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Insurance as a Saving and Investment Vehicle

By Dr. Robert P. Murphy

Nowadays the average American has been taught to believe that a very responsible financial strategy is to plunk as much of his paycheck every month as possible into a “diversified” and “conservative” mix of stocks and, if he wants to really play it safe, to mix in some government bonds. Naturally the acme of savvy saving is supposed to be a tax-qualified vehicle such as a Roth IRA for the self-employed, a 401(k) for salaried employees, or a 403(b) for educators.

It was not always so. In the first half of the 20th century, the average household didn’t dabble in the stock market at all, and certainly this arena had nothing to do with genuine savings (as opposed to speculative investments). No, in this more innocent age, people actually put their savings into instruments that offered a guaranteed return, not subject to the whim of that day’s market price. Back then, households used actual savings accounts at the bank—which were distinct from checking accounts. Households also invested directly in bonds and *life insurance*.

In the present article we’ll review this forgotten history. We’ll also explain the connection between private saving and economic growth, and how the growth of government has perverted this traditionally harmonious relationship.

Life Insurance as a Savings Vehicle

A simple search of the downloadable version of Ludwig von Mises’ classic *Human Action* (1949) shows that the great Austrian economist was well aware of the role played by insurance companies in fostering household saving. The following excerpts prove the point ^(1.):

“For those not personally engaged in business and not familiar with the conditions of the stock market, the main vehicle of saving is the accumulation of savings deposits, the purchase of bonds and life insurance.” ^[547]

“[In a currency devaluation, the] actual effect is that the indebted owners of real estate and farm land and the shareholders of indebted corporations are helped to the disadvantage of the enormous majority whose savings are invested in bonds, debentures, savings-bank deposits, and insurance policies.”

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“In the days of Solon the Athenian, of ancient Rome’s agrarian laws, and of the Middle Ages, the creditors were by and large the rich and the debtors the poor. But in this age of bonds and debentures, mortgage banks, savings banks, life insurance policies, and social security benefits, the masses of people with more moderate income are rather themselves creditors. On the other hand, the rich, in their capacity as owners of common stock, of plants, farms, and real estate, are more often debtors than creditors. In asking for the expropriation of creditors, the masses are unwittingly attacking their own particular interests.”^[538]

Thus we see that when Mises wrote in the first half of the 20th century, it was still commonplace for citizens of the Western nations to save via (among other vehicles) insurance policies.

How Household Saving Leads to Investment and Thus Economic Growth

The Austrian School of economics specializes in (what economists call) capital and interest theory. Even mainstream historians of economic thought would agree that the Austrian economist (and finance minister) Eugen von Böhm-Bawerk was one of the pioneers of the modern understanding of this complex topic.

For our purposes in this article, we can keep things simple. Although households think in terms of money, the “real economy” functions in terms of physical goods. If a household saves \$10,000 every year, in a vehicle that earns an average annual return of 3%, then after 30 years the household will have about \$476,000 in financial assets. The household will expect to be able to use this wealth to (say) buy a house in Florida, take European cruises, send a grandkid to college, and so forth.

But how do the exponentially growing numbers on the household’s financial statements (whether a savings account balance, a life insurance policy’s cash value, or the market value of mutual fund holdings) *physically create* an actual house in Florida, an extra seat on a cruise ship to Europe, and an empty desk in a college (staffed by professors who have been trained themselves in the relevant subjects)? What is the

connection between accountancy and engineering?

The Austrians explained way back in the late 19th century how it all works. When households save, they spend less than their income. This means that they could have spent money on buying “present goods,” things such as restaurant meals and fancy clothes. But instead, then households *refrained* from such present enjoyments, and saved some of their money, perhaps in a savings account at a traditional bank.

With the new deposits, the bank could afford to make more loans. In order to induce borrowers to take out the higher volume of loans, the bank would lower the interest rate it charged on loans. Thus businesses would be more willing to invest in long-term projects, because more projects would appear profitable—in present-value terms—when the business owners plugged in a lower interest rate into their calculations.

In the grand scheme, when households save a higher fraction of their incomes, it redirects spending away from restaurants, perfume shops, and other “consumer” outlets, and channels the spending into construction equipment, the building of new factories, and other “investment” outlets.

The Austrian economists observed that as a simple fact of our world, labor and other natural resources are more physically productive, when they are invested in longer, more “roundabout” projects. For example, if a man on a tropical island wants to get coconuts, he can use his raw labor power by climbing the trees and grabbing the coconuts.

However, if the man is willing to *defer* his consumption by a day, he can first devote a few hours of his labor power into collecting sticks and vines, in order to create a long pole. Then, armed with the pole, the man’s labor will now be far more productive. When all is said and done, the man will be able to harvest more coconuts per hour of his invested labor, even accounting for the time it took to build the pole.

An analogous process occurs in our modern economy. When households defer possible consumption by living “below their means,” this frees up physical resources from consumer goods industries. That is,

movie theaters, restaurants, and luxury car dealerships have to lay people off. These workers and the other freed-up resources can then be channeled into factories making drill presses or fertilizer or other items that make labor more productive. (See my introductory textbook for more details.^(2,3))

The Austrian economists stress that economic growth—the ability to produce a steadily increasing stream of goods and services year after year—is made possible by saving and investment.

The layperson thinks that today, we have a higher standard of living than in the year 1912, because of technological discoveries. Although these are no doubt important, it is also indispensable that every generation saves a large fraction of its income, and channels the savings into productive investments. All the blueprints and inventions are useless, unless entrepreneurs have access to capital with which to implement the bold new ideas.

Saving Interacts with Insurance Differently, Depending on Term Versus Permanent

Many readers of the *Lara-Murphy Report* are fans of Nelson Nash and his “Infinite Banking Concept,” which advises households and business owners on the financing element embedded within traditional whole life insurance policies. To put it simply, besides the death benefit which is available with a no-frills term life policy, Nash shows his readers the “bank” available while the policyholder is still alive, if he pays the extra premiums to set up a whole life policy instead.

In the context of the present article, this distinction between term versus permanent (e.g. whole life) policies comes up in a different way. *Both* term and whole life policies provide means for households to save, and thus for society to enjoy capital accumulation and economic growth, but the actual mechanisms differ with one type of policy versus the other.

It’s simpler to start with whole life policies. Here, so long as the policyholder continues to pay his premium and keep the policy in force, the insurance company knows it will eventually have to pay the stated death

benefit. This is because the policyholder will either die, or he will attain the age (such as 121) at which the policy matures. (This occurs when the growing cash value finally “catches up” with the death benefit, at which point the insurance company sends a check for this amount to the policyholder.)

Because the insurance company knows that the policyholder has the contractual power to continue paying premiums, and eventually be owed a huge check, the insurer had better use those large premium payments to build up assets to cover itself. This is why the premiums on whole life policies are so much higher than the premiums on term policies with equivalent death benefits. Unlike the term policy, the whole life policy is designed to work for the “whole life” of the policyholder; by construction it carries the option of renewing it perpetually, for the same original level premium. The insurance actuaries know that this is an amazing advantage given to the whole life policyholder—who might contract cancer at age 66—and thus they have to price it accordingly.

Incidentally, these reflections also show why it would be incredibly wasteful for someone to take out a whole life policy who doesn’t have a long-term plan for it. By their very nature, these instruments only make sense when used over the course of decades—unless the policyholder dies prematurely of course, in which case life insurance is always a great “investment.”

In the context of our earlier discussion, we can now see the social effects of whole life policies. During their prime working years, individuals consume less than their incomes in order to pay the high premiums required by a sizable whole life policy. The insurance companies in turn invest these funds in traditionally conservative assets, such as highgrade bonds and perhaps local commercial real estate projects. Thus the physical resources that are freed up by the households’ abstinence (needed to pay their insurance premiums) can be channeled into the projects that are funded by the insurance companies’ investments. (Of course, the insurance companies might also invest in policy loans, in which case the policyholders would then have the ability to either consume the savings, or to invest it themselves in productive projects.)

Now when it comes to term life insurance, things are a bit trickier. For people who are relatively young, there actually isn't much physical investment at all, because at this period of people's lives, life insurance is more of a hedge against disaster—analogueous to fire insurance on a house—rather than an estate planning tool.

For example, suppose we look just at a group of 25-yearold breadwinners, who each take out \$1 million 10-year term policies. In this scenario, these breadwinners are obviously not thinking in terms of their legacy to the next generation, and how to structure their assets to avoid estate taxation etc. Rather, they want to set up a cheap emergency plan in case their families are suddenly left without an income.

Theoretically, in a competitive market the insurance companies will charge our hypothetical 25-year-olds premiums just high enough to cover the actuarially expected death benefit checks that the companies will have to send out over the next ten years, when these term policies are in force. Assuming our cohort of breadwinners are all nonsmokers and have no medical conditions, these premiums might be very cheap indeed, perhaps no more than \$50 per month.

In this scenario, the insurance companies wouldn't be buying financial assets. Rather, in a typical month the insurance companies would take in \$5,000,000 in premium payments, assuming that there are 100,000 breadwinners in our cohort, who each pay \$50 per month. But in that same typical month, the actuaries expect 5 of these people to die, meaning the insurance company will pay that \$5 million right back out in the form of death benefit checks.

Thus there is no need—or possibility—for the insurance company to invest the premiums on *term* policies, because the whole thing is a wash from their perspective. It is simply a way to distribute the risk of death evenly among a group of similar people, rather than having everyone play a lotto where disaster strikes a small percentage. (As economists like to do, I'm obviously greatly simplifying things in this discussion. For one thing, I'm ignoring the administrative expenses of running the insurance

company, and the required return on capital for the investors. Also, in the real world, insurance companies are very conservative, and so they will have a buffer or margin for error even on cheap term policies, meaning that in practice they will have extra funds to invest even in this case.)

However, the considerations above shouldn't make us think that term insurance has no beneficial effects. After all, from the perspective of the households, they are still saving. Every month, when the breadwinner sends in his \$50 premium payment, that represents potential consumption that he now can't enjoy. He really is doing something farsighted and responsible with that \$50 premium payment, rather than spending it at the bar.

But where does the physical investment come from, then? The households who save in order to pay their term policy premiums aren't lending the money to corporations, and we saw that (in our simplified example at least) the insurance companies aren't doing it either. Where does the rabbit get into the hat?

The answer is that the *beneficiaries of the deceased breadwinners* will typically invest a large portion of the savings each month! Remember, in a typical month the 25-yearold breadwinners save \$50 out of their paychecks. That is \$5 million in aggregate saving.

Where does that \$5 million go? Why, into the hands of five new widows, widowers, or other next of kin. Typically, those beneficiaries will take the death benefit and invest it, because the whole point of these 10-year term policies is to replace the income stream of the breadwinner who died prematurely. (Note that if, say, a widow uses a large portion of the check to pay off the mortgage and other debts, then this frees up funds for the banks to lend to other businesses.)

Before leaving this section, we should discuss one final twist. Financial planners know that many people turn to term life policies even late in life, such as in their 50s and 60s, and might even take out 20- or 30-year policies even at this late date. Clearly, at this point we aren't talking about a worst-case scenario emergency plan, but instead are talking about estate

planning and tax considerations. By this stage, it's not really a question of *if* the policyholders are going to collect from the insurance companies, it's more a question of *when*.

However, even here—because we are assuming the individuals are buying term policies—in theory the premiums should be priced to reflect the actuarial risk of death. Unlike a whole life policy, the holder of a term policy—even if it's a 65-year-old buying a 30-year policy—is not *guaranteed* a payout. Consequently, so long as the actuaries correctly estimate the likelihood of death and price the policy accordingly, the insurer doesn't need to be investing in assets on the side. (Again, we are speaking in terms of textbook theory here, to distinguish whole life from term. In practice the distinction is blurred because the insurers are conservative and want to cover themselves in case their actuaries have underestimated the mortality rate.)

Now again, we seem to have a paradox: The option of large term life insurance policies, taken out when people are in their 60s, seems like a fairly sure-fire way to channel a bunch of wealth into one's estate. So where is the physical investment that corresponds with these financial assets? We know that it's not the insurance company lending or investing the premiums each month, because it just takes in those payments and sends them right out the door in the form of death benefit checks.

Here, unlike the case with our 25-year-olds, the investment occurred *when the households realized they wanted to fund these big term policies in their old age*. With our 25-year-olds, the premium payments were \$50 per month; chump change. But if a 60-year-old woman wants to take out a 30-year, \$1 million policy on herself, she is going to be charged a very large premium, in the thousands of dollars per month. In order to afford such premiums, she will probably have earlier in her life begun saving and accumulating assets, so that she has a sizable income (at age 60) from sources besides her own labor.

Although the mechanisms are different, depending on the type of insurance and the type of person buying it,

we have seen that life insurance is a very convenient and historically proven way for households to direct their savings into channels that suit their individual plans but also foster economic growth for society as a whole.

Government has to Ruin Everything

Unfortunately, this happy picture is sullied, as usual, by government intervention. Once again we turn to Mises for an explanation:

“The policies advocated by the welfare school remove the incentive to saving on the part of private citizens. On one hand, the measures directed toward curtailment of big incomes and fortunes seriously reduce or destroy entirely the wealthier people's power to save. On the other hand, the sums which people with moderate incomes previously contributed to capital accumulation are manipulated in such a way as to channel them into the lines of consumption. When in the past a man saved by entrusting money to a savings bank or by taking out an insurance policy, the bank of the insurance company invested the equivalent....

Today there prevails a tendency to push the banks and the insurance companies more and more toward investment in government bonds. The funds of the social security institutions completely consist in titles to the public debt. As far as public indebtedness was incurred by spending for current expenditure, the saving of the individual does not result in capital accumulation. While in the unhampered market economy saving, capital accumulation, and investment coincide, in the interventionist economy the individual citizens' savings can be dissipated by the government.

The individual citizen restricts his current consumption in order to provide for his own future; in doing this he contributes his share to the further economic advancement of society and to an improvement of his fellow men's standard of living. But the government steps in and removes the socially beneficial effects of the individuals' conduct.” ^[841]

Conclusion

Saving is a prerequisite to individual financial strength but also to economic growth for society as a whole. Traditionally, life insurance was an important vehicle allowing the common man or woman to channel relatively small savings each month into large investment projects.

Unfortunately, the rise of Big Government has muted the household's incentive to save, through welfare programs and high tax rates. At the same time, what little saving still occurs is largely squandered by government schemes that harness these savings and direct them toward political projects, rather than private-sector investments.

Life insurance—particularly dividend-paying whole life—remains an effective vehicle for managing a household or business's financial flows. Yet unless Americans stop looking to Washington to take care of them, there is little hope in reversing course.

Insurance as a Saving and Investment Vehicle Bibliography

1. All Mises quotations are taken from the scholar's edition of *Human Action* published by the Ludwig von Mises Institute, available at: <http://mises.org/resources/3250>.

2. My textbook, *Lessons for the Young Economist*, published by the Mises Institute, is available for free in several formats: <http://mises.org/resources/5706/Lessons-for-the-Young-Economist>.



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PART III Lesson 4 HOW TO START BUILDING YOUR OWN BANKING SYSTEM

Content: Page 45, *Becoming Your Own Banker* Fifth Edition

In studying table 1 on this page comparing the results of the two methods – the usual reaction of most

people is to ridicule what I'm teaching in the early years and disbelief when they look at the later years in the schedule. "That can't be true," they say, "because everyone knows that life insurance is the world's worst place to put money to work."

Imagine this scenario: The twin ladies put \$5,000 into their respective plans the first year and at the end of the year they have a coffee break to discuss results. C/D Sister says, "I put \$5,000 into my plan, and after the IRS stole from me, I have \$5,200 left over. What do you have, Sis?" Insurance Sister says, "I called my life insurance agent and she said I have \$1,933 in cash value." C/D Sister's response will probably go something like this: "Sis, please don't tell me that you put your money into whole life insurance! Don't you know any better than to do that?"

The following year they had another coffee break and C/D Sister says, "I made another C/D purchase of \$5,000 and now, after taxes, I have \$10,608. How is your accumulation plan coming along, Sis?" Insurance Sister responds, "I have put into my plan the same thing you have, and my life insurance agent says I now have \$6,359 in cash value." C/D Sister is horrified! "You did the same dumb thing you did last year!! You put more money into whole life insurance? Sis, I've got to quit associating with you – after all, we are twins, and whatever you have might be contagious – and I just can't afford that to risk that!"

As we progress down the schedule, please notice that the reasons for ridicule are disappearing and that there is equilibrium at the end of the 14th year. From that point on Insurance Sister's cash values accelerate and the difference between the methods become wider with time. That is because C/D Sister is only earning interest – and Insurance Sister is earning interest and dividends.

Remember, whenever you start any new business there is a time lag before profits begin. This time lag is understood and accepted in most every other business venture. What's more, it is longer and more expensive in most anything else that one might undertake. But, when this same person looks at the schedule of accumulations in a whole life insurance contract,

his qualities of reason and logic seem to disappear! I really don't understand this phenomenon. Maybe it's because the life insurance industry has never explained these things to him before.

A life insurance contract is a long-term plan and it is engineered to get progressively better with time. It becomes more efficient because the cash value is guaranteed to equal the face amount of the policy at age 100. Therefore, the cost of delivering the promised death benefit is disappearing as time goes by. Furthermore, the earlier you start the contract—and the longer it is in force – the better it gets.

The dividends that I have continually emphasized throughout this course accelerate all of this even more. When one uses the dividends to purchase additional paid-up insurance, the face amount of those additions have a cash value, too, and that cash value is also guaranteed to equal that face amount at age 100. The dividend additions also pay dividends. Now, do you begin to understand why the accelerating cash values in Table 1, Method E, on page 47?

Does this help in understanding why the cash values are continuing to grow at retirement time, although Insurance Sister is withdrawing \$50,000 for retirement income? Please, also, understand that she could withdraw even more than the \$50,000 income per year – but if she does, then the death benefit would erode as time goes by. The choice is hers.

My whole point in this exercise is to dramatize how poorly dividend-paying whole life insurance is understood and that commonly accepted other vehicles just don't measure up when they are studied over a long period of time. Most folks just never look at the performance of the life insurance more than the first ten years or so.

In the next lesson we will look at some test questions to measure your understanding of the principles we have studied so far.

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