] Ibid (Page No. 11)
[139] Ibid
[140] Ibid

available collaterals. Also, the role of LOLR is not restricted merely to lend liquidity to the banking sector but the CB is responsible to maintain stability in the financial system of the country. Thereby, there is no hard and fast rule for lending liquidity and CB is empowered to inject liquidity in any type of financial institution to maintain financial stability. As far as the foreign currency liquidity shortage is concerned the CB can impose limitations on the banks which are dealing in foreign currency to maintain a certain amount of liquidity. It is argued in this thesis that the CB is required to maintain financial stability therefore, it has discretionary powers to take any measures aiming to strengthen the financial system of the country.

In spite of the fact that liquidity support in carrying out the operations of LOLR is hazardous, well-principled legislation can tackle it nonetheless. Losses that CBs bear, are transferred to society through government by escalating taxes or waving subsidies.[141] Most jurisdictions have an implicit approach to the role of LOLR which creates uncertainty. Therefore, there must be a consensus regarding the principles of LOLR, and a transparent regime is also needed to operate successfully. This research contributes to the literature and answers several questions regarding the significance and needs of the LOLR to protect the modern financial system. However, it focuses more on the American financial system and has left many questions unanswered about other jurisdictions especially in developing countries. (See 3.5.3)

3.4.2 Kathryn Judge 2016

The research of *"The Role of a Modern Lender of Last Resort"* by *Kathryn Judge* advanced the literature of lenders of last resort by pointing out the contemporary financial issues and the optimal approach to address them. Kathryn Judge is an American researcher thus, she appraises the role of the Federal Reserve (the Fed) during the financial crisis and hauls the attention

[141] Ibid (Page No. 20)

towards the lacunas. To avert a financial crisis the Fed should not wait for the legislative authorities to impart powers for tackling the problem. Instead, it can use the leverage it possesses to inquire about the liquidity flow of the financial institutions.[142] This research further added that the effectiveness of the role of LOLR depends on the magnitude of the dearth of liquidity. Exogenous events sometimes ignite panic among creditors and inflate the demand for liquidity which urges a fire sale of the assets and harms the economic hierarchy.[143] In such circumstances, the traditional approach of lending liquidity to the financial market is apt and resolves the issue of the shortage of liquidity. The heinous financial crisis of 2007-2009, however, has numerous reasons to create a shortage of liquidity.

To Kathryn Judge, in the era of modern banking and risky investments, the ritual approach of LOLR is incapable to avert the financial crisis. Merely lending liquidity can temporarily fix the issue nonetheless; it cannot prevent the financial system from plaguing.[144] Thus, the responsibilities of the Fed as a LOLR have aggravated than before. The Fed observes the power of controlling access to liquidity which is apt to indicate wrong going of the liquidity and can be a useful tool to address the cause of the problem.[145]

Furthermore, the researcher emphasises that the Fed should utilise its powers as LOLR and obtain critical information to evaluate where the problem lies. In the circumstance of uncertainty when the financial institutions are reluctant to work with other institutions because of the unstable financial condition or lack of information, the Fed should intervene and pass the

[142] Kathryn Judge, "The Role of a Modern Lender of Last Resort", (2016) Columbia Law Review, Vol.116 Page No. 843.
[143] Ibid (Page 845)
[144] Ibid (Page 847)
[145] Ibid (Page 848)

information and liquidity.[146] The role of the Fed is more tentative and advanced in the modern economic system than it was decades ago. This research answers the questions that what are the rationales for having a LOLR and how it should act to avert the crisis? It further explains the reasons for the failure of Lehman Brothers and analyses the information which policymakers of that time had. Finally, it compares the approach which the Fed has used to handle the financial crisis with the one the researcher has proposed and draws the difference.[147] The researcher concluded by examining the approach which is proposed and suggests that the issues of the shortage of liquidity and operational challenges can be managed nonetheless; the Fed should act as LOLR with a modern approach.[148]

3.4.3 Maurice Obstfeld 2009

Maurice Obstfeld explains the significance of the role of LOLR at the domestic and international level in his research *"Lender of Last Resort in a Globalized World"*. The recent financial crisis has debunked the lacunas of the existing doctrine of LOLR. The modern global economic systems are more vulnerable because the financial institutions are dealing in many different currencies.[149] Nowadays, the role of multinational companies is curtailing the divergence of economic activities among developed and emerging economies. The importance of the role of IMF as an international LOLR is surging hence; it needs to adopt modern techniques to counter the current challenges.[150] The global economic system has enhanced the dependency of developing and industrialized economies on each other. The rationale behind the operations of CBs as LOLR is to avert a situation where the failure of an institution can raise questions on the

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[146] Ibid (Page 850)
[147] Ibid
[148] Ibid
[149] Maurice Obstfeld, "Lender of Last Resort in Globalized World", (November, 2009), Accessed: March 02, 2018.
[150] Ibid

creditworthiness of other financial institutions.[151] CBs, however, must not assist insolvent institutions because they would be unable to repay even after selling their illiquid assets and spoil the taxpayer's money.

He further argues that the failure of the UK and the US as LOLR enunciate the need for an international lender in difficult times. In the year of 1946, the purpose of the lending of IMF was not to prevent the financial systems but to stabilize the exchange rates. Nonetheless, after 1973 surging flexibility of exchange-rates, liberalisation of domestic and global finance has paved the way for the IMF to be considered as an international LOLR.[152] The collapse of the Lehman Brothers in September 2008 has expanded the balance sheet of Federal Reserves to an unprecedented level. In October 2008 the Federal Reserves revisited its policy and removed the limits of dollar credit to the Bank of England, Bank of Japan, Swiss National Bank (SNB), and European Central Bank (ECB).[153] It allowed the non-US banks to act as LOLR which has played a vital role in explaining the importance of an international LOLR for the global financial world. The demand for liquidity support from the IMF is less than it was a decade ago. It is still lending to many countries, e.g., Iceland and Pakistan.[154] This research mainly enunciates the need for having a LOLR at the domestic and international levels. However, it does not analyse the moral hazard problems pertaining to the role of LOLR.

3.3.4 Stanley Fisher 1999

To Fisher (1999) IMF should not merely act as a lender during the crisis but it has to manage the global economy to deter financial crisis. The operations of IMF have more political targets than economic thus, many Asian countries avoid seeking assistance from it. A truly neutral and

[151] Ibid (Page 5)
[152] Ibid (Page 7)
[153] Ibid (Page 8)
[154] Ibid (Page 9)

independent IMF can be a better LOLR at the global level.[155] The operations of the IMF based on the unanimously formulated rules rather than the discretionary powers will make it politically neutral. Its assistance should only address illiquidity rather than insolvency nonetheless; it is quite difficult to draw the line between both expressions. The problem here is not the ability to pay back the funds but the willingness to do so. Therefore, funds lending should be properly regulated. Notwithstanding, a more flexible regulation of IMF will escalate the more hazard problems and haul it towards a crisis. Finally, it is concluded by emphasizing the legislation for the operations of IMF as LOLR.[156] However, it does not analyse the output of its operations and does not answer the questions around neutrality.

3.5 The Conception of an International LOLR

3.5.1 Edwin M. Truman 2010

The effacing effects of the recent financial crisis divulged the vulnerability of the international financial system without having an international lender of last resort (ILOLR). *Edwin M. Truman* has contributed to the literature by analyzing the financial situation of the world after the crisis. In his research work *"The IMF as an International Lender of Last"* he emphasizes that the IMF which is working as a de facto ILOLR must be regulated and declared as an official body to act as an ILOLR. Although, the IMF can impart an unlimited amount of liquidity to solvent institutions under certain conditions. Nonetheless, there is no parameter to evaluate the difference between illiquid and insolvent financial institutions which is by far a discretionary

[155] Fischer, Stanley. 1999. "On the Need for an International Lender of Last Resort." Journal of Economic Perspectives, 13 (4): 85-104.
[156] Ibid

power of the IMF to judge.[157] Notwithstanding, the IMF's role can be more prosperous if it will comply with the new proposals.

- The countries having apt modern economic regulations must be eligible to obtain flexible credit lines (FCL) on more flexible terms.
- The countries which do not implement strong policies and are unable to meet the qualification criteria for FCL must be offered precautionary credit lines (PCL).
- The IMF must be empowered to take extraordinary steps during the crisis and give unilateral offers to FCL on flexible conditions to the eligible countries.[158]

However, the issue of moral hazard cannot be neglected; therefore, it needs to have a framework to address this issue as well. The CBs while lending to the domestic solvent financial institutions bestows them an opportunity to access unlimited funds. However, CBs must have keen surveillance and appropriate regulations that restrict the involvement of such institutions in excessively risky activities.[159] This will allow the IMF to have supervision on the policies of the member states. The member states will be entitled to use the facilities of IMF however; they must meet the qualification criteria. This research further says that all member states must consult with staff and the executive board of the IMF and revisit their economic policies. The IMF should make its terms and conditions of the lending very clear to the member States which are eligible to seek assistance from it. The countries having a good track record and strong policies and also complying with terms of qualification must be eligible to get support from IMF freely. These facilities should be open to all member states. The recommendations of the staff members of the IMF regarding the policies of the member states should not be binding upon the

[157] Edwin M. Truman, "The IMF as an International Lender of Last Resort", (October 12, 2010) Peterson Institute for international Economics, Accessed: February 04, 2018.
[158] Ibid (Page No. 3)
[159] Ibid (Page No. 7)

executive board. Primarily, this research proposes significant amendments in the framework of the IMF to make its role as a LOLR more effective.

Notwithstanding, its recommendations can be beneficial for the countries having a strong economy. In the global financial system, it is less likely for a country having a strong economy to seek assistance from the IMF. On realistic grounds, the liquidity support of IMF is more needed for the countries which do not have a strong economy and resources to deter any potential recession. Although this research also emphasizes that the IMF must have a regulatory framework, however, its proposals are more suitable for developed countries. This research will also provide recommendations based on the needs of the countries having weak economic systems. It extensively describes the benefits of having an ILOLR but has not addressed the issue of moral hazard problems (See 3.6)

3.5.2 Jean-Pierre 2014

In the equivocal, however, the prospective economic system of the modern era where the financial activities of financial institutions are interlinked and the failure of one can efface the entire system. It is no more a contention if the global economic system requires an international LOLR or not. *Jean-Pierre Landau* divulged the significance of an international LOLR in his research *"International Lender of Last Resort: Some thoughts for 21st century"*. This research enunciates how the debates regarding the need for an international LOLR and its sphere are concluded. Rapidly increasing multi-national trade, the global financial crisis of 2007-2008, and its annihilating aftershocks paved for the formation of international LOLR. The operational regulation of IMF is still valid to counter the financial crisis nonetheless; the diversity of economic systems has created more challenges for international financial markets.[160] This research unfolds the major causes of financial instability in the financial markets. In the current economic environment, the requirement of liquidity is higher than before and due to the cross-border trade, the need for foreign currency has rapidly increased. During the recent crisis, foreign reserves were used as a vital tool to meet the liquidity requirement. Thus, many Central Banks (CBs) while operating as LOLR lend liquidity in foreign currency to their domestic system. A shortage of liquidity urges the CBs to issue more notes which eventually deteriorates the value of the currency. Hence, the foreign reserves are esteemed befitting to deter crisis.[161]

However, the collection of foreign reserves costs a lot to the system which makes the system more vulnerable. To Jean-Pierre, the CBs while acting as LOLR should not merely lend liquidity to the financial institutions but should also stick to their main role which is to ease the pain.[162] The risk pertaining to the LOLR can be curtailed through cannons of worthy collaterals. Nonetheless, it is still an unaddressed challenge for the international LOLR. The empirical study of Goldberg in 2011 explains that foreign currency reserves have played a successful role to restrain the crisis. However, it is yet to debunk if it could be a long-lasting and perpetual solution.[163] This research further describes the framework for the International LOLR that its support should be unconditional unlimited and unsecured.

Additionally, it evaluates the framework and says that it would be an unrealistic approach and could lead to a surge in the moral hazard problems. It will leave the beneficiaries unaccountable and make a frail position for the international LOLR. Therefore, the LOLR operations should not

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[160] Jean-Pierre Landau, "International LOLR: Some thoughts for 21st century", (2014) Bank for International settlement No 79, Page No. 119
[161] Ibid (Page No. 120)
[162] Ibid (Page No. 122)
[163] Ibid (Page No. 125)

be carried out only during the crisis but must be engaged at all times. It should have two policies because the methodology of handling liquidity in normal times may not be effective during a crisis.[164] The currency swap arrangement should be equally explicit and unstipulated for all the countries. Finally, it explains the moral hazard problems which will arise for the international LOLR and the mechanism to curb them. However, this research mainly emphasizes the method of currency swap and does not fully explore the functional and operational mechanisms and challenges.

3.6 LOLR in Different Jurisdictions

3.6.1 Gayane Oganesyan 2013

In the research *"The Changed Role of Lender of Last Resort: Crisis Responses of Federal Reserves, European Central Bank and Bank of England" Gayane Oganesyan* evaluates if the recent global financial crisis has enhanced the functions of LOLR or not. The author argues that Federal Reserves, the European Central Bank, and the Bank of England played the role of LOLR in an unprecedented way which is analyzed in conjunction with principles suggested by earlier economists on LOLR.[165] It compares the actions of Central Banks' to establish that the role of LOLR has evolved. It establishes an argument while comparing the current financial crisis with the *Great Depression of 1903*s that the central banks need to implement LOLR to prevent any further financial crisis.[166] To avoid any instability in the financial system the functions of LOLR have evolved. It analyses the causes of changes in its functions and evaluates if these changes are befitting for the current economic system of the world.

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[164] Ibid (Page No. 130)
[165] Gayane Oganesyan, "The Changed Role of LOLR: Crisis Responses of Federal Reserves, European Central Bank and Bank of England", (2013) Institute for International Political Economy Berlin 19/2013, Accessed: March 30, 2018.
[166] Ibid

This research further explains that the main role of LOLR is more than merely providing liquidity to financial institutions during the crisis and also describes the principles. To Gayane, the assistance of LOLR should not only be for certain institutions or individuals but has to be for the entire system. He believes that the CBs should acknowledge their duty as LOLR to protect the system and ensured the investors regarding the safety of their money.[167] The assistance of LOLR in the form of liquidity should be against a high penalty rate which will not only help to cover the cost of these operations but also curb the moral hazard problems. It further states that although the support of LOLR should be available for all financial institutions nonetheless; it should be stipulated that only those institutions can seek the help of LOLR who can provide worthy collaterals.[168] He endorses the principles suggested by other economists that the liquidity support in the operations of LOLR should only be offered to the solvent institutions because divulging the public money to the insolvent institutions will increase the moral hazard problems and curtail the power of the system to resist against financial crisis. Finally, before concluding this research the author argued that even though in the modern economic systems the role of LOLR has been enhanced, it still needs to be properly regulated.[169] Notwithstanding, no regulation is proposed which can address the contemporary challenges of the financial systems.

3.6.2 Mike Anson, David Bholat, Miao Kang, and Ryland Thomas

The recent financial crisis urged the CBs to act swiftly as LOLR and strengthen their financial markets to counter the anxiety of the crisis. The approach of the CBs to deal with the crisis was different from each other because of not giving importance to the role of LOLR in the policy debates. British scholars *Mike Anson, David Bholat, Miao Kang, and Ryland Thomas* have

[167] Ibid (Page 6)
[168] Ibid (Page 10)
[169] Ibid (Page 30)

contributed to the literature by conducting remarkable research on the approaches of the Bank of England (BOE) while acting as a LOLR. In the research of *"The Bank of England as Lender of Last Resort: New Historical Evidence from daily Transactional data",* they evaluate the mechanism of the BOE and its adherence to the principles suggested by earlier economists to carry out the operations of LOLR.[170] They have used qualitative and quantitative methodologies to carry out this research and used exact figures for the amount of lending and its distribution to the financial institutions. During the nineteenth century, apart from some special circumstances i.e. the crisis period of 1847, 1857, and 1866 the BOE has used Walter's rules to handle financial stability.[171]

Afterward, during the crisis the BOE has followed the rule to lend freely, however; it didn't apply the rules of penalty rates and collaterals strictly. It can be argued to have extraordinary steps in special circumstances nonetheless; it raised moral hazard dramatically. Some ledgers show that the lending was offered to some enterprises even on a lesser interest rate than normal, however; the record shows that the bank and its shareholders had earned from these LOLR operations.[172] It further evaluates if the liquidity support should only be for the financial institutions bearing liquidity problems or for the insolvent institutions as well. The assistance of the CBs should be for the entire financial system rather than benefiting some individual institutions.[173] It explains that the BOE has used its discretionary powers to act as LOLR which allowed it to lend on their conditions and to certain institutions. It made the system fragile and

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[170] Mike Anson, David Bholat, Miao Kang and Ryland Thomas, "The Bank of England as Lender of Last Resort: New Historical Evidence from daily Transactional data", (Bank of England Working Paper No. 691), (November 2007), Accessed: 3rd March 2018.
[171] Ibid (Page No. 3)
[172] Ibid (Page No. 11)
[173] Ibid (Page No. 13)

highlighted the lacunas of the system in the recent crisis.[174] In contemporary financial markets where the financial activities are equivocal, nothing can be expected from the operations of LOLR in the absence of proper regulations. The ledgers and balance sheets used to conduct the research unveil the facts that the lending rules were jeopardized. This research mainly highlights the facts regarding the operations of BOE in the last two centuries and identifies some key problems. However, it does not provide reforms to make the role of BOE as a LOLR fruitful in the contemporary global financial system where the business activities of multinational companies are in many different currencies.

3.6.3 Muhammad Farooq Arby (2009)

The role of LOLR is an essential function of the CBs nonetheless; before the recent financial crisis, CBs were reluctant to adhere to this responsibility. The evolutionary part of the research describes that the role of LOLR was not even part of the major policy debates. It is, therefore, more probable that there is no significant literature available appraising the operations of the State Bank of Pakistan (SBP) as the LOLR for the domestic financial market. Pakistan, however, lies among the countries that were imparted liquidity assistance by the IMF while performing the duties of ILOLR. *Muhammad Farooq Arby* has contributed to the literature by producing noteworthy research regarding the evolution and core functions of the SBP. In his research of *"State Bank of Pakistan: Evolution, Functions, and Organization"* he explains the tentative journey of the progression of the SBP. Usually, the administrative issues of the banking system pave the way for the formation of a CB. However, it is the other way around in the case of SBP as it was established in a newly created country. Thus, it had to be dealt with the ritual banking

[174] Ibid (Page No. 25)

system and structured a flourishing banking regime.[175] The SBP was ordered on its inception to regulate the entire financial system and play its role in the evolution of the economic system.

It is among the fundamental characteristics of the SBP to issue notes, regulate the system, act as the LOLR for the domestic financial system, and conduct monetary policy of the state.[176] Section 24 of the SBP Act 1956 empowers it to issue notes which are being handled by the two departments of the SBP. Section 30 of the SBP Act 1956 restricted the power of issuing the notes by imposing a condition that they cannot issue notes beyond their assets. Section 9A bounds the central board of the SBP to formulate the fiscal policy of the state.[177] Section 17G of the SBP act allows it to operate as the LOLR as it empowers the State Bank to lend loans to the financial institutions that are experiencing a shortage of liquidity. However, while lending liquidity the SBP does not comply with the principles used in the developed countries. Section 18 of the act further provides unaccountable powers to the State Bank that it can directly discount to exercise these powers.[178] Pakistan had introduced a 3-day Repo facility on 1st February 1992 and lend liquidity on flexible grounds. The SBP performs several other functions i.e. management of foreign exchange rates, managing the public debts, advisor to the government, etc. This elaborates the functions of the SBP in detail, however; it does not critically analyse its functions. In the modern global economic era when the economic condition of Pakistan is deteriorating dramatically, it can no longer survive with the current regulation regarding the powers of SBP as a LOLR for the domestic market. After a critical analysis of the operations of Federal Reserves and The Bank of England as LOLR regulatory framework is proposed below in this research.

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175 Muhammad Farooq Arby, “State Bank of Pakistan: Evolution, Functions and Organization”, (MPRA Paper No. 13614), (March 2009), Accessed: March 03, 2018.
176 Ibid (Page No. 6-11)
177 Ibid
178 Ibid (Page No. 14)

3.6.4 Paul De Grauwe

In the research *"The European Central Bank as a Lender of Last Resort," Paul De Grauwe* unfolds the role of ECB[179] as a LOLR. The anxiety of the financial crisis and the subversive consequences of moral hazards, inflation, and fiscal implications could not restrain the ECB to intervene and operate as LOLR against the crisis.[180] The approach of ECB as a LOLR was different in 2010 than it was in 2011 when it provided liquidity to the bond markets of Spain and Italy which enunciated the lacunas; it hauls the attention towards the necessity of a regulatory framework.[181] This paper divulges the loopholes of monetary unions which disrupt the smooth run of the economic system and invokes the ECB to step in as a LOLR.[182] It further elaborates on the need for LOLR and depicts that its existence would prevent bank runs.[183] A minor issue of liquidity in the absence of a LOLR will lead to a bank run because illiquidity spurs the depositors to withdraw their money. Banks at this stage are forced to convert their illiquid assets into liquidity through a swift vend which causes a drastic curtail in their value. Consequently, banks owe more money than they own. Eventually, high demand for liquidity results in a bank run because panic among the depositors is more detrimental to the economic system than other factors.[184]

The paper emphasizes the importance of LOLR in an economic system because its existence ensures the depositors will not be deprived of their money.[185] Strengthening the arguments for LOLR, the ideas stated in the book "*Monetary History of the US*" by *Milton Friedman* are used

[179] European Central Bank
[180] Paul De Grauwe, "The European Central Bank as a Lender of Last Resort", VOX, CEPR's Policy Portal, (August 18, 2011), Assessed: May 17, 2017.
[181] Ibid
[182] Ibid
[183] Ibid
[184] Ibid
[185] Ibid

in this paper. Milton Argued that the failure of the Federal Reserve to operate as LOLR caused the financial crisis.[186] This paper further highlights the criticism on the role of LOLR that it would cause fiscal consequences if the ECB will impart liquidity to government bond markets. The loss will be inevitable to ECB if the government will fail to pay its debts. It counterargues that all open market operations carry risks of loss. Thus, abstaining from open market operations is not possible for a central bank.[187]

Finally, this paper unfolds the portion of moral hazards which is the most criticized part of the role of LOLR. By offering the support of LOLR, the ECB imparts the government an incentive to involve in risky activities. Despite the moral hazards, the CB at the domestic level cannot get rid of its obligations to play the role of LOLR for the domestic financial market. Similarly, ECB is also obliged to play the role of LOLR in the Euro-zone whereas moral hazards can be addressed by imposing limitations on risky activities.[188] This paper revolves around the role of ECB as the LOLR; it depicts its characteristics and key challenges. Nonetheless, it does not provide a complete insight into LOLR at the international level.

3.7. LOLR and Moral Hazard Problems

3.7.1 Mikko Niskanen

In the research of *"Lender of Last Resort and the Moral hazard Problem," Mikko Niskanen* argues that the earlier contribution of Thornton (1802) and Bagehot (1873) and the recent one from Goodhart (1999) have made it clear that the LOLR is essential for the formation of an invulnerable economic system. It further states that the absence of LOLR would allow a minor liquidity problem to emerge as a major financial crisis that can haul the entire system towards a

[186] Ibid (What Milton Friedman would have said?)
[187] Ibid (See Part of Fiscal consequences)
[188] Ibid (See part of What about moral hazards)

debacle.[189] Furthermore, the author argues that the presence of LOLR was criticised not only by economists but the CBs were also reluctant to play this role. He argues that imparting liquidity assistance will allow the banks to get involved in highly risky activities. Insurance by the CB will exterminate the panic of being deprived among the depositors. Resultantly, the risky activities of the banks will not perplex them and their role of monitoring the banks which provide market discipline will be ceased.[190] As a result, this situation strengthens the argument that in the presence of LOLR the banks are more likely to collapse and make the system more vulnerable than not having a LOLR.

Expectations of getting liquidity support from the CB efface the spirit of financial institutions to get rid of the situation which causes moral hazard problems and makes the system more fragile. To curtail the expectations the ECB is using the approach of being vague about the role of LOLR and Federal Reserves (US) is esteeming that it is their discretion to offer the support.[191] Normally, the banks sell their illiquid assets to fulfill the demand for liquidity. However, a swift sale of the assets dramatically decreases the value of the assets and makes the situation worse for the banks. Thus, the CBs sometimes buy the assets of such banks while playing the role of LOLR which strengthens them to overcome the financial crisis.

However, on the other hand, it makes the administration of such banks careless about their illiquid assets and causes severe moral hazard problems.[192] Some strategies are explained in this research to curb the moral hazard problems that if the depositors or deposit insurance companies will charge more from the banks for risky activities it can stop them from investing in risky

[189] Mikko Niskanen, "Lender of Last Resort and the Moral Hazard Problem", (2002) Bank of Finland 17/2002 Accessed: August 10, 2017.
[190] Ibid (Page 9)
[191] Ibid (Page 15)
[192] Ibid (Page 20)

activities. However, this will also allow the banks to invest in risky activities because if the banks will pay more to the insurance companies, they will indeed get more compensation for bankruptcy and aggravate moral hazard problems. Finally, this research concludes that it is essential in the modern economic system to have a LOLR which is helpful to deter a financial crisis. Nonetheless, it is also vigorous to address the moral hazard problems which are pertaining to it.[193] This research mainly emphasises the importance of having a LOLR and reveals some of the moral hazard problems which can endanger the role.

3.7.2 Gerhard Illing and Stephan

In the post-crisis financial debates, the role of the CBs as LOLR has become the central point. All the economists unanimously believe that the issue of moral hazard problems is inseparable from the operations of LOLR. Thus, it is not worthy to neglect this sinister element which can drag the system towards more susceptibility. *Gerhard Illing and Stephan* highlight the major causes of moral hazards and suggest some reforms to address this issue in their research *"Lender of Last Resort Policy – The Risks Involved"*. In this research, they point out another serious issue because of the operations of lending liquidity. They further argue that although emergency liquidity support helps the financial institutions facing the deficiency of liquidity to stabilize their situations and avoid insolvency. Nonetheless, it puts the stability of prices at risk which can cause inflation that is more effacing than the liquidity problem.[194] The parable of the operations of liquidity support of September 2001 is irrelevant because that hadn't lasted long and was sterilized shortly. In contrast, the liquidity support on lower interest rates in stock market failure and the LTCM crisis of 1987 and 1988 respectively caused inflation.[195] This may not be so

[193] Ibid (Page 27)
[194] Gerhard Illing, Stephan, "Lender of Last Resort Policy – The Risks Involved", (September 21, 2007), Accessed: February 07, 2018).
[195] Ibid (The Risk of Inflation Part)

vicious for the countries having a stronghold on the foreign exchange markets but unlimited and unaccountable liquidity support can cause serious issues of inflation.[196]

They further add the effects of liquidity support in the form of moral hazards. The frequent impartation of liquidity by the CBs to the illiquid but solvent institutions to avoid the anxiety of crisis may work for the system and benefit of the public at large. Indeed, the assurance of being rescued in a phase of illiquidity encouraged financial institutions to invest in risky but profitable ventures briskly. However, the chance of their failure and putting the taxpayers' money into a drain cannot be negated.[197] Therefore, many CBs show reluctances to offer liquidity support rapidly. Mervyn King, the governor of the BOE once argued that liquidity support encourages the financial institutions who are involved in wired economic activities to earn money without bothering the consequences and penalizes the institutions working professionally. This would result in nothing less but an intense recession.[198] The modern financial system has engulfed the CBs in a way that the refusal of liquidity assistance can trigger a crisis and the rhetoric of prospective outcomes of the operations of impartations of liquidity has buried the arguments regarding the panic of moral hazard. Although, this research extensively describes the obstacles for the CBs in stabilizing the financial system and rightly points out the consequences if the issues of moral hazard will be disregarded. The modern era of the global economic system cannot survive without having a LOLR but an unregulated system that does not haul its intention towards the problems can be annihilating. Notwithstanding, this research does not propose a solution to the problems which are highlighted. The moral hazard issue needs to be addressed

[196] Ibid
[197] Ibid (The Moral Hazard Issue)
[198] Ibid

adequately because the role of LOLR enhances the sustainability of the system against the crisis. (For reforms see the chapter of reform proposals below).

3.7.3 Giancarlo Corsetti, Bernardo Guimaraes, and Nouriel Roubini

In the globalized economic system where the presence of an international LOLR strengthens the financial system the effects of moral hazard pertaining to it cannot be negated. In remarkable research of *"International Lending of Last Resort and Moral Hazard: A Model of IMF's Catalytic Finance" Giancarlo Corsetti, Bernardo Guimaraes* and *Nouriel Roubini* enunciate the challenges of IMF while acting as international LOLR. The prospective support of an international lender of last resort (ILOLR) cannot haul off the intentions from the detrimental consequences of moral hazards. In the contentions regarding the functions of ILOLR critics argue that the liquidity support of international financial institutions to the countries facing the deficiency of liquidity and standing on the verge of recession can temporarily address the issue. Nonetheless, the assurance of having the ILOLR for rescuing them out causes serious managerial issues.[199] The main causes behind the financial crisis are the policies of IMF, international investors, and the local governments. International financial institutions can prevent a shortage of liquidity through international investors and injecting liquidity. These institutions, however, are increasing their influence in the debtor countries.

Primarily, the financial crisis is caused by liquidity runs and panic among the creditors for being deprived of their investments. However, this issue can easily be avoided by having an ILOLR to lend liquidity to the countries experiencing a shortage of liquidity.[200] This provision can indeed address the issue of liquidity run but it will generate serious moral hazard issues as well. Thus,

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[199] Giancarlo Corsetti, Bernardo Guimaraes, Nouriel, "International Lending of Last Resort and Moral Hazard: A Model of IMF's Catalytic Finance", (2006) Journal of Monetary Economics, Vol. 53, Issue. 3, Page No. 441.
[200] Ibid (Page 8)

the support of the IMF should be limited and contingent. A stipulated bailout that the country will revisit its financial policy can restore the trust of investors and prevent destructive runs.[201] The adjustments in the financial policies will be convincing for the creditors to roll over their positions and provide sufficient time to the debtor country to get rid of the panic of crisis. Although, moral hazard problems are a serious issue in the bailout operations the significance of these operations cannot be denied. Therefore, the IMF needs to adopt alternative techniques that can curtail the annihilating effects of moral hazards.[202]

This research proposes a theoretical skeleton of the ILOLR and suggests the regulatory adjustments to curb the issue of moral hazard. Practically it is not possible for the IMF to fill the external financial gaps nonetheless; the assurance of liquidity support will erase the panic and the issue of distorting moral hazard can also be addressed by imposing limitations on the liquidity support.[203] The developing countries do not possess enough resources to implement apt but costly policies. There is a view that a large amount of liquidity assistance allows the debtor countries to be careless regarding the output of their policies hence; the argument of generating moral hazards prevails. However, the support of ILOLR can enable the debtor country to implement costly but prospective policies. This contributes to the literature by proposing a theoretical framework of an ILOLR and argues that there will be no defence of moral hazards pertaining to the domestic and ILOLR unless the liquidity assistance is stipulated and the rationale behind these operations should not be to attain influence on the debtor countries. This research surfaces the challenges of an international lender of last resort. However, it contributes to the literature by analysis of the challenges of domestic and international LOLR and will

[201] Ibid
[202] Ibid (Page 12)
[203] Ibid (Page 14)

proposes a theoretical framework for the domestic and international financial lender of last resort.

Summary

The literature discussed above has made it clear that the role of LOLR was neglected for a long time and was not a significant part of financial debates until the last financial crisis. The literature explains the need for the LOLR for a domestic and international financial system and suggests that it is developed countries which have significantly regulated the role of LOLR. It has provided evidence that the operations of LOLR are successful in the UK, USA, Europe, and other developed countries and helped their financial systems to fight the crisis. Most of the significant research on this topic is from the USA and UK. Nonetheless, there is no empirical research on this topic from the perspective of the role of the State Bank of Pakistan as a LOLR. This thesis, therefore, contributes to the literature in the field by drawing lessons from the experiences of the UK and the USA and proposing a regulatory framework for the role of LOLR in Pakistan.

Chapter 4 Research Methodologies

4.1 Introduction

This chapter is significant in this research work because it explains the research methodologies which are employed in the formation of the research study. It describes the importance of research methodologies in academic research and further unfolds the rationale behind the selection of the research methods being employed. It further argues why other research methodologies which were ostensibly deemed relevant, are rejected. This legal research appraises the impacts of having a LOLR on the financial system at the domestic and international levels. The research has a theoretical, doctrinal, and conceptual base hence the methodologies which are employed in this research are: doctrinal, comparative, and case studies. This research aims to examine the impacts of LOLR in making a financial system less vulnerable instead of a black-letter legal assessment which only provides the interpretation of the laws and statutory provisions.

The chapter is divided into four parts; the first part considers the scope of doctrinal research methodology and explains the resources which are used in this research methodology. Moreover, it explains the relevance of doctrinal research methodology in this research and finally ends up providing evidence on how the concerned research methodology has been utilised to carry out this research. The second part consists of the information which goes on to explain the strengths and boundaries of the documentary research methodologies. Additionally, it describes the resources which are used in this research method. This part concludes by explaining the relevance of the concerned research methodology in this research and provides examples of how it is capitalised in this research. Additionally, in the third part the scope of comparative research methodology, its limitations, and coherence are described. The Fourth part provides insights into the methodology of case studies and unfolds its significance in legal research. The relevance and implication of the case study methodology are also explained in detail. The final part of this chapter covers the scope and limitations of the historical and conceptual research methodologies and argues why these research methods have not been preferred over the ones being used for this research. It also describes the reliability of the resources which are used to make this work an extraordinary move regarding the concerned phenomenon of LOLR.

4.2 Research Methodologies

Research methodologies that are applied to conduct this research and their importance are described in this part. It enunciates the rationale behind the selection of the doctrinal, documentary, and conceptual research methodologies to address the concerned topic. It further delves into the significance of case studies and their relevance in this research. Before starting a research work it is essential to put the appropriate research methodology into the rucksack of the researcher.[204] Hence, a suitable selection of the research methodologies and their proper implication is imperative to conduct worthy research work. Failure of the researcher to apply appropriate research methodologies will raise serious questions regarding the reliability of the research. A famous Hudson maxim elucidates the significance of research methodologies that "Progression starts with inquiry because curiosity is always better than overconfidence of knowing everything because doubt urges to inquire which leads to inventions".[205]

Research can be conducted by using the methodologies of qualitative and quantitative research. In qualitative research, the researcher needs to conduct empirical research by using questionnaires, interviews, and collecting data from the field, and analyze it. In this research

[204]Chrispas Nyombi, "An Examination of the Evolving approach to UK Corporate Rescue and the impact of subsequent legal reform", (LLM Dissertation, University College, London) Accessed: March 1, 2017.
[205] Md. Joynal Abdin, "The Significance of Business Research & Graduate Research Methods", (2008), Social Sciences Research Network, May, Accessed: April 02, 2017.

methodology, the researcher provides an analysis based on his/her research work and data which was collected to conduct the research. However, in qualitative research, no fieldwork is required, the researcher needs to analyse the research already conducted by someone and provides his insights regarding the topic. In this research, the role of the CBs as a LOLR is appraised and after a deliberate examination of the systems of the US and UK, a regulatory framework is suggested for Pakistan to reform its system. Thus, this research does not require qualitative research because, in this research, the legislations of the US and UK will be studied. It further examines the role of BOE and FBR as LOLR during the financial crises. This research evaluates the current system of Pakistan regarding the role of LOLR. Moreover, it identifies the loopholes of the current system of Pakistan. It further examines the system of the UK and the USA to learn lessons and inform the regulatory reforms for Pakistan.

The qualitative research methodology consists of different methods to conduct research. The role of LOLR is based on a doctrine and it involves an extensive evaluation of the laws. Therefore, the doctrinal research methodology is applied to understand the doctrine of the LOLR and the contemporary challenges of the financial system due to the loopholes in the legislation. This research requires gathering information from various documents relating to the LOLR which includes policy documents and international research papers. The documentary research methodology is appropriate and relevant to be applied. It is important to properly understand the concept of the topic before appraising and proposing a legal framework for it. That is why conceptual research methodology is used to carry out this research study. Finally, the methodology of case studies is also used during this research because in order to illustrate a legal topic it is imperative to examine previous case studies and learn from the experiences.

4.2.1 Rationale of Deploying Research Methodologies

Deployment of relative research methodologies is imperative in all types of researches. it is not possible to get desired results from research without understanding the significance of deploying appropriate research methodologies. It is not possible to conduct legal research depending on one research method therefore a combination of relevant research methodologies is required. In this research, a combination of Doctrinal, Documentary, Comparative research methodologies besides the case studies is deployed. The significance and relevance of these research methods are abridged. How these research methodologies are deployed to carry out this research is also explained.

4.3 Doctrinal Research Methodology

The doctrinal research methodology due to its physiognomies is very common while conducting legal research. It is imperative in legal research to properly understand and analyse the laws and demonstrate the arguments with relevant cases. Latin word "Doctrina" is an ancient word for the doctrine which means lessons, knowledge, and learning. Frequent repetition of the same legal terminologies establishes a doctrine. It explains a logical description of the legislation and explains the acumens behind the laws.[206] The doctrinal legal research consists of the research of legal terminologies, statutes, and case laws and also analyses the development and implementation of the doctrine. It is theoretical research. It helps to understand the capacity of the laws to address contemporary legal issues and examines if the norms of the society are followed or not and that is why; it appeals to a legal researcher a lot.[207]

[206] Vijay M Gawas, "Doctrinal Legal Research Method a Guiding Principle in Reforming the Law and Legal System towards the Research Development", (2017),International Journal of Law, Volume 3, Issue 5, Page No. 128-130
[207] Dr. S. R. Myneni, "Legal Research Methodology, fifth edition 2005", (2005) published by Allahabad Law Agency, Haryanna Indian, Page No. 41

Doctrinal research thoroughly studies case law, legal propositions, and reasons behind the establishment of certain regulations. It provides an insight into the systematic exposition of the laws which are governing the system and identifies the loopholes of the system. It also indicates the challenges which the system will face due to the gaps.[208] Doctrinal research does not merely revolve around the analysis of the laws and judicial precedents, but it also investigates parliamentary debts, policy documents, and provides the historical development of the laws and doctrines. The scholarly research on the law of torts and administrative laws are the classical example of the concerned research approach. It is also used in interpreting the laws and mostly the judges, lawyers, and legal researchers use this approach to conduct research.[209]

Additionally, it provides a critical examination of the case laws and provision of the legislation which are related to the topic of research. Normally, in the concerned approach, both the primary and secondary data are used because it mainly evaluates the laws, enactments, parliamentary proceedings, and case laws. The quality of the research which is being carried out while applying doctrinal research methodology is entirely based on the selection of the material which is used in the study.[210] All of the acts passed by the parliament, the rule of business, and the decision of the higher courts which are binding on lower courts are the sources for doctrinal research. Therefore, doctrinal research is mostly used in qualitative research. In this research, the researcher has to analyse the statutory material, legal history, case laws, and legislation that is why, no fieldwork is required, and the researcher does not require to prove or disprove a hypothesis by utilising the

[208] Vijay M Gawas, "Doctrinal Legal Research Method a Guiding Principle in Reforming the Law and Legal System towards the Research Development", (2017), International Journal of Law, Volume 3, Issue 5, Page No. 128-130.
[209] Terry Hutchinson, "Defining and Describing What we Do: Doctrinal Legal Research", [2012], Deakin Law Review, Vol 17, Issue 1, Page No. 83-119
[210] Terry Hutchinson, "The Doctrinal Method: Incorporating Interdisciplinary Methods in Reforming the Law", [2015] Erasmus Law Review, Vol, 8, Issue 3, Page No. 1.

data collected in fieldwork. This approach is not only useful for legal researchers, but it has turned out to be an integral part of certain types of legal research.[211]

Although doctrinal research methodology may be criticised because of its limited scope and lack of appreciation of law in its social context, there is, it is argued, no research method that is absolute and perfect for all types of research. Doctrinal legal research is important in providing a methodology for systematic examination of legal phenomena. Particularly, this type of doctrinal research is an appropriate research methodology because the topic of this thesis revolves around legal doctrine and legal principles which can be, it is argued, appropriately examined through a 'black letter' legal analysis – that is to say a close analysis of primary legal sources including case law as well as national and international regulation.

The doctrinal research approach is an appropriate selection for constituting this research because the role of LOLR is based upon doctrine. This role was played on mutual understanding and personal relations at the domestic and international levels. Domestically, the financial institutions borrowed money in the time of difficulties when they faced liquidity shortfall from the institutions which were capable of providing liquidity. There were no rules and regulations for these functions, that is why these functions were purely based on the mutual understanding of the depositors and debtors. Similarly, countries based on the personal interest of diplomatic relations lent and borrowed money from each other at the international level. However, after the inception of CBs, this role was attributed to them and legitimised through legislation. Frequent practice of the same functions which was legally backed made it a doctrine. In this research, the evolution of LOLR and its legal implications in the US and UK are examined. The gaps in the system of Pakistan which is governing the powers of the SBP as LOLR are recognized and reform

[211] Vijay M Gawas, "Doctrinal Legal Research Method a Guiding Principle in Reforming the Law and Legal System towards the Research Development", [2017] International Journal of Law, Volume 3, Issue 5, Page No. 128-130

proposals are suggested to make the system invulnerable. Thus, the doctrinal research methodology is relevant to understand the topic.

The concerned research methodology is applied to carry out this research by analysing the doctrine of LOLR. It also revealed the historical background of the operations of LOLR and argued how the problems of moral hazards became a hindrance to the evolution of this role. This research approach is utilised to understand the conceptual underpinning of the LOLR. It also helped to appraise the legislations of the US, UK, and Pakistan regarding the role functions of CBs. Different cases are also illustrated to determine the benefits of this role in deterring a financial crisis. The factors which urged the policymakers to change the laws relating to the powers of CBs as a LOLR are also described. Implementation of the concerned research methodology assisted in evaluating the experiences of LOLR in financial crises of different periods and recognizing the regulatory gaps.

4.4 Documentary Research Methodology

The sphere of documentary research methodology is handy for both qualitative and quantitative research. It is essential to analyse the documents while using primary or secondary materials. Authenticity, credibility, representativeness, and meaning are the vital elements to appraise a document. The reliability of a document and its originality is appraised through the approach of authenticity which helps to identify any alternation in the document. In education, authenticity is regarded as a fundamental criterion of documentary research. Demonstration of genuine and an absolute origin of the documents makes it valid although its content is found absurd, subsequently. In qualitative research, the enunciation of unquestionable origin is not sufficient to accept a document. Thus, the credibility of the information presented in the document will be determined while evaluating the document.[212]

The third approach to analyse a document is representative which means to determine the reliability. Some documents have been used again and again because of their significance thus, they could not survive too long. It is not easy to determine if the document is authentic, credible, and representative or not, that is why, a researcher can use the adverse approach and determine which documents are unauthentic, non-credible, and unrepresentative.[213] This perspective is termed "methodological distrust". Finally, documentary research methodology analyses the content of the document whether the evidence is patent and coherent. This intense appraising of any source of information is the essential characteristic of the documentary research methodology which makes it attractive for the researchers who want to unfold all ins and outs of their concerned topic.[214]

Documents can be produced by the individuals of a group of people through their daily life experiences or as a result of empirical research. There are two types of documents that are used to conduct research i.e., primary documents and secondary documents. For the purpose of this particular research, primary documents are legislations and policy documents issued by government institutions. Primary documents are produced by the legislators or the institutions which are authorized to frame a regulation.[215] On the other hand, secondary documents are produced by researchers who use primary documents and analyse them. The evaluation of any

[212] Craig Kridel, "An Introduction to Documentary Research", (University of South Carolina), Accessed: July 10, 2017.
[213] Jashim Uddin Ahmed, "Documentary Research Method: New Dimensions", [2010] Indus Journal of Management & Social Science (IJMSS). Vol, 4, Page No. 1-14.
[214] Ibid
[215] Monageng Mogalakwe, "The Use of Documentary Research Methods in Social Research", [2006] African Sociological Review, Vol, 10 (1), Page No. 221-230.

law or policy of the state by the scholars is regarded as the secondary documents. The documentary research methodology is an essential tool to analyse the reliability and relevance of the documents which are used to conduct research.[216]

The role of the CBs as LOLR for the financial institutions which experience liquidity shortfall is assigned to them by the legislation. This research describes the evolution of the role of LOLR and examines the laws which authorised the CBs to play this role. This research consists of the study of the laws which empower the BOE, FRB, and SBP to act as LOLR. All these laws are primary documents and numerous economists have argued in favor and against the presence of LOLR which are regarded as secondary documents. No research methodology can be more relevant and appropriate to appraise the authenticity of these documents than the documentary research methodology. Therefore, documentary research methodology is used to examine the documents which are inevitable to carry out this research.[217]

The documentary research methodology is used to examine the laws which legitimise the role of LOLR. Documentary research methodology helps to evaluate the strengths and weaknesses of the laws. In this research, it is important to recognise the efficiency of the laws. The theories of Sir Francis Baring and the principles of Henry Thornton and Walter Bagehot regarding the LOLR to minimise the effects of moral hazard problems are also described. The documents which possess the information and evaluate these principles are secondary. Thus, the methodology of documentary research is utilised to examine the relevance of the context of these documents. Notwithstanding, besides several benefits and relevance of documentary research methodologies it is imperative to provide a fair appraisal of this research method. Documentary

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[216] Monageng Mogalakwe, "The Use of Documentary Research Methods in Social Research", [2006] African Sociological Review, Vol, 10 (1), Page No. 221-230.
[217] Jashim Uddin Ahmed, "Documentary Research Method: New Dimensions", [2010] Indus Journal of Management & Social Science (IJMSS). Vol. 4. 1-14.

research methodologies can have a limited scope so may be suitable to be used in combination with other research methods. The value of this method is that it enables the researcher to evaluate the documents used in the research and to examine whether those documents are reliable sources or not. In this research a range of secondary documentary sources were used to gather specific information regarding LOLR and therefore this method was considered an appropriate choice for the purpose of information gathering.

4.5 Comparative Research Methodology

The role of comparative research has drastically surged in the last century. It is human mania to quest for the best; his nature of appraising everything rationally enlightens the recognition of distinct things over him. Globalisation and the formation of the European Union played a vital role in the enhancement of comparative legal research at the domestic and international levels.[218] A comparative research methodology is applied to compare the legal, economic, and cultural systems of different countries. Comparison of various social systems across the world helps to exterminate perilous norms which are detrimental to society by lending lessons to implement the prospective norms.[219] It annihilates all boundaries and enables the researcher to analyse a variety of systems around the globe which hauls the research to another level. An analysis without a comparison will not be as insightful as the one which implies comparative study.[220] It plays a vital role in the formation of a concept by sharpening the power of description which helps to unfold connections and distinctions from the case studies. Usually, the comparison is used to evaluate a hypothesis that develops the way for the evolution of new theories.[221] In the process of framing a regulatory framework of LOLR for Pakistan, it is essential to analyse the existing

[218] Mark Van Hoecke, "Methodology of Comparative Legal Research", Accessed: July 14, 2017.
[219] Linda Hantrais, "Comparative Research Methods", *Social Research Update,* (Summer, 1995), Accessed: July 14, 2017.
[220] David Collier, "The Comparative Method", (American Political Association, 1993), Accessed: July 14, 2017.
[221] Ibid

systems which are delivering remarkably well. *Dodd-Frank Act of 2010* of the US and the examples of the UK will be compared and appraised. Comparative research methodology, therefore, is indispensable to achieve the milestones of this research.

Before selecting a research methodology, it is imperative to understand what lies within that specific research methodology. Furthermore, it is essential to evaluate if the chosen method addresses the research topic or not. It is also important to analyse the relevance and contribution of the research method in the research. The importance of comparative research methodology is recognized in the globalized world. The role of comparative research has increased especially in the area of law. It has become a fundamental course to learn in legal studies because of its benefits.[222] It is practically valuable for both qualitative and quantitative types of research. Recognition of the importance of this research methodology and its extensive use in legal research has increased the quality of research. The legal systems are established on the pillars of the customs and common norms of society. Although, it is a judicious opinion that legal systems cannot be adopted and should be based on indigenous norms, but a comparative study can provide insights into the identification of the loopholes and strengths of the system.[223]

It is utilised in the second phase of research work because it does not help in finding the resources and relevant literature for the research. For example, the documentary research methodology helps to find out the relevant documents and also evaluates if the documents are valid and relevant to use or not. However, the role of the comparative research methodology starts in the second phase of the research work: whether it be qualitative or quantitative research.

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[222] Marie-Luce Paris, "The Comparative Method in Legal Research: The Art of Justifying Choices", UCD Working Papers in Law, Criminology & Socio-Legal Studies Research Paper No. 09/16, June 22, 2016, Accessed: April 17, 2019.

[223] Frank Esser, Rens Vliegenthart, "Comparative Research Methods", John Wiley & Sons 2017, Accessed: April 21, 2019

It compares the results of the research of the first phase. To comprehend the concept is the initial phase of research, which is intense and time-consuming, however, essential. This phase includes a critical analysis of the relevant literature, narrowing down the topic, appraising the loopholes, and determining the dimensions of the research. A complete understanding is required for a thorough review which can only be obtained by the understanding of the flaws in the existing system and the gaps of the literature. Furthermore, in legal research comparative methodology is versatile because it compares the laws, systems, or case studies and appraises the situation which is useful to revamp the system by addressing the loopholes.[224]

Usually, a variety of research in the fields of social sciences involves conceptual and empirical research engines. It unfolds the theoretical concepts of the topic and explains the terminologies which are used in a particular concept. It describes the reasons behind an incident to depict the phenomenon of the study. Additionally, it helps to understand the topic and that is why it urges the researchers to think about it and use the relevant access information. This methodology of research requires mental sharpness and only engages the researchers in thinking because it does not demand physical ground research, and the researcher merely has to understand the pre-existing theories.[225]

However, conceptual research cannot equip the researcher with enough knowledge to examine whether the concept is right or wrong, but it can only help in the understanding of an idea. Empirical research, on the other hand, evaluates the concepts which are produced by the researchers to assess if they are right or wrong. In empirical research, ground research is

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[224] Syed Aftab Hassan Bukhari, "What is Comparative Study", Social Sciences Research Network December 04, 2011, Accessed: April 21, 2019

[225] Kenneth Einar Himma, "Conceptual Jurisprudence: An Introduction to Conceptual Analysis and Methodology in Legal Theory", (REVUS: Journal for Constitutional Theory and Philosophy of Law, Volume, 26, 2015), Accessed: May 18, 2017.

required, and researchers have to collect the data and examine if a particular concept was true. For example, Aristotle gave a theory that heavy things fall on the ground earlier than the smaller ones which were believed for several years. The conceptual research approach can be helpful in understanding this theory, but its probability can only be checked by empirical research as this theory was later proved wrong by empirical research conducted by Galileo.[226] The conceptual research approach is common in philosophers because it involves research and examination of the present information on a particular topic. This methodology is normally used by the researchers to interpret the existing theories and develop new ones as well. Sir Isaac Newton's work represents a good example of using conceptual research methodology in that he observed everything that was happening in his surroundings and conceptualised it which eventually led him to the development of a theory of gravity. This research methodology evaluates previously developed theories to conduct conceptual research according to which a researcher must follow a certain framework of enquiry.[227]

However, it is important to understand that legal analysis may, in addition to providing a thorough understanding and critical evaluation, require providing a way forward or putting forward recommendations as well. Both conceptual and doctrinal research methodologies can help to understand the conception of the research questions under analysis but they are not the same (even if often utilised to obtain similar results). In this research, the conceptual research methodology is superseded by the doctrinal research methodology because LOLR is a doctrine. In this research, the role of LOLR played by the FRB, BOE, SBP, and IMF was evaluated. It was identified that the role of LOLR played by the FRB and BOE resulted in strengthening the

[226] Tom Tyler, "Methodology in Legal Research", [2017] Utrecth Law Review, Vol, 13, Issue No. 3, Page No. 131-141.
[227] Adi Bhat, "Conceptual Research: Definition, Framework, Example and Advantages", (Question Pro, January 2016), Accessed: May 17, 2017.

economy. However, the role played by the SBP could not bring stability to the economic system of Pakistan. Therefore, the comparative research methodology is deemed inevitable to compare the operations of the CBs for the identification of the problems.

After a deliberate perusal, the examples from each jurisdiction are selected and compared. A comparative research methodology is then utilized to recognize the hazards and learn lessons from the developed systems. Comparison of the role of LOLR played by the CBs of the US, UK, and Pakistan paved the way to suggest the reform proposals for the legal system of Pakistan which is regulating the role of LOLR. Comparative research helps to produce stupendous results, but it has certain limitations as it cannot provide results without the deployment of a proper combination of research methodologies. This research methodology is not merely implemented to compare the operations of LOLR from different jurisdictions, but it is also applied to compare the strength of the financial systems with and without a LOLR. The dimensions of this methodology are very helpful in producing incredible research. It is deployed with a combination of Doctrinal, Documentary, and Case Studies research techniques. The implication of this research methodology has enhanced the susceptibility of the researcher to explore the weaknesses of the financial system of Pakistan by comparing it with the systems of developed countries like the US, UK.

4.6 Case Studies

The case study approach is befitting to use in a research work in which the researcher aims to answer the questions of 'how' and 'why' argued by Yin.[228] The research aims to address the question of how the role of LOLR has evolved and has turned out to be an inevitable part of the economic system. It also investigates why the CB was reluctant to play this role. There is no

[228] Robert K Yin, Case study research, design and methods (3rd edition, SAGE Publications, Thousand Oaks 2003), Accessed: April 04, 2017.

dissent among academic scholars regarding the definition of case studies. A case study is a study of a contemporary phenomenon and investigates its implications in the real-life. It is a study of the outcomes of the implication of a particular law. This study investigates the principles of LOLR and its impact on the financial system. Bromley defines, "it is a systematic inquiry of all the factors which can explain the basic concept of the phenomenon."[229] The methodology of research through case studies is plausible to clearly explain the concept and the effects of its implementation which is why scholars agree that this methodology must be used especially to conduct legal research.

There are three categories of the case studies; exploratory, explanatory, and descriptive. The explanatory provides an insight into an existing phenomenon. It investigates if the research topic exists. Descriptive further describes the phenomenon which exists. And finally, the exploratory; the implications of that phenomenon for example in this research use all three types to inquire about the existence of the LOLR and willingness of the CBs to perform this duty. Some case studies are used to clearly describe the functions of LOLR in a financial crisis. Finally, the case studies describe the benefits of having a LOLR which can ensure the trust of the investors in the system and deter the financial crisis.[230]

The case studies research approach can neither be defined as qualitative or quantitative because it consists of both of them. The data for case studies can be collected by relevant policy documents, international journals, by the interviews of relevant persons, and through the observations of the participants. All the above-mentioned resources can be used for research work. In this research law journals, policy documents, and practices of the BOE, FRB, and SBP are used to illustrate

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[229] Dennis B Bromley, Academic contributions to psychological counselling: I. A philosophy of science for the study of individual cases (1990) 3 (1) Counselling Psychology Quarterly 229, 302.

[230] Aikaterini Argyrou, "Making the Case for Case Studies in Empirical Legal Research", [2017] Utrecht Law Review, Methodology of Legal Research, Volume 13, Issue, 3, pp. 211

the implications of having a LOLR. In case study methodology, both qualitative and quantitative data are necessary to help reach a conclusion about the real-life practical impacts a specific phenomenon could have.[231]

The use of the case studies approach gives many advantages to researchers and helps in a clear understanding of the topic and its effects in real life. In this research methodology, the researcher can use multiple ways to carry out the research, not simply relying on interviews or surveys which can sometimes be time-consuming and also require the permission of the participants. Although these methods are also included in case studies, this approach offers many other resources for the research. This approach uses different documents and historical cases in which the concerned topic is used which provide a clear overview of the topic instead of collecting data from individuals in surveys or interviews. The method requires extensive research of the relevant cases and critical analysis before reaching any conclusions.[232]

In this research, an example of the Northern Rock is used to analyse different approaches of the BOE in the recent financial crisis to strengthen the system. This illustrates that the powers of the CB to act as a LOLR must not be limited and that it could only impart liquidity to the financial institutions which are capable to provide collaterals. The example of Lehman Brothers is also used in this research which examines the circumstances in which a CB is authorised to refuse its liquidity assistance to a financial institution regardless of its size if that institution is unable to provide good collaterals. If a CB has reached an opinion that lending liquidity to a particular institution would enhance the effects of moral hazard problems, it can abstain from rescuing that financial institution because the acumen behind having a LOLR is to strengthen the system rather

[231] Ong, A. D, Weiss, D. J, "The Impact of Anonymity on Responses to Sensitive Questions1", [2000] Journal of Applied Social Psychology, Page No. 1691–1708.
[232] Aikaterini Argyrou, "Making the Case for Case Studies in Empirical Legal Research", [2017] Utrecht Law Review, Methodology of Legal Research, Volume 13, Issue, 3, pp.211

than protecting badly managed institutions. The example of AIG is also used to strengthen the argument of having a LOLR. This company was experiencing a liquidity shortfall and was subsequently rescued by the FBR in 2007. The case study of the KASB bank has a lot of significance in this research and that is why the methodology of case studies has been employed to carry out this study.

4.7 Historical and Conceptual Research Methodologies

The historical research methodology consists of the research of past events which has played a vital role in the establishment of a social or legal phenomenon. It includes both qualitative and quantitative research. It provides insights into the identification of the origin of the concept and also enables the researcher to explore the events which are relevant in the evolutionary process. The sources which are used in this research can be the ones that are used in the research methodology of case studies.[233] However, the scope of historical research methodology is not as wide as the case studies because it only considers the data which is available for a particular incident that has happened in the past and assumes the impacts of that incident to predict its effects in the future.[234] Historical research is mainly used in the research of social sciences in which the researcher is deeply concerned to investigate the historical aspects of the topic. Although in this study of LOLR, it is imperative to comprehend the history of the banking system and CBs, this study requires further evaluation of the relevant aspects of the topic.[235] The historical research has a limited scope which is why it was not preferred to be utilized while carrying out this research. Doctrinal and case studies research approaches widely cover all the historical and contemporary components of the LOLR.

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[233] Diana Richards, "Limits of Quentin Skinner's Methodology in Historical Research" Accessed: March 01, 2017.
[234] Catherin Fisk, Robert W. Gordon, "Foreword: Law as Theory and Method in Legal History", (2011), Accessed: March 01, 2017.
[235] Diana Richards, "Limits of Quentin Skinner's Methodology in Historical Research" Accessed: March 01, 2017.

Researches in the fields of social sciences are processed by two approaches i.e. conceptual and empirical. Conceptual research unfolds the theoretical concepts of the topic and explains the terminologies which are used in a particular concept. It describes the reasons behind an incident to depict the phenomenon of the study. Conceptual research requires the researcher to fully utilise the library resources by analysing the available information. Conceptual research helps to understand the topic and that is why it urges the researchers to think about it and use the relevant access information. This methodology of research requires mental sharpness and only engages the researchers in thinking because it does not demand physical ground research, but the researcher merely has to understand the pre-existing theories.[236]

First and foremost, the step to conduct this research is to select a topic on which the researcher wants to conduct his research because any research cannot be started without finalizing a specific topic. Secondly, after finalizing the topic, it is imperative to gather relevant material. This part has immense significance in conceptual research, and it consumes most of the time of the research because this research methodology is always based on the concepts. Hence, it is not possible to understand the concept without having the material which can explain it. The next step of this research methodology is to identify specific variables of research that enhance its scope and authenticity. The final step of this research methodology is to frame some research questions for the research because the finding of the answers to these questions will turn out to be the basis of the research. In this step, the researcher needs to analyse all the relevant information to fully comprehend the concept of the selected topic.[237] Therefore, due to its limited

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[236] Kenneth Einar Himma, "Conceptual Jurisprudence: An Introduction to Conceptual Analysis ann Methodology in Legal Theory", [2015] REVUS: Journal for Constitutional Theory and Philosophy of Law, Volume, 26, pp.110

[237] Hafizul Othman, Rosni Abdullah, Nasriah Zakaria, "A Conceptual Framework for Understanding Academics Commercialization Decision at Malaysian Research University", [2013] Global Journal of Business and Social Science Review, Vol, 1(1), Page No. 78-92.

scope, it is not preferred in this research, and comparative research due to its wide scope is employed.

4.8 Reliability of the Sources

In research that is entirely based on qualitative research, the biggest threat to the findings is always the biases of the researcher. The researcher’s biases play a vital role in the findings when the researcher only selects the data which strengthens his viewpoint. However, the impartial approach which is essential to conduct valid research is fully acknowledged and endeavors have been made to ensure that researcher’s own like or dislikes should not impact the finding of this research. This is academic research that provides a comprehensive discussion on the benefits of the role of LOLR and identifies the problems which a financial system can have in the absence of a LOLR. The CBs play this role for the financial institutions working within their jurisdictions and IMF plays the role of LOLR at the international level. This role is legitimised with the regulations and certain rules are imposed on the powers of CBs while acting as a LOLR. Therefore, the main sources which are used in this research are regulations and statutes like The Banking Act, 1988 of UK, The State Bank of Pakistan Act, 1956, The Banking Companies Ordinance 1962 of Pakistan, the Federal Reserve Act, 1913, and Dodd-Frank Act, 2010 of US. All these are original statutory documents that are used in this research hence they are fully reliable sources.

Furthermore, insights of the exalted scholars through international law journals are used to understand the conceptual underpinning of the doctrine of LOLR. Only credible law journals are selected to gather information and for legal research, Westlaw is mainly used. Many books are also reviewed in the quest for information regarding the progression of the Federal Reserve Bank, which is published by worthy publishers and the authors are either experienced professionals working in FBR or renowned scholars. The examples are also used to examine the impacts of a LOLR in deterring a financial crisis and recognizing the loopholes in the current regulation. The example of Northern Rock, Lehman Brothers, and American International Group (AIG) are utilized for this research. The sources which were not reliable were not included anywhere in the making of this research work. Another big threat to the findings of research in qualitative research is that in some cases the researchers only rely on a single example and give findings that cannot be a case generally. Therefore, different examples from different jurisdictions are used for the concerned research work to acquire logical findings.

Summary

This chapter considered the significance of research methodologies in academic legal research and described why the selected research methodologies are relevant to this research. The doctrinal research methodology which is applied in carrying out this research is explained. Its strengths and lacunas are also discussed. The documentary research methodology is also selected for this research. The resources which are used in this research methodology are discussed as well. The implementation of documentary and comparative research methodology in this research is unfolded. The approach of case studies for conducting legal research is argued and its framework to make research is explored. This chapter also unveiled the reasons for not selecting the historical and conceptual research methodologies for this research.

Chapter 5: Banking Regime of Pakistan, Basel Accord and LOLR

5.1 Introduction

This chapter consists of the literature related to the banking industry of Pakistan and explains the diversity of the banking sector in the country. The concerned chapter is divided into five parts; the first part of this chapter explicates the significance of the banking system in the modern economic systems and its contribution to the growth of financial systems around the globe. It explores the progression of the banking industry in Pakistan and analyses various approaches that have been used to develop the banking sector. Additionally, this part appraises the policies of nationalization and privatization for the financial institutions and examines their impacts on the banking sector in detail. It further explains the basic difference between the operating systems of conventional and Islamic banks. The second part of this chapter unfolds the effects of financial crises on the systems and also unveils the reasons which cause financial crises.

The third part of this chapter critically examines the current laws which regulate the banking sector of Pakistan. Additionally, it explains the key features of the Banking Companies Ordinance, 1962 (LVII of 1962). The fourth part of this chapter describes the inception of the Basel Accord and extensively explains the reasons behind the failure of banking regulations which became the reason for crises. Furthermore, it explains the regulations of Basel Accord I and analyses its limitations. It also explicates the features of Basel II and III. Finally, it explains the implementation of Basel III in Pakistan. The final part of this chapter surmises the role of LOLR and argues the legitimacy of LOLR in Pakistan by explaining the laws relating to it. Moreover, it brings into light the problems which Pakistan is facing in establishing a LOLR for Islamic banks.

5.2 Banking Regime of Pakistan, Basel Accord and LOLR

In a modern financial system, the vigorous contribution of banks to the growth of Gross Domestic Productivity (GDP) has made the banks an integral part of the system. A strong banking system is indispensable to deter the contemporary challenges being faced by the financial systems. The first bank in the world was established in 1407 in the Republic of Genoa (The Bank of St George). Banks obtain funds from depositors and lend to financial institutions (borrowers), which allows them to enhance their business activities.[238] Banks ensure the security of the funds of the depositors who have surplus money but do not wish to get engaged in business activities and provide these funds to individuals or business corporations who are ready to take risks through their business activities. The banks perform the role of a guarantor by providing funds to financial institutions that contribute towards an increase in business activities. The absence of banking facilities in an economic system will dramatically shrink business ventures, which will result in a diminution of GDP.[239]

The banking industry is not merely an essential part of the financial system; it is also embedded in our lives. The collapse of the banking industry can cause a recession, which will affect all the inhabitants of the State no matter whether they are engaged with banks in any way or not. The stability of the banking industry relies on the trust of the depositors nonetheless, if the public loses its confidence in the banking system, this will increase the demand for liquidity which

[238] Ibish Mazreku, Fisnik Morina, Sami Mazreku (2016) “The Role of the Banking System on the Financing of the Businesses and the Determinants of the Lending Level on the SMEs in Kosova”, SSRN, 7 August (accessed 5 October 2018).

[239] Neslihan Dincbas, Tomasz Kamil Michalski, Evren Ors (2017) “Banking Integration and Growth: Role of Banks’ Previous Industry Exposure”, HEC Paris Research Paper No. FIN-2015-1096, 21.

would cause a financial crisis. Hence, an efficient banking system is the mainstay of the sustainability of the financial system.[240]

Trust in the banking sector allows people to overcome the anxiety of the financial crisis and maintain stability in the financial system. Financial institutions do not merely get debts or loans from the banks; they are also using banks for their transactions, which is a transparent and convenient mode of business.

The Banking Sector of Pakistan operates through the Banking Companies Ordinance 1962 (LVII of 1962), and the State Bank of Pakistan (SBP) plays the role of surveillant, empowered by the SBP Act 1956 (SBPA). The banking history of Pakistan is as old as the history of Pakistan. The SBP was established on 1 July 1948 and holds all the resources of the State; it is empowered to regulate the banking sector. The core functions of central banks (CBs) are to conduct monetary policies and implement them.[241] The CBs supervise and regulate depository institutions. They also maintain stability in the financial system of the State by taking all possible measures. It is the responsibility of a CB to ensure the trust of the depositors in the system.

The CB of the State is the only institution that can emit new notes when needed and implement financial policies. Every CB of the State plays the role of Lender of Last Resort (LOLR) for its financial institutions when they face a liquidity crisis.[242] Similarly, the SBP utilises all its resources to maintain financial stability in Pakistan. The banking industry of Pakistan is more diverse than that of many other countries because it has two different banking systems: one is a conventional banking system that works according to the conventional rule of interest-based

[240] Kelvin Mkwawa (2018) "Importance of Banking Industry", *The Citizen,* 3 May (accessed 5 October 2018).
[241] Heidi Mandanis Schooner (2003) "Central Banks' Role in Bank Supervision in the United States and United Kingdom", *Brooklyn International Law Journal*, January (accessed 6 October 2018).
[242] Ibish Mazreku, Fisnik Morina, Sami Mazreku (2016) "The Role of the Banking System on the Financing of the Businesses and the Determinants of the Lending Level on the SMEs in Kosova", SSRN, 7 August (accessed 5 October 2018).

banking, and the other banking system is known as Islamic banking which works as interest-free banking.[243] Before appraising the banking regime of Pakistan, it is important to elucidate the conception of these conventional and Islamic banking systems.

The conventional banks' operations are based on the rules set by the Board of Directors of such banks. They can establish their rule of business but cannot cross the borderline set by the SBP. The conventional banks have a fixed interest rate by which they receive money from the depositors and lend to the borrowers. Interest is the main source of income for conventional banks because they offer less interest rates to the depositors and charge a higher interest rate from the debtors. They do not bear any risk and shift it to the debtors. The core responsibility of the banking industry is to play the role of intermediary between the depositors and debtors.[244]

On the other hand, the Islamic banking sector claims to follow the injunctions of Sharia laws. Therefore, Islamic banks do not operate on fixed rates for depositors and debtors. The main source of earnings for this sector is service charges, consultancy, and share in profits. They jointly share the risk with the lender, the debtor, and the bank. Islamic banks get shares in the business of the debtors and then, based on that share, they offer a percentage to the lenders. The Islamic banking industry is emerging swiftly over the last decade and a half. Many economists argue that the Islamic banking industry could perform better if there were a separate legal framework to address its operational challenges.[245]

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[243] Muhammad Mahmood Shah Khan, Bushra Shafiq, Farrukh Ijaz, "An Empirical Analysis of Banking Sector in Pakistan: Islamic Versus Conventional Banks", [2017] *International Journal of Islamic Economics and Finance Studies* 3(1), pp.110

[244] Ashfaq Ahmad, Muhammad Imran Malik, Asad Afzal Humayoun "Banking Developments in Pakistan: A Journey from Conventional to Islamic Banking",[2010] *European Journal of Social Sciences*, 17(1).

[245] Muhammad Mahmood Shah Khan, Bushra Shafiq, Farrukh Ijaz "An Empirical Analysis of Banking Sector in Pakistan: Islamic Versus Conventional Banks",[2017] *International Journal of Islamic Economics and Finance Studies*, 3(1).

5.3 Progression of the Banking Sector in Pakistan

Every country strives to establish a sound and prosperous economic system by utilizing all the resources of the state. Each economic system has its dynamics based on religious and social values. Thus, it is not possible to import a financial system from a developed country to govern the system.[246] The history of the Banking sector of Pakistan starts from 14th August 1947 when it got independence from British rule. The formation of the State Bank of Pakistan in 1948 officially regulated the banking industry. An economic system can bring prosperity and establish a strong financial system if it is framed according to the needs of the financial market. Pakistan, therefore, formatted its CB which is mandated to make a financial system that can address the challenges of its economy. Pakistan's banking sector has gone through a long and intense process of evolution. It started with the conventional banking system but now has an Islamic banking system as well.[247] An uninterrupted interaction of the financial institutions to attain financial objects of having a sound economic system is inevitable which can only be possible by judiciously utilizing all the natural, human, and financial resources. The banking sector is deemed to be the most efficient and reliable means to manage financial resources across the globe.[248]

Initially, the financial system of Pakistan suffered a lot due to the absence of an efficient banking system. Nonetheless, its banking system has immensely emerged and is considered a sophisticated system now.

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[246] Ashfaq Ahmad, Muhammad Imran Malik, Asad Afzal Humayoun, "Banking Developments in Pakistan: A Journey from Conventional to Islamic Banking", [2010] European Journal of Social Sciences, Volume: 17, Number: 1, pp.1

[247] Ahsin Shahid, Hibba Saeed, Muhammad Ali Tirmizi, "Economic development and banking sector growth in Pakistan", [2015] Journal of Sustainable Finance & Investment, Volume: 5, Issue: 3 pp.245.

[248] Justin Baer, "History: Banks are at the heart of capitalism", (Financial Times, November 17, 2010), Accessed: October 07, 2018.

However, it is still going through the process of evolution and enduring technological and legislative challenges.[249] Religion has a profound relationship in every act of Pakistan because it is created on the ideology of Islam. The Conventional banking sector faced serious troubles because it works based on interest (Riba) which is strictly prohibited according to the principles of Islam. Therefore, the Council of Islamic Ideology (CII) was established in 1956 to obliterate all interest-based financial activities especially from the banking sector, and is still a part of the current constitution of Pakistan (1973).[250] The CII consulted numerous economists to propose an alternative financial structure for the banking industry of Pakistan. Additionally, the supreme court of Pakistan also ordered the erosion of interest (Riba) from the economic system until June 30, 1992, which was also a major setback for the conventional banking industry in Pakistan. Finally, after a long effort, Pakistan managed to establish an Islamic banking system in 2002 which is claimed to be a non-interest banking system but still not acknowledged concurrently by all religious entities.[251]

5.3.1 Nationalization of Banking Sector

In the first phase, the SBP encouraged the private sector to invest in the banking industry and established several private commercial banks. However, the unsatisfactory growth of the financial system urged the government to take unprecedented steps that could make a sound economic system. The government of Pakistan decided to nationalize all the existing 14

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[249] Ashfaq Ahmad, Muhammad Imran Malik, Asad Afzal Humayoun, "Banking Developments in Pakistan: A Journey from Conventional to Islamic Banking", [2010] European Journal of Social Sciences, Volume: 17, Number: 1. Pp.11

[250] Article 28, of the Constitutions of Pakistan 1956, Article 2A, 31, 37, 38F & 227 of the Constitution of Pakistan 1973.

[251] Dr. Hafiz Muhammad Zubair, Nadeem Ghafoor Chaudhry, "Islamic Banking in Pakistan: A Critical Review", [2014] International Journal of Humanities and Social Science, Vol: 4, Issue: 2, pp 377

commercial banks.[252] The Pakistan Banking Council (PBC) was formatted for the first time to monitor the operations of these nationalized banks and the powers of SBP to regulate the financial institutions were marginalized. The rationale behind this decision was to provide maximum funds to the public industries and surge the income of the public sector. The PBC has framed a new policy and merged small banks into the banks and established five big nationalized banks from 14 commercial banks.[253] The bank of Bahawalpur was merged into the National bank of Pakistan. The Premier bank limited and Sarhad Bank Limited were merged in Muslim commercial bank limited. Pak bank limited was merged with Allied bank limited. Commerce bank limited was merged in United bank limited and Standard Bank limited was merged in Habib bank limited.[254]

This nationalization policy was aimed to discourage hoarding and distribute the wealth equally among the inhabitants of the states. It worked well for the economic system of Pakistan and due to massive changes, the banking sector showed good growth in their profits. However, it worked well only for a short period and created equivocal financial challenges. Due to the absence of healthy competition from the private sector and lack of professionalism, all the nationalized banks showed poor performance. It also discouraged private investment and especially a dramatic decrease in foreign investment was evident.[255] The decision of nationalization proved to be a disaster due to the political involvement in the 1980s and 1990s. Lending decisions were politically influenced and were not commercially motivated. Thus, billions of rupees were looted

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[252] Muhammad Abrar Zahoor, "A critical Appraisal of the Economic Reforms under Zulfikar Ali Bhutto: An Assessment", (2010), Accessed: October 07, 2018

[253] Mubashir Hasan, "The Nationalization Policy of 70's" in Pakistan's Economy in the 80's: Structure and Prospects [1988] Karachi: Press Institute of Pakistan, pp.255.

[254] Amna Khalabat, "History of Banking in Pakistan – of humble origin and vast potential", (The Express tribune November 04, 2011), Accessed: October 15, 2018.

[255] Sulman Badshah, "Impact of Nationalization on Pakistan's Economic Development", [2017] Pakistan Economy, Accessed: October 07, 2018.

from the treasury of Pakistan due to inefficient regulations and the absence of a good command and control system.[256]

5.3.2 Privatization of Banking Sector

Due to the failure of the nationalization policy and massive loss, the government of Pakistan in the 1990s decided to privatize the banking and financial industries which were nationalized in Bhutto's era. In that era, not only the banks but other financial institutions were also privatized to attract private and foreign investment. Hence, Muslim Commercial Bank Limited (MCB) in 1991, Allied Bank limited in 1993, United Bank limited in 2002, and Habib Bank limited in 2003 were privatized consequently.[257] Initially, the privatization policy worked well in the banking industry and many commercial banks started their operations in Pakistan. It was also able to invite private and foreign investment in the banking sector therefore many foreign banks also initiated their work in Pakistan. Competition between private and public entities resulted in good services and an increase in the growth of this sector. However, lack of transparency in the process of privatization and bad economic conditions miserably failed this policy to show any economic growth for the long term. Surprisingly, the improvement of the banking sector after privatization in a decade was lesser than the growth it had achieved after the implementation of the policy of nationalization.[258]

After a bad performance of the privatization policies, transformational reforms were carried out. The original powers of the SBP to regulate financial institutions were reinstated by amending the

[256] Kazim Alam, "Bhutto's economic policies were disastrous for Pakistan", (The Express Tribune, June 30, 2016), Accessed: October 07, 2018.

[257] Dr Munawwar Kartio, Prof Muhammad Ishaque Bajoi, Prof Dr Ambreen Zaib Khaskelly, "Privatization of Banking Sector in Pakistan: A Case Study of MCB Bank Limited", [2017] International Journal of Management & information Technology, Vol: 12, No: 1, pp. 11

[258] Muhammad Shoaib, "Impact of Privatization on Banking Sector Performance of Pakistan", (SSRN Electronic Journal, February 2012), Accessed: October 07, 2018.

Banking Companies Ordinance 1962 and the State Bank of Pakistan Act 1956. Lending from the banking sector was limited to big financial institutions or influential individuals however, it was expanded and offered to microeconomic entities and common customers. So far, these reforms are working well especially for the banking sector of Pakistan and as a result, by the year 2010, there were more than 25 domestic private banks and six foreign banks which were operating in the country.[259] All these private commercial banks are now playing a positive role in the growth of GDP and motivating domestic and foreign investors to invest in the banking and financial industry of Pakistan. However, all these banks are still working on a fixed interest rate (Riba) which is still facing strong criticism from religious scholars and many economists.

5.3.3. Conventional Banks

Pakistan did not have a CB at the time of its inception and therefore, Habib Bank, established in 1941, served as a CB to fulfill this gap. The role of the banking industry was limited in the financial system of Pakistan due to the lack of essential resources. However, the establishment of SBP in 1948 played a vital role to develop commercial banks and encouraged them to enhance the financial capacity of the newly created state. SBP was mandated to flourish the banking industry hence Allied Bank, Habib Bank, and National Bank were supported by the SBP to start their operation.[260] Uncertainty in the political and economic condition always adversely affects the banking industry that is why initially the banking industry was badly damaged due to the unstable political and financial condition of Pakistan.

The Reserve Bank of India (RBI) was working as the CB in the subcontinent till December 1947. However, it was not helping the financial system of Pakistan instead it played a negative role. On

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[259] Amna Khalabat, "History of Banking in Pakistan – of humble origin and vast potential", (The Express tribune November 04, 2011), Accessed: October 15, 2018.
[260] Ibid

the serious reservations of the government of Pakistan, the British government divided the RBI on the proportion of 30/70. Pakistan got 30 percent from the division of RBI in May 1948 and immediately established its CB known as SBP.[261] In November 1949 National Bank of Pakistan has established in east Pakistan.

Nonetheless, the banking industry could not contribute to the financial system because of not having professionals in this field. The SBP was empowered through the State Bank of Pakistan Act, 1956 to allow private investors to establish commercial banks and financial institutions. However, lack of experience and corruption in public sectors became the main hurdle in the growth of this industry during the decades of 1950 and 1960.[262] Many radical changes and amendments in the laws relating to the banking and financial system of Pakistan worked well and established a relatively sound system than the one working before.[263]

5.3.4 The Inception of Islamic Banking in Pakistan

The Islamic banking system does not merely exist in the sermons of religious scholars or the virtual world. It does not only operate within the financial system of Pakistan but also in many Muslim and non-Muslim countries.[264] The history of Islamic banking is not as old as conventional banking. Islamic banks do not offer or charge interest to their depositors and investors; hence it is also known as interest-free banking. In Egypt, the very first Islamic bank, Mit Ghamr Social Bank, was established in 1963. Initially, the financial activity of this bank was

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[261] Ashfaq Ahmad, Muhammad Imran Malik, Asad Afzal Humayoun, "Banking Developments in Pakistan: A Journey from Conventional to Islamic Banking", [2010] European Journal of Social Sciences, Volume: 17, Number: 1, pp. 35

[262] Ahsin Shahid, Hibba Saeed, Muhammad Ali Tirmizi, "Economic development and banking sector growth in Pakistan", [2015] Journal of Sustainable Finance & Investment, Volume: 5, Issue: 3, pp 235

[263] Amna Khalabat, "History of Banking in Pakistan – of humble origin and vast potential", (The Express tribune November 04, 2011), Accessed: October 15, 2018.

[264] Dr Hafiz Muhammad Zubair, Nadeem Ghafoor Chaudhry "Islamic Banking in Pakistan: A Critical Review", [2014] *International Journal of Humanities and Social Science*, 4(2).

limited. It collected funds from depositors and offered loans to the agricultural industry only. In 1973, the Organization of Islamic Conference (OIC) backed the concept of Islamic banking. In 1975, a foundation for Islamic Development Banking was created.[265]

After recognition of Islamic banking by the OIC, the idea disseminated around the world, especially in Muslim states where interest-free Islamic banks were established: the Philippine Amanah Bank in 1973, the Dubai Islamic Bank in 1975, the Faisal Islamic Bank of Sudan in 1977, the Bahrain Islamic Bank in 1979, and the Meezan Islamic Bank of Pakistan in 2002.[266] In 1983, Malaysia passed the Islamic Banking Act to merge all its conventional banks into Islamic banks and obliterate all interest-based banking.[267]

Between 1979 and 1992, several serious efforts were made by the Government of Pakistan to establish an interest-free financial system. In 1979, many interest-free financial institutions were established in Pakistan, for example, the National Investment Trust, the Investment Corporation of Pakistan, and the House Building Finance Corporation.[268] In December 2001, the SBP officially explicated the criteria for establishing an Islamic bank in the private sector. In January 2002, the Al Meezan Investment Bank was able to satisfy the SBP that it complied with the principles of establishing an Islamic bank and got a license. It started its operations as the first Islamic bank of Pakistan under the name of Meezan Islamic Bank on 20 March 2002.[269]

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[265] Dr Rukhsana Kalim, Afia Mushtaq, Noman Arshed (2016) "Islamic Banking and Economic Growth: Case of Pakistan", [2016] *Islamic Banking and Finance Review*, 3(1), pp.14–28,

[266] Ashfaq Ahmad, Muhammad Imran Malik, Asad Afzal Humayoun, "Banking Developments in Pakistan: A Journey from Conventional to Islamic Banking", *European Journal of Social Sciences*, 17(1).

[267] N. Ahmad and S. Haron (2002) "Perceptions of Malaysian corporate customers towards Islamic banking products and services",[2010] *International Journal of Islamic Financial Services*, 3(4), pp. 13–29.

[268] Ashfaq Ahmad, Muhammad Imran Malik, Asad Afzal Humayoun (2010) "Banking Developments in Pakistan: A Journey from Conventional to Islamic Banking", [2010] European Journal of Social Sciences, 17(1).

[269] Ibid.

The banking system is regarded as an integral part of any financial system and plays a vital role in economic growth.

5.4 Current Status of the Banking Sector of Pakistan

The journey of the banking sector of Pakistan is now subtended over seven decades and it has emerged remarkably. However, the goal of establishing an efficient banking system that can address contemporary financial challenges is yet to be achieved. Although an imported financial system cannot address the issue of a system because each system has its compulsion, a comparative study can help to identify the lacunas in the existing system and many lessons can also be learned.[270] Banks play a vital role in the economic development of a country but an uncertain and deteriorating economic system makes the banking sector vulnerable because banking sectors survive only if the depositors keep their trust in the system. The banking sector of Pakistan is now improving because the local and foreign depositors are investing in this sector.

Now, due to a healthy competition between conventional and Islamic banks, the banking sector is providing good services, and to engage more customers, they are extending their loan services to the common man.[271] The banks were reluctant to offer their loan services to small business entities and private persons in the past. Only big enterprises could avail the facility of loan or it was offered based on nepotism. To attract more customers, the banks are using different methods

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[270] Ahsin Shahid, Hibba Saeed, Muhammad Ali Tirmizi, "Economic development and banking sector growth in Pakistan", (Journal of Sustainable Finance & Investment, Volume: 5, Issue: 3, 2015), Accessed: October 07, 2018.
[271] Ashfaq Ahmad, Muhammad Imran Malik, Asad Afzal Humayoun, "Banking Developments in Pakistan: A Journey from Conventional to Islamic Banking", [2010] European Journal of Social Sciences, Volume: 17, Number: 1, pp.11

and branchless banking is also introduced in Pakistan e.g. Tameer Bank, Easypaisa, and UBL Omni.[272]

The competitive environment has increased awareness in the customers and a bank can only remain its customer if he is satisfied with the quality of services provided by that bank. Islamic banks are working within the limits of Shariah laws but still, they are continuously expanding their loan facilities to various forms of business while remaining within the limitations of Shariah laws. Due to the competition, conventional banks are also offering several debt services which are increasing the financial activities in the country. Islamic banks have started a new scheme (Qarz-e-Hasana 1991) in which they offer no interest and benefits to the depositors and then lend credits on an interest-free basis. However, it was observed that due to an inefficient legal framework these credits were only offered based on personal relations.[273] The profitability in the banking sector is directly proportional to the services which banks are offering to their customers. Islamic banks are showing swift progression because they are offering better services as compared to conventional banks.[274] Finally, financial liberalization can be detrimental to the system in the absence of strong regulation. Although the private sector holds much of the assets of the banking sector, the SBP must remain autonomous to regulate the banking sector of Pakistan.

5.5 Legal Framework to regulate the Banking Sector of Pakistan

The history of the banking industry of Pakistan is as old as the history of the country. State Bank of Pakistan was established in July 1948 and mandated to establish a prosperous financial

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[272] Amna Khalabat, "History of Banking in Pakistan – of humble origin and vast potential", (The Express tribune November 04, 2011), Accessed: October 15, 2018.
[273] Ashfaq Ahmad, "An Overview of the Operations/Products offered by Islamic Banks in Pakistan", (ResearchGate, June 2011), Accessed: October 20, 2018.
[274] Dr. Hafiz Muhammad Zubair, Nadeem Ghafoor Chaudhry, "Islamic Banking in Pakistan: A Critical Review", [2014] International Journal of Humanities and Social Science, Vol: 4, Issue: 2, pp.15

system. If a country is blessed with several resources but its laws are full of lacunas it cannot survive for a long time. Pakistan's banking industry has gone through an intense process of evolution and many different financial approaches were used to make a strong system. The Banking Companies Ordinance 1962 (LVII of 1962) regulates the banks and financial institutions of Pakistan. The salient features of these ordinances are;

Section 5 of the Banking Companies Ordinance, 1962 (LVII of 1962) explicates the key terms which are used to govern the banking industry.

- Securities are key elements of the banking industry and this section explains approved securities which can be used in this business in which a trustee can invest in accordance with section 20 of the Trust Act, 1882 and it will also include everything as approved securities which the federal government will declare in the official Gazette.[275]
- It further explains the term "Banking" which means accepting the money from the depositors to lend or invest. Additionally, it imposes an obligation that the depositors' money will be repayable on demand and withdrawable by cheques or other means.[276]
- "Banking Company" denotes any company that will be considered as a banking company that is carrying out its business that falls under the definition of banking explained in this law. If such a company is incorporated in Pakistan this law will apply to all of its branches and subsidiaries even if they are working outside Pakistan. However, no company will be considered as a banking company merely on the ground if that company accepts deposits from the public to finance its business and does not fully comply with the definition of banking.[277]

[275] The Banking Companies Ordinance, 1962 (LVII of 1962), Section 5 (a)(i)(ii)
[276] Ibid, Section 5 (b)
[277] Ibid, Section 5(c)

- "Branch" or "Branch office" means any place where the deposits are received, cheques can be cashed, and money lent from there will be recognized as a branch office of a banking company no matter if called by pay or sub-pay office or any other name.[278]
- "Creditor" includes legal and natural persons who have surplus money to deposit in the banks for the participation in profit and loss.[279]
- "Company" means any company which is incorporated in accordance with the Companies Ordinance 1984 (XL VII of 1984). It also includes a foreign bank company carrying out its banking business in Pakistan which is being licensed by the State Bank of Pakistan.[280]
- "Debtor" includes a person, financial institution, or banking company that obtains finances as defined in the Banking Tribunals Ordinance, 1984.[281]
- "Demand liabilities" means the liabilities of the financial or banking companies which must be met on demand.[282]
- "Foreign banking company" is a company which is not incorporated in Pakistan. However, it is having a branch or branches and carrying out banking business in Pakistan after obtaining a license from the State Bank of Pakistan.[283]
- "Loan" means advances, credit, or finance as described in the Banking Tribunals Ordinance, 1984.[284]
- "Secured loan or advance" means a loan or advance which is offered against good collaterals having the same market value as of the loan and the loans and advance which is based on bad securities are known as unsecured loans.[285]

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[278] Ibid, Section 5(d)
[279] Ibid, Section 5(dd)
[280] Ibid, Section 5(e)
[281] Ibid, Section 5(ee)
[282] Ibid, Section 5(f)
[283] Ibid, Section 5(ffa)
[284] Ibid, Section 5(gg)

5.5.1 Ordinance to Override Memorandum

If the memorandum of a banking company, contracts executed, a resolution passed in the general meeting, or by the directors of the company are repugnant to the Banking Companies Ordinance, 1962, they will not be legitimate.[286]

5.5.2 Use of the word "Bank"

No company can contain the word bank or any other name which indicates that it is a banking company if it is not carrying out the business of banking.[287]

5.5.3 Prohibition of Trade

No banking company of Pakistan can be involved in any business of trading activities other than the one described in section 7 of the same ordinance.[288]

5.5.4 Restriction on Removal of Records and Documents

All the banking companies which are being operated in Pakistan are bound to obtain prior permission from the SBP if they want to move any of their business records outside Pakistan which include ledgers, daybooks, cash books, account books, and other documents they use for the purpose of their business.[289]

5.5.5 Requirement of minimum Capital

No banking company can carry out business in Pakistan unless it maintains the minimum capital requirement fixed by the SBP. A banking company that is not incorporated in Pakistan will have

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[285] Ibid, Section 5(m)
[286] The Banking Companies Ordinance, 1962 (LVII of 1962), Section 6(a)(b)
[287] The Banking Companies Ordinance, 1962 (LVII of 1962), Section 8(a)(b)
[288] The Banking Companies Ordinance, 1962 (LVII of 1962), Section 9
[289] The Banking Companies Ordinance, 1962 (LVII of 1962), Section 12

to maintain a minimum capital requirement by having deposits in the SBP via the transfer of foreign funds.[290]

5.5.6 Election of New Directors

The State Bank of Pakistan is empowered to direct a banking company to call a meeting of all of its shareholders in a given time not less than two months to conduct fresh elections and elect new directors of the company. Directors can hold the office for a time their predecessor had or till the new election. Elections that are duly conducted under this section cannot be challenged in any court. Notwithstanding, SBP is authorized to appoint not more than one director in the banking company even if it is repugnant to the memorandum of the company. Directors elected through the election or appointed by the SBP cannot hold their offices for more than six consecutive years.[291]

5.5.7 Cash Reserve

Every banking company incorporated in Pakistan which is not a scheduled bank is obligated to maintain in the form of cash reserve with itself or through a current account in the SBP or partly in cash and partly in such account equivalent to at least two percent of its time liabilities and five percent of its demand liabilities in Pakistan.[292]

5.5.8 Restriction on Loans and Advances

No banking company is allowed to offer loans or advance against its securities. No loans or advances can be made on the guarantee of any of the director, family member of the director, any firm, or private person in which the banking company or the director or family member of the

[290] The Banking Companies Ordinance, 1962 (LVII of 1962), Section 13
[291] The Banking Companies Ordinance, 1962 (LVII of 1962), Section 15
[292] The Banking Companies Ordinance, 1962 (LVII of 1962), Section 22

director is a stakeholder. Moreover, it is also restricted for the banking company to lend loans to a director of the company or to a company or firm in which a director is a partner without getting approval from the majority of the directors excluding the concerned director.[293]

5.5.9 Power of the State Bank to Control loans and Advance

The SBP is authorized to step in if it finds it expedient for the interest of the public to give a policy for loans and advances for the banking companies in general or a banking company in particular. All the banking companies or a particular banking company are bound to comply with that policy determined by the SBP in such context. [294]

5.5.10 Power of the State Bank to Collect and Furnish credit information

It is mandatory for all banking companies to furnish credit information to the SBP which can in its motion or at the request of any banking company make this information available on the payment of the fee SBP may fix from time to time.[295]

5.5.11 Preparation of Special Reports

To ensure transparency and update the government regarding the financial condition of the country, the SBP is obliged to prepare special reports yearly in which it provides all the details of the loans, banking securities of domestic and foreign banks, and their advances to the federal government.[296]

5.5.12 Power of the State Bank not to accept deposits from the banking companies not incorporated in Pakistan

[293] The Banking Companies Ordinance, 1962 (LVII of 1962), Section 24
[294] The Banking Companies Ordinance, 1962 (LVII of 1962), Section 25
[295] The Banking Companies Ordinance, 1962 (LVII of 1962), Section 25A
[296] Ibid, Section 25AA

The SBP is empowered to declare in an official notification which may be in the form of an official gazette that it will not accept any deposits bearing interests from the date mentioned in the gazette from the banking companies incorporated outside Pakistan. However, such notification cannot be effected immediately or from a date less than six months from the date of the notification.[297]

5.5.13 Deposits

The banking companies will receive deposits for the purpose that depositors will share in profit and loss. Domestic operations of the companies will remain interest-free until, if the federal government officially notify in the official gazette otherwise. The person or company who is depositing money based on sharing the profit and losses will also be bound to comply with the directions which SBP may give.[298]

5.5.14 Licensing of Banking Company

To operate a banking company in Pakistan, all individuals or companies must obtain a license from the SBP. The license can be issued in some conditions. SBP is empowered to require certain assurance from the company or individual seeking the license that they are in a position to return the money of its current and future depositors on their demand. Assurance of not getting involved in a business that can harm the interest of its depositors can also be required. The SBP is authorized to cancel a license of a banking company if it will not comply with the rules and regulations to carry out this business. However, if it is not a matter of urgency for the interest of the depositors or the public at large, the SBP is bound to grant sufficient time to the concerned banking company so that it can comply with the rules and regulations. The banking company has

[297] The Banking Companies Ordinance, 1962 (LVII of 1962), Section 26(1)(2)
[298] Ibid, Section 26A

the right to file an appeal within thirty days to the Central Board of State Bank (CBSB) against the cancellation of the license. Nonetheless, the decision of the CBSB will be administratively final. However, it can be challenged in a competent court of law.[299]

5.5.15 Maintenance of Liquid Assets

It is essential for every banking company operating in Pakistan to maintain liquid assets which can be in the form of cash, gold, or unencumbered approved securities in Pakistan. The value of such liquidated assets should not be less than the total liabilities of the company in Pakistan at any time.[300]

5.5.16 Responsibilities of the State Bank

The SBP is obliged to have surveillance on all banking companies and ensure that all the banking companies which are operating in the financial system of Pakistan are abiding by the imposed rules and regulations for carrying out this business. It is the duty of the SBP to inform the federal government every quarterly or even more frequently if it is necessary regarding the banking system and the government can timely take actions to prevent a major loss.[301]

5.5.17 Islamic Banking

To establish an Islamic bank in Pakistan, it is obligated to strictly follow the injunctions of Islam described in the Holy Quran and Sunnah. The transactions of Islamic banking shall be interest-free. Conventional banks are also allowed to operate Islamic banking branches if they will

[299] The Banking Companies Ordinance, 1962 (LVII of 1962), Section 27(1-6)
[300] The Banking Companies Ordinance, 1962 (LVII of 1962), Section 29
[301] The Banking Companies Ordinance, 1962 (LVII of 1962), Section 40A

comply with the rules and regulations set for Islamic banking as subsidiaries branches.[302] Apart from the difference in operation from conventional banks, Islamic banks are carrying out their business on an interest-free basis. All other obligations are the same for the banking companies and SBP also possesses the same powers and obligations for Islamic banking in Pakistan.

5.6 Financial Crisis and Basel Accord I, II & III

The financial crisis and severe losses in banking sectors across the global hauled the contentions towards the solution of the economic crisis. Empirical research to unfold the causes of financial unrest enlightened that the collapse of the banking sector had played a vital role to ignite recession. A financial crisis is not like a natural disaster that occurred surprisingly, but it always has reasons and cautions to befall. In the modern economic system, the causes of the financial crisis can be domestic and international. The collapse of international banking and multinational companies can harm the economic system of a country that is growing otherwise. Policymakers around the globe are striving to make plausible regulations that can curtail the vulnerability of the economic systems.[303] Before explicating the salient features and contemporary significance of the Basel Accord, it is imperative to investigate the causes and consequences of the financial crisis.

5.6.1 Financial Crisis

Surging demand for money creates a situation in which depositors start withdrawing their money from banks which causes a liquidity shortage. Usually, banks sell their illiquid assets to fulfill the demand for liquidity. However, the failure of the banks to handle the situation causes

[302] In sub-section (1) of section 23 of the Banking Companies Ordinance
[303] Dusan Baran, "Causes and Consequences of the Global Economic Crisis in the Present Period and its impact on the Slovak Republic", (22nd Australian Finance and Banking Conference 2009), (August 25, 2009), Accessed: September 05, 2018.

financial unrest which can drag the entire economic system towards a financial crisis. Financial crises can be caused by several reasons but mostly a panic among the investors or a major bank run becomes the main reason behind a crisis. After the Great Depression (1929) the financial crisis of 2007-2008 was the worst which mainly occurred because of the collapse of the banking system.[304] However, it was argued by many economists that the Community Development Act, 1974 which ordained the banks to reduce their credit check requirements played a vital role in creating a financial crisis.[305] A financial crisis is a generic term that is used for a situation of financial unrest. It can be further divided into six parts.

5.6.2 Currency Crisis

Many countries use a fixed exchange rate and, in a situation, where the currency valuation becomes unsustainable in the foreign exchange markets. Sometimes, the investors start violating the official fixed rate which puts immense pressure on the economic system and creates a panic among the investors. Consequently, the currency loses its value in the foreign markets which affect the traders adversely. Deterioration in the values of the currency curtails foreign investment and increases the prices of everything in the country. A currency crisis makes the economic system vulnerable and curbs the capacity of the system to deter a recession. Turkey and Pakistan have faced the currency crisis in the recent past which has had an adverse and long-lasting impact on the financial systems of both countries.[306]

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[304] S. Pelin Berkmen, Gaston Gelos, Robert K. Rennhack, James P. Walsh, "The Global Financial Crisis: Explaining Cross-Country Differences in the Output Impact", (IMF Working Paper No. 09/280), (January 05, 2010), Accessed: September 05, 2018.
[305] Ibid
[306] Stefanescu, Razvan, Dumitriu, "*Impact of the foreign exchange rates fluctuations on returns and volatility of the Bucharest Stock Exchange", [2013] (*Proceedings of the 5th International Conference on Economics and Administration No.2 pp. 197-209).

5.6.3 External Debt Crisis

The external debt crisis usually happens when a country is facing a current account deficit which means a country is unable to make a balance in the flow of the money. In other words, it is a situation in which the country's imports drastically increase in contrast to its exports. It occurs when the country is unable to produce the capital to avert a current account deficit. The collapse of foreign reserves can also be a vital cause of the external debt crisis in this situation, the country immediately needs a bailout package to maintain the balance of payment. However, a bailout can only be a temporary solution to this crisis because the money will continuously be going out from the system, the bailout will be unhandy to maintain the sustainability of the system. This crisis can also happen due to the currency crisis because the devaluation of the currency will make it harder to maintain the balance of payment.[307]

5.6.4 Sovereign Debt Crisis

A sovereign debt crisis is a situation where the government obtains loans from external means to clear its fiscal deficits and is unable to produce sufficient capital to return this debt and interest. This is a situation in which the government itself faces a financial crisis and is unable to cover its financial liabilities. Normally, the government through the CB lends liquidity to the financial institutions which are unable to fulfill the demand of liquidity by utilizing all of their resources.[308]

However, when the government is unable to pay back the loans and interests it requires emergency financial lending by the IMF or any other external means. In such conditions

[307] Rashid Zaman, Muhammad Arslan, "The Role of External Debt on the Economic Growth: Evidence from Pakistan Economy", [2014] Journal of Economics and Sustainable Development, Vol, 5, Issue No. 24, pp.27
[308] Viral V. Acharya, Tim Eisert, Christian Eufinger, Christian W. Hirsch, "Real Effects of the Sovereign Debt Crisis in Europe: Evidence from Syndicated Loans", (Social Science Research Network, February 05, 2018), Accessed: September 07, 2018.

governments usually increase taxes which causes inflation. Greece is a befitting example that obtained three bailouts in 2010 just to repay the loans and interests of the government. This is a worse situation for an economic system to sustain and be prosperous when the government requires more loans to clear earlier ones. A sovereign debt crisis can also be converted into a major financial crisis in the country.[309]

5.6.5 Banking Crisis

The banking crisis occurs mainly due to the governance issues in general and loss of trust by the depositors in specific. The banking system can be regarded as the backbone of the economic system in this modern era. Banks are extensively involved in financial activities and many financial institutions are also relying on it. Without having fortitude in the political and economic system, it is not possible to establish a strong baking system. Banks, across the globe, are playing a key role in the economic growth of the countries. Financial institutions lend liquidity from banks when they face a liquidity crisis which helps them to get rid of the anxiety of liquidity issues.[310]

However, if the banking system of a country starts facing a crisis, it puts the sustainability of the entire economic system of the country at risk. In a banking crisis investors desperately start taking their money out from the system which urges the banks to sell their illiquid assets quickly to fulfill the demand for liquidity. Moreover, the quick sale of assets drops the value of the assets and makes the situation worse. The collapse of the banking system of Italy and Cyprus can be

[309] Filippo De Marco, "Bank Lending and the European Sovereign Debt Crisis", (Journal of Financial and Quantitative Analysis, July 22, 2017), Accessed: September 07, 2018.
[310] Boubacar Siddy Diallo, "THE ROLE OF THE BANKING SECTOR AND FINANCIAL MARKETS ON ECONOMIC DEVELOPMENT", (February 2015), Accessed: September 08, 2018.

used as an example to appraise the effects of the banking crisis which eventually led to a major financial crisis.[311]

5.6.6 Household Debt Crisis

A household debt crisis can also be converted into a major financial crisis. In the UK and USA, the household debt crisis was surged and researched at a stage where it badly affects the financial system and plays its role along with other factors to cause the financial crisis of 2007-2008. It is a crisis in which people are unable to pay their mortgage, personal loans, and credit card dues. The Basel accord I and II allowed the banks to involve in risky mortgages and became a major cause of the financial crisis. All these different types of crises are interlinked because when the people will not pay their loans back or will not be able to pay the interests back to the banks, they will start facing a crisis. The banking crisis harms the entire economic system of the country, resultantly the income of the government decreases which can create a sovereign debt crisis or external debt crisis.[312]

5.6.7 Broad Financial Crisis

This is a crisis that can be caused due to the combination of any of the above-mentioned crises or it can be a situation in which one crisis becomes the reason for another crisis. Several countries have faced these crises, for example, Mexico in 1994, Russia in 1996-1997, Argentine in 2001, and Chine in 2015 have faced the financial crisis, which was caused for more than one reason, hence can be termed as a broad financial crisis. To avoid such a financial crisis, significant changes have been made in the regulations relating to financial systems at the domestic and

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[311] Mehmed Ganic, "The Impact of the Global Financial Crisis on the Banking Sector of Western Balkans: Cross-Country Analysis", [2012] Journal of Economic and Social Studies, Vol, 2, Issue No. 2, pp.45

[312] Tobias Adrian, Hyun Song Shin, "The Shadow Banking System: Implications for Financial Regulation", [2009] FRB of New York Staff Report No. 382

international levels.[313] The financial crises are now becoming common and frequent in the world and these are happening all over the world therefore, a particular country's legislation cannot be blamed for it. There are many reasons for the financial crises because the financial systems are becoming more equivocal and larger than they were before. However, they can be managed through proper regulatory frameworks.[314] Basel accord III is aiming to curtail the panic of the financial crises which will be explained in the next part of this chapter.

5.7 The Repercussion of the Financial Crisis

Financial crises always have effacing effects not only on the economic systems but on the society as well. In the modern economic system, where the financial systems have more financial institutions than before, and the operating methods are also nebulous, the causes of occurring a financial crisis also surge. The main causes of a financial crisis are elucidated above which normally creates a situation where it becomes impossible for the financial system to survive without the intervention of an external lender.[315] It is not possible to get rid of the effects of a financial crisis overnight because it always has a long-lasting impact on the system. The financial crisis does not occur accidentally instead it happens due to bad governance and failure of the regulatory frameworks. Although it is indefensible to argue that the financial crisis has no adverse effects in developing countries, however, it was realized after the recent financial crisis of 2007-2008 that it has more detrimental impacts on developing countries.[316]

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[313] Matthew Oxenford, "The Lasting Effects of the Financial Crisis Have Yet to Be Felt", (January 12, 2018), Accessed: September 10, 2018.

[314] Ibid

[315] Mehmed Ganic, "The Impact of the Global Financial Crisis on the Banking Sector of Western Balkans: Cross-Country Analysis", [2012] Journal of Economic and Social Studies, Vol, 2, Issue No. 2, pp.21

[316] Justin Y. Lin, Will J. Martin, "The Financial Crisis and its Impacts on Global Agriculture", [2016] World Bank Policy Research Working Paper No. 5431.

The domestic market of a country seeks assistance from the government when they face financial issues. Normally, the CBs play the role of LOLR and lend liquidity to the financial institutions on the required stipulations. However, if the dread regarding the failure of the economic system disseminates among the investors it makes the system more vulnerable for the financial crisis to harm it because they start withdrawing their money. The sustainability of the financial system is directly proportionate to the trust of the debtors and it is the responsibility of the CB to ensure that it has the capacity to lend frequently during panic and deter a financial crisis.[317] The failure of the CB to maintain the trust of the investors starts kicking out the investment from the system and minimise foreign investment and remittances. The immediate effect which a financial crisis causes is unemployment. Increasing unemployment puts a lot of pressure on the government and leaves adverse effects on society and it takes several years to get out of the after-effects of the crisis.[318]

The prices of all commodities drastically increase in a financial crisis and it leaves no room for the government to subsidize it. It damages the low-income countries badly in contrast to the developing countries. The financial crisis coerces the government to seek assistance from external lenders to overcome the financial challenges however, the aid or debt normally comes with tough conditions. IMF is playing the role of an international lender, but it is always criticized by many economists across the globe that the IMF tries to influence the political and economic system of the states which seek assistance from it.[319] Governments take foreign loans to handle the financial challenges however, to return these loans and interests compel the

[317] Viral V. Acharya, Matthew P. Richardson, "Causes of the Financial Crisis", [2009] Critical Review Vol, 21, Nos, 2 & 3, pp. 195-210.
[318] Nicholas Oulton, Maria Sebastia-Barriel, "Long and Short-Term Effects of the Financial Crisis on Labour Productivity, Capital and Output", [2013] Bank of England Working Paper No. 470.
[319] Myriam Senn, "The Impact of the Financial Crisis – Institutional Issues", [2010] 6th Global Administrative Law Conference, Viterbo, June 11-12, pp.27

government to increase taxes which has an adverse impact on the poor. Finally, the worse thing about a financial crisis is, it lasts for a long time. Notwithstanding, efficient financial policies and regulations which can handle the challenges of modern economic systems not only can help to curtail the effects of the financial crisis but will be helpful to deter further crisis.[320]

5.8 Background of the Basel Accord

The banks play a vigorous role in maintaining financial stability and immensely contributed to the GDP of the financial systems at the domestic and international levels. In the modern economic era, banks have turned out to be an indispensable part of the financial system. However, loopholes in the regulations allow the banking industry to become involved in risky financial activities, which can create a financial crisis.[321] The banks around the globe have played an important role in economic growth; however, due to an inappropriate legal system, the banking industry has caused financial crises. Thus, many countries have implemented mandatory deposit insurance policies to secure the deposit of the investors, but nothing worked as a perpetual solution. After the collapse of serval banks around the globe, the G10[322] group established the CB of Governors in 1975 which constituted a committee (the Basel Committee) to propose a solution for the banking system.[323]

The Basel Committee proposed a regulation to minimise risk, but this could not work because the method used by the Basel Committee to evaluate risk was obsolete. Therefore, the Basel Acord I was amended in November 1991 to tackle the challenges. Many lacunas existed in the

[320] Wilson N. Sy, "Implications of the Global Financial Crisis", [2015] Journal of the Economics and Business Educators NSW, Issue, 2, pp, 26-34.
[321] C.W. Calomiris and G. Gorton "The origins of banking panics: models, facts, and bank regulation", [1991] *Financial Markets and Financial Crises*, Chicago, IL: University of Chicago Press, pp. 109–174.
[322] Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, Netherlands, Spain, Sweden, Switzerland, the UK, and the US.
[323] C. Goodhart, "The Basel Committee on Banking Supervision: A History of the Early Years, 1974–1997, Cambridge: Cambridge University Press.

Basel I regulations, hence the Basel Committee introduced Basel II in June 1999. Basel II was esteemed to be a good regulation for preventing a financial crisis. However, major concerns regarding its capacity arose after the financial meltdown of 2007–2008. Thus, the Basel Committee introduced Basel III, which is yet to be implemented.[324]

Initially, only the G10 formed the Basel Committee, but later they enhanced their membership and now more than 28 countries are members of the Committee.[325] Although there are no direct repercussions for the member countries if they refuse to implement the regulation proposed by the Committee, it has still been adopted by many countries. The Basel Accord is regarded as a soft international law because, unlike international regulations, there are no substantial consequences for not implementing it. However, there is an indirect repercussion for the country that does not implement the suggestions of the Committee because foreign investors and banks will be reluctant to invest. However, the implementation of Basel's suggestions can reassure investors that the financial system is sound and there will be no risk of a financial meltdown.[326]

5.8.1 Basel Accord I

The banking sector took a prospective start and, due to its profitability, it grabbed the attention of both public and private investors. Several banks in the United States, Bankhaus in Germany, and Long Island's Franklin National Bank collapsed in the 1970s. Although the Federal Reserve tried

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[324] A. Toor (2017) "International Financial Regulation and the Basel Accord: How the Impact of a Soft Law whisper Results in Compliance Throughout the Global", SSRN, 23 May (accessed 29 October 2018).
[325] Bank for International Settlement (2014) Basel Committee on Banking Supervision: A Brief History of the Basel Committee, October (accessed 1 November 2017).
[326] A. Toor (2017) "International Financial Regulation and the Basel Accord".

to frame a regulation that could prevent the failure of the banking system, it could not stop the banks from avoiding this regulation.[327]

- The Basel Accord is considered a major milestone in the history of the banking system because it proposed a minimum capital standard for banks around the globe. Member countries of the Basel Committee agreed to set a minimum capital requirement of 8% of risk-weighted assets for all internationally active banks in their jurisdictions. Bank capital was also defined in Basel I. The minimum capital requirement was proposed because the banks already held a low level of capital which declined further due to the increase of off-balance-sheet activities. Another reason behind setting the minimum capital requirement was the desire of the banks of some jurisdictions to obtain a short-term competitive advantage in financial markets. They were maintaining a very low level of capital to get this advantage, and this turned out to be a serious problem for the financial systems.[328]
- The minimum capital requirement set by Basel Acord asked the banks to generate more capital to fulfill the requirement. However, during the 1990s, banks developed various techniques to undermine the riskiness of different parts of their portfolio and introduced a new category of economic capital. Consequently, discrepancies arose between the minimum required capital and economic capital, which allowed the banks to avoid regulatory requirements.[329]
- To fulfill the requirement of minimum capital, the banks started turning to securitisation schemes. Thus, until 1998, the outstanding securitisation was more than $200 billion on behalf of the 10 largest banks of the United States. All these strategies resulted in the

[327] P. Jackson (2001) “Bank Capital Standards: The New Basel Accord”, Bank of England Quarterly Bulletin, Spring (accessed 17 September 2018).
[328] A. Toor (2017) “International Financial Regulation and the Basel Accord”.
[329] P. Jackson (2001), “Bank Capital Standards: The New Basel Accord.

failure of Basel I to maintain the capital requirement internationally. Additionally, there were no proper standards to recognise the level of risk attached to the financial activities of the banks. Basel accord I's scope was also limited for evaluating the reduction of risk in the presence of worthy collaterals, which hindered the banks from taking advantage of it.[330]

- All these issues of capital requirement and the inability of the Accord to recognise the reduction of risk through collaterals put pressure on the Basel Committee. Thus, the Committee amended the regulation in 1996 and allowed the banks to use value at risk models for the recognition of the reduction of risk.[331]
- Finally, although there were major loopholes in the regulatory framework of Basel Accord I, it was still adopted by member nations of the Basel Committee and some other countries as well.

5.8.2 Basel Accord II

The Basel Committee tried to address the lacunas of Basel I and so they made a major amendment to it. They tried to comprehend new techniques that had been developed by banking officials. However, the changes made by the amendment were not sufficient enough to address the issues. The Basel Committee was pressurised to allow the banks to use credit risk models for fulfilling the capital requirement, but the Committee was unsure regarding the accuracy of these models. Research carried out by the Bank of England indicated that the model of credit risk was at a very early stage of development. Hence, the Committee had to propose a new regulation to

[330] J. Bhowmik, S. Tewari (2010) "Basel Accord and the Failure of Global Trust Bank: A Case Study", The IUP Journal of Bank Management, 9(3), pp. 37–62.
[331] P. Jackson (2001), "Bank Capital Standards: The New Basel Accord".

address the issue and comply with contemporary issues of the capital requirement and assessment of the riskiness attached to the financial activities of the banking industry.[332]

- Although Basel II came a few months before the financial crisis of 2007–2008 hit the financial markets, it was still blamed by many economists for not averting the crisis. Basel II was proposed to address the loopholes of Basel I and framed an advanced financial regulation. The failure of the method of calculating capital and recognising the risk reduction in the presence of collaterals urged the Basel Committee to repeal Basel I and propose a new Accord. Only one method had been used to calculate capital by Basel I; however, three methods were proposed in Basel II.

a) Standardised Approach

The Standardised Approach was not a new method used in Basel II, as it was also used in Basel I. However, it was altered according to the requirements of the modern banking system. According to this method, a fixed percentage of risk was used after assessing the financial markets. For example, a 35% risk was fixed for the residential loans in Basel II. Similarly, according to the nature of the business, the risk was predetermined and fixed for all types of financial activities.[333]

b) Foundation of the International Rating Approach

This was a new approach proposed in Basel II which empowered the lender to determine the risk attached to financial activities and required a respective amount of minimum capital. The acumen behind offering this approach for the capital requirement was that the lenders had a maximum stake in the stability of the system and so would not allow

[332] K. Dowd, M.O. Hutchinson, S.G. Ashby (2011) "Capital Inadequacies: The Dismal Failure of the Basel Regime of Bank Capital Regulation", *Cato Institute Policy Analysis No. 681*, July (accessed 7 July 2018).
[333] P. Jackson (2001) "Bank Capital Standards: The New Basel Accord".

the banks to become involved in risky activities without holding sufficient capital. Nonetheless, this approach allowed the banks to play with their lenders and avoid the minimum capital requirement by undermining the risk because normally the depositors had no parameters to determine it. Basel II was criticised by many economists after the financial crisis due to this approach.[334]

c) Advanced Internal Rating Approach

This method was also initially proposed in Basel II, by which the lenders had to determine the probability of default, loss given default, and exposure at default. This method was used because it could swiftly determine the risk attached and help the lender recognise the requirements of the capital. Banks used their own loss probabilities models in this approach.[335]

- Basel accord I could not address operational risk, but Basel II did address this issue. Operational risk is a kind of risk attached to the operation of the banks while undertaking a financial activity. Basel II was not aimed merely at implementing new capital rules. Rather, it was mandated to increase the quality of risk management and supervision. Basel II introduced three pillars for its regulatory framework. Pillar I, elucidated the minimum capital requirement. Pillar II was a Supervisory Review allowing the supervisors to cross-check if the banks' assessment regarding risk was reasonable. Mere reliance on the minimum capital requirement defined under Pillar I was not sufficient, so the banks and the supervisors must understand the risk profile and capitalise it

[334] Bank for International Settlement (2014).
[335] Basel Committee on Banking Supervision (2001) *Consultative Documents: The International Rating-Based Approach*, 31 May (accessed 30 October 2018).

accordingly. Pillar III was a market discipline that enhanced transparency in the banks' financial reports.[336]

5.8.3 Basel Accord III

Basel II addressed the lacunas of Basel I and tried to comprehend the needs of the modern banking system. New techniques were also defined in Basel II to recognise the capital requirement for banks. The financial crisis of 2007–2008 is regarded as the worst crisis in the history of financial crises after the Great Depression. This financial crisis harmed the entire world badly, but it changed the mindset of the policymakers and urged them to consider the proposals of the Basel Accord and LOLR as an essential part of the financial systems to strengthen them against the crisis. The collapse of Lehman Brothers (September 2008) was seriously contentious and highlighted the loopholes of Basel II. Additionally, the detrimental effects of the crisis led the Basel Committee towards a new regulation: Basel III.[337]

- The capital requirement for commercial banks was revised in September 2010, which later turned out to be part of Basel III. The causes of the financial crisis were deliberated in depth; all possible loopholes were identified and addressed by the Basel Committee in Basel III. It was recognised by the Committee that Basel I and Basel II were not implemented properly in many states, which had contributed to the crisis. Thus, 27 states announced that they would start implementing Basel III on 1 January 2013.[338]
- The three main pillars of Basel II were re-formed in Basel III. For common equity, the minimum capital requirement was 2% in Basel II, which increased to 3.5% in Basel III.

[336] S. Venkataraman (2006) "Integrated Risk Management Framework and Basel II", SSRN, 24 February (accessed 11 May 2018).
[337] E. Lee (2015) "Basel III and Its New Capital Requirements, as Distinguished from Basel II", [2014] The Banking Law Journal University of Hong Kong Faculty of Law ,Vol, 131(1), pp. 27–69.
[338] M.R. Saidenberg and T. Schuermann, "The New Basel Accord and Questions for Research", [2013] Wharton Financial Institutions Center Working Paper No. 03-14, June (accessed 31 October 2018).

For Tier I, the minimum capital requirement was 4%, which increased to 4.5%. The term 'bank' was explicitly elucidated in Basel III. For all risk-weighted assets, the minimum capital requirement was declared to be 8%. 'Capital buffer' was a new term to use in the banking system as defined in Basel III, which can be calculated as:

i) Available Capital – Risk Capital = Capital Buffer[339]

- After the proposals of Basel III, many economists voiced their concerns that it will not be able to prevent further financial crisis and argues that it would be a tough task for the banks to meet the minimum capital requirement set by Basel III. The banking systems of small economies would not be able to meet the capital standards and so they would not be able to implement them. Basel III tries to enhance the level of communication among banks and to improve transparency to help evaluate riskiness accurately.[340]

5.9 Implementation Challenges of the Basel Accord in Pakistan

Although 27 states were committed to fully implement Basel III from 1 January 2013, according to the report of the Basel Committee published in April 2013, only 11 states could implement it. Not only do countries with small economies struggle to implement it, but countries like Canada are also struggling. They passed rules to implement the framework of the Basel Accord in December 2012, but they were not able to implement them until January 2014.[341] Moreover, developed countries like the United States adopted a different method to implement the framework of the Basel Accord. The Dodd-Frank Wall Street reforms and the Consumer Protection Act were used to implement it at the domestic level. The Capital Requirement Regulation (CRR) and the Capital Requirement Directive (27 June 2013) were mandated to

[339] E. Lee (2015) "Basel III and Its New Capital Requirements".
[340] J.K.M. Mawutor "Analysis of Basel III and Risk Management in Banking", [2014]European Journal of Business Management, Vol, 6, pp.6
[341] A. Gurrea-Martinez and N. Remolina, "The Dark Side of the Implementation of Basel Capital Requirement: Theory, Evidence and Policy", [2017] SSRN, 18 October (accessed 13 April 2018).

implement Basel III in Europe. The CRR is now part of the domestic law in all member states. Basel III is not a regulation for the banking system alone; it also covers all the financial institutions. However, some states like Switzerland have set an even higher capital requirement for their banking systems to minimise the dread of insolvency.[342]

There is a split on the matter of capital standards in the EU because the United Kingdom and Sweden are of the view that the capital standards must be at the discretion of the state instead of having the same standard. However, Germany and France emphasise having the same capital standard in the EU states.[343] Pakistan is a country facing several economic and political challenges. It is listed as a developing economy and among countries having a small economy. For a country like Pakistan, it is not an easy task to implement the capital requirement regulations of Basel III immediately. It can take several years to fully implement Basel III. Pakistan, unlike many other developing countries, took serious initiatives to implement it. The SBP issued a circular (BPRD Circular No. 06, 2013) which was passed by the Parliament in 2013, mandating the implementation of the framework of Basel III in Pakistan.[344] Initially, this circular only addressed eligible capital, capital ratio, and leverage ratio and explicitly stated that other parts of the framework of Basel III would be addressed separately. This circular, however, sends a resounding message to the financial institutions of Pakistan regarding its intentions to implement the framework of Basel III. The SBP set a deadline of 31 December 2019 to fully implement Basel III in all its banks and financial institutions.[345]

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[342] M. Ojo (2018) "Progress on Adoption of Basel III Standards: Monetary Policy, Leverage Ratio and Risk Based Capital Adequacy Measures", SSRN, 8 March (accessed 15 April 2018).

[343] A. Gurrea-Martinez and N. Remolina (2017) "The Dark Side of the Implementation of Basel Capital Requirement".

[344] S.A.A. Shah (2012) "Why Pakistani Banks Failed to Adopt Advance Approaches of Basel Accord According to Road Map of State Bank of Pakistan", SSRN, 28 August (accessed 21 April 2018).

[345] O. Masood, "Risk Management and Basel-Accord-Implementation in Pakistan", [2017]Journal of Financial Regulation and Compliance, Vol, 20Issue, 3, pp 111.

5.10 LOLR in the Perspective of Pakistan

The LOLR is also an imperative part of modern financial systems like the Basel Accord. The inception of the banking system has played an important role in the growth of financial systems at the domestic and international levels. However, avarice lured the business fraternity towards risky business activities and the absence of efficient regulations caused the financial crisis. The failure of the domestic banking regulations and the detrimental effects of financial crises compelled the policymakers to come out of their trance that the freedom of business for the banking sector was enhancing the growth of the economic system. It is indeed an undeniable fact that banks have contributed a great deal to financial growth.

Nonetheless, the damage which occurred due to the loopholes in the legislation relating to the banking system is also alarming. After the failure of many banks around the globe, the policymakers recognised the lacunas and realised the need for an international banking regulation, which eventually led them to the Basel Accord. The significance of the Basel Accord has been extensively described above. The Basel Accord is not simply an international banking regulation for the member states of the Basel Committee; rather, it is disseminated across the globe.[346]

At an earlier stage of the banking and financial evolution, the role of LOLR was not well accepted by the policymakers. It was regarded as a rescue package for larceners and criticised by economists as nothing but a waste of taxpayers' money. As the role of CBs evolved and financial crises of different eras badly damaged the world economy, the debate surged among policymakers regarding the need for a LOLR for the system. Initially, the understanding of the LOLR was nothing more than a rescue package in the form of liquidity or through buying the

[346] M.D. Bordo ,"Rules for a Lender of Last Resort: An Historical Perspective", [2014], Accessed: February 02, 2019

illiquid assets of the financial institutions which were facing the problem of insolvency. Until the financial crisis of 2007–2008, this role could not grab the attention of policymakers as an integral part of the financial system.[347]

Now, after a long process of deliberating on the causes of financial crises, it has been realised that the trust of the depositors is the key factor in deterring a crisis. However, if dread regarding the failure of the financial spreads among investors, they will immediately start demanding their money from the financial system. A surge in the demand for liquidity adversely affects the system and pushes financial institutions either to sell their illiquid assets swiftly or to seek the intervention of the CB in the form of LOLR. The presence of a LOLR assures the investors that the financial institution will not collapse, which helps the financial institutions keep the trust of their depositors.[348]

5.11 Legitimacy of LOLR in Pakistan

Pakistan has established its CB known as State Bank of Pakistan in 1948 which holds the power to emit new notes and plays the role of LOLR for its financial system. The banking industry took a slow start in Pakistan and different banking policies were deployed to make a modern banking system. Pakistan is among those countries which have two entirely different banking systems; the conventional and Islamic banking systems. Pakistan is a developing country where the laws relating to the banking sector are still in the process of evolution. Tentative financial conditions and major financial crises have urged the policymakers of Pakistan to comply with the international banking regulation of the Basel Accord and address the lacunas of its domestic legislation.

[347] F. Capie (2002) “Can there be an International Lender of Last Resort?”,[2002] International Finance, Vol. 1, Issue,2 pp. 15
[348] M. Berlemann, K. Hristov, and N. Nenovsky (2002) “Lending of Last Resort, Moral Hazard and Twin Crises Lessons from the Bulgarian Financial Crisis 1996/1997”, 7 May 2017 (accessed 10 February 2018).

The SBP is empowered through the State Bank of Pakistan Act, 1956 to play the role of LOLR for the financial institutions which are facing the problems of liquidity. The SBP has played this role for several financial institutions and provided liquidity. However, the absence of strong regulation and a frequency in playing the role of LOLR made it difficult for the SBP to survive. Thus, Pakistan sought the intervention of the international LOLR (ILOLR) and obtained a rescue package from IMF which plays the role of ILOLR.[349] There is only one section regarding the role of LOLR in the SBPA, 1956 which empowers the SBP to play this role. However, a proper framework to regulate the operations of LOLR is still absent.

- If a scheduled bank starts facing a liquidity shortage and seeks assistance from the State Bank of Pakistan the SBP may lend liquidity after recognizing that the bank is solvent and has the capacity to provide adequate collaterals.[350]

The laws which authorized the SBP to play the role of LOLR have not left it merely on the discretionary powers of SBP either to lend liquidity support or not. Walter Bagehot is among the few of them who played an imperative role in introducing the legal framework of LOLR. He had proposed the basic rules for the CBs which should be followed while lending liquidity to the financial institutions. The CBs should only lend liquidity to the illiquid, however, the solvent institutions. The liquidity support should only be limited to those financial institutions which can provide worthy collaterals. Finally, the support of liquidity should be encouraged and that is why a high-interest rate should be charged as a penalty.[351]

[349] Sara Cheema, "The IMF: Pakistan's History and Future with the LOLR", (Eurasia Review, June 19, 2017), Accessed: November 04, 2018.
[350] Section 17G of the State Bank of Pakistan Act, 1956
[351]Robert E. Keleher, Thomas M. Humphery, "The Lender of Last Resort A Historical Perspective", (1984) Cato Journal, Vol.4, No.1, Page No. 275.

Appraisal of the law which is regulating the role of LOLR in Pakistan gives the impression that the rules of Walter Bagehot are followed. These were proposed in an era when the presence of LOLR was objected to by many economists that it was a package for those who were not performing their duties. However, in modern times, the financial needs are different and the role of LOLR also emerges a lot. These rules are still playing an important role however, on many occasions even the Bank of England operated as LOLR and superseded these rules.[352]

5.11.1 The LOLR for Islamic Banks

The operations of LOLR are based on high-interest rates as a penalty around the globe; no liquidity support comes free because it is against the basic rule of having a LOLR. Even the liquidity which the SBP has obtained at different times from the International Monetary Fund (IMF) is based on high-interest rates. The conventional banks work on the interest-based system in Pakistan. However, the Islamic banking system claims to operate as an interest-free industry. The conditions under which the role of LOLR could be played for the Islamic banks are still under deliberation. In Pakistan, the understanding of LOLR still revolves around the concept that any financial institution which has liquidity in surplus can play the role of LOLR by lending liquidity to financial institutions that are experiencing problems of liquidity. Thus, the SBP has allowed conventional banks to open Sharia-compliant windows to act as LOLR for Islamic banks. *Sukuk* (Islamic bonds) have also been introduced to address this issue.[353]

Islamic banks are growing exceptionally well in Pakistan but still a deep evaluation of the history of financial crises divulges that LOLR is an integral part of the banking industry. The absence of

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[352] Mateen Altaf, “Role of State Bank of Pakistan in Economic Development of the Country”, [2016] Economy & Finance, Accessed: November 04, 2018

[353] S. Zaheer and M. Farooq (2014) “Liquidity Crisis: Are Islamic Banking Institutions More Resilient?”, paper presented at the joint RES-SPR Conference on Macroeconomic Challenges Facing Low-Income Countries hosted by the International Monetary Fund, 30–31 January (accessed 4 November 2018).

LOLR can add to a trivial financial panic and convert it into a serious financial crisis. Therefore, it is still a milestone, not only to regulate but also to appoint a LOLR for Islamic banking that is compliant with Sharia law.[354] The Islamic banks operate as interest-free sectors and they do not offer any fixed interest to their depositors and do not charge any interest from debtors. The SBP offers liquidity support based on interest-free grounds which is charged as a penalty to discourage the financial institutions from obtaining it again and again. However, if the Islamic banks are offered liquidity support with no interest or penalty charged, it will encourage them to seek financial support frequently. The history of financial crises enunciates that a continuous engagement of the CB in lending liquidity as a LOLR causes a financial crisis. Hence, a system that can discourage Islamic banks from seeking liquidity support and comply with Sharia law remains undiscovered.[355]

5.12 Summary

The banking regime of Pakistan is explained in this chapter and all the laws which regulate the banking industry are also described. The role of the banking sector in any financial system is appraised and argued on different policies that are used to establish a sound financial system in Pakistan. The effects of a financial crisis are enlightened. The Banking and Companies Ordinance, 1962 (LVII of 1962) is also discussed in detail which is used to regulate the banking sector in Pakistan. Basel accord is an international regulation for the banking system. The reasons for establishing a Basel Committee and loopholes in the Basel I and II are also illustrated in it. The implementation challenges of Basel III are examined and the steps which Pakistan took so far to implement Basel III are also evaluated. Finally, the role of LOLR is explicated in the

[354] M. Umer (2015) "Lender of Last Resort for Islamic Banks under review", *Dawn News*, 1 April (accessed 4 November 2018).

[355] M. El Hamiani Khatat (2016) "Monetary Policy in the Presence of Islamic Banking", *IMF Working Paper 16/72*, March (accessed 4 November 2018).

context of Pakistan and the laws which legitimize its functions are also appraised. The diversity of the banking system is also described and the challenges which Pakistan is facing to establish a system of LOLR for the Islamic banks are also observed.

Chapter 6: Case Study of Pakistan

6.1 Introduction

The core purpose of this chapter in this thesis is to identify the problem in the regulatory system of Pakistan in the context of LOLR. The chapter also answers the research question of this research. It provides a detailed discussion on the operation of LOLR by the SBP to identify the problem. It argues that the power of acting as LOLR is allocated to the SBP after the financial crisis of 2007-2008. The SBP is empowered to act as LOLR through an amendment in the State bank of Pakistan Act 1956 in 2015. The Section is examined in this chapter. Furthermore, a case study of the KASB bank is examined to identify the problem. The establishment of the KASB is discussed besides the functioning of the bank until the merger took place. All of the legal formalities which were required to fulfill in the amalgamation of the KASB into the BankIslami are appraised. The chapter concludes by arguing that although there are loopholes in the regulation, the main problem lies in the transparency issues while conducting the LOLR operations.

6.2 Case Study of the KASB Bank

To evaluate the role of the State bank of Pakistan as a LOLR, a famous case of KASB bank from recent times is befitting to appraise. KASB bank was established in 1994 by Khadim Ali Shah Bukhari.[356] The main head office of the bank was in Karachi which is the largest city in Pakistan. The bank was established under the Banking and Companies Ordinance of 1962.[357] The legal formalities of establishing a banking company under this law are discussed in detail in chapter four of this study. KASB group of companies owns the KASB bank which is regarded as one of

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[356] Khadim Ali Shah Bukhari (PVT) LTD, < https://kasb.com/about/ > Accessed: March 21, 2020.
[357] Shahbaz Rana, "Legal Formalities of Defunct KASB Bank Remain Unfulfilled", The Express Tribune, (Pakistan, 8 September 2019).

the oldest capital markets in Pakistan. KASB group of companies was established in 1952 by Mr. Khadim Ali Shah Bukhari. The bank was established to provide financial support to the business fraternity of the country. KASB group of companies has a major contribution in real estate (KASB Tower), education (KASB Institute of Technology), agriculture, and media industry.[358]

The CB of Pakistan known as SBP requires the banks working within the country to meet minimum capital requirements. Although Basel Accord III is not implemented yet in Pakistan still the banks which are operating in the country are under an obligation to maintain capital which is required. Requirements of the capital and principles of Basel Accord III are briefly discussed in chapter four of this study. To identify the problem in the LOLR operations the merger of KASB is used as a case study. During the financial crisis of 2007-2008, the KASB bank started facing liquidity problems.[359] In compliance with the rules of Basel to maintain stability in the banking sector, the SBP warned the bank to meet the regulatory capital requirement. The owner of the bank owns many other companies and tried to utilise their capital to meet the minimum capital requirement.[360]

Furthermore, the SBP placed the bank under a moratorium by using its regulatory powers. Rather than imparting liquidity to KASB bank by following the rules of demanding collaterals and evaluating the solvency of the bank the SBP allowed another bank to take over this bank.[361] This approach was not only unprecedented but also raised several questions. The SBP was accused of lack of transparency while using the regulatory powers. The report of the Auditor General of

[358] Khadim Ali Shah Bukhari (PVT) LTD, < https://kasb.com/about/ > Accessed: March 21, 2020.
[359] Muntazar Bashir Ahmed, "KASB Bank Limited: Capital Shortage", Sage Journals, (Pakistan, 5 March 2018.
[360] Khurram Hussain, "Analysis: The little bank that couldn't", Dawn Newspaper, (Pakistan, 02 May 2015).
[361] Mian Abrar, "KASB Bank merger – a tale of misplaced Priorities", (Pakistan Today, 09 May 2015).

Pakistan on the merger of the bank also objected to the role of the CB.[362] The SBP allowed BankIslami to take over the KASB bank because it failed to meet the regulatory capital requirement. Moreover, no liquidity was provided to the KASB bank by imposing any of the conditions which could help the bank to get over the liquidity crisis. The SBP lent Rs. 5 Billion (PKR) at (0.01%) to BankIslami which resulted in litigation and embezzlement inquiries.[363] The Banking and Companies Ordinance 1962 which empowers the SBP to act as a regulator for the banking of Pakistan also binds the government to present the report before the parliament and make it a public document.

"Copies of the scheme or any order made under sub-section (11) shall be laid on the table of the Legislature, as soon as may be, after the scheme has been sanctioned by the Federal Government, or as the case may be, the order has been made"[364]

However, this report is not published nor presented before the parliament which raised serious questions on the transparency of the role of LOLR of the SBP.[365] Moreover, the SBP lifted a moratorium from KASB immediately after its merger into BankIslami without giving appropriate reasons for it.[366]

The SBP Act, 1956 empowers the CB of the country to officially play the role of LOLR for the financial institutions at the domestic level which are experiencing financial troubles.[367]Although the Act stated the principles for carrying out the operations of LOLR, there was a lack of

362 Muhammad Farooq, "AGP Says BankIslami-KASB bank merger resulted in Rs. 3.5 billion loss to national exchequer", (Pakistan Today, 01 April 2018).
363 Shahbaz Rana, "Legal Formalities of Defunct KASB Bank Remain Unfulfilled", The Express Tribune, (Pakistan, 8 September 2019).
364 The Banking and Companies Ordinance 1962, Section 47(12)
365 Shahbaz Rana, "Legal Formalities of Defunct KASB Bank Remain Unfulfilled", The Express Tribune, (Pakistan, 8 September 2019).
366 Mian Abrar, "KASB Bank merger – a tale of misplaced Priorities", (Pakistan Today, 09 May 2015).
367 The State Bank of Pakistan Act 1956, Section 17G

transparency in most of its LOLR operations due to heavy political influence on the management of the CB. Thus, not only this role of the SBP is controversial but it is also adversely affecting the financial system of the country. It is a fundamental principle of carrying out the LOLR operations that liquidity support should not be offered without following the basic principles. The lack of a proper regulatory framework allows the politician to influence the regulatory powers of the SBP which resulted in severe moral hazard problems. Therefore, rather than strengthening the financial system through the assurance of liquidity support, the presence of LOLR is making the financial system more fragile.[368]

The State bank of Pakistan lent liquidity to several commercial banks and State institutions which were unable to fulfill their financial liabilities.[369] Due to the unsatisfactory performance of the banking sector, Pakistan has implemented the policy of the nationalisation of financial institutions including all commercial banks. The policy of nationalisation is discussed in detail in chapter five of this thesis. In the early 1990s, many financial institutions including Muslim Commercial Bank and Allied Bank were privatised due to their bad performances. Most of the employees working in these banks were employed on a political basis. More than necessary employees were causing big losses to these banks.[370] Rather than the SBP, it was the Federal Government of Pakistan that decided to nationalise or privatise these financial institutions. The SBP has also acted as LOLR for the government of Pakistan on several occasions.[371] There is no record available in the public domain for the rescue operations of the SBP because it was acting

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[368] Shahbaz Rana, "Legal Formalities of Defunct KASB Bank Remain Unfulfilled", The Express Tribune, (Pakistan, 8 September 2019).

[369] Arshad Ali, "The Impact of Financial Crisis on Pakistani Economy" Vol. 28, *Strategic Studies,* (Winter 2008 & Spring 2009), pp. 106-117

[370] Prof Muhammad Ishaque Bajoi, Prof Dr Ambreen Zaib Khaskelly, "Privatization of Banking Sector in Pakistan-A Case study of MCB Bank Limited", Volume 12, No. 1, ISSN, 2278-5612, International Journal of Management and Information Technology, PP, 3159-3166.

[371] http://www.sbp.org.pk/FS/4.4.asp Accessed: April 10, 2020

on the directions of the Government. The SBP is empowered to regulate the banks working within the country and implement financial policy. However, as far as the role of LOLR is concerned it is explicitly attributed to the SBP through an amendment in the State Bank of Pakistan Act, 1956 in 2015.[372] Therefore, the liquidity support to the financial institutions or the policy of nationalisation or privatisation of the banks is considered as national policy rather than the LOLR operations of the SBP. After the amendment in the State Bank of Pakistan Act 1956, there is a case of KASB which is already discussed above. The doctrine of LOLR is yet to be properly evolved in the system of Pakistan.

There are some serious questions pertaining to the merger of the KASB Bank into BankIslami. The minimum capital requirement for the banks in Pakistan was increased by the SBP from 1 billion to 10 billion after the financial crisis of 2007-2008.[373] For this purpose, the KASB bank was pressurised by the SBP to meet the minimum capital requirement (MCR). The SBP holds the powers to act as LOLR or it can also exercise the powers to sell the bank. Notwithstanding, it is also imperative to consider that the KASB bank was working efficiently despite its inability to fulfill the obligation of capital requirements.[374] There was no panic for the bank run nor there were any complaints regarding the dishonoring of the cheques in the bank. Furthermore, in 2014 the KASB bank was maintaining liquidity of 16 billion which was the highest among its peer group. Nonetheless, the SBP opted to put a moratorium on it.[375] Although it is the duty of the CB as a regulator to ensure that all banks are complying with the requirement of MCR, it must not be partial in its operations.

[372] State Bank of Pakistan (Amendment) Act, 2015

[373] Shahbaz Rana, "Legal Formalities of Defunct KASB Bank Remain Unfulfilled", The Express Tribune, (Pakistan, 8 September 2019).

[374] Asim Yasir, "Selling of KASB Bank to BI in just RS 1000 echoes in PAC meeting", International The News (Pakistan, 27 April 2018).

[375] Shahbaz Rana, "Legal Formalities of Defunct KASB Bank Remain Unfulfilled", The Express Tribune, (Pakistan, 8 September 2019).

Any bank which is working in a State and incorporates according to the laws of the land has some rights besides several obligations. The KASB bank also possessed the right to seek liquidity support from the SBP by fulfilling the conditions. The LOLR powers were allocated to the SBP through an amendment in the State Bank of Pakistan Act 1956 in 2015. The merger of KASB also took place in the same year. The SBP rather than using its LOLR powers used other regulatory powers in this case which are unjust, ostensibly. The SBP does not hold any powers to restrict the right of any bank to seek liquidity from other sources, domestic or international. The KASB bank managed to get liquidity support of $100 million from a leading Chinese company to meet the MCR.[376] One of the largest leading commercial banks of the country Muslim Commercial Bank also showed its interest in buying the KASB bank or injecting liquidity. However, both of the options were rejected by the SBP.[377] Additionally, had the Chinese company been allowed to buy the KASB bank a substantial amount of foreign currency would have been injected into the financial system of Pakistan. However, the SBP rejected the offer of the Chinese Company named Cybernaut and stated that the functioning of the company is dubious.[378]

The KASB bank filed a petition in the Islamabad High Court to restrain the SBP from selling the bank which was accepted. In the petition, the KASB bank promised to get liquidity and meet the MCR. On April 20, 2015, the bank managed to get an offer of $100 million from Cybernaut, a Chinese company that had an investment fund of $10 billion in China. A formal letter was submitted into the SBP stating that the Chinese company will inject $100 million. The letter stated that $20 million will be injected before 13th May, a further $30 million will be injected in

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[376] Ibid
[377] Asim Yasir, "Selling of KASB Bank to BI in just RS 1000 echoes in PAC meeting", International The News (Pakistan, 27 April 2018).
[378] Shahbaz Rana, "Legal Formalities of Defunct KASB Bank Remain Unfulfilled", The Express Tribune, (Pakistan, 8 September 2019).

August, and the remaining $50 million will be injected by the end of the year.[379] Subsequently, Khadim Ali Shah Bukhari the owner of the Bank would become a minority shareholder, and the new name of the bank was proposed as Pak-China Bank.[380] On April 21, after the submission of the offer to the SBP the KASB bank withdrew its petition unconditionally. The offer of the Chinese company impacted the shares of the bank in the stock exchange in a positive way and doubled its share price.[381]

However, on April 27 the KASB bank received a letter from the SBP titled “Draft Scheme of Amalgamation”. The SBP used its powers stated under section 47 of the Banking Companies Ordinance 1962. The section is stated above in this chapter. Despite the offer from a Chinese company that could be brought substantial foreign currency into the country, the SBP indulged in a controversial sale of the KASB to BankIslami.

The Public Accounts Committee (PAC) headed by the then chairman Syed Khurshid Shah stated in a formal letter to the chief justice of Pakistan to take Suo Motu action to prevent the KASB bank from injustice.[382] The SBP provided a loan of 15 billion PKR to the BankIslami for one year at 4.7 percent in contrast to 7.6 percent, then a standard interest rate.[383] This resulted in a Rs 435 million loss to the national exchequer.[384] The PAC also asked the National Accountability Bureau (NAB) to initiate an inquiry in this matter. The NAB stated in its preliminary report that the SBP was unable to remain impartial in this sale and favored the BankIslami in this deal.[385]

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[379] Ibid (Under the heading Not only the One)
[380] Mian Abrar, “KASB Bank merger – a tale of misplaced Priorities”, (Pakistan Today, 09 May 2015).
[381] Shahbaz Rana, “Legal Formalities of Defunct KASB Bank Remain Unfulfilled”, The Express Tribune, (Pakistan, 8 September 2019).
[382] Asim Yasir, “Selling of KASB Bank to BI in just RS 1000 echoes in PAC meeting”, International The News (Pakistan, 27 April 2018).
[383] Mian Abrar, “KASB Bank merger – a tale of misplaced Priorities”, (Pakistan Today, 09 May 2015).
[384] Asim Yasir, “Selling of KASB Bank to BI in just RS 1000 echoes in PAC meeting”, International The News (Pakistan, 27 April 2018).
[385] Ibid

The SBP not only failed to comply with its LOLR duties but also failed to maintain transparency in the sale of KASB bank.

There was no dread concerning the solvency of the bank which was functioning efficiently despite its failure to comply with MCR. Moreover, the bank was able to bring foreign investors to inject liquidity into KASB bank which was not the only beneficiary for the bank to meet the MCR but could impact positively on the financial system of Pakistan. The CB of a country should act without any political influence is fine theoretically. Nonetheless, the decisions of the CB even in developed countries are arraigned for being politically influenced. Apparently, the KASB merger into BankIslami is a decision of the SBP followed by the failure of the bank to meet MCR. However, the former finance minister who is in relegation to avoid the inquiries of embezzlement is also accused of influencing this merger.[386] This was an unprecedented approach taken by a CB while acting as LOLR. The KASB could be rescued by injecting liquidity into it rather than providing a loan to BankIslami at a favored rate of a mere 4.6 percent. The examples from the UK and the USA are, therefore, used to learn lessons to reform the regulatory framework in Pakistan. The examination of the case study of KASB bank demonstrates that transparency in the operations of LOLR is more important than anything else.

6.3 Role of Financial Stability Board:

In the modern era, financial stability becomes as imperative for the survival of a state as its defense. Financial stability means that an economic system is working smoothly. It is, thereby, emerged as one of the vital duties of the Central bank of the country. The CB must intercept the vulnerability of its financial system and take preventive steps to ensure the trust of the

[386] Mian Abrar, "KASB Bank merger – a tale of misplaced Priorities", (Pakistan Today, 09 May 2015).

investors.[387] The SBP is empowered under the State Bank of Pakistan Act, 1956 to act as a regulator for the financial system of Pakistan. SBP is obliged to "regulate the monetary and credit system of Pakistan and to foster its growth in the best national interest"[388] Thereby, the SBP has established the Financial Stability Department (FSD) to ensure stability in the financial system country. SBP has also initiated working in many other areas aiming to ensure financial stability. It is now working on;

a) Designing of financial stability framework

b) Crisis management framework

c) Review and update of consolidated supervision framework

d) Framework for identification and supervision of D-SIP in Pakistan

The SBP is also playing a vital role in ensuring the solvency of the individual financial institutions and in the smooth functioning of the payment system to make a hazard-free environment for the financial system of Pakistan. There is a Financial Stability Executive Committee (FSEC) which is an internal committee of the SBP is an official forum to discuss all the potential challenges to the financial system of Pakistan. FSEC is also empowered to take effective measures to maintain stability in the financial system. This committee comprises on

i) Governor State bank of Pakistan is the Chair

ii) Deputy Governor, Chief Economic Advisor, Executive Directors, and Director FSD are members of this committee.[389]

[387] https://www.sbp.org.pk/FS/4.4.asp
[388] https://www.sbp.org.pk/FS/4.4.asp
[389] https://www.sbp.org.pk/FS/4.4.asp

This committee performs several vital duties to ensure stability in the financial system. It holds periodic assessments to intercept the potential challenges to the system. It also has a proper mechanism to monitor systemic risk. There is also a system of resolution framework which ensures a smooth settlement of the issues through a viable plan. This Board can be handy for the SBP while acting LOLR. Its reports and suggestions are based on empirical research, thereby, are most likely to be correct. Nonetheless, in the case of KASB, the SBP didn't take input from FSEC. Resultantly, the SBP carried out a disputatious operation and allowed Bank Islami to take over KASB bank.[390]

KASB did not hold the position of the Systemically important bank (SIB) like some other large banks working within the financial system of Pakistan. The powers of acting as LOLR are incorporated in the State Bank of Pakistan Act, 1956 through an amendment in 2015. There is no bank working in the financial system of Pakistan which was facing solvency challenges since then nor has any such bank sought a rescues package from the SBP. It was only the KASB in the recent past which is taken over by the Islamic bank due to the challenges of solvency. Although, the SBP used its power of being a regulator vested under section 48 of the State bank of Pakistan Act, 1956, and allowed another bank working in its financial system to take over KASB. Whereas the SBP was empowered to act LOLR for KASB, thereby, the study of KASB in spite of its status of not being a SIP makes it consonance for this research.

6.4 Conclusion

This chapter provided a detailed argument on the problems which lie within the financial system of Pakistan and are causing serious financial troubles for the country. This chapter explored the research aims of this thesis. It argued on the establishment of the KASB bank and its

[390] Mian Abrar, "KASB Bank merger – a tale of misplaced Priorities", (Pakistan Today, 09 May 2015).

controversial amalgamation into the BankIslami. This chapter identified the problem of the financial system of Pakistan concerning the LOLR. It explained the capital requirement of the banking sector and argued that the SBP misused its regulatory powers in the case of KASB. This chapter highlights the key problems in the system. The reform proposal to address the issues identified in this chapter is provided in chapter seven of this research.

Chapter 7: Comparison of the System of the UK and USA and Critical Analysis

7.1 Introduction

This chapter of the research provides an insight into the system of LOLR in the UK and the US and further explicates the significance of this role to deter a financial crisis. This chapter is mainly divided into three parts. The first part examines the role of LOLR played by the SBP to identify the loopholes in the current regulation. Furthermore, it also discusses the role of the Bank of England as LOLR and the laws which empower the BOE to play this role. The second part of this chapter starts by arguing the establishment of the Federal Reserve Bank and elucidates the factors which compelled the policymakers to recognise the need for a CB. Moreover, it unfolds the essential characteristics of the Federal Reserve System and debates on the powers of FBR to play the role of LOLR before the great depression. This ends with the discussion on legislative amendments which were made after the financial crisis of the 1930s and enhanced the powers of FBR as a LOLR. The third part consists of examples to illustrate the role of BOE and FBR as the LOLR. It further explains in detail the case of Northern Rock, Lehman Brothers, American Insurance Group, and enlightens the principles which were used by the BOE and FBR while playing the role of LOLR. Furthermore, it compares the actions of BOE and FBR and describes the rules which they have followed. It derives certain lessons for the system of Pakistan which can be learned from the experiences of the UK and the US. Finally, this chapter concludes by providing a critical analysis of the role of LOLR played by the Federal Reserves, The Bank of England, and the State Bank of Pakistan.

7.2 Comparison of the Systems of LOLR in the US and UK and lending lessons for Pakistan

The importance of LOLR has increased after the recent financial crisis and it has become an essential part of the functions of CBs. The role of LOLR played by the Federal Reserves and Bank of England to deter the financial crisis is widely venerated.[391] Although the unprecedented measures taken by the CBs of the countries have led to the emergence of LOLR, it has also raised several legislative issues and urged the policy makers to regulate the operations of LOLR. In the modern economic system, the need for the LOLR cannot be denied, however; it requires a proper system to achieve the milestone of having a less vulnerable financial system.[392] Developing countries can take a lot from the examples of developed countries nonetheless; it is not befitting to adopt policies from any financial system. There are numerous divergences in the dimensions of the economic systems and each economic system has its strengths and weaknesses.

Thus, no financial system can prosper by importing financial policies from developed countries because of the differences in the working of the systems. Notwithstanding, developing countries can learn lessons from them while keeping domestic needs in mind. Pakistan does not have a strong economy because of the absence of an efficient economic system. It is the need of the hour to implement robust policies hence Pakistan can learn many lessons from the systems of the United States and the United Kingdom. The rationale behind choosing these two systems lies in the similarities among the system of Pakistan, the US, and the UK. Pakistan falls in commonwealth countries, therefore; the parable for the UK is befitting and like the US, Pakistan

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391 Marc Dobler, Simon Gray, Diarmuid Murphy, and Bozena Radzewicz-Bak "The LOLR Function after the Global Financial Crisis" (2016), IMF working paper No. 16/10, ISBN: 9781498355995/1018-5941,Assessed: May 17, 2017.

392 Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.

also has potential in agriculture. To lend lessons from the US and UK it is important to examine these systems and compare them to evaluate their strengths and loopholes.[393]

7.3 LOLR in the UK

Before 1871, Paris was the competitor of London in the international capital markets nonetheless; the conquest of the French by the Prussians made London the sole center of the international capital market. The establishment of the Bank of England played a vital role in the emergence of the domestic financial system. Leoni Levi argued that the CB is the LOLR in times of crisis. It is already discussed in part one of this research that CBs were reluctant to accept the responsibility of LOLR however; by the 1870s the BOE accepted this duty.[394] The Gurney Crisis and the principles regarding the role of LOLR by Bagehot in his book Lombard Street in 1873 have played an important role in its emergence. The management of the money markets by the banking system of the UK is the key factor to make its position strong in the international sphere. It was then realized that the bank rate can be influential for the internal and external movement of the capital flow hence; it will be effective to increase the reserves of the BOE. Initially, the bank rate strategy was used only during the crisis but later it was established that an effective bank rate policy will be befitting to protect the reserves.[395]

However, it did not work well and weakened the interaction between bank and market rates. The BOE made the discount houses more self-reliant in 1858 which consequently eroded their contact with the market. Secondly, the massive emergence of Joint Stock Banks (JSB) and the

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393 Dietrich Domanski, Richhild Moessner, William R. Nelson, "CBs as LOLR: Experiences During the 2007-2010 Crisis and Lessons for the Future", (FEDS Working Paper No. 2014-110, January 11, 2015), Accessed: November 13, 2018

394 Esther Madeleine Ogden, "The Development of the Role of the Bank of England as LOLR, 1870-1914", (September 1988), (Doctoral Thesis, City University London), Accessed: April 23, 2018.

395 Ibid

discount houses had affected the position of BOE as the "head of the financial system".[396] Lastly, in this period, the BOE was concerned about its income because JSBs were making more income. All these factors offered hindrance in the implementation of the bank rate policy.

In 1873, the financial crisis started from the continent and swiftly spread across Europe and hit the market of the United States. The BOE was not affected by this crisis hence it had increased the bank rate which helped a lot to gather massive reserves. The collapse of the City of Glasgow Bank in 1878 again created financial unrest. The BOE refused to rescue it because it was suspected that it was insolvent which was later established by its failure. It was observed as a matter of fraud and mishandling hence its directors were tried and convicted which had happened for the second time in the history of JSB in the United Kingdom.[397]

However, this case raised the contention against unlimited liabilities of the banking sector and hauled the system towards limited liabilities.[398] In that era, there were many bankruptcies in Scotland and many financial institutions demanded help from the BOE but there was no serious financial crisis. Due to many bankruptcies and financial issues during the 1870s, the BOE was able to attain full control over the bank rate and used it as an efficient tool to maintain its reserves. In 1890, the British financial system had faced another crisis known as the Baring crisis which mainly happened due to the loans of domestic and foreign financial institutions. The Baring Brothers have a long history of enriching the BOE to purchase gold from other CB and enhance its reserves, but the financial instability coerced them to seek a rescue operation from

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[396] Ibid
[397] R. Button, S. Knott, "Desperate Adventurers and men of Straw: The Failure of City of Glasgow Bank and its enduring impact on the UK Banking system", (Bank of England Publication 2015), Accessed: April 24, 2018.
[398] Esther Madeleine Ogden, "The Development of the Role of the Bank of England as LOLR, 1870-1914", (September 1988), April 23, 2018.

the BOE.[399] Afterward, the Baring crisis raised a major debate on how much liquidated reserves banks must keep all the time and to what extent they can depend on the support of the BOE.[400]

These financial crises one after another enhanced the need for a financial institution that could frame the financial policies of the country and provide liquidity support to the financial institutions facing problems. Sir Francis Baring in 1797 argued that the financial system cannot survive without having a CB and the CB must play the role of LOLR for the domestic market.[401] As it has already been discussed that financial institutions were individually lending liquidity in the form of loans and the BOE also lent liquidity, but it was a loan against an interest rate. The BOE was also lending liquidity like the private institutions to earn profits hence; the Bank interest rate fluctuated to compete with market interest rate. Henry Thornton (1802) also emphasized the need for LOLR and expressed his concerns regarding the moral hazard problems. (see chapter three)

In the nineteenth century, the British financial system faced several financial crises which exposed the vulnerability of the system and raised many questions.[402] Walter Bagehot (1873) analyzed the financial system and located several reasons behind the financial crises. He made the skeleton of the operations of LOLR and argued that it could make a safe financial environment.[403] Although, there were many other domestic and international political and financial reasons which had caused the financial crisis the main reason behind the collapse of the financial institutions was the escalation of panic among creditors. The presence of LOLR

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399 Eugene N. White, "How to Prevent a Banking Panic: The Baring Crisis of 1890", (2016), Accessed: April 24, 2018.
400 Ibid
401 Michael D Bordo, "Rules for a Lender of Last Resort: An Historical Perspective", (2014) Journal of Economic Dynamics and Control, Vol 49, Page No. 126.
402 David Laidler, "Two views of the LOLR: Thornton and Bagehot", (2003), Accessed: April 24, 2018.
403 Vincent Bignon, Marc Flandreau, Stefano Ugolini, "Bagehot for Beginners: The Making of LOLR Operations in the Mid-Nineteenth Century", (March 30, 2016), Accessed: April 24, 2018.

prevented the escalation of financial panic and strengthened the financial institutions against the crisis. Although Sir Francis Baring and Henry Thornton argued that the LOLR must be a vital part of the duties of the CB, it was badly disapproved due to the moral hazard problems by the policymakers.[404] Bagehot suggested that the CB must give its policy regarding the assistance of LOLR and lend freely to curtail the financial panic. It must only lend to the solvent financial institutions which can provide good collaterals. The issue of moral hazard can be addressed through a high penalty rate which should be charged on the support of LOLR.[405]

The LOLR's functions have evolved with the progression of BOE as the CB of the State and played a vital role to prevent the system from the financial crisis. It was considered merely an operation of imparting liquidity during a crisis and was not considered as a continuous role to govern the financial system.[406] However, its operations played a vital role to extend its functions and achieve effective results. It was witnessed during the crisis that the financial institutions swiftly sold their assets which caused deterioration in the value of those assets and made a more difficult situation. Thus, the BOE while playing the role of LOLR sometimes helped the financial institutions by purchasing their illiquid assets.[407] There are nonetheless many repercussions of these acts because of serious moral hazard issues which are discussed in chapter five.

During the twentieth century, the LOLR helped the financial system in tough times and prevented many crises. The last financial crisis occurred in 2007-08 in which the BOE used its

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[404] Mikko Niskanen, "Lender of Last Resort and the Moral Hazard Problem", (2002) Bank of Finland 17/2002 Accessed: August 10, 2017.
[405] Vincent Bignon, Marc Flandreau, Stefano Ugolini, "Bagehot for Beginners: The Making of LOLR Operations in the Mid-Nineteenth Century", (March 30, 2016), Accessed: April 24, 2018.
[406] Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.
[407] Marc Dobler, Simon Gray, Diarmuid Murphy, and Bozena Radzewicz-Bak "The LOLR Function after the Global Financial Crisis" (2016), IMF working paper No. 16/10, ISBN: 9781498355995/1018-5941, Assessed: May 17, 2017.

discretionary powers and at times went beyond the principles of Bagehot.[408] Certain questions need to be addressed to make the role of LOLR more efficient. The principles of Bagehot emphasises that the LOLR support should only be for the illiquid but solvent financial institutions. However, it is quite difficult to identify the difference between illiquidity and insolvency. In the recent financial crisis, the role of LOLR is venerated but its operational challenges have raised a debate to regulate it.[409]

In the modern financial system, where each country has many multinational countries, the role of LOLR is inseparable to curb the panic of a financial crisis and establish a less vulnerable system. Rather than being aloof from the financial system until the occurrence of financial unrest, the BOE is uninterruptedly playing the role of LOLR. It is important to remain in contact with the financial system to realise the need for the system and act rapidly to erode the panic of the crisis. The functions of LOLR have evolved in accordance with the needs of the financial system and are fully operating to establish a strong system. There are several cases in which the operations of LOLR helped the financial institutions to deter against crises like Baring Brother, Banking Sector of Scotland, and Northern Rock.[410] It is befitting to evaluate the financial system of the US as well because it has a different historical background of the CB from that of the UK. The comparison of these systems will highlight the strengths and weaknesses of both systems and make it easy to lend worthy lessons for suggesting an appropriate regulatory framework of LOLR in Pakistan.

[408] Vincent Bignon, Marc Flandreau, Stefano Ugolini, “Bagehot for Beginners: The Making of LOLR Operations in the Mid-Nineteenth Century”, (March 30, 2016), Accessed: April 24, 2018.
[409] David Laidler, “Central Bank as the LOLR- Trendy or Passe”, (2004) University of Western Ontario, Economic Policy Research Institute 20048: Accessed: May 20, 2017.
[410] Mike Anson, David Bholat, Miao Kang and Ryland Thomas, “The Bank of England as LOLR: New Historical Evidence from daily Transactional data”, (Staff Working Paper No. 691), (November 2007), Accessed: March 3, 2018.

7.3.1 Legitimacy of LOLR in the United Kingdom

The Bank of England was established in 1694 which was initially owned by private stakeholders. The BOE is the eighth-oldest bank in banking history which was nationalised in 1946.[411] Several countries esteemed it as a model while establishing their CB. The BOE is the only bank that emits new notes in England and Wales and is among one of the eight banks which are empowered to emit and regulate notes in the United Kingdom. The BOE is authorized to regulate the financial institutions working in the country and holds the power to set the interest rate for the banking system. The role of LOLR emerged as the role of the CB evolved in maintaining the stability of the financial system. Sir Francis Bearing, in his book "Observations on the Establishment of the Bank of England," used the term "the dernier resort" for the CB. He argued that the CB must play the role of LOLR for the financial institutions which are facing liquidity shortage because if no institution plays this role a trivial panic regarding the financial crisis will be detrimental for the entire system. However, the problems of moral hazards were not addressed.[412]

After the financial crisis of 2007-2008 major reforms have been done to make a less vulnerable system. The Bank of England Act, 1998 states;

- The Bank of England is empowered to give monetary policy and give directions to the financial institutions which are carrying out their businesses within the jurisdiction of this Act.[413]

[411] John Plender, On the money: A history of the Bank of England", Financial Times (London 01 September 2017).
[412] Robert E. Keleher, Thomas M. Humphery, "The Lender of Last Resort A Historical Perspective", (1984) Cato Journal, Vol.4, No.1, Page No. 275.
[413] The Bank of England Act, 1998, Section 10

- The Bank of England is obliged to maintain price stability in the country by implementing the monetary policy and it should support the economic policies of the government.[414]
- Monetary Policy Committee should be constituted by the Bank of England which must consist of the Governor and deputy of the bank, two members must be appointed by the Governor after consultation of the Chancellor of the Exchequer, and four members should be appointed by the Chancellor of Exchequer. The committee will be responsible for formulating the monetary policy.[415]

The financial crisis of 2007-2008 became the reason for major changes in the regulations of the financial system. The Government decided to strengthen its financial system through new legislation aiming to address the loopholes in the financial laws. The Financial Services Act, 2012 was implemented. Resultantly, the Financial Policy Committee (FPC) and the Prudent Regulation Authority (PRA) were established to deal with financial stability. The role of the FPC is to identify the dread risks which can be detrimental to the stability of the financial system and take appropriate actions. The PRA plays the role of a regulator which regulates the commercial banks, building societies, and investment firms that are carrying out their businesses in the UK.[416] The core aim of having a LOLR is to have an institution that ensures to take all necessary steps for making a prosperous financial system and protects the system from a financial crisis. Instead of leaving all the duties to deter a financial crisis on the CB the BOE introduced a new method and opened new institutions that are performing certain duties that a LOLR should perform. However, BOE plays the role of surveillant for these institutions. In the financial

[414] The Bank of England Act, 1998, Section 11(a)(b)
[415] The Bank of England Act, 1998, Section 13(1)(2)
[416] Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.

system of the UK, there is no specific regulatory framework that governs the role of LOLR, but the system is developed by having more institutions. Notwithstanding, the BOE plays a vital part in the role of LOLR and lends liquidity to the commercial banks which suffer the problem of a liquidity shortfall. The presence of LOLR ensures the trust of the investors in the system and helps to deter a financial crisis. Northern Rock Bank was rescued by the BOE when it was experiencing the liquidity shortage through injecting liquidity into it.[417]

7.4 Central Banking in the United States

The history of LOLR started with the history of the CBs which were established after realizing that an institution that can regulate the financial institutions is inevitable. The emergence journey of the LOLR is extensively explicated in chapter one of this research. However, to understand the role of LOLR in the jurisdiction of the United States it is imperative to appraise the progression journey of the CB in the US. Usually, the government owns the CB and empowers it, regulates the financial institutions, and promotes the economic policies of the government. Maintaining stability in the financial system is the utmost responsibility of a CB in the modern economic era. In 1791 the US congress had declared the Bank of the United States as the CB bank. It was designed after learning lessons from the Bank of England. The establishment unlike the BOE was not welcomed by all the stakeholders in general and agrarian in specific had opposed the idea of having a CB and use of paper currency at the expense of gold and silver. The ownership of the bank was also disputed, and it was argued by many economists that the CB will favor the interests of commercial banks and industries.[418]

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[417] Marc Dobler, Simon Gray, Diarmuid Murphy, and Bozena Radzewicz-Bak "The LOLR Function after the Global Financial Crisis" (2016), IMF working paper No. 16/10, ISBN: 9781498355995/1018-5941,Assessed: May 17, 2017.

[418] Kidwell, David S. and Richard Peterson, *"Financial Institutions, Markets, and Money,"* 5th edition, 1993, Page No. 54

Although the foreign shareholders had no right to vote which can influence the operations of the bank but still it was a part of serious contentions that 70 percent of the shares were owned by foreigners till 1811.[419] The Bank of the United States (BUS) was obliged to perform its duties for both the public and private sectors. Disseminating the reserves in different parts of the country and controlling the supply of money through regulation was the most vigorous role of the BUS. It was privately owned and competing with other commercial banks to earn profit hence, it faced major opposition because it had the right to regulate the financial institutions at the same time when it was competing with them. In 1811 at the renewal of the Bank it possessed 20 percent of the total national paper currency and was the most liquid bank in the US.[420] However, the constitutional objections, foreign ownership, and public opinion regarding the bank led to its collapse and it could not get a renewal from Congress and get closed in 1811. The absence of the CB and its regulations allowed the commercial banks to operate in the US to increase the number of banknotes. The absence of a regulator and race in emitting new notes caused inflation in 1812-1815 and prices for all commodities started increasing. The prices were increased at an average of 13.3 percent per year during that time. Deteriorating financial conditions evinced the significance of having a CB hence, in 1815 the policymakers tried to establish a new CB but could not get consensus until 1816.[421]

The Second Bank of the US was established in 1816 and was empowered with the same powers and assigned the same obligations as the first bank. The issue of foreign ownership was curtailed, and foreign ownership was reduced to 20 percent. The CB was obliged to maintain a currency principle to control inflation, but it could not capitalize on it. The legitimacy of the bank was

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[419] Hixson, William F., *Triumph of the Bankers: Money and Banking in the Eighteenth and Nineteenth Centuries*, London: Praeger, 1993 Page No. 115

[420] Symons, Edward L., Jr. and James J. White, *Banking Law*, 2nd edition, 1984. Page No. 12

[421] Galbraith, John K., "*Money: Whence it Came, where it Went",* Boston: Houghton Mifflin, 1995. Page No. 13-58

challenged in the court and the supreme court of the US decided in McCulloch v. Maryland (1819) that the establishment of the second bank is constitutional. Chief Justice Marshall explicitly explicated that the act of establishing a CB is lawful and part of the supreme law of the state. The court reinforced its decision in the case of Osborn v. Bank of the United States (1824).[422] The second bank of the US was able to gain some control over the money supply and managed to maintain financial stability until 1828. Congress produced a bill for the renewal of the bank in 1832 and voted for it. However, President Jackson used his veto powers and rejected the bill of renewal of the second bank of the US. Thus, the Second Bank of the United States became dysfunctional in 1836 when its charter was expired.

After a long gap, the National Banking Acts of 1863 and 1864 were framed to implement the economic policies of the federal government on the banking system instead of establishing a new CB. The main purpose of implementing these acts was;

a) Establish a system for the national banks

b) Recognized one national currency

c) Create a secondary market for treasury resources.[423]

Although the National Banking Acts played a vital role in regulating the banking system of the US, they were unable to address the issues of inelastic currency and liquidity. The small banks in the rural areas were having their deposits in large urban banks. The rural banks require their liquidity in the planting season and the urban banks used their deposits in autumn. The larger banks had tried to fulfill the liquidity demand of the small rural banks but could not maintain it

[422] Hixson, William F., *Triumph of the Bankers: Money and Banking in the Eighteenth and Nineteenth Centuries,* London: Praeger, 1993 Page No. 117

[423] Ibid, Page No. 120-150

for long. Consequently, in 1873, 1884, 1893, and the wall street panic of 1907 the financial system of the US had faced financial crises.[424]

The Federal Reserve Act, 1913 was a major milestone in the history of the CB in the US which initially proposed a new model for the banking system. A Federal Reserve System was established which was owned by private banks and operated in the interest of the public. Bankers could run twelve banks however, those banks were supervised by the Federal Reserve Board consisting of the members of the secretary of the Treasury, the Comptroller of the currency, and other officials which the president can appoint. The Federal Reserve System was amended twice after the Great Depression and a financial crisis of the 1970s to address the loopholes. The Federal Reserve Bank of the US consists of twelve regional banks and plays the role of CB for the US. It was established under the Federal Reserve System which was framed in the Federal Reserve Act 1913. All twelve regional banks are jointly responsible to implement the monetary policy of the federal government. The system of Central Banking in the US is different from many other systems because the countries normally have one institution as the CB, but in the US twelve banks are operating as the CB under Federal Reserve System.[425]

7.4.1 LOLR in the US

The US has recognized the need for the role of LOLR to address the panic regarding the collapse of the financial system after a deliberate examination of financial crises. No financial system can survive without reserving the trust of its investors because if the investors feel unsafe in an economic environment, they will withdraw their money. The liquidity shortage of a financial

[424] Barry P. Bosworth, Aaron Flaaen, “America’s Financial Crisis: The End of an Era”, (Brooking, April 14, 2009), Accessed: November 05, 2018.
[425] The Federal Reserve System: Purposes & Function (Federal Reserve System Publications), Last Updated, October 25, 2018, Accessed: November 05, 2018.

institution can be addressed by selling illiquid assets or borrowing money from an institution that has the capacity to lend. However, if the panic regarding the system surges among the depositors it increases the demand for liquidity which makes it nearly impossible for the financial institution to survive. Thus, the intervention of LOLR is paramount for a financial system to survive the financial panic. The Great Depression and the recent financial crisis of 2007-2008 elucidated how much perilous financial panic among the depositors can be for a financial system.[426]

A deliberate appraisal of the failure of the banking system divulges that there are two major factors that can lead to its collapse. The first factor is internal which is mismanagement, dishonesty, and concealment of facts; and the second is external which includes changes in relative prices and major changes in overall prices. The changes in relative prices can affect the value of the banking assets immensely. However, an astute banking structure can prevent the failure of the banking system caused by the changes in relative prices. A banking system that allows the banks to have nationwide branches can absorb the effects caused by the changes in relative prices. In the 1920s nearly six thousand banks were collapsed which were operating in the small agriculture unit. Nonetheless, in Canada where the banking structure was different, the banks having nationwide branches remained persistent and no bank was closed. Additionally, several branches of the banks were closed which were operating in the small regions.[427] In elucidating the significance of the role of LOLR Friedman and Schwartz argued that had the Federal Reserve Bank timely acted as LOLR and injected the required amount of liquidity into

[426] Stanley Fischer, "The Lender of Last Resort Function in the United States" (2016), International Finnace, Vol. 2 Page No. 239-60.
[427] Michael D. Bordo, "The LOLR: some historical insights", [1989] Proceeding Federal Reserve Bank of Chicago, Page No. 177-197

the financial market in 1930 and 1931 the deteriorating value of the banking assets could have been avoided.[428]

A financial system must have a CB which can implement monetary policies of the government and regulate the financial institutions. The strength of a financial system always lies in the trust which its depositors have in it however, it is not surprising that a financial institution starts experiencing liquidity problems. Thus, the presence of an institution that can lend liquidity during a financial panic is inevitable and this is one of the main reasons behind the establishment of the Federal Reserve Bank so that it can play the role of LOLR for the financial institutions operating in the US.[429] The LOLR can protect the financial system and help to keep the interest of the investors. However, bad policies for of operation of this role and a continuous dependency of the financial institutions on its facilities can make it a cause of a major financial crisis.

FBR played an important role as a LOLR to overcome the damages of financial crises which occurred at different times. The acumen behind having a LOLR is to maintain stability in the financial system that is why in 2007-2009 the FBR had reduced its interest rate and lend liquidity to the financial institutions. The rationale behind reducing the interest rate was to encourage investment and maintain stability in the financial system. Thus, FBR has reduced its interest rate from 5.25% to 0- 0.25%.[430] However, mere the policy of lowering the interest rate was not enough to address the problem of the financial crisis because the commercial banks were illiquid and facing the problems of insolvency. A major deflation occurred in the prices of all illiquid assets of the financial institutions which had turned the situation into a crisis. The anxiety of the

[428] Ibid
[429] Stanley Fischer, “The Lender of Last Resort Function in the United States” (2016), International Finnace, Vol. 2 Page No. 239-60.
[430] Hansjörg Herr, Sina Rüdiger & Jennifer Pédussel Wu, “The Federal Reserve as LOLR During Subprime Crisis- Successful Stabilization Without Structural Changes”, (Institute for International Political Economy Berlin, Working Paper No. 65/2016), Accessed: November 07, 2018

financial crisis urged the CBs around the globe to take unprecedented steps. Therefore, even the BOE superseded the principle of Walter Bagehot to lend against good collaterals because it is very difficult to evaluate if the collateral is sound or not especially during the crisis. Therefore, the FBR injected $1.2 Trillion into the private sector aiming to maintain the stability of the financial system against the crisis.[431]

The financial system of the US was governed without having a CB before the formation of the Federal Reserve System. Initially, many economists were against the presence of LOLR due to the moral hazard problems pertaining to it. However, the evolution of the banking system and a deep study of financial crises revealed the needs of a financial system. The banking system of the US faced collapses of many banks however, the establishment of the CB and its role as a LOLR to control the effects of crises is appreciated. Before the occurrence of the financial crisis of 2007-2008, the role of LOLR was not properly legislated in the US like in other countries.[432] The FBR played the role of LOLR and used its discretionary powers in recusing the financial institutions. A deliberate examination of the operations of FBR enunciates that no hard and fast rule was deployed to carry out rescue operations. The acumen behind the presence of a LOLR is to strengthen the financial system against crisis and the CBs are empowered to take all necessary steps to ensure the stability of the financial system.[433]

The FBR hasn't restricted itself to the principles of Walter Bagehot that the CB should lend free but only to the institutions which are solvent and susceptible to provide worthy collaterals. Additionally, the CB must charge a high-interest rate and make this clear ahead of the financial

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[431] Stanley Fischer, "The Lender of Last Resort Function in the United States" (2016), International Finnace, Vol. 2 Page No. 239-60.

[432] Michael D. Bordo, "The LOLR: some historical insights", [1989] Proceeding Federal Reserve Bank of Chicago, Page No. 177-197

[433] Kenneth N. Kuttner, "The Federal Reserve as LOLR during the Panic of 2008", (Department of Economics, Williams Collage, December 30, 2008), Accessed: November 09, 2018

crisis on which ground the CB will intervene and rescue the financial institutions. Instead, the FBR has reduced its interest rate during the crisis and lent liquidity without bothering about the market value of the available collaterals. Thus, all the efforts of FBR were unhandy to deter the financial crisis nonetheless, it was able to minimise the damage. The liquidity was injected into the financial system to curtail the dread of the investors which is a core function of the role of LOLR. However, the FBR failed to enforce its policies appropriately which is also an integral part of LOLR because without implementing the financial policies regarding the assistance of LOLR it will itself turn out to be a major cause of the crisis.[434] The ignorance of the moral hazard problems and continuous lending of liquidity is more detrimental than the collapse of a financial institution. The conception of moral hazard problems is extensively explicated in chapter one of this research.

7.4.2 Legitimacy of LOLR in the US

After the inception of the banking sector in the economic system at a domestic and international level, the growth of the financial system became faster. The banks obtain money from the depositors who have in surplus and offer them interests for their deposit and lend it to the debtors and charge interest from them. This had made it easy for financial institutions and even for individuals to obtain debt and invest in their businesses. Doing business has become much easier in the presence of the banking sector than it was ever before. Although, mainly banks provide loans to their customers and charge interest other financial institutions and even natural persons who are susceptible to lend liquidity are also lending liquidity on personal relations or mutually understood stipulations. The financial institutions in the modern economic era are dependent on

[434] Hansjörg Herr, Sina Rüdiger & Jennifer Pédussel Wu, "The Federal Reserve as LOLR During Subprime Crisis-Successful Stabilization Without Structural Changes", (Institute for International Political Economy Berlin, Working Paper No. 65/2016), Accessed: November 07, 2018

each other, especially on banks to fulfill the problems of liquidity. However, in the anxiety of financial unrest banks sometimes face liquidity shortages to fulfill the demand for liquidity, or in some cases, they are reluctant to lend liquidity due to uncertain financial situations.[435]

Banks are providing tremendous services to financial institutions and contributing a lot to the economic growth of domestic and international systems. However, the avarice of earning more dragged them into the involvement of risky financial activities which consequently became a major cause of financial crises. The economic system of the US was governed for many decades without a CB nonetheless, the role of the CBs like BOE to handle the economic system against financial crises compelled the policymakers in the US to recognise the need for a CB. Furthermore, new banking regulation in the form of the Basel Accord which imposes certain obligations on the banking industries and requires them to maintain a minimum capital is strengthening the financial system around the globe.[436]

It was the time when the conception of having monetary policy was not invented. The financial panic of 1907 could be easily addressed by the presence of LOLR which could lend liquidity to the financial institutions which were enduring the liquidity shortfall. Thus, FRB was established to play the role of LOLR for the financial system of the US and ensures the trust of the investors in the system. The FBR played an admirable role and deter seasonal financial panics. However, its failure to protect the financial system from the detrimental effects of the great depression in the 1930s raised several questions on its capability to protect the system from the financial crisis.

[435] Gary Gorton, Andrew Metrick, "The Federal Reserve and Panic Prevention: The Roles of Financial Regulation and LOLR", [2013] The Journal of Economic Perspectives, Vol. 27, No. 4, Page No. 45-64
[436] Ellis W. Tallman, Elmus Wicker, "Banking and Financial Crises in United States History: What Guidance can History offer Policymakers?", (FBR of Cleveland Working Paper No. 10-09, August 2010), Accessed: November 07, 2018.

The Federal Reserve Act, 1913 has established the FBR and empowers it with certain authorities.[437]

- The Reserve Bank Committee (RBC) was established which consisted of the Secretary of the Treasury, the Comptroller of the Currency, and the Secretary of Agriculture which was mandated to establish Federal Reserve Cities not less than eight or more than twelve. The RBC shall divide the United States into districts and no district shall contain more than one federal reserve city. The district can be readjusted or more districts can be created by the federal reserve board however, the maximum number of districts can be twelve.[438]
- The RBC holds the power to seek assistance from the expert counsel where it is deemed necessary. Each district shall have a federal reserve bank and the RBC shall supervise everything to establish reserve banks in the districts. The federal reserve bank shall include the name of the city in which it is established for example "The Federal Reserve bank of Chicago".[439]
- Each Federal Reserve Bank constituted under the Federal Reserve Act by the RBC shall open its branches within the district in which the federal reserve bank is located. It is also empowered to open its branches in another district where the federal reserve bank has been suspended under section 2 of the federal reserve act, 1913.[440]
- The branches of the federal reserve banks shall be operated by the board directors under the rules and regulations approved by the federal reserve board. The directors of these branches shall not be less qualified than the directors of the federal reserve bank. The

[437] Benjamin Remy Chabot, "The Federal Reserve's Evolving Monetary Policy Implementation Framework: 1914-1923", (FBR of Chicago Working Paper No. WP-2017-1, January 19, 2017), Accessed: November 07, 2018.
[438] The Federal Reserve Act, 1913, Section 2
[439] Ibid
[440] The Federal Reserve Act, 1913, Section 3

bank is empowered to appoint four directors in these branches and three directors shall be appointed by the federal reserve board. All these directors will remain in their offices for the time the directors of the federal reserve bank and federal reserve board will. The federal reserve bank shall appoint one of the directors as the manager of the branch.[441]

- After the establishment of the federal reserve cities by the FRC under section two of the Federal Reserve Act, 1913 the handler of the currency shall issue a certificate stating the geographical jurisdiction of each federal reserve bank.[442]
- The Federal reserve board shall consist of seven members five of which shall be appointed by the president of the US after the consent of the Senate and Secretary of the treasury and the manager of the currency shall also be the ex officio members. All these five members appointed by the president shall be from five different federal reserve districts.[443]
- The members of the federal reserve board during the term in their office and after two years shall not be eligible to work in any federal reserve bank. Furthermore, two out of the five members appointed by the president shall be experienced in the field of banking or finance.[444]
- Each federal reserve bank is empowered to lend liquidity to the banking sectors which is working within its geographical jurisdiction if that bank can provide worthy collaterals, and shall charge a high-interest rate on its lending to discourage the dependency of the banking system on the federal reserve bank.[445] The banking institutions can seek liquidity assistance from the federal reserve bank when they are facing a liquidity

[441] Ibid
[442] The Federal Reserve Act, 1913, Section 4
[443] The Federal Reserve Act, 1913, Section 10.
[444] Ibid
[445] The Federal Reserve Act, 1913, Section 13

shortfall and no other financial institution is willing to lend them. However, it is explicitly stated in the Act that lending liquidity is a discretionary power of the federal reserve bank. The Federal Reserve Banks performed well in contrast to the performance of the first and second CB of the US. However, the great depression started a new debate on the capacity of the federal reserve banks. A deliberate evaluation of the causes of the great depression and the limitation of the federal reserve banks in addressing the financial issues revealed that the conditions to lend liquidity to the banking sector were very strict. Thus, the Federal Reserve Act, 1913 was amended and the lending powers of the FRBs were greatly expanded. In 1932, section 13.3 was added to the Act which waived certain obligations to lend liquidity and allowed the FRBs to lend liquidity not only to the banks but to nonbanks and private sectors. The strictness of providing worthy collaterals was also loosened. The growth of financial and banking sectors created several new challenges for federal reserve banks thus the banks were granted more powers to address the issue and protect the system from financial crises. Monetary Control Act, 1980 and Federal Deposit Insurance Corporation Improvement Act, 1991 further allowed the federal reserve banks to lend liquidity to the financial institutions when they need it.[446]

The vast powers of the FRBs to lend liquidity to the banks and nonbanks could not prevent the financial system of the US from the financial crisis of 2007-2008. It was argued by many economists that the ability of FRBs to lend liquidity even if the financial institution or the commercial banks seeking the liquidity were unable to provide worthy collaterals cause a

[446] Hansjörg Herr, Sina Rüdiger & Jennifer Pédussel Wu, "The Federal Reserve as LOLR During Subprime Crisis-Successful Stabilization Without Structural Changes", (Institute for International Political Economy Berlin, Working Paper No. 65/2016), Accessed: November 07, 2018.

financial crisis. The role of LOLR is good for the financial system however, a continuous dependency of the financial institutions on the liquidity support of the LOLR can harm the entire system. The Dodd-Frank Act, 2010 was framed after the recent financial crisis to impose certain restrictions on the discretionary powers of the FRBs to lend liquidity. The purpose of implementing the Dodd-Frank Act, 2010 is to reduce the need for LOLR.[447] Although certain restrictions are imposed on the facility of LOLR by the Dodd-Frank Act still the FRBs are empowered to act as LOLR in different ways. The FRBs can provide discount window loans to depository institutions, commercial banks, credit unions, thrift institutions, and foreign banks instead of directly lending liquidity. Such loans can be provided to individual institutions that are facing problems or to the banking sector to deter the stress of the crisis.[448] The Dodd-Frank Act, 2010 has not restricted the FRBs from playing the role of LOLR but imposes some conditions, it requires the banks to publish the information regarding the discount windows and the details of the debtors. Walter Bagehot's rule to lend liquidity freely but only to the institutions which can provide good collaterals is reinforced through the Dodd-Frank Act, 2010.[449]

7.5 Comparison of the Systems of LOLR in UK and US

The banking system of the UK is one of the oldest and developed systems in the world. Many countries have used this system as a model while establishing their banking system. The banking system due to its contribution to the evolution of societies and economic systems has turned out to be an integral part of the financial system. The conception of borrowing money for business or personal purposes is far older than the history of banking. However, lending and borrowing were

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447 WJ Dodwell, "Reforms of the Dodd-Frank Act and its Implication", (Review of Banking & Financial Law, Vol, 36, 2016-2017), Accessed: November 10, 2018.

448 Gary Gorton, Andrew Metrick, "The Federal Reserve and Panic Prevention: The Roles of Financial Regulation and LOLR", [2013] The Journal of Economic Perspectives, Vol. 27, No. 4, Page No. 45-64

449 Stanley Fischer, "The Lender of Last Resort Function in the United States" (2016), International Finnace, Vol. 2 Page No. 239-60.

merely based on personal relations, and the conditions varied from case to case. A person, legal or natural could only obtain debts on his acquaintances which was providing opportunities only for a smaller part of the society.[450] Although, the beginning of the banking system was not much different than the pre-banking rituals because banks were mainly owned by private individuals and they offered loans on personal relations. Due to the significance and input of the banking system in the financial system, serious contentions were incepted regarding its capacity and rules of businesses. It was recognized that the banking system can only continue to perform well if it will be properly regulated. Thus, the conception of a CB was invented which can regulate the banking system and play the role of a surveillant. The concept of having a LOLR was also an imperative element in establishing a CB.[451]

In the UK the banking system because of its services and input in the growth of national income was warmly accepted. The banks started their business by obtaining deposits on a relatively lower interest rate and lent it to the borrowers at a higher rate for business purposes in the beginning, and for personal matters too afterward. Banks became a trustworthy institution for the deposition of saving and getting interests as well. The acumen behind operating a banking system is to earn money therefore many commercial banks started to get involved in risky but profitable ventures. The loopholes in the banking regulations were fully used by the banking system for their interests. Eventually, after a tremendous start due to insured loans and the failure of the debtors to return money banking sectors around the world started collapsing.[452]

[450] Neslihan Dincbas, Tomasz Kamil Michalski, Evren Ors, "Banking Integration and Growth: Role of Banks' Previous Industry Exposure", (HEC Paris Research Paper No. FIN-2015-1096), (July 21, 2017), Accessed: October 05, 2018.
[451] Heidi Mandanis Schooner, "CBs' Role in Bank Supervision in the United States and United Kingdom", (Brooklyn International Law Journal, January 2003), Accessed: October 06, 2018.
[452] Marc Flandreau, Stefano Ugolini, "Where it All Began: Lending of Last Resort and the Bank of England During the Overend-Gurney Panic of 1866", (Norges Bank Working Paper No. 2011/03, May 27, 2011), Accessed: August 11, 2018

The policymakers had concluded that there must be a CB in each financial system that shall regulate the banking system while understanding the needs of the system. The BOE was a private bank and was carrying out its operations to earn money hence, its ability to work as a regulator was questioned while remaining a competitor in the market. The role of LOLR is also older than the history of CB but this was also played based on personal relations. Not only banks but the financial institutions were helping each other in difficult times by lending liquidity. However, these lending operations were purely based on mutual understandings, but it was recognized after the collapse of several banks that the system cannot be governed without having an official LOLR. The CB which holds several powers to regulate the system and emit new notes was also assigned with the duty of playing the role of LOLR for the financial institutions which were facing financial problems.[453]

On the other hand, in the US right after its independence first CB was established in 1791 which was empowered to regulate the financial market. In the US the concept of having a CB was not warmly accepted because it was a bank owned by not only private individuals but nearly 40% of shareholders were foreigners. The banking system of the US is different from the system of the UK because unlike the UK's banks which lent to the financial institutions the US banks were lending to the agriculture industry. The first CB of the US was also mandated to lend liquidity to the banks which were facing liquidity shortfall. However, even after lending liquidity to many banks, the CB was not able to protect against the collapse of banks. After its failure, the second CB was established in 1816, however, unfortunately, nearly 20% of shares of this bank were also owned by foreigners. The second CB of the US was also established to strengthen the system not

[453] Michael Anson, David Bholat, Miao Kang, Ryland Thomas, "The Bank of England as LOLR: New Historical Evidence from Daily Transaction Date", (Bank of England Working Paper No. 691, November 17, 2017), Accessed: March 03, 2018.

only with regulations but also through lending liquidity to the banks that were facing problems. The Second CB of the US was not backed by the politicians that is why eventually, it also failed and was abolished in 1836.[454]

The US banking system was governed without a CB for more than seventy years before the establishment of the Federal Reserve Bank in 1913. The banking collapse in the US was more severe than any other competitive country in the nineteen-century. After a long debate, the policymakers of the US had concluded that the banking system cannot survive without having a LOLR which can ensure the trust of the investors and lend liquidity to the banks which are merely illiquid not insolvent and can be protected through injecting liquidity.[455] A Federal Reserve System (FRS) was established under the Federal Reserve Act, 1913 which was mandated to establish a CB for the US. The banking system of the US is very diverse and big as compared to the banking system of the UK. The FRS has divided the United States of America into twelve parts and established twelve banks that are empowered to operate as the CB of the US. A frequent dependency of the financial institutions on it can harm the system even more severely than the collapse of an institution.[456]

The FRB was established mainly to regulate the banking system of the US and lend liquidity to the banks to protect them from collapsing. Section 13 of the Federal Reserve Act, 1913 empowers the FRB to act as the LOLR for the banking sector in case of a financial crisis. The framework which was framed by Walter Bagehot was adopted to empower the FRB for playing the role of LOLR. The FRB played its role admirably and curtailed sessional financial panics

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[454] Barry P. Bosworth, Aaron Flaaen, "America's Financial Crisis: The End of an Era", (Brooking, April 14, 2009), Accessed: November 05, 2018.

[455] Kidwell, David S. and Richard Peterson, *"Financial Institutions, Markets, and Money,"* [1993] 5th edition, Page No. 54

[456] Vincent Bignon, Marc Flandreau, Stefano Ugolini, "Bagehot for Beginners: The Making of LOLR Operations in the Mid-Nineteenth Century", (March 30, 2016), Accessed: April 24, 2018.

until the great depression. The FBR was allowed to lend liquidity only to the banks on the grounds if they can provide good collateral. However, after the great depression the federal reserve act, 1913 was amended and section 13.3 was added to it. The FRB was authorised to lend liquidity to the nonbanks and private sector which required liquidity assistance. The requirement of producing worthy collaterals for getting liquidity support was also loosened. The FRB played the role of LOLR effectively for many financial institutions and protected them from collapsing after getting a mandate to lend freely.[457]

The BOE has played a vital role in maintaining the stability of the financial institutions operating in the UK in the recent financial crisis of 2007-2008. The BOE lends liquidity to many financial institutions and on many occasions, it bought the illiquid assets of the financial institutions to curtail the panic regarding the collapse of the institution and thereby ensured the trust of the investors in the system. The BOE superseded the principles proposed by Walter Bagehot for the role of LOLR and lent to some financial institutions without demanding good collaterals.[458] The unprecedented role of the BOE in lending liquidity helped the financial institutions to survive the financial crisis. Notwithstanding, many institutions were refused to be rescued by the BOE because the bank was of the opinion that those financial institutions were insolvent, and injecting liquidity will not help to protect them. The BOE still enjoys several discretionary powers in playing the role of LOLR because no restrictions are being imposed on its powers so far.[459]

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[457] Hansjörg Herr, Sina Rüdiger & Jennifer Pédussel Wu, "The Federal Reserve as LOLR During Subprime Crisis-Successful Stabilization Without Structural Changes", (Institute for International Political Economy Berlin, Working Paper No. 65/2016), Accessed: November 07, 2018.
[458] Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.
[459] Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (BIS Paper No. 79), Accessed: Feb 03, 2018.

The Federal Reserve Bank played a vigorous role as a LOLR to protect the financial institutions from collapsing in the recent financial crisis of 2007-2008. The FRB implements the monetary policy of the State on its financial institutions. To ensure the trust of the investors the FRB had injected $1.2 trillion into the financial system and lend to the financial institutions which were not capable to provide good collaterals. However, unlike the BOE the discretionary powers of FRB are amended after the financial crisis through the Dodd-Frank Act, 2010. Although, the powers of FRB are amended after the financial crisis still the role of LOLR played by the bank in curbing the effects of the crisis is recognized. The significance of the role of LOLR is accepted and to make it more efficient it is further regulated to maintain stability in the financial system.[460]

7.6 Examples of the LOLR operations from the UK and USA

The essential characteristics of LOLR can be illustrated by the evaluation of the rescue operations conducted by the CBs in different eras and jurisdictions. LOLR is not an institution that is assigned the duty to lend liquidity during the financial crisis, nor it has a mere duty to impart liquidity to the financial institutions which are experiencing a shortfall of liquidity. Among many other duties of CBs LOLR is also a vital part. Examples of the UK and USA unveil the progression of this role which started from injecting liquidity into the financial system in times of financial panic and has turned out to be an indispensable part to govern the economic system.[461] The LOLR ensures the trust of the investors in the system by injecting liquidity, buying illiquid assets of financial institutions, and regulating the financial system. The Bank of England and Federal Reserve Bank played the role of LOLR for financial institutions to deter the

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[460] WJ Dodwell, “Reforms of the Dodd-Frank Act and its Implication”, [2017] Review of Banking & Financial Law, Vol, 36 pp. 21

[461] Dietrich Domanski, Richhild Moessner, William R. Nelson, “CBs as LOLR: Experiences During the 2007-2010 Crisis and Lessons for the Future”, (FEDS Working Paper No. 2014-110, January 11, 2015), Accessed: November 13, 2018

financial crises at different times. The fruitful outcomes of this role made it an integral part of the system and obliterated the contentions that the presence of LOLR is detrimental for the system due to the moral hazard problems pertaining to it.[462]

The Bank of England has played an imperative role as the LOLR to strengthen the financial institutions during the financial crises of 1847, 1857, and 1866. The role which the BOE has played was not based on the principles framed by Henry Thornton and Walter Bagehot. The BOE dealt with the crises on the basis of the reasons behind it and lent liquidity to the financial institutions which varied from case to case. Initially, the BOE had only provided liquidity assistance to its top borrowers instead of injecting it into the system. It can be examined that many financial institutions were rescued without even demanding the collaterals. The principle of charging a high-interest rate was followed in the crises of 1857 and 1866. However, it was superseded in the crisis of 1847.[463]

The role of LOLR played by the BOE was criticised by many economists who argued that there must be a similar approach for all financial institutions while acting as LOLR. Otherwise, this facility will only remain between the bank and its favorite customers. The presence of LOLR faced criticism due to the moral hazard problems relating to it. Thus, the BOE had used multiple approaches to curb the effects of moral hazard problems. A thorough study of the role of BOE as LOLR imparts that the principles of Walter Bagehot were used on many incidents but not strictly followed all the time. Many financial institutions were not rescued because the directors of the

[462] Ibid

[463] Michael Anson, David Bholat, Miao Kang, Ryland Thomas, "The Bank of England as LOLR: New Historical Evidence from Daily Transaction Date", (Bank of England Working Paper No. 691, November 17, 2017), Accessed: March 03, 2018.

BOE were of the opinion that those institutions were insolvent. The role of LOLR during the financial crisis of 2007-2008 has played a vital role in its progression.[464]

7.6.1 Northern Rocks Run

From 14th September to 17th September Northern Rocks was the first bank to run due to the liquidity crisis in the United Kingdom since Victorian times.[465] The directors of Northern Rocks were responsible for the difficulties that the company has faced since August 2007. A reckless business model was pursued by the directors which were mainly reliant on wholesale fundings. It was the regulatory failure of the Financial Service Authority to ensure that Northern Rocks did not pose a systematic risk.[466] The Chancellor of the Exchequer reported that the concerned bank is posing a systematic risk to the financial system, thereby, immediately authorised the BOE to intervene. However, the Tripartite authorities failed to materialised an adequate support plan by not announcing the Government's guarantee on the deposits of the Rocks.[467] Northern Rocks had, 4,811 full-time and 1,125 part-time employees at the end of 2006.[468] It was formerly building security nonetheless, it was demutualised on 1st October 1997. It had assets of £101 billion by the end of 2006.[469] In the Community Report, it has described itself as "a specialist lender", thereby 89.2% of its assets were residential mortgages.[470]

On 9th August 2007 due to the global shock to the financial system in which the American sub-prime mortgage was the one burnt badly, the banks' traders noted a "dislocation in the market"

[464] Chris Giles, "Bank of England Defends Response to Financial Crisis after Criticism", (Financial Times Economics Editor, April 10, 2018), Accessed: November 13, 2018.
[465] HC Deb 26 January 2008, Vol 1.
(House of Commons Treasury Committee, The Run on the Rocks, fifth Report of Session 2007-2008).
[466] HC Deb 26 January 2008, Vol 1.
[467] Ibid
[468] Northern Rock, Annunal Report 2006, p 72
[469] Northern Rock Annunal Report 2006, p 59
[470] Northern Rock Annual Report 2006, p 9 & 82

for their funds. The worldwide liquidity crisis surprised Northern Rock as well. They were expecting to maintain the attraction of funds by using their low-risk mortgages but failed to do so. It could not foresee the closing of its financial markets simultaneously. It had its funding programs in the United States, Europe, Far East, Canada, and Australia, thereby, its administration was careless because it was unlikely that all of the markets will close simultaneously.[471] The Governor of the BOE stated that the Northern Rock did not bother to have insurance against any potential trouble and referred to a bank of the United States Countrywide that too had faced liquidity crisis due to the US's sub-prime crisis. It had paid millions of dollars for its liquidity insurance therefore; it was able to claim that insurance during the crisis and maintained to draw down $11.5 billion of committed credit lines.[472]

In the case of Northern Rock, the BOE has used an approach of nationalization of the institution to avoid the effects of moral hazard problems. It sometimes becomes difficult for the CB to refuse liquidity assistance to a financial institution even if the institution is insolvent and unable to provide worthy collateral. Thus, the CBs use their discretionary powers and rescued such institutions because they have an immense impact on the system and their collapse can deeply harm the entire system. The acumen behind having a LOLR is not to protect the institutions which are facing liquidity challenges but to protect the system and for that purpose the CBs protect the institutions.[473] That is why the BOE did not provide free liquidity to the Northern Rock. There is a regulatory failure as well in the collapse of the concerned bank. The Financial Services Authority has acknowledged that the business model of the Northern Rock was clearly

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[471] HC Deb 26 January 2008, Vol 1.
(House of Commons Treasury Committee, The Run on the Rocks, fifth Report of Session 2007-2008).
[472] HC Deb 26 January 2008, Vol 1.
(House of Commons Treasury Committee, The Run on the Rocks, fifth Report of Session 2007-2008).
[473] Roman Tomasic, "The Rescue of Northern Rock: Nationalization in the Shadow of Insolvency", (2009) Accessed: May 5, 2018.

indicating the risks associated with it. Rapid growth as a company and a fall in its share price since February 2007 were the clear signs of high risk. However, as a regulator, the FSA failed to tackle the basic impediments in its funding model and did nothing to prevent the problems.[474]

The Bank of Northern Rock started facing liquidity problems and its failure could escalate the detrimental effects of the financial crisis of 2007-2008. The bank tried to fulfill the demand for liquidity through the sale of its illiquid assets however, the anxiety of financial crisis and panic among the investors made it difficult for it to survive. The moral hazard problems have remained in the debates since the inception of LOLR and many economists have proposed several methods to curtail the effects of moral hazard problems.[475] The CB should provide liquidity assistance to all financial institutions which are facing troubles, but its assistance should be conditional otherwise the frequency in the operations of LOLR can ignite a bigger disaster. The CB should demand collaterals from the institutions before imparting liquidity and the value of the collaterals must be able to fulfill the cost of liquidity support offered by the CB. The liquidity support should only be for illiquid but solvent financial institutions. Nonetheless, appraisal of the previous financial crises enunciates that it is hard to recognize that if the financial institution is merely illiquid or it is facing the problems of solvency.[476]

Additionally, it was suggested that CBs must make their LOLR policy clear before the crisis and charge a high penalty rate on the support of liquidity.[477] The acumen behind these suggestions was to minimise the moral hazard problems. However, if a financial institution is large enough

[474] HC Deb 26 January 2008, Vol 1.
(House of Commons Treasury Committee, The Run on the Rocks, fifth Report of Session 2007-2008).
[475] Patrik J. McConnell, “Northern Rock - The Group that Thinks Together, Sinks Together”, (December 20, 2012) Accessed: May 5, 2018.
[476] Hyun Song, “Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis”, Accessed: May 5, 2018.
[477] See Chapter two (Walter Baghot)

that its failure can cause a financial crisis, but the institution is unable to comprehend the policies imposed by the CB on the support of LOLR. The CB will still be compelled to rescue those institutions because it is the responsibility of the CB to protect the system. In such a situation all the principles to curtail the effects of moral hazard problems seemed unhandy. Notwithstanding, the BOE used a new approach in the case of Northern Rock and nationalised it by using the powers it was granted in the Banking Act, 2008. The Act was enacted in special circumstances that empower the CB to take all appropriate measures which are necessary to maintain stability in the financial system.[478]

Nationalisation is also a proposed method to minimise the effects of moral hazard problems in a case when the LOLR has no other option but to rescue a financial institution. The Northern Rock Bank has started facing a major liquidity crisis in September 2007. Initially, the bank tried to handle the situation by converting its illiquid assets into liquid but eventually, it reached a situation where the only option left for its survival was the intervention of the BOE as the LOLR. The evaluation of the situation of the concerned bank revealed that the bank is badly administered and heavily involved in risky activities without bothering about the repercussions. In past, the BOE has used its discretionary powers and refused to play the role of LOLR for many financial institutions that were not meeting the standards of obtaining such support.[479] However, the case of Northern Rock was special because the directors of the BOE after thoroughly examining its impact on the system concluded that its failure will badly affect the entire system. A whopping amount of £28 Billion was injected to rescue the concerned bank. However, the bank was nationalized in the process of rescuing. The BOE has used the same

[478] Andrew Hauser, "LOLR Operations During the Financial crisis: Seven Practical Lessons from the United Kingdom", (BIS Paper No. 79e, October 08, 2014), Accessed: November 14, 2018.
[479] Roman Tomasic, "The Rescue of Northern Rock: Nationalization in the Shadow of Insolvency", (2009) Accessed: May 5, 2018.

approach for nonbanks financial institutions and nationalized them e.g. Rolls Royce (1971) and British Leyland Ltd (1975). There are many cases in which the BOE has refused to play the role of LOLR for many financial institutions which are illustrated in the chapter of critical evaluation of this research.[480]

The role of the Federal Reserve as the LOLR contributed a lot in handling the damages of the financial crises of different eras. The banking system of the US faced more financial crises than any other developed country. It was argued by economists that the banking system of the US was running without a CB which made it more vulnerable because it is examined that trivial liquidity issues resulted in the collapse of the banks which could be addressed by injecting liquidity. The banks were lending liquidity to each other during financial troubles but the absence of an official LOLR let the financial dreads spread among the investors. Consequently, many banks were collapsed.[481] The inception of FRB has strengthened the financial system of the US and frequent failure of banks was stopped. The FRA is also empowered to lend liquidity to the financial institutions which can provide collateral. A financial institution, no matter how big, can be denied liquidity assistance by the CB if it fails to meet the required criteria for obtaining the support of LOLR. Although, it is the responsibility of each CB to protect the system against the financial crisis if the CB is having an opinion that the institutions which are demanding liquidity support are insolvent and liquidity support will not protect it from collapsing it can use its discretionary powers and abstain from acting as LOLR.[482]

[480] Dalvinder Singh, "U.K. Approach to Financial crisis Management", [2010] Transnational Law & Contemporary Problems, Vol, 19, Page No. 872-927.
[481] Jon R. Moen, Ellis W. Tallman, "Why Didn't the United States Establish a CB until after the Panic of 1907?", (FBR Atlanta Working Paper Series No. 1999-16, January 25, 2015), Accessed: November 12, 2018.
[482] John A. Weinberg, "The Pursuit of Financial Stability: Essays from the Federal Reserve Bank of Richmond Annual Reports", [2015] Economic Quarterly, Issue 1Q, Page No. 1-4.

Lehman Brothers, a banking company was established in 1850 and it continued to operate successfully before September 2007. It was regarded as one of the largest banking companies in the US hence, it had a deep impact on the system. The concerned company started facing financial troubles in 2007 and like all other financial institutions it had tried to overcome the issue. However, the administration of Lehman Brothers had reached a stage where the company can only be protected from collapsing by the intervention of FRB as LOLR. The case played a significant role in the progression of LOLR not only in the US but around the globe. The main criticism of the role of LOLR was that it is nothing but a rescue package for those financial institutions which are badly governed. It was evinced in this case that the support of LOLR is not for particular financial institutions but the entire system. In the banking history of the US, the bankruptcy of Lehman Brothers is regarded as the biggest one.[483]

This case has established that merely lending liquidity to the financial institutions which are facing the shortage of it is not the entire role of LOLR, but it can protect the system by taking more appropriate steps. Furthermore, it has also demonstrated that it is not necessary for the CBs to impart liquidity to the large institutions even if they are unable to meet the standardized criteria. The demand for liquidity by the investors urged the concerned company to seek assistance from the FRB. However, after a deliberate perusal of the case of Lehman Brothers, the FBR decided to use its discretionary powers and refused to recuse it. Although it was understandable that if the FBR will refuse to rescue the concerned company it will collapse and leave adverse effects on the system, the FRB decided not to intervene as LOLR.[484]

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483 John M. Kawaku Mansha, "The Failure of Lehman Brothers: Causes, Preventive Measures and Recommendations", (March 2, 2015), Accessed: November 08, 2018.

484 Kwabena Boamah, "The Collapse of Lehman Brothers: How it Happened?", (August 15, 2011), Accessed: November 08, 2018.

The directors of the FBR argued that administrative flaws of the Lehman Brothers influenced their decisions to refuse the liquidity support to it.[485] Deceptive matters were used to conceal the actual situation of the company from the stakeholders. Dodgy financial statements were made to show that the company is earning money by using the Repo 105 Procedure[486]. Shareholders of a company play the role of surveillant and make the directors accountable for their misdeeds. However, the directors of the concerned company had established an equivocal system so that shareholders cannot understand the business activities of the company. Investing in the sub-prime mortgage has turned out to be a major cause of the failure of many banking companies in the US during the financial crisis of 2007-2008. Lehman Brothers had also invested in sub-prime mortgages even after being cautioned by the FRB.[487]

The FBR was criticized for its decision to abstain from playing the role of LOLR for Lehman Brothers but its decision made it vehemently clear that the support of LOLR is not for the financial institutions no matter how large they are who are unable to meet the regulatory requirements. The acumen behind this decision was to curtail more hazard problems and sent a resounding message to the administrators of the financial institutions that they will only be recused if they will be able to satisfy that they were not involved in risky activities without considering the repercussions. Although it was a failure of a large financial institution that was influential in the system, it left several lessons for the CBs around the world which are facing criticism because of the moral hazard problems.[488]

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485 John M. Kawaku Mansha, “The Failure of Lehman Brothers: Causes, Preventive Measures and Recommendations”, (March 2, 2015), Accessed: November 08, 2018.

486 An accounting trick in which a company classifies a short-term loan as a sale and subsequently uses the cash proceeds from said sale to reduce its liabilities.

487 Dimitios V. Sisko, “Lehman Brothers Case: Failure, Prevention and Recommendations”, (November 22, 2013), Accessed: November 10, 2018.

488 Michael J. Fleming, Asani Sarkar, “The Failure Resolution of Lehman Brothers”, (Economic Policy Review, Forthcoming, April 10, 2014), Accessed: November 10, 2018.

On the other hand, the FRB has played the role of LOLR for American International Group (AIG) which is also an important example because of its comparison with the case of Lehman Brothers. AIG is not only one of the largest companies in the US, but it is also ranked among one of the largest companies in the world which are operating in more than 130 countries.[489] The main business of this company was to provide insurance to the financial institutions and several banks were also insured by it. This company was playing the role of LOLR for the financial institutions which were its customers. The company provided funds to the institutions which faced financial troubles. However, it was governing its business on certain rules and only offered its insurance to the institutions which were adhering to its rules. The financial crisis of 2007-2008 damaged many financial institutions around the world. Hence, many banks and financial institutions which were insured by AIG started facing a liquidity crisis and started claiming their insurance from the company.[490]

A frequency in the failure of banks and financial institutions which were insured by AIG has created liquidity shortfall for the company. Panic among the investors due to the financial crisis has made the situation worse and made a situation for the company in which it was unable to fulfill the demand of liquidity even after a swift sale of its illiquid assets. After utilizing all the possible resources and effectors the management of the AIG decided to seek assistance from the FRB to play the role of LOLR and impart liquidity. This case was not directly handled merely by the FBR but due to the emergency created by the financial crisis, it was presented before the Senate which after a deliberate appraisal of the facts of the case opted to rescue it. However, it

[489] Robert L. McDonald, Anna L. Paulson, "AIG in Hindsight", (April 2005), Accessed: November 09, 2018.
[490] Anelize Slomp Aguiar, "The Controversies over the AIG's Collapse", (July 1, 2009), Accessed: November 10, 2018

was not merely rescued because it was too large and had a deep impact on the system. The facts of this case were different from the case of Lehman Brothers.[491]

AIG was not involved in risky activities nor it was managed by a corrupt administration. The company was not using any techniques to avoid the implementation of regulations. The company was running its business without bothering about the repercussions just because of the confidence of having the FBR at their back as LOLR. This example is very important in the history of bailouts by the CBs which left several lessons for the financial institutions. In the modern business environment, the liquidity crisis can be ignited due to many reasons and cause a situation for a financial institution in which the institution requires liquidity support from the LOLR.[492] Thus, the intervention of LOLR varies from case to case as illustrated above in this part of the research. In many cases, the liquidity support was denied on the grounds that the financial institution which was seeking the assistance could not provide collateral. On the other hand, many institutions were rescued even without demanding the collaterals. Therefore, after the recent financial crisis, the US has regulated the role of LOLR by enacting the Dodd-Frank Act, 2010. However, in the UK the BOE still possesses several discretionary powers while acting as LOLR.[493]

7.7 Lessons from the System of UK and US for Pakistan

The role of the banking system and financial institutions in the growth of a national income cannot be denied because after the inception of the banking system the growth has become much faster than it was ever before. However, the banking system has its weaknesses as well which

[491] A. V. Narshimha Rao, “AIG Crisis: Impact on Insurance Business with Special Reference to China, Japan and India”, (May 17, 2012), Accessed: November 10, 2018.
[492] Robert L. McDonald, Anna L. Paulson, “AIG in Hindsight”, (April 2005), Accessed: November 09, 2018.
[493] Matthew Schoenfeld, “Aligning Incentives: How to Make Dodd-Frank Work”, (May 10, 2012), Accessed: November 11, 2018.

can be detrimental for the economic system especially in an environment of financial panic. Dread among the depositors is the most hazardous thing for the financial system because it drastically increases the demand for liquidity and leaves no window for the financial system to survive without seeking liquidity assistance from other institutions that can provide liquidity.[494] CBs are inevitable to implement the financial policies of the State and regulate the banking and other financial institutions. Additionally, ensuring the trust of the investor and help the financial institutions by injecting liquidity in times of financial emergencies is also an integral part of the duties of CBs.[495]

The SBP is established on the model of the BOE and is empowered to protect the financial institutions by lending liquidity against a crisis. The banking system of Pakistan is emerging which can learn from the experiences of the BOE and FRB because they have played an important role to strengthen the financial system of the UK and the US during crises, respectively. It was recognized by the policymakers of the UK in nineteen-century that the collapse of the financial institutions can be prevented if the BOE intervene and lend liquidity.[496] Furthermore, the issue of moral hazard problems has turned out to be the main hindrance to the evolution of the role of LOLR. Henry Thornton (1802) and Walter Bagehot (1873) suggested the framework for the operations of LOLR. In the UK it was observed that the BOE possessed

[494] Dietrich Domanski, Richhild Moessner, William R. Nelson, "CBs as LOLR: Experiences During the 2007-2010 Crisis and Lessons for the Future", (FEDS Working Paper No. 2014-110, January 11, 2015), Accessed: November 13, 2018.
[495] Gillian Tett, "Have We Learnt the Lessons of the Financial Crisis?", (Financial Times, August 31, 2018), Accessed: November 13, 2018.
[496] Michael Anson, David Bholat, Miao Kang, Ryland Thomas, "The Bank of England as LOLR: New Historical Evidence from Daily Transaction Date", (Bank of England Working Paper No. 691, November 17, 2017), Accessed: March 03, 2018.

several discretionary powers as the LOLR as was discussed above in the example of Northern Rock.[497]

The BOE used the basic principles of LOLR in several cases and refused to recuse the banks and many financial institutions which were unable to provide good collaterals. Notwithstanding, it can also be realized that where it became essential to protect a financial institution the failure of which could harm the entire system, the BOE has superseded the rules and recused the financial institutions without bothering about the availability of the collaterals. A frequent dependency on the financial institutions and their inability to produce collaterals can also harm the system even more severely. Thus, to curtail the effects of moral hazard problems in the case of Northern Rock Bank the BOE has realised that the failure of the concerned bank can contribute a lot to the effects of the financial crisis that is why the BOE opted to rescue it and imparted liquidity.[498] However, the concerned bank was heavily involved in risky activities and could not provide collateral. Therefore, instead of leaving the money provided by the BOE in the administration of the bank, they decided to nationalize it. In the UK the LOLR is authorized to take all appropriate steps which are necessary to deter the financial crisis. There are no hard and fast rules imposed on the powers of BOE while playing the role of LOLR. To establish an invulnerable economic system the government of the UK has enacted regulations to make the banking and financial system transparent.[499]

Moreover, the role of the FRB as a LOLR in the financial crises also provides insights into the establishment of an economic system that addresses the challenges of modern financial and

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[497] Andrew Hauser, "LOLR Operations During the Financial crisis: Seven Practical Lessons from the United Kingdom", (BIS Paper No. 79e, October 08, 2014), Accessed: November 14, 2018.
[498] Chris Giles, "Bank of England Defends Response to Financial Crisis after Criticism", (Financial Times Economics Editor, April 10, 2018), Accessed: November 13, 2018.
[499] Andrew Hauser, "LOLR Operations During the Financial crisis: Seven Practical Lessons from the United Kingdom", (BIS Paper No. 79e, October 08, 2014), Accessed: November 14, 2018.

banking institutions. Before the establishment of FBR, the system of the US was governed without having a CB for a long time but eventually, the policymakers had concluded that a CB is inevitable for a banking system to maintain stability against financial panics. The FBR's powers to act as LOLR was strictly based on the principles that it could only lend liquidity to the banks which can provide good collaterals. However, after the great depression, the powers of the FBR were revisited and enhanced through an amendment in the Federal Reserve Act, 1913. It was then allowed to recuse the non-banking institutions as well and the restrictions regarding the collaterals were also loosened. The powers of FBR as a LOLR were again amended after the recent financial crisis of 2007-2008 by the enactment of the Dodd-Frank Act, 2010.[500]

In Pakistan, the SBP plays the role of LOLR for its financial institutions which is empowered by the State Bank of Pakistan Act, 1956. The SBP can only impart liquidity to the financial institutions which provide worthy collaterals. The laws relating to the powers of the SBP as LOLR are explained in chapter four of this research. The financial institutions of Pakistan were recused by its CB many times, however, a frequent engagement in playing the role of LOLR caused stability issues for the SBP. Therefore, the IMF was asked to play the role of LOLR for the SBP.[501] Pakistan must bring transparency in its banking and financial institutions and stop imparting liquidity to the public financial institutions which are not returning it and surging financial pressure on the CB. Pakistan can learn from the example of Northern Rock Bank in which the BOE could not let it collapse but at the same time was reluctant to provide liquidity to the same administration. Therefore, they decided to nationalize it and save the institution and the money which was used in rescuing it. Pakistan must also learn from the system of the US and

[500] William R. Nelson, "Lessons from LOLR Actions During the Crisis: The Federal Reserve Experience", (BIS Paper No. 79d, October 08, 2014), Accessed: November 14, 2018.

[501] Sara Cheema, "The IMF: Pakistan's History and Future with The LOLR", (Eurasia Review News & Analysis, June 19, 2017), Accessed: November 13, 2018.

implement the laws like Dodd-Frank Act which can regulate the powers of the CB while acting as LOLR. The LOLR for Islamic banking in Pakistan is also not decided yet which needs to be addressed immediately.[502] The approach of SBP was not befitting as mentioned in the above case study. Additionally, the evaluation of the examples of the UK and USA provides many lessons to inform regulatory reforms in Pakistan.

7.8 Functions of the Lender of Last Resort

In the modern economic system, it is a common fact that financial institutions can face liquidity shortages and it is only the CB of the state which is empowered to generate liquidity to fulfill its demand. There is no separate institution that is authorised to exercise the powers of LOLR. It is a vigorous part of the duties of CBs at the domestic level and IMF, which is a branch of the World's bank, performs the duties of LOLR at the international level.[503] Usually, the understanding of LOLR is that the CBs intervene by lending liquidity to the financial institutions which are in need of liquidity. The uncertain situation of the financial system and surging panic among investors invoke the operations of LOLR to enhance the resistance of the financial institutions against a crisis.[504] However, the impartation of the liquidity by private individuals or the institutions to the financial markets cannot attribute the role of LOLR to them because it is a part but not the entire function of this role. This role is not limited only to provide liquidity but has several functions. The stability of the financial system lies in the trust of the depositors,

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502 Asad Sayeed, Zubair Faisal Abbasi, "The role of CBs in Supporting Economic Growth and Creation of Productive Employment: The case of Pakistan", Employment Policy Department, Employment Working Paper NO. 171, 2015), Accessed: November 14, 2018.

503 Henery C. Wallich, "Central Banks as Regulators and Lenders of Last Resort in an International Context: A View from the United States" Accessed: March 13, 2018.

504 Curzio Giannini, "The IMF and LOLR Function: An External View", (1999), Finance & Development, Vol 36, No.3, Page 1.

however; ups and downs are part of its activities.[505] In the modern financial systems, the institutions are working with each other hence they provide loans to the financial institutions which are facing problems. However, in some circumstances when they are unable to handle the issue and CB realizes that it could be detrimental for the system it operates as a LOLR.[506]

In 1797, Sir Francis Baring argued that the BOE holds this power to lend liquidity when all other financial institutions failed to do so. Henry Thornton and Walter Bagehot have designed the characteristics of LOLR and explained the insight behind its operations.[507] The impartation of liquidity in the apprehension of a financial crisis is different from lending a loan. The CBs have the responsibility to govern the system not to protect individual institutions. Therefore, liquidity assistance in the operations of LOLR can only be granted to solvent institutions.[508] The core function of the CBs as a LOLR is not to intervene during special circumstances but it is obligated to take all necessary steps to make an indomitable system. The dread of a crisis is more annihilating for the survival of the system than the shortage of liquidity. It is a vital part of the functions of the LOLR to ensure the trust of the stakeholder in the system.[509] The reason behind establishing a CB is to have an institution that can regulate the financial system and also have the power to implement its policies.[510]

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[505] Stanley Fischer, "The Lender of Last Resort Function in the United States" (2016), International Finnace, Vol. 2 Page No. 239-60.

[506] Thomas M. Humphrey "LOLR: The Concept in History", (1989) FRB Richmond Economic Review, Vol. 75, No. 2, Page No. 8.

[507] Robert E. Keleher, Thomas M. Humphery, "The Lender of Last Resort A Historical Perspective", (1984) Cato Journal, Vol.4, No.1, Page No. 275.

[508] Stanley Fischer, "The Lender of Last Resort Function in the United States" (2016), International Finnace, Vol. 2 Page No. 239-60.

[509] Michael D Bordo, "Rules for a Lender of Last Resort: An Historical Perspective", (2014) Journal of Economic Dynamics and Control, Vol 49, Page No. 126.

[510] Gerald P. O'Driscoll Jr, "Why Do We Have a CB?", (The Wall Street Journal, December 3, 2010), Accessed: April 10, 2018.

The functions of LOLR are enhanced and it is no more a mere facility to provide liquidity during a crisis. It is regarded as a tool to govern the economic system. Thus, monitoring the financial policy of the State is also an important part of this role.[511] It must have an accurate check and balance on the system and identify the insolvent financial institutions. The regulations regarding the functions of LOLR must be well clear that in which circumstance and on which grounds its assistance can be availed. It also ensures the trust of the domestic and foreign investors in the system by taking all necessary steps.[512] According to the needs of the system, it provides opportunities for the financial systems to excel in their businesses. Finally, if the financial institutions start facing liquidity shortages and are unable to overcome the problem by the normal loan facilities of the market,[513] the CB extends its support of liquidity as a LOLR to abolish the problem of liquidity and curtail the panic of a crisis. The mandate of the role of LOLR is not limited to impart liquidity but it can also purchase the illiquid assets of the financial institutions which are in trouble.[514] Normally, to fulfill the demand for liquidity the financial institutions start selling their illiquid assets, and a rapid sale always deteriorates the value of the assets and makes the situation worse for the institutions to handle. Therefore, the functions of LOLR are not limited to certain operations, it can go to any limit for the survival of the system.[515]

The functions of an international LOLR are limited as compared to those of the domestic one. It is no more a contention if the modern global economic system requires an international LOLR or

[511] Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.
[512] Kathryn Judge, "The Role of a Modern Lender of Last Resort", (2016) Columbia Law Review, Vol.116 Page No. 843.
[513] Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.
[514] Ibid
[515] Maurice Obstfeld, "LOLR in Globalized World", (November, 2009), Accessed: 2nd March 2018.

not. The failure of the domestic system has effacing effects on the world's economy.[516] Financial institutions seek help from the CBs when they face difficulties and the CBs in their difficult times ask the IMF to rescue them which is currently working as an ILOLR.[517] It can ask foreign investors to invest in the country which is facing liquidity problems or ensure the existing investors that it will rescue the CB if needed, which eliminates the panic and allows the system to stabilize itself.[518] The ILOLR can play the role of a consultant, however; it cannot give the financial policy of the states. Like the domestic LOLR, the IMF cannot purchase the assets of the CB which requires its assistance. It can make its support conditional that the CB which needs its help must provide a viable financial policy that will be able to return the money.[519]

In the modern economic era, the significance of LOLR cannot be denied. Its salient functions and successful role in the recent financial crisis make it an inseparable part of the functions of the CBs at domestic and IMF at the international level.[520] Liquidity shortage and minor financial panics are common in the current financial systems which can be converted into a large financial crisis in the absence of an institution that can lend liquidity to address such problems.[521] A trivial liquidity issue can escalate the apprehensions of crisis and make it difficult for even a solvent institution to survive. Large financial institutions in the absence of a LOLR will be mighty in the financial system and will make the conditions of loan facilities unapproachable for small

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[516] Edwin M. Truman, "The IMF as an International Lender of Last Resort", (October 12, 2010) Peterson Institute for international Economics, Accessed: February 04, 2018.
[517] Jean-Pierre Landau, "International LOLR: Some thoughts for 21st century", (2014) Bank for International settlement No 79, Page No. 119.
[518] Ibid
[519] Edwin M. Truman, "The IMF as an International Lender of Last Resort", (October 12, 2010) Peterson Institute for international Economics, Accessed: February 04, 2018.
[520] Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.
[521] Ibid

institutions.[522] The rationale behind having a LOLR on a domestic and international level is not merely to have an institution that will provide liquidity in difficult times but to make such an effective and efficient system where all institutions enjoy the same rights and can excel. However, to achieve this goal proper legislation is required to regulate this role according to the insights of having it.[523]

7.8 Federal Reserves, Bank of England, and State Bank of Pak as LOLR

7.8.1 Federal Reserves as LOLR

Every financial system requires a CB to maintain the stability of the system and back the financial institutions in tough economic conditions. The first CB for the United States was created in 1791 and it is known as the Bank of the United States. It was established to fulfill the traditional duties of a CB to assist the federal government in its financial matters. It was authorized to emit notes which were accepted by the federal government in making financial payments.[524] Though it was not well accepted unanimously by the inhabitants of the USA, and particularly its private ownership allows it to work as an independent institution rather as a government institution. Hence, even after 20 years, it was unable to get approval from Congress to continue working as a CB. In 1836, President Andrew Jackson used his powers and rejected the bill of the extension of the second CB of the US.[525] The absence of a CB was causing harm to the system and the country had faced many financial crises in 1839, 1857, 1873, 1893, and 1907. It was realized that the presence of an institution, which can give monetary policy and help the financial institutions when they face liquidity problems will curb the occurrence of these crises.

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[522] Jean-Pierre Landau, "International LOLR: Some thoughts for 21st century", (2014) Bank for International settlement No 79, Page No. 119.
[523] Maurice Obstfeld, "LOLR in Globalized World", (November, 2009), Accessed: 2nd March 2018.
[524] Jerome H Powell, "America's Central Bank: The History and Structure of the Federal Reserves", (2017), Accessed: April 20, 2018.
[525] Ibid

Minor financial institutions can create panic among the creditors and create a situation where the financial institutions will be unable to address it. The CBs are designed to help the financial institutions when the demand for liquidity rises and prevent the financial crisis. The CBs were collaterals hence, they were lending liquidity to the solvent institutions and allowed them to fulfill the demand of liquidity without selling off their assets. At the outset of the 20th century, the US did not have a CB hence; it had faced many crises one after another.[526] Finally, the financial crisis of 1907 paved the way for the establishment of Federal Reserves though many economists were still opposing the idea of having a CB and were arguing that the powers should be granted to the regional bodies.[527]

The Federal Reserve Act (FRA) 1913 empowered the Federal Reserve to play the role of LOLR and lend liquidity to the financial institutions which were facing liquidity shortages. In the recent global crisis, the role of the Federal Reserves is commendable as it took a radical approach to deter the crisis.[528] It did not rely on the traditional lending policies and took the unconventional step to prevent the financial institutions from collapsing which also played an important role to extend the conception of LOLR. Sections 10-B, 13, and 14 of FRA 1913 legalized the operations of the Federal Reserve as LOLR. At the starting of 2007, the Federal Reserve lent liquidity to the financial markets to enable them to resist the crisis. Although Bagehot emphasized that a high-interest rate should be charged to curtail moral hazard problems, it was reduced to encourage the

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[526] Gayane Oganesyan, "The Changed Role of LOLR: Crisis Responses of Federal Reserves, European CB and Bank of England", (2013) Institute for International Political Economy Berlin 19/2013, Accessed: March 30, 2018.
[527] Jerome H Powell, "America's Central Bank: The History and Structure of the Federal Reserves", (2017), Accessed: April 20, 2018.
Ibid
[528] Hansjörg Herr, Sina Rüdiger and Jennifer Pédussel Wu, "The Federal Reserve as LOLR During the Subprime Crisis – Successful Stabilisation Without Structural Changes", (Working Paper No. 65/2016), Accessed: April 20, 2018.

banking sector to lend each other which worked well to stabilize the system.[529] Federal Reserve's completely ignored the principles of Bagehot and directly lent to the insolvent institutions. It lent freely to the AIG company which worked well to stabilise it.[530] The Federal Reserve also followed the examples of the Bank of England and purchased the illiquid assets of the financial institutions which were forced to sell them rapidly because of the liquidity demand. This step provided liquidity to the financial institutions and also prevented the depreciation of their assets.[531]

The role of LOLR is regarded as a vital part of the modern economic system, however; it was not warmly accepted by many economists because of the moral hazard problems. In the case of Lehman Brothers when the Federal Reserve refused to lend liquidity it was badly criticised by economists. It was perhaps the biggest bankruptcy in the history of the United States and left many lessons for the financial institution to be learned.[532] The presence of LOLR allows financial institutions to ignore the consequences of risky investment because they believe that they will eventually be rescued if there will be a panic which creates moral hazard problems. It is extensively described in the part of the moral hazard in this research.[533] To address the issue of moral hazard problems Federal Reserve has set an apt precedent in the case of the Lehman brothers. Although, the Federal Reserve has played a very effective role to resist the financial crisis, even then it was observed that there are many gaps in the legislation and this significant

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529 Gayane Oganesyan, "The Changed Role of LOLR: Crisis Responses of Federal Reserves, European CB and Bank of England", (2013) Institute for International Political Economy Berlin 19/2013, Accessed: March 30, 2018.
530 Ibid (Page No. 12)
531 Marc Dobler, Simon Gray, Diarmuid Murphy, and Bozena Radzewicz-Bak "The LOLR Function after the Global Financial Crisis" (2016), IMF working paper No. 16/10, ISBN: 9781498355995/1018-5941, Assessed: May 17, 2017.
532 Kwabena Boamah, "The Collapse of Lehman Brothers – How it Happened?", (August 15, 2011), Accessed: March 9, 2018.
533 See the part of Moral Hazard Problems

role cannot be left at the discretion of the Federal Reserve, therefore, it needs to be legislated.[534] The United States which was struggling to have a CB which can play a role of LOLR when the financial institutions need liquidity is now leading in expanding the doctrine of LOLR. After the recent financial crisis to address the loopholes of the existing laws and fixing the moral hazard problems the United States has enforced the Dodd-Frank Act 2010. It provides principles on which the financial institutions will be provided with liquidity.[535]

7.8.2 Bank of England as LOLR

This part of the research explains how the Bank of England (BOE) adhered to the insights of Sir Francis Baring and played the role of LOLR for the financial institutions during the crisis. It is important to appraise the operations of LOLR in previous crises to get guidance. As Lord Mervyn King said, “During the crisis, I found that the study of earlier periods was more illuminating than any amount of econometric modeling”.[536] The evolution of the LOLR is extensively described in Chapter 1.1 that although the BOE had lent liquidity in Eighteenth-century lending liquidity to the financial institutions when they need it, it is a duty of the CB which was established in the last quarter of the nineteenth century.[537] It is important to evaluate if the BOE has altered its policies after accepting the role of LOLR or not. There is no evidence that can enunciate that there was an empirical change in the policies of BOE henceforth. It was

[534] Paul Tucker, “The LOLR and Modern Central Banking: Principles and Reconstruction”, (2014) Bank for International settlement, Page No 10.
[535] Kathryn Judge, “The Role of a Modern Lender of Last Resort”, (2016) Columbia Law Review, Vol.116 Page No. 843.
[536] Lord Mervyn King former governor of the Bank of England
[537] ESTHER MADELEINE OGDEN, “THE DEVELOPMENT OF THE ROLE OF THE BANK OF ENGLAND AS A LOLR, 1870-1914”, (September 1988), Accessed: April 26, 2018.

criticised for its primary aims of profit maximization and the presence of a conflict of interest and therefore, it could not hold the position of CB.[538]

The BOE has played the role of LOLR in the crisis of 1847, 1857, and 1866. Bagehot in his book *Lombard Street* (1873) described the rules for LOLR which were followed by the CBs around the world.[539] Bagehot's doctrine has three main principles of lending: i) the CB must lend freely, ii) it must lend at a high-interest rate, iii) its lending must be against worthy collaterals. Although it can be evinced by the operations of the BOE as LOLR that it has freely lent liquidity, it was lent only to few institutions.[540] Like the other CBs, there were no regulations regarding LOLR. Thus, BOE has also used its discretionary powers and lent three-fourth of the total amount of liquidity to the top five borrowers.[541] The principle of charging a high-interest rate was strictly followed in the crises of 1857 and 1866. The interest rate was more than the commonly practiced rate. Nonetheless, in the crisis of 1847, the interest rate on the lending of BOE was even below the normal market rates. Therefore, it can be argued that there was no absolute condition for the lending of liquidity in the operations of LOLR because the CBs lent liquidity on lower interest rates to strengthen the system.[542] Finally, the principle of lending against worthy collaterals was also practiced but the BOE has again used its discretionary powers to evaluate the collaterals and did not follow the same rules for all enterprises.[543]

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[538] See Chapter 1.1

[539] Mike Anson, David Bholat, Miao Kang and Ryland Thomas, "The Bank of England as LOLR: New Historical Evidence from daily Transactional data", (Staff Working Paper No. 691), (November 2007), Accessed: March 3, 2018.

[540] Ibid

[541] Ibid (Page No.3)

[542] Gayane Oganesyan, "The Changed Role of LOLR: Crisis Responses of Federal Reserves, European CB and Bank of England", (2013) Institute for International Political Economy Berlin 19/2013, Accessed: March 30, 2018.

[543] Mike Anson, David Bholat, Miao Kang and Ryland Thomas, "The Bank of England as LOLR: New Historical Evidence from daily Transactional data", (Staff Working Paper No. 691), (November 2007), Accessed: March 3, 2018.

The principle behind the operations of LOLR is that it will only intervene and lend liquidity to the financial institutions which are experiencing liquidity problems but are not insolvent.[544] In the cases of Barings and Yorkshire Penny Bank (YPB) when both of them were unable to fulfill the demand for liquidity, assistance was sought from the BOE and they were rescued because they were illiquid and not insolvent.[545] However, in 1878 the City of Glasgow Bank (CGB) was refused to get liquidity support because the collaterals which were produced by the CGB were not accepted as good securities. It is, however, an unaddressed issue that how a CB can determine if the financial institution is illiquid or insolvent.[546] Baring was rescued and had established an argument that it was merely illiquid, but it took four years to settle its liabilities. Many institutions that were declared insolvent and could not get the support of LOLR would have been able to settle their liabilities had they been granted several years like other institutions. In the case of Northern Rock, the BOE has used an entirely different approach and instead of lending liquidity, the BOE decided to nationalize it because it was not befitting for the system to let it fall on the grounds of not having good securities.[547]

Sir Paul Tucker[548] (2014) expressed his views that it was a tragedy that the role of LOLR was neglected in the major policy debates of Central Banking and no effects have been made to legislate on it. Albeit, the significance of the LOLR in the modern financial system cannot be

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[544] ESTHER MADELEINE OGDEN, "THE DEVELOPMENT OF THE ROLE OF THE BANK OF ENGLAND AS A LOLR, 1870-1914", (September 1988), Accessed: April 26, 2018.
[545] Ibid
[546] Mike Anson, David Bholat, Miao Kang and Ryland Thomas, "The Bank of England as LOLR: New Historical Evidence from daily Transactional data", (Staff Working Paper No. 691), (November 2007), Accessed: March 3, 2018.
[547] Roman Tomasic, "The Rescue of Northern Rock: Nationalization in the Shadow of Insolvency", (2009) Accessed: April 15, 2018.
[548] Former Deputy Governor of the Bank of England

denied but leaving its functions at the discretion of CB will be fatal.[549] The role of BOE as a LOLR during the financial crisis was well regarded by many economists, however; it is also emphasized by all the policy-makers that like the issue of moral hazard problem it is also important to frame a regulatory framework for the functions of LOLR. The absence of an effective regulation will continue to allow the BOE to use its discretionary powers to judge if the financial institution is insolvent or merely illiquid. Hence, this role will remain controversial and it will not be possible to achieve the desired goals.[550]

7.8.3 State Bank of Pakistan as LOLR

Pakistan is among the developing countries and its banking sector is still evolving. State Bank of Pakistan (SBP) holds the gold resources of the country and has the power to emit notes. It is the only institution that can lend liquidity to financial institutions when no other institution is capable of lending.[551] The SBP plays the role of LOLR to strengthen the financial institutions against a crisis. However, its functions as being a LOLR are equivocal and still emerging. The State Bank of Pakistan Act 1956 legalize the LOLR operations of SBP. Due to unprogressive financial policies and unproficiency in the operations of LOLR, Pakistan has faced a severe financial crisis.[552] In this modern era, the role of LOLR is not merely to lend liquidity in a crisis, it has several functions to protect the system from the recession as it was described earlier in Chapters 7.4.1 and 7.4.2. The panic among the creditors is the most annihilating factor for the financial system which the CB should eliminate while performing the role of LOLR. The SBP

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[549] Mike Anson, David Bholat, Miao Kang and Ryland Thomas, "The Bank of England as LOLR: New Historical Evidence from daily Transactional data", (Staff Working Paper No. 691), (November 2007), Accessed: March 3, 2018.

[550] Kathryn Judge, "The Role of a Modern Lender of Last Resort", (2016) Columbia Law Review, Vol.116 Page No. 843.

[551] Raja CRN, "Role and Functions of the State Bank of Pakistan", (August 22, 2009), Accessed: April 21, 2018.

[552] Mateen Altaf, "Role of State Bank of Pakistan in Economic Development of the Country", (April 11, 2016), Accessed: April 21, 2018.

lent liquidity to many financial institutions to stabilize the system and issued a large number of new notes to fulfill the demand. However, the emittance of new notes rapidly deteriorated the value of the currency and caused inflation.[553] Therefore, Pakistan sought assistance from the IMF which is playing the role of international LOLR.

The role of LOLR has emerged swiftly after the recent financial crisis in developed countries especially in the UK and the USA. Nonetheless, it is still not part of major financial debates in the financial and economic forums of Pakistan.[554] Islamic Banking is an emerging sector in Pakistan however; there is no legislation and clear policy of the SBP that in case if this sector faces the liquidity crisis who will play the role of LOLR.[555] There are no set principles for providing liquidity support and it will not be befitting to adopt the principles of the UK or USA because each system has different needs and dimensions.[556] The banking sector is not the only one getting liquidity support from the SBP but it also lends to government institutions like Pakistan International Airlines (PIA), Pakistan Steel Mill and Pakistan Railways, etc. Most financial and governmental institutions are unable to return the money to the SBP. The absence of a strong regulation to curtail moral hazard problems is hauling the system towards crisis. Public money is going in vain and due to moral hazard problems, the LOLR itself is becoming the cause of a recession. Thus, the SBP had no other option but to seek assistance from the IMF.[557] Notwithstanding, it is a dilemma that Pakistan's economy is standing on the verge of destruction and miserably depending on the aid of IMF but still there are no financial regulations

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553 Muhammad Farooq Arby, "State Bank of Pakistan: Evolution, Functions and Organization", (MPRA Paper No. 13614), (March 2009), Accessed: March 3, 2018.
554 Mateen Altaf, "Role of State Bank of Pakistan in Economic Development of the Country", (April 11, 2016), Accessed: April 21, 2018.
555 Muhammad Umer, "LOLR for Islamic Banking Under Review", (April 01, 2015), Accessed: April 23, 2018.
556 Muhammad Farooq Arby, "State Bank of Pakistan: Evolution, Functions and Organization", (MPRA Paper No. 13614), (March 2009), Accessed: March 3, 2018.
557 Sara Cheema, The IMF: Pakistan's History and Future with the LOLR", (June 19, 2017), Accessed: April 21, 2018.

that can address these issues. Although the IMF is working as an ILOLR it is alleged that it is influencing the economic systems of the countries and its stipulations are fair with the developing countries.[558] This research aims to propose a regulatory framework for the functions of LOLR in Pakistan.

7.9 Criticism on the Role of LOLR

Imparting liquidity to the financial institutions which are facing a shortage of liquidity and are unable to attain it by using their resources is a vital part of the role of LOLR.[559] In the modern economic systems, CBs at domestic and IMF at the international level are playing this role. Nonetheless, the conception of this role was nothing more than lending liquidity to the financial institutions or in some cases to the CBs. Therefore, this role was played by different companies and even persons and they lent liquidity even in the Nineteenth Century.[560] The rationale behind this role is to prevent a financial institution from collapsing which can survive with the support of liquidity. In business activities, it is not astounding that even a solvent institution could face a deficiency of liquidity. A trivial liquidity issue can be converted into a severe financial crisis if there are no institutions that can lend liquidity in such circumstances.[561] The role of LOLR is one of the fundamental justifications for having a CB and it has played an important role to control the financial crisis.[562]

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558 Edwin M. Truman, "The IMF as an International Lender of Last Resort", (October 12, 2010) Peterson Institute for international Economics, Accessed: February 04, 2018.

559 Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.

560 Robert E. Keleher, Thomas M. Humphery, "The Lender of Last Resort A Historical Perspective", (1984) Cato Journal, Vol.4, No.1, Page No. 275.

561 Matthew C Klein, "Do Lenders of Last Resort Actually make the Financial System Safer?", (January 12, 2017), Accessed: December 10, 2017.

562 Ben O'Neill. 2013. "The LOLR: A Comparative Analysis of Central Banking and Fractional-Reserve Free Banking." (Libertarian Papers. 5 (1): 163-186), Accessed: April 5, 2018.

Natural and legal persons are the owners of their assets hence if they are capable of offering liquidity support to other institutions working in the financial markets, then they are free to do so.[563] The liquidity support to the financial system in the domestic market or a CB can be based upon their personal or business benefits. Usually, private lenders lend liquidity to small business entities and earn profits by charging a high-interest rate.[564] In the operations of LOLR, the private entities can gain or lose their money which is their business activities, therefore, there is no point where policymakers can intrude. However, in a modern economic system, when the conception of LOLR is wider than merely lending liquidity, this role is officially played by the CBs.[565] The resources which the CBs hold are not owned by them because they possess all the resources and taxes of the state. It has more obligations towards the system than commercial banks or private financial institutions. The main justification behind the operations of LOLR conducted by the CBs is that the failure of some financial institutions can harm the entire system. Thus, its liquidity support is neither provided to the individual institutions nor it is unaccountable assistance.[566]

The collapse of a large financial institution can escalate the panic among domestic and international investors which increases the demand for liquidity. Therefore, the policymakers argue that liquidity support helps such financial institutions to sustain against the illiquidity crisis. The assurance of the CB to recuse financial institutions helps to curtail the panic among creditors which is most annihilating for the survival of the system.[567] The responsibility of the

[563] Ibid
[564] Michael D. Bordo, "The LOLR: Alternative Views and Historical Experience", (Economic Review January/February 1990), Accessed: April 5, 2018.
[565] Ulrich Bindseil, Luc Laeven, "Confusion about the LOLR", (January 13, 2017), Accessed: April 6, 2018.
[566] Michael D. Bordo, "The LOLR: Alternative Views and Historical Experience", (Economic Review January/February 1990), Accessed: April 5, 2018.
[567] Matthew C Klein, "Do Lenders of Last Resort Actually make the Financial System Safer?", (January 12, 2017), Accessed: December 10, 2017.

CBs is to make a stabilized and prosperous economic system hence it is entirely in the favor of the public at large to play the role of LOLR. The operations of CBs as a LOLR are not like those of the private institutions, they must follow the rules set in the financial policies.[568] They lend liquidity to the institutions which can produce worthy collaterals and are just illiquid and not insolvent. To fulfill the cost of such operations, a high-interest rate is being imposed.

Notwithstanding, there is a strong criticism of the CBs because of the role of LOLR. The financial institutions which have involvement in risky activities to earn high profits have no intention to share their profits with anyone apart from their shareholders.[569] However, the presence of LOLR assures that if they will bear losses from risky activities they will be rescued. The resources which are used in rescuing such financial institutions by the CBs belong to the nation. Hence, to use the money of the nation to fulfill the losses of a financial institution owned by a few individuals will mean extending the losses nationwide.[570] It is argued that the CBs are meant to announce the financial policy of the state and maintain the stability of the system. Although, in the apprehensions of the financial crisis when the financial market is unable to provide sufficient liquidity support to the institutions facing troubles the CB is the only institution that is empowered to issue new notes and control the situation. It is argued that the frequent issuing of new notes will deteriorate the value of the currency and cause inflation.[571]

The CBs were reluctant to play the role of LOLR and were opposing the presence of it because of its moral hazard problems. The evolution of the economic systems has also led to the

[568] Marc Dobler, Simon Gray, Diarmuid Murphy, and Bozena Radzewicz-Bak "The LOLR Function after the Global Financial Crisis" (2016), IMF working paper No. 16/10, ISBN: 9781498355995/1018-5941,Assessed: May 17, 2017.
[569] Ben O'Neill. 2013. "The LOLR: A Comparative Analysis of Central Banking and Fractional-Reserve Free Banking." (Libertarian Papers. 5 (1): 163-186), Accessed: April 5, 2018.
[570] Dietrich Domanski, Richhild Moessner, and William Nelson, "CBs as LOLR: Experiences during the 2007-2010 crisis and Lessons for the Future", (2014), Accessed: April 10, 2018.
[571] Michael D Bordo, "Rules for a Lender of Last Resort: An Historical Perspective", (2014) Journal of Economic Dynamics and Control, Vol 49, Page No. 126.

emergence of this role and several proposals are suggested to curtail the issues of moral hazards.[572] LOLR has played a vital role to strengthen the financial systems by the CBs and IMF at domestic and international levels respectively. Its operations during the crisis were indeed beneficial for the system hence its presence is considered inevitable in modern economic systems. However, the CBs have used their discretionary powers to play this role because there was no proper legislation on it. Many insolvent financial institutions were rescued and solvent institutions were refused liquidity support which gives rise to several queries.[573] It was argued that the financial institutions become illiquid because of mishandling and the support of LOLR is a bonus for inefficient administrations.[574] Thus, the contemplations regarding the existence of LOLR cannot be neglected merely because a modern financial system will be unable to survive in the absence of LOLR. Though it is an established fact that its presence is needed nonetheless; it cannot be left on discretionary powers of the CBs. Proper legislation is as important as the existence of LOLR to make a less vulnerable economic system.[575]

7.10 Summary

This chapter widely explained the powers of the BOE as a LOLR and argued on the laws which authorized it to act as a LOLR. The operations of the LOLR in the UK are discussed on which grounds the liquidity support was offered. It further explicated the factors behind the establishment of FBR and its role in curtailing financial anxiety from the economic system of the US. The powers of FRB to act as LOLR are explored and the key features of the Dodd-Frank

[572] Paul Tucker, "The LOLR and Modern Central Banking: Principles and Reconstruction", (2014) Bank for International settlement, Page No 10.
[573] Matthew C Klein, "Do Lenders of Last Resort Actually make the Financial System Safer?", (January 12, 2017), Accessed: December 10, 2017.
[574] Matthew C Klein, "Do Lenders of Last Resort Actually make the Financial System Safer?", (January 12, 2017), Accessed: December 10, 2017.
[575] Dietrich Domanski, Richhild Moessner, and William Nelson, "CBs as LOLR: Experiences during the 2007-2010 crisis and Lessons for the Future", (2014), Accessed: April 10, 2018.

Act, 2010 are evaluated as well. The case of Northern Rock and the reasons for its nationalization are examined. The cases of Lehman Brothers and AIG are also studied which played an imperative role in the progression of the role of LOLR. Finally, certain lessons for the system of Pakistan from the experiences of the UK and US are derived by comparing the operational strategies of the BOE and FBR. This chapter has provided a critical evaluation of the role of LOLR. It has discussed the functions of LOLR and also explained that if there will be no institution that will play the role of LOLR for the financial system in this modern system, the entire system can collapse because of a minor liquidity problem**.** LOLR can address the liquidity problem and eliminate pain among investors. It had discussed the role of the Federal Reserve, the Bank of England, and the State Bank of Pakistan as LOLR. It had also explained the laws of all three countries relating to the role of LOLR.

Chapter 8: Regulatory Reform Proposals and Conclusion

8.1 Introduction

This chapter contains details about reforming the role of LOLR in Pakistan and explains how it would benefit the financial system of the country. All problems of the financial system of Pakistan which are discussed in the chapters above and the lessons which are extracted after a deliberate examination of the systems of the UK and US regarding the role of LOLR are regarded as the key principles before proposing a way forward in this chapter. The first part describes the rules and regulations for the role of LOLR in the UK and US and unfolds the problems which were faced by the BOE and FRB in the past but were subsequently reformed at a later stage. The second part argues the limitations of the current legislation to address the financial problems in Pakistan and suggests reform proposals to make a modern system for LOLR. It concludes with a discussion on the implications of the suggested proposals.

8.2 System of LOLR in Pakistan

The State Bank of Pakistan is the CB in Pakistan which was established in 1948 and authorized to act as the LOLR for the financial institutions in its jurisdictions. Although, the SBP was established on the model of BOE, the financial system of Pakistan has many similarities with the system of the US also. The financial system of Pakistan has gone through an intense process of evolution and different models for the banking and financial institutions were employed. The financial system has progressed a lot, but it is still far from a developed system. The banking and financial system of Pakistan started with the investments of the private sector and aimed to attract foreign investment to establish a prosperous economic system. However, the unsatisfactory performance of the banking and financial sector urged the policymakers to nationalize all the banking and financial institutions in the 1970s which has been extensively discussed in chapter four of this study. Additionally, the inability of this policy to deliver according to the expectations and a paradigm shift of the political ideologies from the commercial system to Islamization again privatised the banking and other financial institutions in the 1990s.[576]

The inception of Islamic banking is another big change in the functioning of the banking sector in Pakistan. The SBP is authorized to lend liquidity to financial institutions which face liquidity challenges. However, unlike the BOE, the SBP is bound by the legislation to offer liquidity assistance to the financial institutions which can provide good collaterals. In Pakistan, the government is the biggest borrower of the SBP to fulfill the demand of the liquidity which urged the SBP to emit new notes without even holding the reserves at the back, and resultantly it caused inflation. Many national institutions have been going in the loss for a long time and the SBP is injecting liquidity into them for their survival. PIA, Pakistan Steel Mills, and Pakistan Railways are the major examples that are continuously surviving on the liquidity support which the SBP is providing as a LOLR. It is clearly stated in section 17 of the State Bank of Pakistan Act, 1956 that the bank could provide liquidity support to the financial institutions which could provide collaterals, but the government is continuously superseding these rules by the ordinances which are coming every year and lending liquidity to these financial institutions.[577]

The role of LOLR was criticised for a long time after its inception due to the moral hazard problems and it was argued by many economists that it would cause wastage of the national money. All theories relating to the role of LOLR indicate that if a CB would be frequently

[576] Muhammad Farooq Arby, “State Bank of Pakistan: Evolution, Functions and Organization”, (MPRA Paper No. 13614), (March 2009), Accessed: 3rd March 2018.
[577] Muhammad Mahmood Shah Khan, Bushra Shafiq, Farrukh Ijaz, “An Empirical Analysis of Banking Sector in Pakistan: Islamic Versus Conventional Banks”, (International Journal of Islamic Economics and Finance Studies, March 2017, Vol: 3, Issue: 1), Accessed: October 06, 2018.

engaged in the operations of LOLR it would be annihilated for the entire system. It was warned that liquidity support must not be offered to the financial institutions which were not capable of returning it. The BOE has denied its support as a LOLR to many financial institutions on the grounds that the financial institutions were not able to satisfy the administration of the BOE that they would be able to return the money. In cases like Northern Rock Bank, when the BOE had no choice but to rescue it, the bank instead of lending liquidity in the hands of the administration of the concerned bank, nationalized it, because the acumen behind having a LOLR is to maintain stability in the financial system. Therefore, the governments empowered their CBs with discretionary powers so that they can take all necessary steps to protect the system. The debacle of Lehman Brothers is still regarded as one of the biggest bankruptcies in the banking history of the US but still, the FRB was not pressurized by the government to rescue it. FRB denied the liquidity support because the directors of the FRB were of the opinion that if they will inject money into the rescue operation of the concerned bank it will put the taxpayers' money into the drain.[578] Thus, Pakistan must learn from the examples of the BOE and FRB and erode the unnecessary influence of the politicians from the SBP. The SBP must elucidate its rescue policy for all banking and financial institutions and only lend liquidity when it is in the greater interest of the entire financial system of the state.

8.3 Reform Proposals

The SBP is continuously playing the role of LOLR towards many national and private financial institutions by superseding the basic principles of this role. It is commendable that the policymakers of Pakistan recognised the need for a LOLR at the time of the establishment of the CB known as SBP and empowered it to act as a LOLR for the financial institutions which could

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578 Gayane Oganesyan, "The Changed Role of LOLR: Crisis Responses of Federal Reserves, European CB and Bank of England", (2013) Institute for International Political Economy Berlin 19/2013, Accessed: March 30, 2018.

meet the standards stated in the regulation. However, an express provision regarding the role of LOLR is incorporated through an amendment in 2015 which states overtly the principles which will be followed while acting as LOLR. The first and foremost thing which Pakistan needs to comply with is to understand the acumen of having a LOLR and look at its conception in a wider depiction rather than considering it merely a facility of imparting liquidity in times of emergency. After a deliberate study of the financial systems of the UK and the US and the financial crises of different times, it is identified that a concern among the investors could convert a trivial financial issue into a major financial crisis. Therefore, instead of merely injecting liquidity into the financial institutions or in the financial market, the role of a LOLR is to keep the trust of the depositors. It is analysed above in the case studies of the UK and USA that this approach helps to control the demand for liquidity and provides sufficient time to the financial institutions to overcome the liquidity problem.

Notwithstanding, the panic among the investors drastically increases the demand for liquidity which compelled the financial institutions to sell their illiquidity assets swiftly. A quick sale of the illiquid assets causes a decrease in their value and leaves no window for the financial institutions but to seek assistance from the CB as a LOLR. In Pakistan, the role of the SBP, particularly in the case of KASB bank, and an undue influence of the politicians are repugnant to the philosophy of having a LOLR. The Trust of the creditors is imperative to maintain stability in the financial system. However, the political rhetoric of the failure of the system is spreading panic which is making it difficult for the SBP to get full benefits from the LOLR facility. Foreign investment helps an economic system to grow and Pakistan is endeavoring to encourage foreign investors to bring in investment. Nevertheless, for political reasons, government officials may sometimes create panic among existing investors and this has become somewhat of a political norm to castigate the fiscal policies of the authorities and introduce instability.

Secondly, the SBP must be allowed to work as an independent institution instead of working as a subordinate of government officials. The government's prerogative of appointing the governor of the SBP is a main reason for creating a suspicion of political influence over the institution because in the presence of a politically appointed head of the institution there may be less independence of the CB. The governor's selection can be influenced by the directors of the SBP and final approval can be subject to the advice of the cabinet. Additionally, the SBP role as LOLR in the case of KASB bank lacks the required transparency normally required, for example with the BOE and FRB. The only requirement is that a factual annual report be presented in parliament stating all the information regarding the operations of SBP as the LOLR.

Thirdly, the principle of charging a high penalty rate on the liquidity support by the CB on LOLR operations is established so that the expenses of such operations can be recovered. However, the SBP failed to recover the original amount imparted as liquidity support. As a result, the SBP started facing liquidity problems and was rescued eighteen times by the IMF. Currently, the new government is also striving to get another rescue package from the IMF. The dependency on the support of the IMF will have no end until the system is reformed. The principles of charging a high penalty rate should be followed strictly with no exceptions. There should be no lending to the financial institutions which are unable to provide collateral. Also, SBP must establish a mechanism to get factual audit reports of the financial institutions working in the system on a regular basis.

Fourthly, the SBP must strictly implement the principle of minimum capital requirement proposed in the regulation of Basel Accord III for financial institutions with no exceptions.

Besides the requirement of providing worthy collaterals, audit reports of the last five years must be consulted before lending liquidity to a financial institution which will help to evaluate whether the financial institution is merely facing liquidity challenges or is going to be insolvent. No financial institution must be rescued for the second time without the approval of the cabinet if that institution has failed to repay the amount which is injected for its first rescue. Also, SBP must appoint directors to closely monitor all the financial activities of the institution.

Finally, the problem of having a LOLR facility for Islamic banks based on interest-free liquidity support is also a big challenge for the SBP to address. Islamic banks work as interest-free companies that is why it is not possible for the SBP to play the role of LOLR for these banks based on the classical theories of LOLR. The CBs around the globe charge a high-interest rate to discourage financial institutions from relying on the liquidity support of the LOLR. The SBP while acting as LOLR for Islamic banks can use the option of nationalisation as the BOE did in the case of Northern Rock because if the liquidity support will be interest-free, it will allow Islamic banks to frequently seek liquidity assistance. Consequently, the SBP will start experiencing a liquidity crisis which will lead it to seek another bailout package from the IMF. Additionally, the SBP can use the same approach as the Islamic Banks and take a share in the profit of these banks. Furthermore, the SBP can purchase the illiquid shares of Islamic banks instead of directly injecting liquidity into them, and once they overcome the liquidity problem, resale those illiquid assets on the market value at a time when SBP can earn money as much as it has spent while playing the role of LOLR. The SBP must impose conditions on Islamic Banks that are seeking liquidity support from it that they could only invest in the progressive businesses.

8.3.1 Implications of Reform Proposals

It is imperative to reform the functions of the system according to contemporary issues because a rigid approach makes it difficult for the system to address new challenges. Every system is going through a continuous process of evolution and that is why it is not possible for any system to survive without embedding modern techniques. The system of LOLR existed even before the inception of CBs and domestic financial institutions borrowed money from banks or other financial institutions when they required it. These borrowings were based on mutual understandings of the parties and were mainly based on personal relations. The countries were also using the same approach at the international level and borrowed money from other countries based on political relations or interests. However, the emergence of banking and economic systems created the need for an official LOLR at domestic and international levels. Therefore, the duty of playing the role of LOLR has played an important part in the inception of the CBs.

The LOLR was badly criticized by most economists because it was merely a duty of the CB to lend liquidity to the financial institutions which were enduring liquidity shortfalls. Moral hazard problems had turned out to be the main cause of the emergence of this role. However, economists like Henry Thornton and Walter Bagehot suggested a framework for the role of LOLR and tried to address the issue of moral hazard problems. Several financial issues have also urged policymakers to recognize the need for this role. Initially, in the UK, it was proposed that the CB would only rescue the financial institutions which could provide good collaterals and agreed to pay a high-interest rate on the liquidity support. No financial institution was eligible to seek financial assistance from the CB which was insusceptible to meet the standard of being solvent. Although these suggestions were handy to curtail the anxiety of moral hazard problems, the deliberate examination of the financial crises highlighted many questions on these proposals. It was acknowledged that the assessment of the CB regarding the solvency of the institution during the crisis, was wrong in many cases and some institutions could be successfully rescued even if they were unable to provide collaterals. Thus, it can be realized that the system was frequently reformed according to the requirements. The BOE used its discretionary powers and lent liquidity to the financial institutions which were unable to provide collaterals. In many cases, the interest rate was reduced even from the market rate of the time. All these steps allowed the BOE to perform well during the financial crises and it had remarkably protected the financial system against crises. Reforms of the system strengthened the system and developed a modern and efficient system however, if the BOE continued to act according to the suggestions of Walter Bagehot, it may not protect the system against crises.[579]

Similarly, in the US, the experiment of the first CB was not successful but with the passage of time, the policymakers have established a system that is now among the best systems in the world. The key to their success was to continuously reform the system and quest for a better one that could address the contemporary issues of that time. The FRB was established in 1913 and mandated to play the role of LOLR for the banking system in the US which was facing more financial problems than any other banking system of the first world. The powers of the FRB were also subject to the proposal of Walter Bagehot and it was only providing liquidity support to the banks which were able to provide collaterals. However, after the Great Depression (the 1930s) it was recognized that the system related to the LOLR needs to be reformed. The powers of FRB were reformed, and it was authorized to provide liquidity assistance to the nonbanks and without strictly imposing the conditions of worthy collaterals. The recent financial crisis of 2007-2008 was the biggest test of the capability of the LOLR functions to protect the financial system

[579] Mike Anson, David Bholat, Miao Kang and Ryland Thomas, "The Bank of England as LOLR: New Historical Evidence from daily Transactional data", (Staff Working Paper No. 691), (November 2007), Accessed: 3rd March 2018.

against the crisis. The FRB played the role of LOLR which was admired by many economists, but it was still reformed through the Dodd-Frank Act, 2010.[580]

In Pakistan, the SBP is authorized to play the role of LOLR for the financial institutions which are working in its jurisdiction. The powers of the SBP are subject to the conditions of good collaterals. No financial institution can obtain liquidity support from it which is unable to provide collaterals. However, this rule is not being followed and SBP was ordained by the government to lend liquidity to the national institutions on several occasions. Non-transparency in the functions of national institutions is one of the main reasons which is causing financial problems in Pakistan. The frequent dependency of the financial institutions on the support of CB has created a situation many times when the economic system of Pakistan was rescued by the IMF. The IMF has imparted liquidity to the SBP eighteen times but still, the financial system of Pakistan is facing uncertainty.[581]

The understanding of the role of LOLR and the realisation of its significance will have a positive effect on the financial system of Pakistan. Due to political milestones, the government officials are disseminating information regarding the financial system of Pakistan that it was facing serious financial problems and would require to be rescued by the IMF again. Panic among investors always has adverse effects on the system. Therefore, a policy of not allowing the politicians and unprofessional people to talk about the financial conditions for their interests will help the SBP to ensure the trust of the investors in the system. The independence of the SBP will ensure that it could work according to the rules and regulations and would be able to produce

[580] Paul Tucker, “The LOLR and Modern Central Banking: Principles and Reconstruction”, (2014) Bank for International settlement, Page No 10.

[581] Ashfaq Ahmad, Muhammad Imran Malik, Asad Afzal Humayoun, “Banking Developments in Pakistan: A Journey from Conventional to Islamic Banking”, (European Journal of Social Sciences, Volume: 17, Number: 1(2010), Accessed: October 06, 2018.

positive results. An election among the directors of the concerned bank and the appointment of the governor after the approval of the cabinet will curtail the direct influence of the government on the institutions because, in the past, the governor was appointed based on the personal relations of the politician. Hence, SBP was later used to be governed for personal and political purposes. The independence of the SBP in its functioning and the strict accountability of its employees can bring a revolutionary change in the financial condition of Pakistan.[582]

Furthermore, if the government and the SBP have reached a point where it has become imperative to rescue a national or private financial institution that is not able to provide good collaterals and its failure can harm the entire system, the SBP must rescue it but on the conditions of providing an independent audit and feasibility report. It will help the SBP to recognize the problems which are causing financial problems for the institution. All the audit and feasibility reports of the financial institution which are subject to the liquidity assistance by the SBP must be produced before the parliament for approval otherwise the liquidity support should be denied. It will have a great impact on the financial system of Pakistan and curtail the issues of using the SBP for personal and political purposes. A complete report of the amount which will be used in rescuing the institutions and conditions will become a public document that will decrease embezzlement in the national financial institutions and curtail the burden of SBP. It will also discourage financial institutions from depending on the liquidity support of the LOLR.[583]

The Islamic banking sector is swiftly emerging in Pakistan and contributing to the financial growth of the country. Although, the starting of the Islamic banking system is good and it is progressing over time but still the panic of collapse cannot be ruled out. The Conventional banks

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582 Sara Cheema, "The IMF: Pakistan's History and Future with the LOLR", (Eurasia Review, June 19, 2017), Accessed: November 04, 2018.

583 Ahsin Shahid, Hibba Saeed, Muhammad Ali Tirmizi, "Economic development and banking sector growth in Pakistan", (Journal of Sustainable Finance & Investment, Volume: 5, Issue: 3, 2015), Accessed: October 07, 2018.

also had a dramatic start, not only in the developed countries but in Pakistan as well. A deliberate study of the banking industry and case studies of the collapse of several banks enables the policymakers to realize that the banking sector could not survive without having a LOLR. Thus, it is more important to address the issue that which institution would play the role of LOLR for Islamic banks and on which conditions the liquidity assistance would be offered. The SBP cannot provide liquidity support to Islamic banks on a high-interest rate which is a common practice in the operations of LOLR because the working of these banks is interest-free. Therefore, it will enable the SBP to recover its expenses which will be used in the rescue operation of an Islamic bank if it will take share from the profits of the bank. Moreover, an assessment of the businesses of these banks will also provide a clear view that which businesses were in loss and the SBP would be able to impose conditions that those banks could no more invest in the businesses which were in loss. If the issue of LOLR will not be addressed for the Islamic banks and delayed until the collapse of some Islamic banks, it will make it harder for the SBP to maintain stability in the financial system of Pakistan.[584]

8.4 Summary, Justification, and Concluding Remarks

Lending liquidity to the financial institutions is being practiced even before the establishment of the CBs. Financial institutions and even natural persons were capable of playing the role of LOLR if they were holding sufficient liquidity which they could lend. There were no laws that could regulate the operations of lending liquidity because these operations were conducted on mutually understood stipulations. Various countries (Germany, Pakistan, KSA) also lent liquidity and rescued the economy of other countries because of their diplomatic relations of political

[584] Ashfaq Ahmad, Muhammad Imran Malik, Asad Afzal Humayoun, "Banking Developments in Pakistan: A Journey from Conventional to Islamic Banking", (European Journal of Social Sciences, Volume: 17, Number: 1(2010), Accessed: October 06, 2018.

gains. This ritual of lending liquidity at the domestic and international levels has not gone obsolete in the modern economic system. Notwithstanding, CBs at the domestic level and IMF at the international level are officially playing the role of LOLR. However, the powers of the CBs and IMF to perform the role of LOLR are accountable and regulated by domestic and international regulations. Thus, the CBs and the IMF charge high-interest rates on the liquidity support which they offer while performing the role of LOLR. The support of liquidity also comes only against worthy collaterals. A minor liquidity problem can escalate the panic among the creditors and surge the demand for liquidity which can haul the entire system towards insolvency. More than injecting liquidity into the financial system, the LOLR must assure the trust of the creditors in the system and curtail the demand for liquidity.

This thesis is divided into eight main chapters and each one of them is segregated further for a better understanding of the reader. The conceptual underpinning of the LOLR and its contemporary significance in the modern financial system is elaborated. The pragmatic experiences of the Bank of England and Federal Reserve are critically examined and the lessons to reform the current laws of Pakistan are also drawn. In chapter one, a comprehensive description of the functions of LOLR and its importance in establishing a stable financial system is provided. Moreover, the progression of LOLR is unfolded which was considered nothing but lending liquidity to the financial institutions during the crisis. The contributions of Sir Francis Baring, who first used the term LOLR for the CB of the UK, are discussed in detail. The principles of Walter Bagehot and Henry Thornton to address the problem of moral hazard are also briefed. A critical analysis is provided for these principles which were proposed for the CBs to abide by while playing the role of LOLR. The need for an international LOLR is highlighted and the emergence of IMF as an official international LOLR is also explained. A continuous dependency of the financial institutions on the liquidity support of the CB creates severe moral hazard problems. The causes which enhance the anxiety of moral hazard problems and their solutions are examined in the final part of this chapter.

Chapter three is an important part of this thesis because it appraised the literature on the LOLR and evinced the relevance and significance of this topic in the modern financial system. This chapter was further divided into six parts. The first part evaluated the literature regarding the evolution of the role of LOLR. The relation of imparting liquidity between financial institutions in difficult times was happening even before the establishment of CBs. However, the CBs are now officially playing this role at the domestic level along with their other duties. Furthermore, the operations of the BOE and FRB are studied. The rationale behind the approaches which were used in performing the role of LOLR is also clarified. The decision of the nationalization of the bank of Northern Rock by the BOE is discussed in detail. A review of the literature which inspects the approaches of FRB while playing the role of LOLR for Lehman Brothers and AIG is provided. The role of FRB during the recent financial crisis of 2007-2008 is also evaluated. Additionally, the financial challenges which a financial system will be facing in the absence of the LOLR and the benefits of having it are extensively described. A minor issue of the shortage of liquidity can surge the panic among the creditors and enhance the demand for liquidity which is detrimental for the financial institutions. Thus, the presence of LOLR is very important to handle such situations and prevent the collapse of financial institutions. The need for a LOLR for the modern global economic system is briefly discussed and it provided a review of the literature which contains the information regarding the evolution in the functions of IMF. The literature regarding operations of BOE, FRB, and SBP which is relevant for this research is also reviewed. It further added the literature review regarding the moral hazard problems which are pertaining to the operations of LOLR. Finally, this chapter explained the limitations and gaps of the existing literature and unfolded the contributions of this thesis to the literature of LOLR in general and especially in the context of Pakistan.

Chapter four described the importance of the research methodology in a research study and clarified the consequences of the deployment of irrelevant research methodologies. The topic of research is examined, and it explored which research methodologies are relevant for this research. The scope of doctrinal research methodology and its relevance in this research is provided. Furthermore, the documentary research methodology and the rationale behind its selection to carry out this research are elucidated. The evidence for the magnitude of the comparative research methodology and its contribution to this research is elaborated. In legal research, the significance of case studies is also described along with empirical cases that are used in this research. The irrelevancy and limitations of historical and conceptual research methodologies are also explained. Although, the historical and conceptual research methodologies are not completely irrelevant to this research due to their limited scope they are not preferred. Finally, a critical evaluation of the resources which are used in this research is provided.

The banking sector of Pakistan, inception of the Islamic banking, and the current position of the recommendations of Basel Accord III are elucidated in chapter five of this thesis. This chapter was divided into five parts. The banking system which is now a vital part of any financial system and its contributions to the GDP of Pakistan is expressed. The evolution of the banking industry of Pakistan and the impacts of the policies of nationalization (the 1970s) and privatization (1990s) on the financial system are examined in detail. Moreover, the inception of a new model of the banking system in the form of Islamic banking (2002) in the system of Pakistan is also discussed. A critical analysis of the factors which cause a financial crisis and the reasons for the instability of the financial system of Pakistan is provided in the second part of this chapter. The third Part elaborated the Banking Companies Ordinance, 1962 (LVII of 1962) which regulates the banking sector in Pakistan. The powers and duties of the SBP are also expressed. The Fourth part argued the causes which had contributed to the collapse of many banks in the world and unfolded the main reasons behind the proposals of the Basel committee. Basel I and II and the reasons for their failure to deter the financial crisis of 2007-2008 are also accessed. The hurdles to implement Basel III are unveiled. Finally, the loopholes in the current regulations which empower the SBP to play the role of LOLR are highlighted and the challenges of establishing a LOLR for Islamic banking are examined.

Chapter six of this thesis identified the problem in the regulatory system of Pakistan in the context of LOLR. The chapter also answered the research question of this research. It has provided a detailed discussion on the operation of LOLR by the SBP to identify the problem. It argues that the power of acting as LOLR is allocated to the SBP after the financial crisis of 2007-2008. The SBP is empowered to act as LOLR through an amendment in the State bank of Pakistan Act 1956 in 2015. The Section is examined in this chapter. Furthermore, a case study of the KASB bank is examined to identify the problem. The establishment of the KASB is discussed besides the functioning of the bank until the merger took place. All of the legal formalities which were required to fulfill in the amalgamation of the KASB into the BankIslami are appraised. The chapter concluded by arguing that although there are loopholes in the regulation, the main problem lies in the transparency issues while conducting the LOLR operations.

Chapter seven provided a detailed assessment of the operations of BOE and FRB as LOLR by evaluating examples. It identified the gaps of the current system of Pakistan and after comparing the system of the UK and US draws lessons to propose a way forward. The establishment of the BOE is discussed which was established as a commercial bank. Its emergence as a CB for the UK and its rescue operations as a LOLR are also unfolded. The Principles of Walter Bagehot and Henry Thornton to curtail the effects of moral hazard problems are described in detail. The use of the discretionary powers while playing the role of LOLR which the BOE keeps is accessed. The establishment of the first CB in the US and the reasons for its collapse are unfolded. The divergence between the first and second CB of the US is also discussed. The era in which the financial system of the US was governed without a CB is evaluated. The establishment of Federal Reserves and its role in strengthening the financial institutions against financial crises is explicated. Dodd-Frank Act, 2010, which regulates the functions of LOLR in the US, is studied. The example of Northern Rock, Lehman Brothers, and AIG are accessed to draw lessons for the system of Pakistan. Furthermore, a critical evaluation of the role of LOLR in the context of the Bank of England, Federal Reserves, and State Bank of Pakistan is provided. The functions and the importance of LOLR in the modern financial system are described. Moreover, the understanding regarding the role of LOLR before the recent financial crisis of (2007-2008) is accessed. The LOLR was limited to lending liquidity to the financial institutions which were facing liquidity problems. The role of BOE and FRB in protecting the financial institutions in the financial crisis of 2007-2008 is explained extensively. The approaches used by the CBs of the UK, US, and Pakistan are also expressed in detail. Additionally, the domestic laws which empower the BOE, FRB, and SBP are examined. The reasons why policymakers were critical of the role of LOLR for a long time are unfolded.

Chapter eight unfolded all the changes which were made in the financial laws of the UK and the US to enhance the capacity of the role of LOLR. The BOE possesses several discretionary powers while playing the role of LOLR. However, on the other hand, after the implementation of the Dodd-Frank Act, 2010, the discretionary powers of FRB are curtailed. Although the SBP is also bound to lend liquidity to the institutions which can provide worthy collaterals, it spends a large amount in providing liquidity to rescue national institutions that are not providing any collaterals. The loopholes in the current system of Pakistan are identified and a reform proposal is illustrated. Finally, a critical evaluation of the reform proposal is also provided which elaborated on the benefits of implementing these reform proposals. The contemporary challenges regarding the LOLR facility for Islamic banking are addressed and a reform proposal in this regard is provided. The significance of the recommendations of the Basel accord III in making a stable banking system is also accessed. Furthermore, a summary of the thesis is provided besides the justification for undertaking this research. Moreover, the findings of this thesis are also elucidated. Finally, it concludes by providing recommendations for further research and concluding remarks.

8.4.1 Justification for Undertaking this Research

In the modern economic system, the significance of the banking industry cannot be denied because of its fruitful role in financial growth at the domestic and international levels. Banks have become an essential part of the financial system. However, a deliberate study of the collapse of various banks in almost every jurisdiction of the world has unfolded the need for LOLR for the survival of the banking system. The strength of a financial system does not rely on its resources, but it depends on the trust of its investors. Dread among the investors enhances the demand for liquidity which coerces the financial institutions to convert their illiquid assets into liquidity. A swift vending of the illiquid assets and uncertainty in the stability of the system drastically decrease the value of the assets. Therefore, financial institutions seek liquidity support from the CB. The presence of LOLR curtails the panic of the investors, which decreases the demand for liquidity and provides sufficient time for the financial institutions to handle the situation.

The Bank of England is empowered to play the role of LOLR for all banks and financial institutions which are incorporated in its jurisdiction. There were many incidents in general and particularly the recent financial crisis of 2007-2008 when the BOE acted as a LOLR for various financial institutions. It enjoys several discretionary powers which were used in the greater interest of the financial system of the UK. An unprecedented approach was deployed while playing the role of LOLR for the bank of Northern Rock when it was nationalized (2008). A critical evaluation of the empirical approaches used by the BOE while playing the role of LOLR elucidates that its rescue operations were capable of accomplishing the tasks of strengthening the financial institutions and prevent them from collapsing. Similarly, the Federal Reserves persisted in strengthening the financial institutions during the financial crisis. Many financial institutions were rescued, which are solvent now and generating great revenue (see Chapter seven). However, the rescue operations conducted by the State Bank of Pakistan could not bring stability to the financial system. Billions are injected into the financial system, but the financial institutions are still facing the challenges of insolvency. Resultantly, the SBP started facing insolvency challenges and sought liquidity support from the IMF. An appraisal of the financial regulations of Pakistan highlighted the loopholes which need to be addressed to maintain stability in the financial system. Thus, the undertaking of this research study is fully justified because it proposes a way forward after identifying the lacunas in the system (see Chapter eight of this research).

8.4.2 Findings

An inevitable need for the LOLR in the modern financial system is established because of its successful operations in rescuing financial institutions during the crisis. The financial system will be vulnerable and unstable if there will be no institutions that can lend liquidity during the crisis. The creditors will also be uncertain about the persistence of the system against the financial crisis. Although the presence of LOLR addresses all these issues at the same time, it gives rise to several moral hazard problems. The assurance of the CB to impart liquidity, when it will be needed, erodes the surveillance of the creditors on the activities of the financial institutions because they feel no insecurity for their money. It allows the administration of the financial institutions to invest in risky business ventures without paying heed to the repercussions which can be harmful. The CBs keep the public money which can also be wasted if it will be imparted into the financial institutions which are not capable of surviving by utilizing their resources. Moreover, the principles of lending freely, but to the financial institutions which can provide good collaterals and imposition of high-interest rate, can be useful to minimize the effects of moral hazard problems (see Chapter Two). Notwithstanding, the main findings which were made through this research are;

a) Moral hazard problems cannot be permanently eliminated but can only be curtailed through the deployment of financial strategies. The fiscal policy of the CB regarding the operations of LOLR should be overtly expressed at the starting of each financial year. The CB must not act as a LOLR only during the financial crisis rather it must take all necessary steps to prevent a financial crisis. Vigilant financial strategies mean a meticulous assessment of the financial activities of the institutions working within the system quarterly. Assessment includes the maintenance of required liquidity under the Basel Accord, business activities, the risk involved, worth of illiquid assets, etc.

b) The CB must be well informed regarding the strengths and weaknesses of the financial systems. All of the audit reports must be published quarterly. CB must also have a piece of accurate information if the financial institution is merely illiquid or it is facing insolvency challenges because;

c) It is not possible to precisely evaluate the difference between illiquidity and insolvency during the financial crisis. Therefore, the CB should make sure that it is having factual reports of the financial institutions working in its domain.

d) No financial system can survive if it will fail to ensure impartiality and transparency while playing the role of LOLR. As discussed in chapter six that SBP was not impartial while using its regulatory powers for KASB Bank. Also, the SBP and the Govt were reluctant to make their report public which raised serious questions regarding their transparency. Operations of LOLR must be conducted on the approvals of the experts and committees working within the SBP. The Bank of England's example in the case of Northern Rock can be followed in which the government waited for the parliamentary committee's report on "the bank run" before taking any action. To ensure impartiality and transparency in the operations of LOLR a CB bank must provide a comprehensive report which should address the questions of why a LOLR was needed, how it was conducted and why the CB refused to act as LOLR, if applicable? Details of the amount injected and covenants should also be provided and the CB should make such its reports public.

e) The implementation of the proposals of Basel accord III can make a strong financial system and prevent the collapse of banks (see Chapter five).

8.5 Recommendations for Further Research

Two main challenges were encountered through this research which can be addressed through further research. First, mainly the parables of the CBs of the UK and US were utilized to explicate the significance of the presence of LOLR. However, the operations of CBs from developed countries e.g. France, Germany, Canada, and Japan can also be examined. The rationale behind the selection of the BOE is that the SBP is established on the model on which the BOE is established. FRB is selected because the fluctuation in the demand for liquidity in the banks of the US which are involved in lending to the farmers is relevant to the circumstances of the banking industry of Pakistan. Furthermore, although the presence of LOLR is widely acknowledged by the policymakers mainly after its successful role in the recent financial crisis of 2007-2008 it must be examined how the anxiety of moral hazard problems can be permanently eroded. Secondly, the role of the IMF as an international LOLR is not extensively examined which must be considered because it has a deep effect on the global financial system. Although, it was recognized in this research that the IMF has rescued several CBs by injecting liquidity, but it has failed to evince impartialness. The scope of this research was limited because the objective of this research was to identify loopholes in the current financial system of Pakistan by utilizing the pragmatic parables of the BOE and FRB. Thus, this research cannot address the queries which were raised regarding the role of IMF (see Chapter One). Additionally, the reforms which are proposed in this research are also subject to further research. Researchers can propose a more plausible system especially in the context of Islamic banking which is a fast-emerging industry nowadays. Lastly, recommendations of the Basel Committee are also subject to further research in the context of developing countries.

8.6 Concluding Remarks

Since the recent financial crisis of 2007-2008, the role of LOLR has been admitted as an inseparable part of the functions of CBs. Although, it has demonstrated its role in deterring a financial crisis the apprehensions of the wastage of public money should not be ruled out. This study has evaluated the role of LOLR played by the BOE and FRB during the financial crisis and unfolds the facts that it was quite helpful to prevent the collapse of many financial institutions. There is no financial system in which the financial institutions do not suffer liquidity challenges even in developed countries like the UK and the US; the CBs have to impart liquidity to protect their financial institutions. Similarly, it is not astonishing that the financial institutions in Pakistan experience the same but the reasons for not getting fruitful results through rescue operations are lack of transparency and inefficient laws. Thus, contemporary challenges need to be identified and addressed accordingly.

8.7 Summary

This chapter, and indeed the thesis more generally, has presented and analysed the problems of the systems of the UK and the US and then explained how the policymakers of both countries have reformed their systems. The thesis has demonstrated the crucial significance of continuously reforming banking systems and making them efficient to address contemporary issues and concerns. The current financial issues of Pakistan are elucidated and the loopholes in the legislation are examined in the thesis with a view to looking for precedents to follow in reforming the banking institutions there. Furthermore, the reform proposals for the system of Pakistan are proposed to address the gaps in the current regulation and to fully establish a modern banking system. The implications of these reform proposals are examined in detail. The benefits which the financial system of Pakistan can derive from reform are, it is argued, significant and yet the repercussions of a lack of reform, in the light and knowledge of what can happen in times of financial crisis, cannot be lightly dismissed.

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