

Flaherty should stay out of the banks' business



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There's an old saying: "Fool me once, shame on you. Fool me twice, shame on me."

If only Federal Finance Minister Jim Flaherty remembered it.

One of the main causes of the current financial crisis is that banks in the United States made irresponsible loans to people with questionable credit-worthiness.

This was spurred on by a well-intentioned U.S. government, which wanted to help low-income individuals afford their own houses.

In 1996, the government ordered Fannie Mae and Freddie Mac, government-sponsored enterprises that purchased mortgages, to make sure at least 42 per cent of the mortgages they bought were issued to borrowers with below-average incomes.

Banks are greedy. Like any

business, they want to make money. Their shareholders, just like shareholders of other companies, are interested in the bank's bottom line.

How do banks turn a profit? They take our money, which we deposit into their chequing accounts, savings accounts and GICs, and lend it out to borrowers at a higher rate.

The more loans a bank makes, the more money it will make — unless it makes irresponsible loans.

That's because when borrowers default on their loans, the bank loses the money it lent.

In the U.S., banks saw Fannie Mae and Freddie Mac's newfound appetite for mortgages to low-income individuals after 1996, and started making riskier loans knowing that Fannie Mae and Freddie Mac would take them off their hands.

The scheme worked as long as house prices kept going up, because borrowers who ran out of money could sell their house for more than they bought it, and pay back their loan.

But when housing prices started falling, many people didn't have enough money to repay their mortgage. It was

the start of the current financial crisis.

The lesson from the past few months is that banks respond to incentives. If governments offer to pay for risky loans, then banks will be more irresponsible with their lending in order to make higher profits.

But if governments leave banks alone, banks will be more scrupulous about who they lend to because they will lose money if they lend to people that are unlikely to pay back their loan.

Banks will do whatever is most likely to generate the biggest profits for their shareholders.

Flaherty doesn't seem to have grasped this. He met with bank CEOs on Jan. 5, seeking ways to create more credit. The *Toronto Star* reported that Flaherty and the federal government are "looking at ways to increase influence over loan availability in Canada."

It appears Flaherty wants the government to tell banks how to lend. "I encourage the heads of the banks, the CEOs, to work with the government," he told reporters.

Flaherty's intentions are good. Access to credit is important for economic growth, and if lending slows

down, the economy can slow down too.

However, it is natural for credit to dry up a bit during economic downturns such as the one we are currently experiencing. With many businesses and consumers struggling more than usual, prudent banks should be more cautious about who they lend to.

However, as long as there are banks, credit will never dry up completely because banks make their money by lending.

But if Flaherty forces banks to make questionable loans, he will place banks' future stability at risk.

Canadians should be worried. The current financial crisis has shown what happens when governments interfere with banks by creating incentives for them to lend more.

Flaherty should have learned his lesson by now, and should leave banking to the banks. The short-term credit drought will be worth it if it guarantees the long-term health of our country's banks.

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