

THE THEORY OF BANKING ECONOMICS

THE CAUSE OF THE CURRENT CRISIS – SOLUTIONS

This article uses the Theory of Banking Economics, which is based on looking the Operating System of Capitalism (“OSC”) and at how it works, i.e., the bank regulatory mechanism. When one looks at the present crisis from the perspective of the bank regulatory mechanism, it becomes very clear that 1/ proves the Bush Administration is not at fault for the current banking and credit crisis, 2/ raising taxes on businesses and those in the top 20% income quintile will further collapse bank capital and lead to the government having to take over all banks resulting in Marx’s vision of true Communism in Das Kapital, 3/ the imperative to bring back America’s international oil companies to develop oil, nuclear and alternative energies to prevent future spikes in energy that could have the same affects, and 4/ the imperative bring back America’s international construction companies to renew and develop infrastructure throughout the country to generate greater productivity and high paying jobs.

There is a more developed article in <http://admc24-7city.com/TheoryBankingEconomics> and <http://admc24-7city.com/TheoryBankingEconomicsDiagrams>, which goes into greater detail explaining (i) how the bank regulatory mechanism works, (ii) how the Fed operates to create balance in the economy through the bank regulatory mechanism, (iii) what the causes are of the current crisis, where it becomes clear that the Bush Administration had no involvement, (iii) historical examples of how sudden changes in oil prices and taxes change the value of the monthly mortgage payment to home owners, commercial property owners and businesses resulting in the expansion or contraction of the economy, (iv) specific **low cost** solutions in housing that have an immediate and dramatic effect through the bank regulatory mechanism to bring about an immediate turn around in the economy and start an economic boom.

Theorem

The expansion and contraction of the economy is directly related to the leveraging of the increasing and decreasing values of bank capital, as those values are determined by the changes in (i) the affordability of the monthly mortgage or loan payment (i.e., the strength of the yield of bank assets based on their debt service coverage) and (ii) the risk adjusted ratio of (cash flow bases) assets to capital.

With this theorem as a base, all the outcome of all planned and unplanned programs (such as the effect of tax policy changes, regulatory changes, etc.), of the government and economic events (such as sudden change in private or business income, sudden change in one’s living and business operating expense), can be accurately predicted.

The Bank Regulatory Mechanism:

Economics and economic modeling is generally based on some theories that are used to analyze and interpret data usually oriented to support whichever political persuasions of the economist. The Theory of Banking Economics, however, is entirely different; it looks directly at the operating system of Capitalism (“OSC”), which is the **bank regulator mechanism**.

Within this OSC, we can see that *changes in the affordability of a monthly mortgage payment alter the value of the underlying mortgages, which make up and are the basis for the value of securities, thereby causing a devaluation of bank capital according to their risk adjusted ratio of assets to capital of the bank,*

Affordability formulas for home buying are based on their stable spending habits. For commercial real estate and business the affordability is the debt service coverage ratio (“DSCR”) or the ability of a commercial property to cover the mortgage payment based on their net operating income (“NOI”).

The cash flow value of a property as determined by the mortgage formula:

The easiest way to understand this is by example: Let’s say you have an income of \$100,000 per year and your car, credit card and other fixed payments is \$10,000, then the NDI is \$90,000. If the lender uses a formula of 33% as the mortgage allotment, then you have \$30,000 per year for your property tax, home insurance and the mortgage payment itself made up of an interest and principal portion. Let’s say the property tax is \$4,000 and the insurance is \$1,000. That leaves \$25,000 to cover the interest and principal.

Now let's say the regulations are for a maximum amortization period of 25 years, then the lender takes the monthly payments and adds them together for 25 years, then deducts what the interest would be for that 25 years, based on the term of the loan, fixed or adjustable, and what's left over is the amount of principal in the mortgage that the Lender can provide the borrower, less any points, government insurance fees, etc.. Now, what you will see the lender do is just plug in the NDI into a box on their computer screen, type in the market interest rate, amortization period, the percent of the mortgage, the property tax and insurance, etc., and press "Enter" and the loan amount pops up.

This is the simple explanation of how the **principal value** of mortgage loan is determined, where in this case, you have \$25,000 times 25 years or \$625,000, less interest at, say 6% of \$360,000, the result a loan principal of **\$266,000**, less closing points and fees.

In a declining economy, if the Fed reduces interest rates, the value of the principal increases, thus stabilizing bank asset values and, therefore, bank capital, and equity; and visa versa.

Causes of the Crisis:

The Theory states that the value of a mortgage is based on its NDI. Now, as stated above, the NDI is made up of standard expenditures people (and businesses) have. Thus if there is a sudden negative radical change in any standard expenditure, relative to the formula used adjusted for the sudden change, it would then be deducted from the NDI, meaning that one would start with a new NDI and consider how much the principal value of the loans should be, again after deducting the percentage of sudden change in expenditure.

For example, many estimates have it that around 5% to 10% of people's monthly income, depending on their level of income, was lost due to the sudden spike in oil prices.

In the above example of the homeowner with a \$100,000 per year income, if the change is only 5%, the adjusted NDI would be \$85,000 per year and a lender would lend only \$202,000 for an interest of 6%. This represents a sudden drop of 24%, in cash flow value for the property to the homeowner and asset to the bank represented by the principal value. Thus, in order to bring the principal value of the bank back to the original loan amount, and cash flow value back to the homeowner, the Fed has to reduce interest rates from 6% in this example to 3.3%, which is a 55% rate reduction.

The Fed took these actions, belatedly, because the Fed typically reacts to the direction of the market, and any sudden change to the dynamic changes to income in the economy, generally takes 3 to 6 months to have their full effect. This would be predicted using the Theory of Banking Economics.

*In this case oil prices spiked upwards by **245%** from \$60 per barrel in May 2007 to \$147 per barrel by July 2008, after a 3.5 year doubling from \$30 per brl from December 2003 to May 2007. This sudden spike in the oil price caused a dramatic increase to standard expenses within the NDI reducing the value of all home mortgage loans, as well as all other loans where the cost of energy is a major component. In the process in "real" terms, the value of the principal portion of all oil related loans was driven down dramatically, as well as the equity value in property and shares.*

During the first 3.5 years, the economy expanded so fast, together with the increasing Globalization, the costs of cheaper quality goods being imported and gains in productivity, that the Fed was able to gradually raise interest rates to around 5% from the low of 1%, during the same period that began with the effect of 9/11 on the cash flows of businesses. This raising of interest rates was intended to increase the value of the dollar and stabilize oil prices valued in dollars, as well as to provide a cushion against any other economic crisis. It was partly made possible, as well, because of the increasing of income and productivity for the home owners and for business, where at one point, many economists and analysts were sighting that this period was one of the first times in economic history that every sector of the economy was booming, even that we might be headed into a "Golden Age."

But with the 245% spike in oil prices from May 2007 to July 2008 from \$60/brl to \$147/brl, dramatically diminishing the "real" NDI, the Fed could hardly keep up, as other new and past regulatory actions, including the SEC following the direction of BASEL II, requiring all banks to shift assets held at their book value to Mark-to-Market accounting, compounding the problem into the "perfect storm" - *\$500 billion in bank asset values were lost, collapsing home prices*

Examples of Oil price spikes and tax changes on business and upper income earners upwards and downwards that have resulted in economic boom and bust, clear to understand using the Theory of Banking Economics.

1. The **1973 Oil Embargo**, caused a spike in oil prices from \$8/brl to \$18/brl, resulting in the collapse of property values and the stock market in 1973/4
2. The **1978 Oil Embargo**, caused a spike in oil prices from \$18/brl to \$28/brl, resulting in the collapse of property values and the stock market in 1979/80, and Carter's infamous "Malaise" speech that America would no longer be a super power and Americans would have to tighten their belt, something we hear from politicians and business people today.
3. The **1981 deregulation of oil**: In Reagan's Inaugural Address of January 1981, he declared an economic war against the Soviets (and the Ayatollah Khomeini of Iran), through the deregulation of oil, which he declared as his first act, causing the collapse of oil prices from \$40 per brl down to \$28/brl, down to \$18/brl and finally \$8/brl by 1996, then sustained through January 2001.
4. **1989 Tax increase**: Bush 41 followed his campaign promise of "Read my lips. No new taxes" by siding with the Democrats for one of the biggest tax increases in history, while Europeans were lowering theirs to expand their economies and reduce their welfare states. The result of the income tax spike on the upper incomes in the top 20% income quintile, as the biggest owners of assets held by banks was that bank asset values fell.
5. Bill Clinton 42's **Regulatory reduction of the mortgage equity requirement** came after the Bush tax hike left most homeowners locked into 12% interest rates brought about by the booming Reagan years. The Bush 41 tax hike resulted in collapsed property values and 6% interest rate bank loans that homeowners could not access due to the 20% minimum equity requirement to refinance. Clinton released the power of the consumer by authorizing \$6.7 Trillion in new FNMA and GMNA loan guarantees, in which anyone seeking to refinance their mortgage could pay a 1% Federal government insurance fee to allow a 95% refinancing, similar to what the Veterans Administration allowed for GI's. The result of this was that within 6 months everyone that could had refinanced their loans, reducing their mortgage payment immediately and an enormous pent up demand for cars, appliances, cloths, vacations, etc. prevailed across the land, as loans were refinances based on the strength of cash flows at 95% versus 80% of comparative market values. This started the Clinton Boom.
6. Bush 43. The **sudden reduction in income taxes, corporate taxes and dividend taxes** resulted in an immediate reversal of the Clinton recession by effecting an increase in "real" NDI relative to the mortgage formula, resulting in an increase in 70% of bank assets effected by the tax reduction, and relative to their expanded capital values, and as people with higher incomes refinanced their loans, the economy boomed.
7. And the **crisis now**, based on the one year 245% spike in oil prices, due to the lack of necessary infrastructure to extract, process, refine and transport oil, changing the NDI relative the original loan underwriting, collapsing principal values of bank assets, bank capital and all equity capital.

Mortgage Relief – Low cost quick solutions to the crisis:

Looking at the past market and government actions that brought about radical changes to bank asset values, by changing the values of the original underwriting and the solutions of the Administration, the Treasury, the Fed, other regulators, Congress and others, and considering the Theory of Banking Economics, that positive changes to NDI for homeowners and DSCR for businesses and commercial property owners can **overnight** reverse a sharp downward trend, we can propose solutions within the powers given by Congress in the past and currently to the FDIC, Fed, SEC and Treasury, and given that the Fed, Treasury and FDIC are on track to recapitalize the major US banks, buy and restructure securities to segregate and repackage the subprime toxic securities from the quality cash flow based mortgages, as securities for sale in better markets, and other actions to create interbank lending and lending to companies, ***we can propose the following additional solutions that will in a very short period of time reverse the economy and launch another long running economic boom. These are as follows:***

I. Suspending Mark-to-Market accounting for mortgages not intended for sale:

Mark-to-Market accounting is suspended, possibly on a permanent basis, while better controls are put into effect regarding the management of defaulted loans in any securitization pool

II. Long term management of mortgage loans in default:

A government agency established to acquire such mortgages to convert the properties into rentals or fixer uppers, until resale, based on their ability to generate income. Similar management rules would be established for private label securities, where the Trustee would convert the properties to rentals or fixer uppers for eventual resale.

III. Lending against the cash flow value of a property:

Similar to the Clinton guarantee program for FNMA and GNMA in 1993, which allowed people to refinance without adhering to the 20% equity rule, a similar program can be authorized through FNMA, GNMA, Freddie Mac, and all other government lenders, whereby, when anyone pays an insurance fee of 1%, they can get 95% financing or with 2% fee a 100% financing of the comparative appraised value, provided that they qualify for the loan under the cash flow formula of affordability, i.e., the principal value is supported.

The intent here is to enable the vast majority of people to refinance, and to the extent they cannot, the government would develop other programs through which, provided the borrower pays a fee, the government will temporarily assume some portion of the principal to make the property mortgage affordable to the borrowers, until they are able to generate enough income to assume the entire principal under their mortgage.

IV. Making the monthly mortgage payment more affordable:

The government would provide another insurance program, where, provided the home owner pays a fee, the government will assume the payment for some portion of the mortgage payment, thus increasing the affordability to the monthly mortgage payment, with the intent to return the level of affordability of the mortgage payment to levels before the oil price spike, until after some period when housing values would return to their cash flow basis.

V. Recovering losses from Mark-to-Market accounting:

Based on the above combined programs, within a matter of months virtually all mortgages will be refinanced. Mortgages are then pooled into their comparative types for securitization and resale at a new book value, thereby recovering the \$500 billion in Mark-to-Market losses.

VI. Hold or sell:

All refinanced mortgages would then be held by the banks and lenders or sold into a private label securitization or government agency guaranteed securitization.

What are the effects of the increasing mortgage affordability for all home buyers, not just for the banks and the subprime group, but everyone. These are as follows:

1. Everyone gets freed up **cash to spend**, which revives consumer spending for pent up demand, and we start another boom, similar to what happened under Clinton's \$6.7 billion FNMA/GNMA guarantee program that released trapped spendable income.
2. The **value of all refinanced mortgages improves dramatically** on the books of the banks, so that and all banks capital will also improve dramatically. The increase value of the \$250 billion to the Treasury and taxpayer might be several times.
3. As all loans will be refinanced with tight controls, the **Fed can again have a real effect on interest rates**, and in the coming boom would probably start to raise interest rates back to normal secure levels, where the Fed will again have a cushion against other problems.
4. The **extremely profitable bank shares**, which would be seen as socialism, if the government retained the shares, could be **swapped for Treasuries to the SS System**, where the Treasury would guarantee their cost value. However, the SS System could wind up with an investment profit of a trillion dollars, thus saving the SSS for the foreseeable future.

Warning - No increase in taxes:

The Theory of Banking Economics, where spikes in standard homeowner and business expenses cause a devaluation of bank assets, home owner's equity, commercial property values, business equity, supported by the many examples, shows clearly that increases in any income taxes for the top 20% quintile income earners and business, representing 70% of bank assets, will be detrimental to the current weak and recovering economy, resulting in additional requirements for government to capitalize banks throughout the country, pushing the economy to the Communism envisioned in Marx's Das Kapital, in which Marx explains that true Communism will result, when the banks fail and the government takes them over by guaranteeing their assets and capital.

On the other hand there are also many examples that show that lowering taxes, increases affordability of the monthly mortgage payment, as well as the ability for business to expand, where, similar to the studies on energy savings, for every 1% reduction in costs of operations for businesses, there will be a 2% to 3% increase in manufacturing, industry and other businesses.

The fallacy of this tax on higher income earners is that most of them in the 20% income quintile are people that through experience, savings and investment have advanced through the years, from when they first entered the workforce to a higher level of income, meaning that young people duped to voting to have tax increases on higher income earners are really voting to increase taxes on themselves in the future, meaning that younger people are fooled into being jealous of themselves in the future.

Infrastructure and quality high paying job creation - to create productivity gains:

The oil spike problem was caused by rapid and sudden rising oil prices, which could return with any new market expansion, primarily because of the inadequate infrastructure in the Middle east, Russia and other oil producing nations, for ports, pipelines, refineries, processing and storage facilities, etc..

Therefore, to prevent another spike in oil, it is imperative that the US immediately stop treating the US oil companies as villains, and bring them back to the US to build the oil economy and related infrastructure with expanded drilling programs to keep prices in the \$60 range, which many countries feel will be adequate to finance the rebuilding of oil infrastructure around the world.

At the same time, the proposal for 50 nuclear power plants to be built around the US to reduce the dependence in oil is also an imperative, as well as the creation of tax credits for every home owner and business to launch into is also a way to reduce carbon energy dependence.

These three energy related areas bring high paying quality infrastructure jobs back to the US, while not diminishing the US's strategic alliances with the Middle East and other countries through oil.

According to other aspects of the Theory of banking economics related to expanding productivity, the long term economic strength of the economy will benefit considerably by the **modernization and development of the infrastructure** for highways, bridges, airports, waterways and ports, train stations terminals and railway transportation, even space expansion, because all these areas increase the productivity of the people and companies and economy as a whole. Here, the US Federal government would work with the States and private sector investors to rebuild the entire US infrastructure, where the result is an improvement of commerce, as with Lend Lease after WWII and many other examples. and quality good paying jobs. That this expands an economy can be seen in China and the Middle East, where vast amounts of money are invested through government and private cooperation, resulting in whole new cities emerge with quality jobs.

Complete article: <http://admc24-7city.com/TheoryBankingEconomics>

Diagrams: <http://admc24-7city.com/TheoryBankingEconomicsDiagrams>

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