

## edward j dodson's cooperative individualist view



For most of their history, banks were managed by people who understood the banking business to be that of an intermediary between lenders and borrowers. People who enjoyed incomes greater than their immediate needs deposited surplus cash with the bank. The bank created an account for the depositor and permitted the depositor to write checks against the account balance. The bank charged for this service when the depositor did not keep in the account an amount that enabled the bank to cover its own expenses by investing the cash elsewhere or making loans to borrowers. The bank would actually share its investment revenue by paying *interest* when the depositor agreed to open a savings account with more restricted access for withdrawal of funds. The bankers knew what their cost of funds was, knew what their expenses were to operate the bank, knew what market forces would permit as a profit margin, and charged borrowers *interest* accordingly.

What makes this rather straightforward model of the banking business more complicated is the process of evaluating risk. And, for bankers, there are several important risks to consider. First, there is duration risk; that is, the risk that an unstable interest rate environment will jeopardise profit margins when rates on deposits are rising while rates on loan assets are not. Second, there is default risk, where the creditworthiness of a borrower has been incorrectly analysed or has materially deteriorated while a loan is outstanding. And, third, there is business environment risk. To the extent possible, banks try to engage third parties to mitigate these risks, which adds another layer of complexity to the business model.

The current problem for banks of widespread defaults by borrowers, who were given loans for the purchase of residential properties, occurred because they ignored everything their predecessors had learned about risk. Instead, they accepted the dubious idea that government planners and central bankers had successfully developed the fiscal and monetary tools to achieve sustained economic conditions. And, they felt very protected by what almost everyone accepted as a positive economic indicator: rising property prices. With property as collateral for loans, losses due to defaults and foreclosures would be minimal or even non-existent. So confident were some bankers that they did not even require borrowers to pay for mortgage insurance when they could not make the *traditional* 20 percent down payment.

We are now in the midst of a global economic meltdown, and many banks are in danger of closing their doors. Failing to understand the cyclical nature of the land markets that drive property markets, banks have watched helplessly as the value of their collateral has fallen and continued to fall.

To save the surviving banks from themselves, this is an opportune time for new regulation that greatly restricts or prohibits banks—whose depositors are protected by government insurance—from accepting land as collateral for future loans. This one measure would remove a significant portion of the accelerant from the next credit-fueled upward movement in the land market cycle.