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The Policy Loan Debate Explained

by L. Carlos Lara

Until 1976, no one in the life insurance industry had ever done an empirical analysis of the policy loan option in an insurance contract. With the life insurance industry being centuries old, the fact that this type of research had never been done before is quite surprising. However, in 1976, two industry insiders, Wilfred A. Kraegel[1] and James F. Reiskytl,[2] dug deep into transactions of the Actuarial Society of America; the records of the American Institute of Actuaries; the general proceedings of the American Life Convention; and other journals, conferences, and court renderings of the 1800s and early 1900s to uncover a host of revealing historical facts about this unique policy feature that brought serious scrutiny to their findings by other members of the actuary societies of that day.

Neither the motivations to undertake such a study nor the year in which they were done are happenstance. These actuaries were looking to change things. In 1974 the percentage of policy loans compared to ordinary life insurance reserves—loosely speaking, the fraction of the insurers' assets in the form of outstanding policy loans—had reached a high level of 18 percent, exceeded only by the early 1930s when a peak figure of 21 percent had been reached. But the prevailing fear in the 1970s was *inflation*. It was projected that inflation, if not abated, would send the percentage ratio to 34 percent by 1989—*yet in reality, in some respects, it turned out worse!*

This ***Lara-Murphy Report*** article explains why and in doing so helps the Authorized IBC Practitioners gain a greater understanding of where the policy loan controversies of today first originated. Though some of the specific concerns of that earlier time no longer exist, the disputes as to whether policy loans are actually good or bad for the life insurance industry continue to this day. What we hope to demonstrate is that the causes for the negative numbers have plausible explanations, but central among them was a statutory embedded fixed policy loan interest rate that was below market rates of interest. At the time this was very good for policy owners, but not so good for the life insurance companies. The painful consequences that followed for the life insurance companies teach us once again that government's direct role in the market and the machinations of the Federal Reserve can be devastating to businesses and the economy.

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Financial Institutions

If you look far back enough into history you will find that all financial institutions have black marks on their record. The life insurance industry is no exception. The difference is that compared to Wall Street and commercial banks their records are less tarnished and created less havoc on the general economy. One other notable attribute is that insurance companies have learned from their mistakes and have made important risk management adjustments that have strengthened their business model.

But the forces of government intervention and bad monetary policy remain uncontrollable foes even now as they have been throughout history.

To put all this into proper perspective we should first say something about financial institutions in general. Life insurance companies, like commercial and investment banks, are financial intermediaries. They are "intercessor" institutions for providers and users of money. Other forms of financial intermediaries in our economy include finance companies, mutual funds, and hedge funds. Financial intermediaries are in essence the ***consummate middlemen***. All intermediaries issue their own financial products such as insurance policies, certificate of deposits, or mutual funds shares, to individuals and businesses and receive money for them. These monies are in turn invested in financial markets in ***primary securities*** such as bonds, mortgages, and stocks.

The larger portions of an economy's population do not have the time, resources, or ability to gather comprehensive information about each possible financial undertaking. Intermediaries serve an important role in the economy by disseminating adequate financial information between buyers and sellers, facilitating risk and liquidity transformation, and through economies of scale they reduce transaction costs. For this reason financial intermediaries have historically taken in large sums of money from the investing public. As of the year-end 2012 life insurance companies held $5.6 trillion[3] in financial assets compared to $15 trillion in assets held by banks. The commercial banks and by extension investment banks are directly regulated by the Federal Reserve while the insurance industry is regulated by the individual states with the federal government overseeing it *indirectly*.

Life insurance companies are unique intermediaries and operate differently from banks and investment firms in that they are ***actuarial*** as well as financial intermediaries. The financial products they sell offer protection as a first objective and the accumulation of savings as a second. In a real sense life insurers can be considered to be a liability driven business since they take in funds from individuals and businesses today to make conditional payments in the distant future. This leads life insurers to invest in a collection of long-term assets, mostly bonds. A recent study[4] of the entire insurance industry done by the Federal Reserve of Chicago shows that 74.8 percent of life insurers' general account assets in 2012 were bonds with 44.2 percent of the aggregate being made up specifically of *corporate* bonds. Additionally, life insurance companies tend to purchase these fixed-income securities with fairly long maturities in order to match their long-term liability commitments. This investment strategy of matching the duration of assets to the duration of liabilities is known as asset–liability matching and is intended to limit companies' exposure to interest rate risk. This is a practice that is continually being refined by life companies as they navigate the new world of systemic risk.

What Are Policy Loans?

In addition to bonds, the life insurance companies hold several other types of investments including mortgages, equities, real estate, cash, derivatives and other short-term investments comprising a total of 15.3% of invested assets as of 2012. One such investment among this group is the policy loan. As of 2012, the life insurance industry's aggregate assets in policy loans stood at only 3.7%![5] This is a ratio to take careful note of in light of the theme of this article. As you can see policy loans remain a very small percentage of invested assets. This is a strong indicator that tells us that no matter what

the problems may have been with regards to policy loan excesses in the past, corrective measures and changes within the industry have obviously altered all of that.

According to a leading life insurance textbook:

> *"Policy loans are unique among life insurance investments for two reasons. First, they are not made as the result of an investment management decision. They are options exercised at the discretion of the policyowner. Second, because loans should never exceed their cash values and unpaid principal amounts may be deducted from cash surrender or policy death proceeds, the safety of principal associated with most loans is absolute."*[6]

Curiously policy loans do not have many of the characteristics of an investment, or as an asset for that matter. It would seem that from the company's point of view they have no market value at all. Unless the policy owner decides to repay the loan it never matures, but is instead subtracted from the death benefit at death or when the policy is surrendered. From an accounting standpoint and the nature of the insurance business it seems reasonable to see them more as a reduction of liabilities (rather than an increase in assets), because an outstanding policy loan reduces the amount that the insurer contractually owes to the policyholder in the event of a surrender or death.

The truth is that the life insurance industry created the policy loan option in 1848 in order to dissuade policyholders from surrendering their policies. It was a brilliant idea at a time when there were very limited resources for credit for the surging middle class. Also consider that from the standpoint of the policyholder *liquidity* is a very important characteristic when considering an investment. However, surrendering an insurance policy for its cash value also means giving up an equally important element—<u>*protection*</u>. Since the cash value is in a sense an amount be longing to the policyholder in the first place, the policy loan option was a natural consequence of sound thinking on the part of the insurance industry. Better to grant the policyholder a loan than to have him opt for surrendering his policy when he needs his cash. As one actuary put it, *"A policy loan then is really a cash-value withdrawal, temporary or permanent. We probably make an analytical mistake if we view it in the traditional way (as an investment or an asset)."*[7]

Providing credence to this view of policy loans is a 1910 Supreme Court ruling on their nature. In *"Board of Assessors of the Parish of Orleans v. New York Life Insurance Company, 216 U.S. 517. The Court noted that a policy loan creates no personal liability of the policy owner, so that it is not a debt, even though interest is charged."*[8] This finding struck this author so profoundly that a complete review of an official U.S. government report of all *Supreme Court Decisions Overruled By Subsequent Decisions*[9] was carefully examined up until 2010. No overruling existed. Providing that no new evidence has been introduced in the last four years to change this fact, this ruling stands to this day.

Nevertheless during the 1960s there developed a rising tide of criticism from the insurance industry toward policy loans that portrayed them as *"unwise, un-businesslike and dangerous."*[10] By 1976 they were being seriously considered for complete removal from the insurance contract. What most financial professionals may not know is that ever since 1906 almost all of the state laws mandated the policy loan option to be a part of all life insurance contracts. Though there may be a few straggler states that do not have a statutory policy loan requirement, competition amongst life insurers has forced all companies to include the policy loan provision in their contracts.

The Real Issue Was The Rate Of Interest

Why did such a negative view of policy loans develop in the insurance industry that carries over even to this day? If the insurance industry created the policy loan in the first place, why were they so eager to recall that decision and attempt to remove it from the contract altogether? Actually, it even seemed odd to many in the life insurance profession in 1976

though they fully recognized their core problem. One actuary in particular expressed it this way:

> ***"If we were car dealers it is a little like saying—here we have built this option into our cars, an option that we have reflected fully in our price, but we are going to ask our dealers not to promote this feature in their sales approach, and will urge our customers not to use it too frequently, because it will impair the operating efficiency of their vehicles."***[11]

The culprit, of course, was the statutory low fixed rate of 5% and 6% maximum on policy loans during the periods of 1906 through 1969. This was because state laws typically followed the pattern of English usury laws. The rate did eventually move up to 8% in 1975 but by law it remained ***fixed***—contrasted with an inflationary economy that raised the price of borrowing money to historic highs. The industry, quite frankly, was stuck. If there had been such a thing as a *variable* interest rate at that time there wouldn't have ever been a problem.

The fixed low interest rates on policy loans especially in the older policies naturally encouraged the use of ***arbitrage*** by thousands of Americans that only accentuated the festering problem. The more sophisticated policy owners would borrow at the low policy loan rate and invest elsewhere at a higher rate. In 1913 Congress had passed a law permitting the deduction of interest paid on indebtedness when computing net taxable income. Although no indebtedness is involved in a policy loan, ac- cording to the Supreme Court ruling three years earlier, policy owners customarily deducted the interest. Consequently, the interest deductibility created an even greater impetus for arbitrage. Still others extended this idea into another area that came to be known as the "mini-dip" whereby the cash value was used to pay for the policy itself. *"If premiums and interest are paid with sufficient frequency, cash values will build up, permitting discretionary borrowing for other purposes."*[12]

Finally, there was the matter of the creation of inequality between borrowers and non-borrowers as it pertained to the distributable surplus on all participating policies. Actuary tradition had always pointed out that "equity requires that surplus be distributed to policy owners in proportion to their contribution to it."[13] So naturally, there was fear that excessive policy loan borrowing would eventually lead to discrediting the industry.

In reality when a person can borrow at below market rates and invest the proceeds in market rates he or she is wise to do so. The right to a policy loan is the same as a call option on a bond. But in examining the entire spectrum of the problem, what we see in summary is that an inflationary economy, coupled with regulation that prevented insurers from increasing the policy loan rate to keep pace with the money market rate of interest, set the life insurance industry up for a fiasco.

The Past Is Not Easily Forgotten

As stated earlier, none of these issues exists any longer. Today almost all life insurance companies are permitted by law to use a variable interest rate on policy loans, the tax deductibility of the interest paid on a policy loan has also been removed as a general rule, and we now have a choice of direct or non-direct recognition life insurance companies to deal with the inequality issue of the divisible surplus.

If this is the case, then why are there lingering debates and strict company policies regarding policy loans among various life insurers? I would offer that the reason is that the memories of the unprecedented economic volatility of the 1960s and then again in 1979-1982 are not yet in the too distant past. These years marked the end of the postwar era in which the industry was driven by demand for income security and protection, but rapid inflation and soaring interest rates shifted the demand to investment accumulation. Once interest rates were deregulated, insurers responded to the competitive pressure from other intermediaries with a wide variety of interest sensitive products. They also boosted yields on their general accounts in an attempt to regain their financial footing by intentionally mismatching assets. In other words, purchasing high-yield long-

term bonds to fund short-term liabilities. The results were disastrous when the junk market faltered. These ramifications extended into the late 1980s when *"[l]iquidity demands (policy loans and surrenders) soared, and the industry escaped massive cash flow insolvencies only because most policy owners failed to exercise their rights efficiently."*[14] The trend, however, took its toll and in 1991 A. M. Best had to list 103 life insurers of the 2,000 in operation as insolvent during this period.

This industry 5 percent failure rate is the same as the one experienced during the Great Depression of the 1930s when 20 of the 350 life insurance companies failed, but it was considerably less than bank failures. There were 4,000 bank failures out of 25,000 in operation during the Great Depression, or 16 percent and 1,200 bank failures out of 7,000, or 18 percent, during the 2008 financial crisis. The point is that over the span of U.S. history life insurance company failure rates still remain considerably lower than commercial banks and all other financial intermediaries.

The main thing to keep in mind from all these implications is that it did change the life insurance industry from what it used to be to something dramatically different. Drawing again on the Chicago Federal Reserve report,[15] at the end of 2011, 64 percent of the life insurance industry's total reserves were for annuities, while 30 percent of them were for life insurance. This is a stark contrast to that of 1960 during which 72 percent of total reserves were for life insurance and just 18 percent was for annuities. As we pointed out at the recent *Night of Clarity* event in Nashville, the universe for the beloved dividend-paying Whole Life insurance contact is now very small comparatively speaking. Fewer than 50 insurance companies currently offer the product. There is an entire new generation of Americans who are totally unfamiliar with all of its multi-dimensional benefits. When specially designed by an Authorized IBC Practitioner, Whole Life provides a form of privatized banking that is not only very useful for business and individuals, but helpful to the insurance industry and the economy as well. The room for growth in this area of the business is enormous.

Conclusion

The reality is that the existence of policy loans against cash values dates back to the mid-1800s, but the life insurance industry has never vigorously promoted them. It's true that issues regarding policy loans were serious during the Great Depression, but since then there had been little concern until inflation hit in the late 1960s. But now we recognize why. The painful experiences that followed these events profoundly affected the industry. Life companies came to under- stand their business in light of the new economy and the gaining of this new understanding paid off.

The crucible for the industry's strength and resiliency was proven during the Great Recession of 2007-2008. Here we saw the pouring of the public's confidence and funds come back into the conservative financial sector with marked increases going into the Whole Life product specifically. When everything else in the market place failed and there was nowhere else for businesses and individuals to go, the life insurance companies were standing strong, ready to provide the high demand for safety.

Today matching asset-liability cash flows in a low interest rate environment is the industry's new challenge, but when the next crisis hits again—and it will hit—the life insurance companies are poised and ready for another tremendous inpouring of funds. We plan for the Authorized IBC Practitioner to be there to help the public facilitate that transition.

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Fortieth in a monthly series of Nelson Nash's personally written Becoming Your Own Banker© *lessons. We will continue these lessons until we have gone through the entire book.*

Part V, Lesson 5 An Even Distribution of Age Classes

Content: Page 69-72, BECOMING YOUR OWN BANKER – The Infinite Banking Concept.

Back in my days as a consulting forester, I was teaching landowners who were 60 to 70 years old about planting trees. There was no way that these people could see the fruits of their labors. But, they could see clearly that they were creating a heritage for future generations and that was something very valuable to them – psychic income if nothing else. Based on this experience I developed the scenario on page 69 of the book as a model to compare a better way to create a financial heritage for future generations.

The elderly couple in this story was introduced to the idea of establishing substantial life insurance plans for their four grandchildren. Two were boys and two were girls. The boys belonged to one of their sons and the girls belonged to the other. The grandparents put $2,000 premium per year into policies on each of the grandchildren, retaining ownership of the policies until their own death, with ownership going to their sons at that time.

Their sons are now grandparents and they have a total of eight grandchildren, collectively. They have diligently followed the example established by their parents. Whenever a grandchild is born each will start up a new policy on the newborn with a $2,000 annual premium. Each policy is designed according to the guidelines on page 41 of BECOMING YOUR OWN BANKER, emphasizing cash accumulation and de-emphasizing death benefit at the outset. Premiums are

planned for a period of 22 years – approximately one generation – and are to be paid by the grandparents out of current resources or, maybe, a trust that they have set up for this purpose.

On page 71 of the book you will see the illustration of the last policy that was added when a grandson was born. Studying the illustration on this page you will note that, after the first 22 years, the Paid-Up Additions Rider is terminated and the premium of the base policy ($600) is paid by dividend surrenders, resulting in no cash outlay from that point on.

With this particular company and based on the information shown, this is not a Modified Endowment Contract. If premiums were to be paid four more years, it would become one.

Note that there are no examples of using this policy for "banking" purposes illustrated here. Based on what you have already been taught in this course, suppose that the policy was used to buy a car at the beginning of the 23rd year and the repayment amount and schedule were designed to meet those same guidelines – what would happen to all the figures below that point? Answer: they would increase.

Also, suppose that the grandchild wishes to go to college. Where is the best place to get the funds to do so? What about a repayment schedule?

What should the payments be? You supply the answer.

Look at the cash value on line 40. ($412,080). This is prime home-buying time in the typical household. Suppose that the Insured wants to buy a new home at that time – what should he pay back? Answer: the closing costs that his next door neighbor had to pay on a mortgage plus monthly payments that would be equivalent to the current mortgage rates – or preferably, more than that. Remember, it will go to his policy and increase its cash value. This will result in increased "passive income" at retirement time.

Now, go to page 72 and look at the "passive income" beginning at his age 70 ($225,000 per year). Let's assume death at age 85 and you will note that he has recovered the $22,000 that his grandparents paid into the policy, plus $3,556,000 in income and it still delivers $6,375,923 to the next generation.

There are other significant advantages to this idea

- It covers multiple generations – promotes long range planning.
- Underwriting problems are minimized.
- Tax-free buildup of cash values over a long period of time.
- Outlay is very small compared with the ultimate yield.
- The generation paying the premium can most easily afford them.
- When death benefit occurs, the system becomes self-sustaining.
- Precludes any need for Social Security.
- Retirement income is assured.
- Estate planning is greatly simplified.
- Wealth "mentality" is transferred to succeeding generations over a long period of time to produce consistent understanding. They are learning a process – not buying a product.
- Promotes the understanding of what stewardship is all about.

Take control of your financial world by
Becoming Your Own Banker
Find a Practitioner Near You

The following financial professionals joined or renewed their membership to our ***Authorized Infinite Banking Concepts Practitioners*** team this month:

- Patrick Johnson, McMinnville, Oregon
- Bruce Wehner, St. Louis, Missouri
- Ryan Griggs, Rockwall, Texas
- Jacob Neathery, Alvarado, Texas
- Jim Kindred, Saint George, Utah
- Hayden Padalino, Cambridge, Ontario
- David Cheatham, St Charles, Illinois
- Brett Kulman, Southampton, New York
- Dustin Davis, Bloomington, Illinois
- Karl Schnitzer, Philadelphia, Pennsylvania
- Tom Renic, Anola, Manitoba
- Jose Salloum, Montreal, Quebec
- Garett Bras, Pearl City, Hawaii
- Roman Pushkar, Steinbach, Manitoba
- Liz Lamond, Vancouver, British Columbia
- Kenneth Lester, Smyrna, Georgia
- Joel McGriff, Birmingham, Alabama
- James Pollard, La Salle, Manitoba
- Ronald Campbell, Glen Burnie, Maryland
- Tom Laune, Nashville, Tennessee

Before you look for a practitioner, we suggest listening to the following two episodes of ***The Lara Murphy Report.***

How-To Guide for Starting IBC, Part 1 How to begin your study of Infinite Banking, including finding an Authorized Practitioner.

How-To Guide for Starting IBC, Part 2 How to prepare for your first meeting with an Infinite Banking Authorized Practitioner.

You can view the entire practitioner listing on our website using the Practitioner Finder.

IBC Practitioner's have completed the *IBC Practitioner's Program* and have passed the program exam to ensure that they possess a solid foundation in the theory and implementation of IBC, as well as an understanding of Austrian economics and its unique insights into our monetary and banking institutions.

The *IBC Practitioner* has a broad base of knowledge to ensure a minimal level of competency in all of the areas a financial professional needs, in order to adequately discuss IBC with his or her clients.

Authorized IBC Practitioners, 2023 IBC Think Tank registation now open.

Now more than ever, a strong IBC Practitioner Community is needed to ensure that Nelson's vision for IBC continues to be grounded in the principles of IBC that most overlook. With this in mind, I urge you to make every effort to attend the upcoming Think Tank. ***Every active Authorized IBC Practitioner should be in attendance!***

Think Tank date is 22-23 February, 2023.

Location is the Forum Theater at The BJCC, 2100 Richard Arrington Jr Blvd N, Birmingham, AL 35203

We are slowing down the pace of the event this year with the intent of providing a better learning environment and more time to network with fellow *Authorized IBC Practitioners*. This will be accomplished by having fewer speakers, giving those speakers more time to present and have ample Q&A time.

Event registration link, pricing and the schedule are posted on the IBC Think Tank Landing Page accessible through the ***NNI Homepage*** *[members need to be signed in to their Practitioner Account to see the registration link]*.

Sincerely,

David Stearns

This online **video series** for the general public provides a comprehensive introduction to the *Infinite Banking Concept.*

The first four modules are free, you can view them here:
infinitebanking.org/foundations
The remaining eight modules are subscription-based, costing $49.95 for all eight.

*Or contact an **Authorized IBC Practitioner** and ask for a coupon code that will enable you to watch all twelve modules FREE.*

Module 1: Introduction to the Nelson Nash Institute

Module 2: What the Infinite Banking Concept Is

Module 3, Part 1: How IBC Works

Module 3, Part 2: Policy Loans & The Nature of Collateral

Module 3, Part 3: How to Read a Policy Illustration

Module 4: Why Nelson Calls It The Infinite Banking Concept

Module 5: The Life Insurance Industry

Module 6: Why Not Buy Term and Invest the Difference?

Module 7: Using IBC to Pass Wealth to Future Generations

Module 8: The MEC Rule and Policy Design

Module 9: Does IBC Work for Older People?

Module 10, Part 1: IBC for the Business Owner

Module 10, Part 2: IBC for the Business Owner

Module 11, Part 1: Using Your IBC Policy: Premiums, Dividends, and Policy Loans

Module 11, Part 2: Using Your IBC Policy: Premiums, Dividends, and Policy Loans

Module 12: IBC as a Way of Life

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