# When Affordable Lending Is Illegal

*or*

# Why Banks Don't Lend

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# Mandatory Overview Slide

## What We're Gonna Do

- The Challenge: your reasons for not lending
- The Analysis: expert reasons for not lending
- Who Cares?

# Why not lend?

Case Study: Wade wants $100,000

- Facts:
  - You have $100,000
  - I want it

- Analysis: under what conditions will you lend to me?

# Why not lend?

Popular Explanations When Banks Refuse to Lend *Me* Money at the Rate I Want

- Premise 1: Banks have money
- Premise 2: Banks could lend
- Premise 3: Banks don't lend
- Conclusion (Alternative 1): Banks are greedy, blood-sucking parasites who must be compelled to shell out the cash
- Conclusion (Alternative 2): Uh, maybe not

# Who's the Boss?

Who's money is it anyhow?

- Sources of Bank Funding
  - D
  - In
  - C
- So

*Fiduciary Duty

# The Rules of the Game

Two Rules:

1. Obey the (Banking) Rules

2. Obey the (Market) Rules

# What's the Problem?

Successful banks must balance costs, risks and revenues

Revenues < Cost + Risk → Bankruptcy

Revenues = Cost + Risk → Subsistence

Revenues > Cost + Risk → Prosperity

# Five Basic Problems

The Freedman-Click Analysis:

- High reserve requirements
- Defective legal and regulatory environments
- Crowding out by government bonds
- Asymmetrical information
- Inadequate skills for assessing and managing risk

# Problem 1: High Reserve Requirements

[redacted]

# Problem 1: High Reserve Requirements

*It's a Wonderful Life*: "But don't you see, that's not how it works . . ." George Bailey

Math Case Study: Reserves and Revenues

Background: Banks make money from fees and interest

Facts: MLT Savings & Loan has

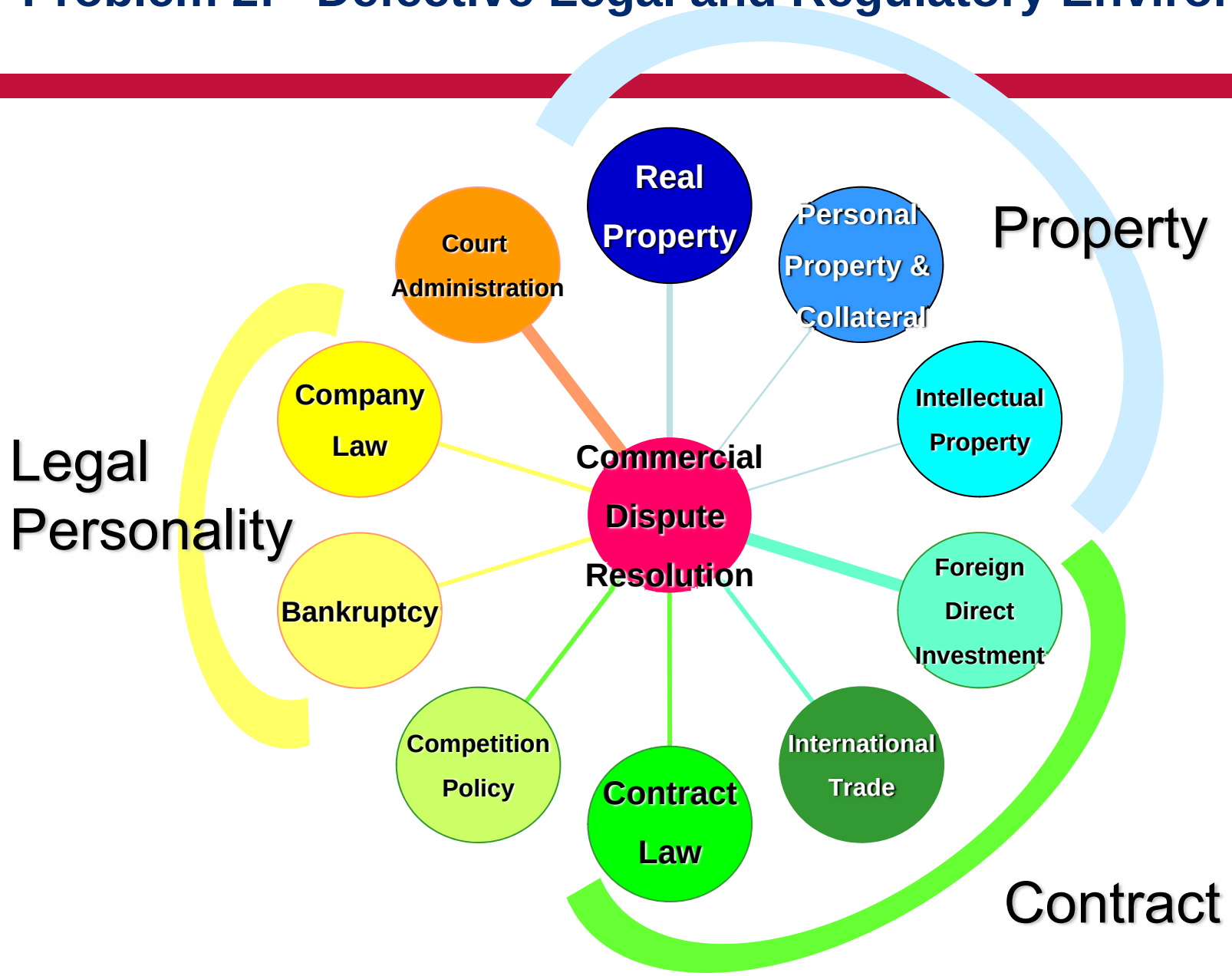
- Operating Costs of $1 million
- Capital of $20 million
- All revenues come from interest

# Problem 1: High Reserve Requirements (the Test)

Problem: *What interest rate is needed to generate $1 million from $20 million in capital?*

| Reserve Requirement | Funds Available for Lending | Interest Rate Needed |
|---|---|---|
| 0% | 20,000,000 | 5.00% |
| 20% | 16,000,000 | 6.25% |
| 40% | 12,000,000 | 8.33% |
| 60% | 8,000,000 | 12.50% |
| 80% | 4,000,000 | 25.00% |

# Problem 2: Defective Legal and Regulatory Environment



# Problem 2: What Laws Affect Finance?

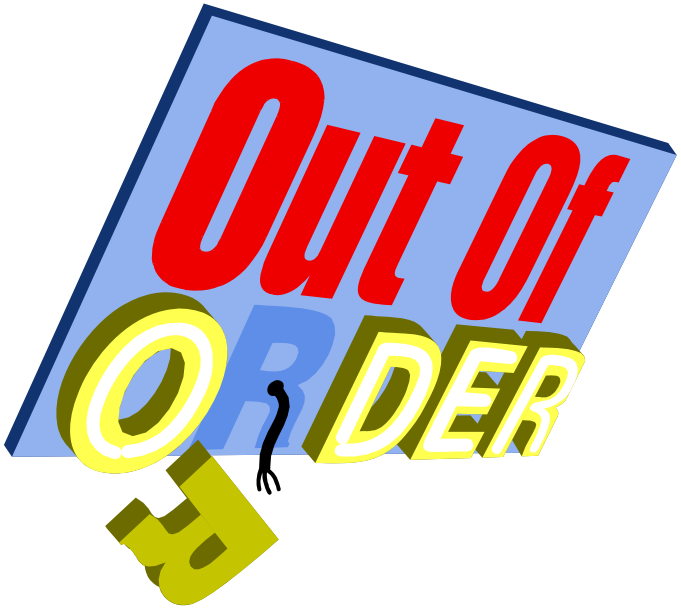
*Doing Business*:

The tip of the iceberg?

# Problem 2 *(still)*: CLIR, BizCLIR, BEER

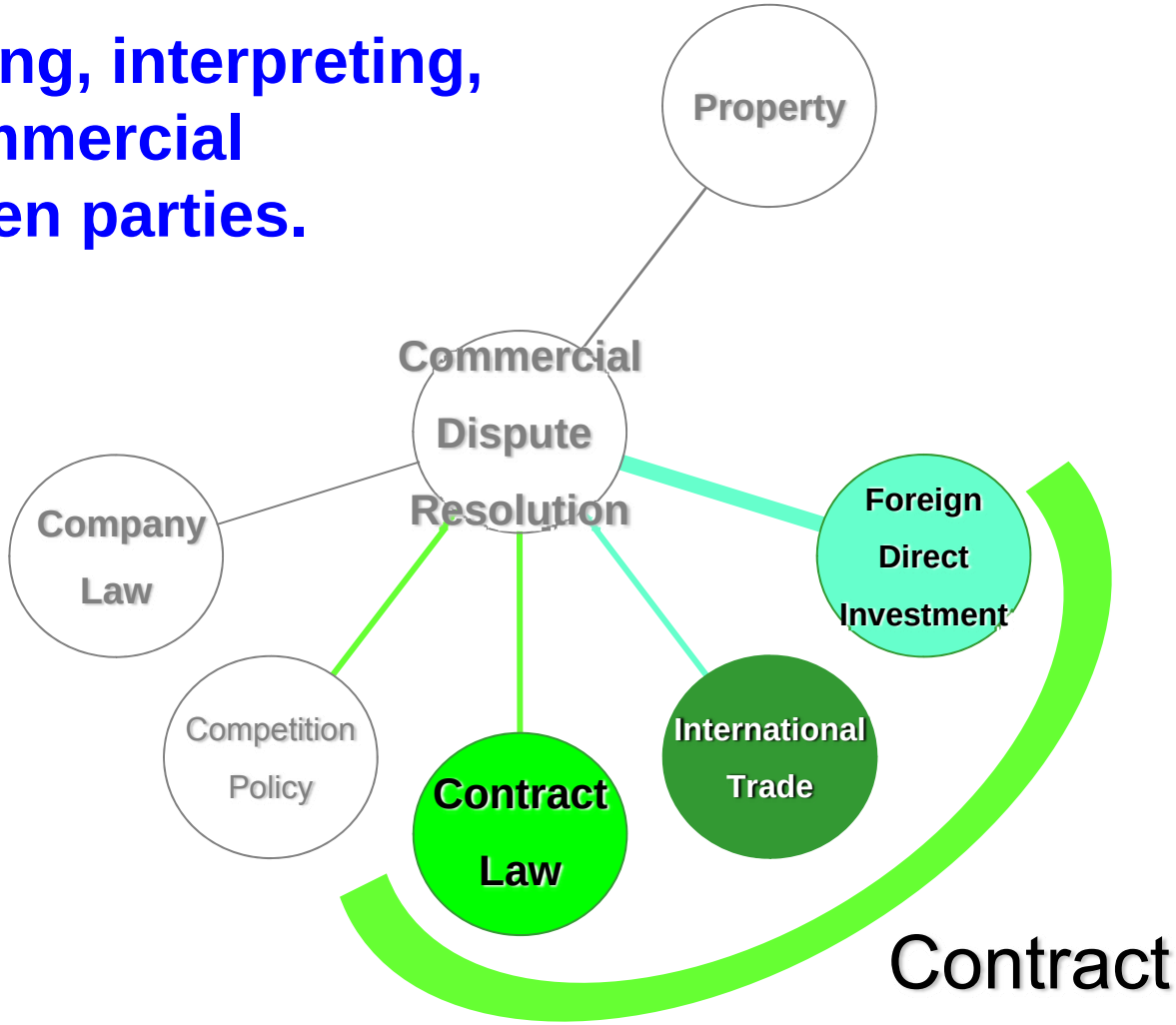
Freedman and Click's *3 Big Problems*:

1. Contract
2. Collateral
3. Bankruptcy

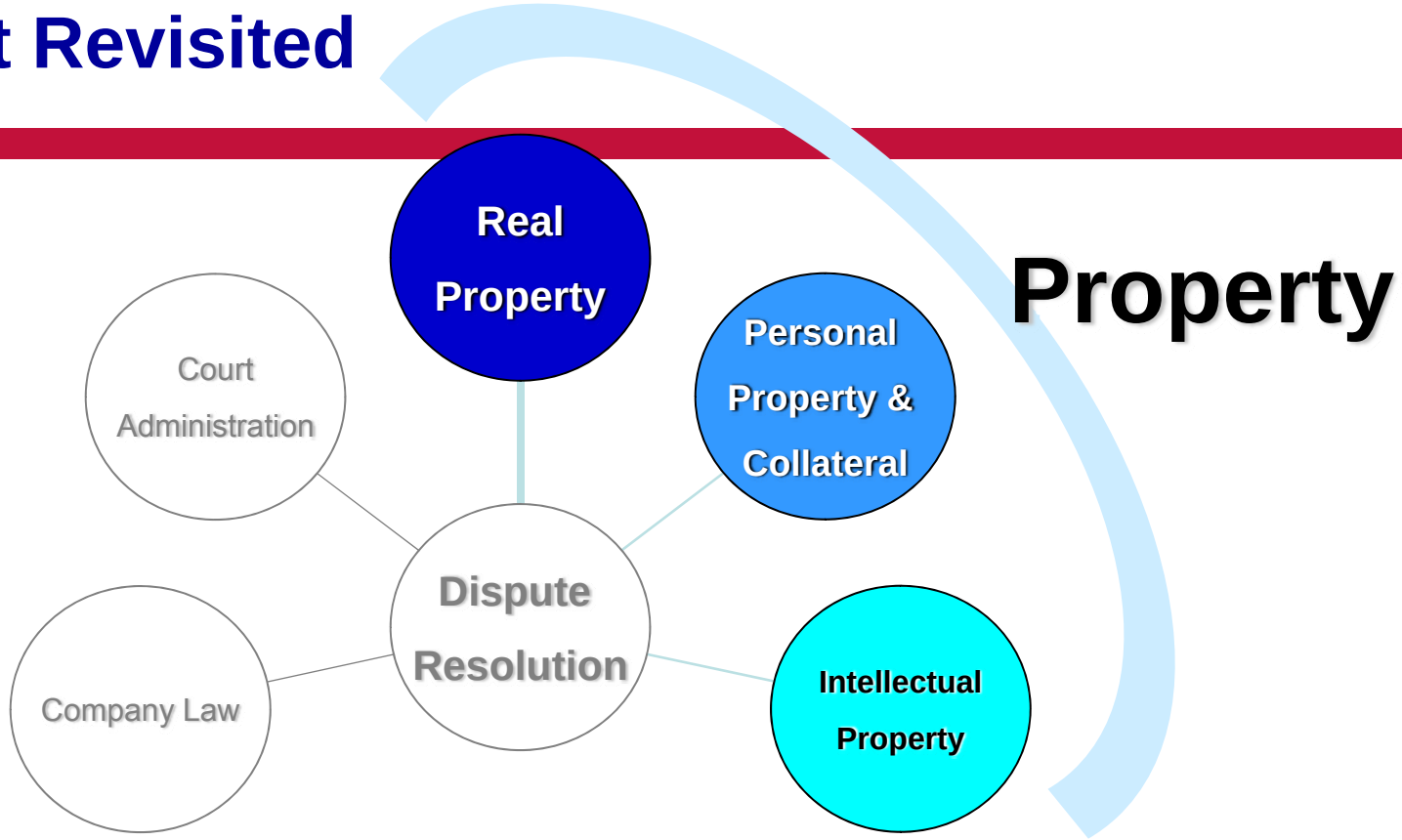


# Contract

**A system of creating, interpreting, and enforcing commercial obligations between parties.**



# Contract Revisited




**A system of laws, regulations, and institutions that creates, recognizes, administers, and protects rights in property.**

# Collateral: More Dead Capital

| **Digression Analysis of Certain Seminal Bovine Characteristics (*1st Iteration*)** (Channell 2006) | | |
|---|---|---|
| **Milk** | ✓ | ✓ |
| **Fertilizer** | ✓ | ✓ |
| **Offspring** | ✓ | ✓ |
| **Beef** | ✓ | ✓ |
| **Financing** | ✓ | ✗ |

# The Other Property: Movables and Intangibles Defined

1. It exists or will exist
2. Lenders find it valuable
3. Legal system supports it
4. BONUS: Impact on Women

# Problem 2 (Continued again): BEER & Bankruptcy

Liquidation

Reorganization

Purpose: To reduce lending and borrowing risks

# Problem 3: Crowding Out by Government Bonds

## THIS IS A TEST!

You have $1 Million

You will be in really big trouble if you lose it

Choose the Best Investment:

**10 % return with**

**1. Really Low Risk**

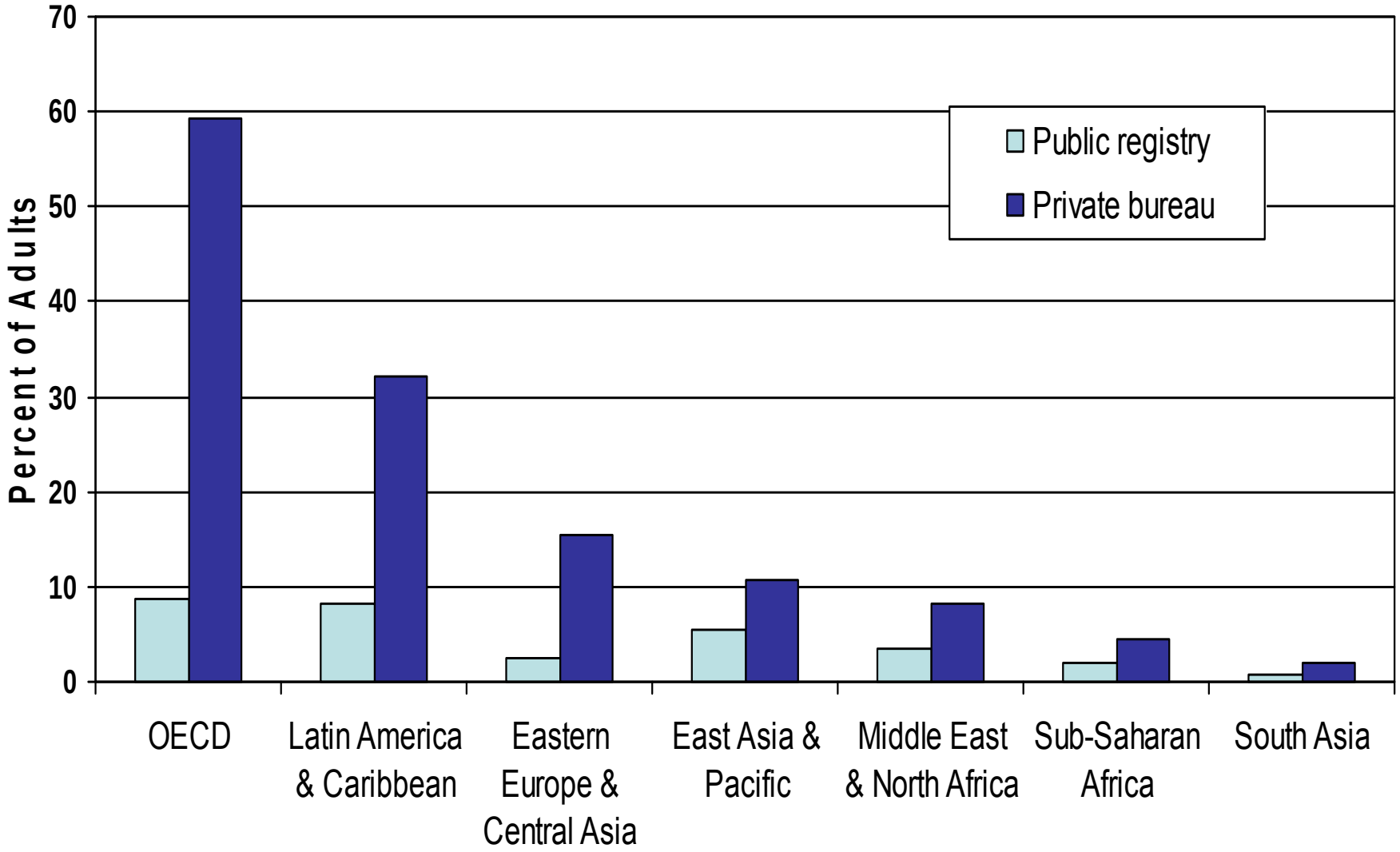
**2. Lots of Risk**

**3. Free Subscription to *EG Matters***

# Problem 4: Asymmetrical Information

Huh? Asymmetrical ≈ Unbalanced

# Problem 4 (in English): Credit Bureaus



# Problem 5 (finally): Inadequate Skills

Freedman and Clicks *2 Missing Skills:*

- Risk Analysis
- Risk Management

Assumptions

- Decent Records
- Enforcement Capacity

# Final Test

Channell/Shiman *Indisputable* and *Universal* **Law** of **B**usiness and **B**anking **S**uccess:

Revenues > Cost + Risk → Prosperity

| Problem | Cost | Risk | Revenues |
|---|---|---|---|
| *Reserve Requirements* | | | X |
| *Legal & Regulatory Framework* | X | X | |
| *Crowding Out* | X | | |
| *Asymmetrical Information* | X | X | |
| *Lack of Skills* | X | X | |

# Penultimate Slide: Who Cares?

Stakeholder Recap – Fill in the Boxes

| Problem | Public | Private | Other |
|---|---|---|---|
| *Reserve Requirements* | | | |
| *Legal & Regulatory Framework* | | | |
| *Crowding Out* | | | |
| *Asymmetrical Information* | | | |
| *Lack of Skills* | | | |

# Final Slide: Success and Sub-Optimality

| Problem |
| --- |
| *Reserve Requirements* |
| *Legal & Regulatory Framework* |
| *Crowding Out* |
| *Asymmetrical Information* |
| *Lack of Skills* |

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