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ABOUT LARA & MURPHY

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In 2010 he co-authored the highly acclaimed book, *How Privatized Banking Really Works* with economist Robert P. Murphy.

He is a co-creator of the IBC Practitioner Program for financial professionals and sits on the board of the Nelson Nash Institute.

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***"Heroic leaders can arise** who will not fail to deliver their country from evil hands when they set about their task with a firm, whole hearted and sincere intention."*

—Etienne De La Boetie

The Politics Of Obedience: The Discourse of Voluntary Servitude, 1553

"Why do people obey the commands of the government, which always constitutes a small minority of the total population?" In 1553 Etienne De La Boetie, a young French law student and member of the ruling class, asked this intuitive question and then proceeded to answer it. In doing so he delved deeply into the nature of tyranny and into the nature of state rule itself. The insight he found is astonishing.

Boetie gets our attention almost immediately by stating that every tyranny is grounded upon general acceptance of the public. In other words, the people grant their obedience by their own consent. The public is basically indoctrinated into obeying evil rulers simply because they have been raised in subjection.

Freedom from servitude, Boetie states, comes not from violent action, but from the refusal to serve. Tyrants fall when the people withdraw their support. The thinking of the public, which constitutes public opinion, must change.

But in order to be courageous enough to take these steps, *"one must realize the extent to which the foundation of tyranny lies in the networks of corrupted people with an interest in maintaining tyranny."* Nothing has helped us see this web of fraudulence more clearly than Austrian economics.

"It is the masses that determine the course of history, but its initial movement must start with the individual."

— How Privatized Banking *Really* Works

Without the benefits of these unique insights, we would not be as far along as we are in reaching our goal. But by being armed with this knowledge we are motivated all the more to share our message of hope to all who will listen.

Our message is a message of assurance. Once our recommendations are implemented, they actually free people from financial bondage. This is the proof of our undertaking. In actuality, our counsel accomplishes a form of secession from the existing corrupt order. Yet it is perfectly legal and peaceful. It is a real solution for the people.

What is plain for us to see is that we must press on and finish the work we have started of helping thousands, always having faith that our efforts will continue to be fruitful and will multiply until we reach our goal.

"Liberty is the natural condition of the people. While freedom is forgotten by many there are always some who will never submit." The people Etienne De La Boetie wrote about centuries ago are the ones we refer to as *"the remnant"*—the true members of the 10%. Thank you for counting yourself among us.

Yours truly,
Carlos and Bob

"It is the masses that determine the course of history, but its initial movement must start with the individual."

— How Privatized Banking *Really* Works

PULSE ON THE MARKET

Fed Driving Stocks

WHERE HAVE WE HEARD THIS THEORY BEFORE...?

Well, we're glad others are starting to notice the obvious. In early March the financial blogs buzzed with the results of a new study by ValueBridge Advisors economist Brian Barnier, who is also the founder of FedDashboard.com. Barnier analyzed market and economic data and concluded that from the start of its QE (quantitative easing) programs, the Fed has been responsible for more than 93 percent of the stock market's gains. (Note that the S&P 500 index is about where it stood near the end of 2014 when the "taper" ended and the Fed stopped buying assets.)

To repeat our normal caveats: We cannot be sure what the Fed will do in the future. It's possible that the Fed launches another round of QE, or engages in negative interest rates, in at attempt to jumpstart the market. However, what we *can* say is that repeated bursts of monetary inflation cannot be a long-term solution. We have argued in previous articles in the *LMR* why we believe that the Fed has shifted away from "easy" money into a strategy of tightening, but the broader point is that even if they reverse course, there is no "exit strategy" that will avoid pain. Suppressing interest rates and pumping the financial sector up with new money will only cause the resulting crash to be that much worse.

Lights Off Venezuela

VENEZUELAN GOVERNMENT ORDERS FIVE-DAY EASTER CELEBRATION TO CONSERVE ENERGY

The situation in Venezuela continues to deteriorate. Their government's horrible combination of massive money-printing coupled with price controls has led to shortages. A few months ago the country ran out of toilet paper—which is no mere inconvenience—and this month they extended the Easter vacation in order to ease the power shortage.

As quoted in the Toronto Star, Jean Daudelin, a professor and Latin American specialist at Carleton University, declared that "Venezuela is going through the worst crisis in its 200-year history."

Venezuela's real GDP contracted by 10 percent in 2015, and current estimates of its annual price inflation rate range from 200 to 700 percent. (Those are not typos.) One resident was quoted in the Toronto Star saying, "I have water only 20 minutes a day three times a day, but I never know when that will be. People are frustrated and tired of not finding solutions."

Although the situation is horrible for the Venezuelans suffering such privation, the sordid episode offers a useful reminder. This is why the *LMR* and other outlets are so earnest in our evangelism of the principles of sound money and free markets. In Venezuela we are currently witnessing what happens when a government runs the printing press and sabotages the operation of the market economy.

Credit Suisse Shedding

ANOTHER BANK IN TROUBLE

In previous issues we have covered the problems of the financial sector in general and Deutsche Bank in particular. A recent article in Reuters alerts us to the woes of Credit Suisse, Switzerland's second-biggest bank, which will *"accelerate its cost-cutting plan as Chief Executive Tidjane Thiam admitted he had been unaware of trading positions that triggered more big writedowns in the first quarter."* The bank will reduce costs by $821 million and cut 2,000 additional jobs. *"The unit is expected to record a 40 to 45 percent drop in first-quarter revenues and is selling off holdings of illiquid assets that the bank's senior management had not had on its radar."*

On these pages of the *LMR* we are trying to give evidence from different perspectives, so that our readers can really gain a foothold on what is happening. We have presented the "high theory" of Austrian economics and shown how central banks around the world have merely postponed the crisis of 2008. Now, in the wake of explicit Fed tightening, we expect to see more examples of financial stress "in the trenches," especially if the Fed continues to raise rates as they still maintain.

Our favorite aspect of the surprisingly successful film *The Big Short* was its depiction of how the people warning of disaster were dismissed as kooks, *and* that there was a long period in which it seemed that they were. Yet, in retrospect, the warning signs were obvious to anyone who knew where to look.

THE CASE FOR FREE TRADE

by Robert P. Murphy

Back in the 1980s when I became seriously interested in economics, I remember learning that there were two policy areas on which virtually all economists—both conservative and liberal—agreed: Minimum wage laws reduced employment among teenagers, and free trade served the public interest by promoting general prosperity. Nowadays many professional economists have been tearing down this old consensus, arguing in turn that minimum wage hikes might not be so bad[1] and that free trade might not be so good.[2]

In light of this juggernaut coming not just from populist political candidates but also Nobel economists, there's a danger that the average citizen will lose sight of what had established that original consensus for free trade. In the present article I'll first summarize some of the intuitive arguments that show why the common hostility to "cheap imports" is misplaced. Then, for more advanced readers, I'll walk through a numerical example illustrating David Ricardo's famous principle of "comparative advantage."

There's a danger that the average citizen will lose sight of what had established that original consensus for free trade.

The Intuitive Case for Free Trade

The most famous essay in the case for free trade is Frédéric Bastiat's 19th century petition of the candlemakers.[3] This was a satirical petition from the manufacturers of candles to the French legislature, asking them to require all buildings in France to close their shutters during the day. The purpose was to prevent the unfair competition of light from the sun. The candlemakers pointed out how their proposal to keep out sunlight would boost their candle sales and hence hiring and payrolls.

Now this is clearly an absurd proposal, yet it is instructive to think through exactly *why*. The answer is that it would be wasteful and foolish to ignore the free gift of light from the sun. Instead, it would be more productive for the French people to use the free sunlight

when it was available, and devote their scarce resources into making *other* things (rather than candles for use during the daytime). There would be no *net* boost to employment from the candlemakers' proposal, because it would merely divert French workers from other potential industries into (unnecessary) candlestick production.

Naturally, the whole point of Bastiat's brilliant essay is to expose the silliness of *actual* protectionist arguments. The difference between worrying about "cheap foreign imports" and "free solar imports" is one of degree, not kind. Once the reader stops to consider exactly what is wrong with the fictitious petition of the French candlemakers, it becomes clear what is wrong with real-world pleas from domestic industries to shield them from foreign competition.

Another classic argument for free trade comes from Henry George, who observed, "What protection teaches us, is to do to ourselves in time of peace what enemies seek to do to us in time of war."[4] If it were really true that a "protective tariff" made us richer by promoting domestic employment, then why wouldn't a blockade during wartime make the besieged country richer? After all, now the enemy's workers would be assured full employment opportunities because their people would have to buy everything internally.

The whole point of Bastiat's brilliant essay is to expose the silliness of actual protectionist arguments.

Here's another argument: If someone thinks that it would make America richer by erecting a large tariff barrier vis-à-vis the rest of the world, then why stop there? Why not draw a line down the middle of the country, so that people in California (say) had to pay a 30% surtax on goods produced anywhere east of the Mississippi River? Would that make people in California richer?

The most famous essay in the case for free trade is Frédéric Bastiat's 19th century petition of the candlemakers.

Letting the Protectionist Respond

I realize that sometimes a *reductio ad absurdum* approach seems like "cheating," because few people advocate measures that are palpably absurd. Yet it is very instructive to consider these proposals—such as my hypo-

thetical suggestion of drawing a line down the United States, or Bastiat's idea of barring the sun—in order to think through the logic of the situation. When you realize why those proposals are silly, then you can see that actual proposals to restrict trade are very often resting on the same footing.

This type of justification for tariffs has problems. For one thing, it still ignores the logic of Bastiat's satirical essay. Remember, he had shown why it was good to rely on the *free* "imports" of light from the sun. The sun was willing to work for *zero* wages, not just low wages, and yet it obviously doesn't impoverish the French to let sunlight into their economy. (The sun doesn't obey any labor laws or pay taxes, either.) By the same token, letting TVs made from low-wage workers (in countries with lax business regulations) into the U.S. economy won't impoverish Americans.

When you realize *why* those proposals are silly, then you can see that actual proposals to restrict trade are very often resting on the same footing.

In this section, let's deal with an obvious *counterargument* from a protectionist. (Note: The doctrine of levying tariff barriers to "protect" domestic jobs is called *protectionism.*) In order to rebut my hypothetical line down the United States, in which Californians pay tariffs on goods shipped in from the eastern United States, the protectionist might claim that trade among *peers* works well. However, the protectionist might continue, when one country (such as the U.S.) has high wages and strict business regulations, while many other countries do not, then unfettered trade with *these* partners would indeed pull down the U.S. standards.

Generally speaking, having more options enhances your position. If Americans can obtain goods on better terms from foreigners than they can be produced domestically, it makes sense to do so. Protectionist arguments may sound compelling in their narrow context, but once we apply them in novel situations their absurdity is obvious.

Absolute vs. Comparative Advantage

This section and the next may be beyond the interest level of casual readers, but I know we have some overachievers subscribing to the *Lara-Murphy Report* and so I want you to have the option of really understanding these nuances, if you so desire. To fully understand how economists think about trade, we need to explain how David Ricardo's treatment improved upon Adam Smith's, making the case for free trade much more general.

In his famous book *The Wealth of Nations* (1776), Smith destroyed the intellectual foundations of mercantilism. Mercantilism was a philosophy that said a government should enact policies so that its country ran a *trade surplus,* meaning that its people exported more goods to the rest of the world than they imported. In this way, the country would, on net, accumulate precious metals over time. In other words, by constantly selling more than they bought, the people in a country would gain more and more money over time.

Although it is understandable where the mercantilists were coming from, in practice their ideas led to counterproductive policies. Typically, they would try to encourage exports and discourage imports. We see the same mentality to this very day, where people lament the purchase of foreign items that "could have been made by American workers." The only difference is that the mercantilists in the 1600s were (partly) aiming to accumulate gold and silver, whereas the protectionists of our day are concerned about domestic employment.

To fully understand how economists think about trade, we need to explain how David Ricardo's treatment improved upon Adam Smith's.

What Smith showed in *The Wealth of Nations* is that it would be foolish to produce at home goods that could be purchased on better terms from abroad. We see this idea

in our everyday lives: Even if a man is trying to "sell more than he buys" and accumulate savings, that doesn't mean the man should grow his own food and sew his own clothes. On the contrary, he should focus on producing the goods and services at which he excels, and then buy the things he wants from people who excel in making them.

However, in his examples and arguments, Adam Smith relied on a notion of absolute advantage, in which a country would import goods from other countries that could produce those items with a smaller expenditure of labor hours and other resources. For a modern example that would resonate with Americans, it would be as if Smith argued that it made perfect sense for people in Alaska to "export" barrels of crude oil to Florida and to "import" oranges in return. This would make the Alaskans and Floridians far richer than if they each relied only on their own state for the production of oranges and oil.

What Smith showed in *The Wealth of Nations* is that it would be foolish to produce at home goods that could be purchased on better terms from abroad.

Yet even though Smith's analysis was excellent as far as it went, it left open the possibility of a country considering trade with another country that was inferior in every line of production. Here is where David Ricardo's (later) discussion came into play. (Note that Ricardo wasn't the first to discover comparative advantage, though.) Ricardo showed that even in such a scenario, it made sense for the richer country to open up trade with the poorer country. Although it's not as obvious as in the case where one country is clearly superior in one good while the other country is superior in the other good, nonetheless we can always find a good where even the poorer country has a *comparative* (or relative) advantage.

A Numerical Illustration

In the interest of brevity, it's quickest just to dive right into a numerical illustration, which should then shed light on the broad-

However, in his examples and arguments, Adam Smith relied on a notion of absolute advantage.

er principle. The following table shows the number of labor hours it takes to produce either a TV or a jet engine in either the United States or Mexico. (Obviously I am choosing the numbers for simplicity, not for accuracy.)

Country	Worker-Hours to Make a TV	Worker-Hours to Make a Jet Engine
United States	1	5
Mexico	2	20

As the table indicates, with these hypothetical numbers American workers are more physically efficient in *both* lines of production. That is, a U.S. worker can make a television set in less time than it takes his peer working in a factory in Mexico, *and* the U.S. worker can also produce jet engines more quickly. So one might not guess that the United States could still benefit from specializing in one line of production and trading with Mexico.

However, there *are* gains from trade. Specifically, notice that if we consider American factories, the implicit tradeoff between TVs and jet engines is 5-to-1. That is, if we are just restricting ourselves to American production, then the *opportunity cost* of producing an additional jet engine is 5 TVs.

In contrast, in Mexico the opportunity cost of producing an additional jet engine is *ten* TVs. We now see the scope for mutually beneficial trade. Jet engines are relatively more expensive (in terms of TVs) in Mexico than in the United States—or, what is the same thing, TVs are relatively *cheaper* to make in Mexico than in the U.S.—and so it makes sense for the U.S. to specialize in jet engines and Mexico to specialize in TVs.

To put the matter differently, it would be crazy if the United States devoted any of its workers to making television sets if Mexico devoted any of its workers to making jet engines. Rather than do that, we could increase the total amount produced if the U.S. shifted its workers out of TV production and into jet engine production, while Mexico did the opposite.

Let's give some more numbers just to make this scenario concrete. Now I'm going to choose these numbers carefully to make the resulting benefit a no-brainer, but interested readers can tweak the numbers to see the underlying principle in different forms. Note that throughout this demonstration, we're still using the figures in the table above.

Suppose that Mexico and the U.S. both have 1,000 labor-hours to devote to these two industries. Initially, in a state of "autarky" (which means no trading with foreigners), further suppose the U.S. devotes 300 worker-hours to TV production and 700 worker-

Now I'm going to choose these numbers carefully to make the resulting benefit a no-brainer, but interested readers can tweak the numbers to see the underlying principle.

hours to jet engine production. That means without trade, where each nation produces and consumes it own goods, that the U.S. workers produce a total of 300 TVs and 140 jet engines. But Mexico for its part devotes 100 worker-hours to TV production and 900 worker-hours to jet engines, meaning that in autarky Mexico produces 50 TVs and 45 jet engines.

Now suppose that trade barriers are removed. What happens? Well, the "cheap imports" of TVs from Mexico flood the U.S. market. And yep, just as the critics warned, it throws U.S. producers out of business, so they lay off their workers who can't compete with the "cheap Mexican labor."

But at the same time, in our hypothetical example the Mexican jet engine producers find that *they* can't compete with the efficient U.S. factories. Relatively "cheap U.S. imports" of jet engines throw the Mexican factories out of business, and they lay off their workers.

In this simplistic example, suppose in the new equilibrium things work out perfectly so that all of the U.S. workers are now in jet engine production, while all the Mexican workers are in TV production. In this case, the U.S. produces 200 jet engines, while Mexico produces 500 TVs.[5]

Notice something interesting. With this particular example, total output of *both* goods has increased. That is, under autarky total TV production in both countries was 300+50 = 350. Yet now, with specialization and trade, total TV production (all in Mexico) is 500. Thus there are 150 more TVs being produced.

The same is true of jet engines. Originally under autarky, there were a total of 140+45 = 185 jet engines produced. Yet now, with

In our hypothetical example the Mexican jet engine producers find that *they* can't compete with the efficient U.S. factories.

specialization, there are 200 jet engines produced (all in the United States). Thus there are 15 more jet engines produced each period than before.

In this example, the gains from trade are crystal clear. By removing trade barriers, the U.S. export market for jet engines expanded employment in that industry, absorbing the workers who lost their jobs in the TV industry. The opposite happened in Mexico. When the dust settled, *all* workers in our example had a higher standard of living. People in both countries can enjoy more jet engines and TVs per capita than before.

Remember: In this example, the U.S. workers were better at making TVs *and* jet engines. So if someone has the idea that "the U.S. can only lose if it deals with low-wage countries" then this example should blow that notion to smithereens. That's the point of walking through examples like this, to show that knee-jerk rejections of free trade often rely on faulty hunches.

To wrap up this section, let me acknowledge that *of course* I chose these numbers very specifically to yield the result that more units of both TVs and jet engines were produced. However, I did this just to make sure the reader saw the physical waste of trade barriers. More generally, the principle is that trade allows for more options and hence makes a country richer. By opening up to trade, Americans and Mexicans immediately were able to obtain TVs and jet engines (respectively) at a lower *opportunity cost* than they could if they relied on their domestic manufacturing plants.

When the dust settled, *all* workers in our example had a higher standard of living. People in both countries can enjoy more jet engines and TVs per capita than before.

If someone has the idea that "the U.S. can only lose if it deals with low-wage countries" then this example should blow that notion to smithereens.

Now in practice, when something becomes cheaper, we can't predict that a person will buy more of everything. But the person is still unambiguously better off. To repeat, in this example I picked the numbers so that the Americans and Mexicans *did* decide to "spend" their newfound wealth in a way that increased both TV and jet engine enjoyment, but even if they had chosen differently, it still obviously benefits a group of people (on average) if they can obtain something on cheaper terms than they could produce it themselves.

Conclusion

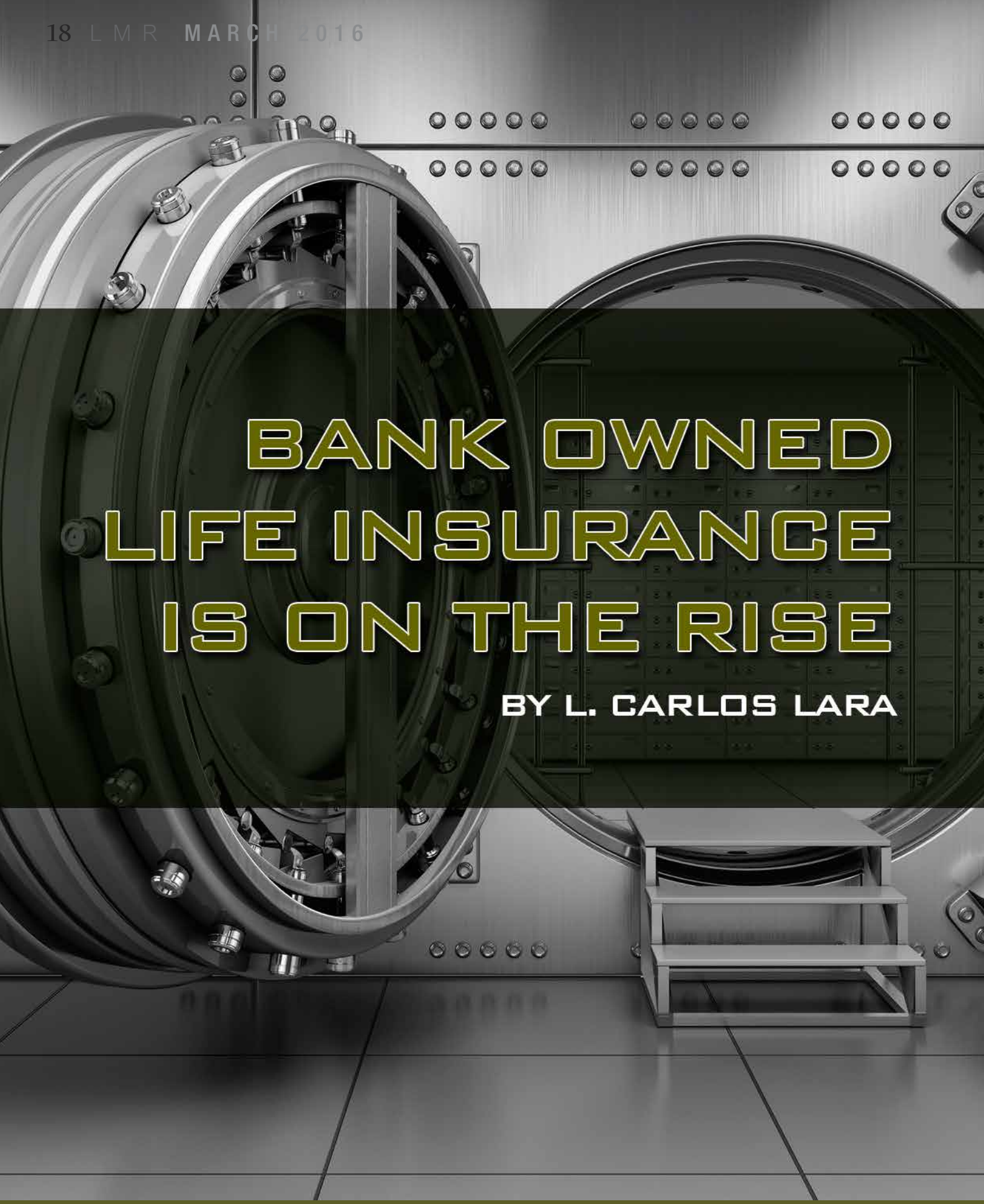
To be sure, international trade is a very complex matter, ultimately involving billions of people and thousands of different goods. Within a country, workers are not identical, and changes that benefit some may simultaneously hurt others. In this arena, simple models and arguments by themselves do not give the final word on what the most efficient or equitable policy is.

However, I hope I have shown in this article several different arguments and illustrations in order to make the *default* in favor of free trade. In particular, most of the popular protectionist arguments we hear from politicians and pundits commit the crassest of fallacies, which have been exploded centuries ago by the classical economists.

◆◆◆

References

1. See for example this 2010 paper from Dube et al., which many economists think is one of the best showing that modest minimum wage hikes apparently have little effect on employment: http://www.irle.berkeley.edu/workingpapers/157-07.pdf
2. See for example Paul Krugman's recent blog post, "A Protectionist Moment?" New York Times, March 9, 2016, available at: http://krugman.blogs.nytimes.com/2016/03/09/a-protectionist-moment/.
3. Bastiat's famous essay is available at: http://bastiat.org/en/petition.html.
4. For an excellent essay discussing the work of Henry George and others, see: https://mises.org/library/all-hail-free-trade-and-henry-george
5. With all 1,000 worker-hours devoted to jet production (and remember it takes 5 worker-hours to make one jet engine), the U.S. produces 200 total jet engines. With all 1,000 worker-hours in Mexico devoted to TVs (where it takes 2 worker-hours to make a single TV), a total of 500 TVs are produced.



BANK OWNED LIFE INSURANCE IS ON THE RISE

BY L. CARLOS LARA

First quarter 2016 numbers are just now closing, but analysts everywhere are still analyzing 2015 year-end results across all sectors of the global economy. The numbers don't look too good. In fact they are downright anemic. However, there is one area that is remarkably robust. Bank owned life insurance (BOLI) assets and new purchases reached a new high of $156.2 billion in 2015, compared to $149.6 billion in 2014.[1] Over 90% of this 4.4% increase in BOLI assets on the books held by commercial banks, savings banks and savings associations are in *permanent cash value life insurance policies.* For those unfamiliar with this terminology, that's the kind of life insurance policy that covers you for the entirety of your life.

According to a Wall Street Journal article[2], banks of every size will receive a combined estimated $400 billion in death benefits over the coming decades, prompting this author to say that *"if permanent cash value life insurance is such a terrible investment the way the TV and radio gurus tell us, then why are banks buying so much of it?"* Indeed, a number of banking institutions own life insurance with aggregate cash surrender value in excess of 25% of Tier I capital.

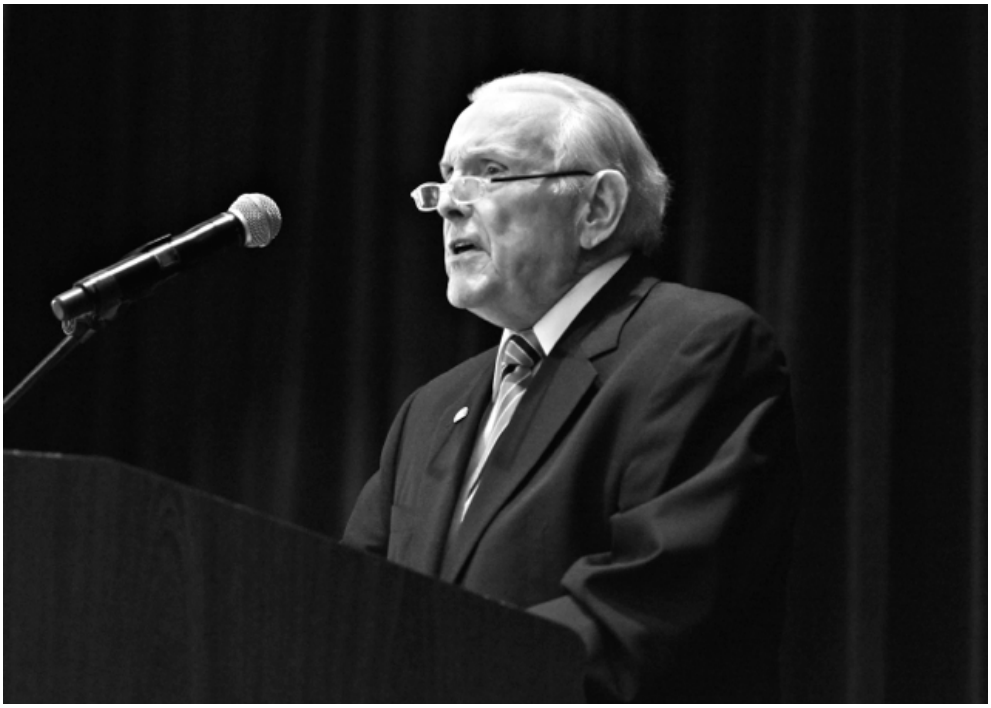
In this article I intend to explain this phenomenon in terms that hopefully everyone should be able to understand. There is much we can all discover from looking deeper into this particular study and learn why banks have been purchasing BOLIs since the 1980s, and how this practice has significantly increased since the 2008 financial crisis.

"If permanent cash value life insurance is such a terrible investment the way the TV and radio gurus tell us, then why are banks buying so much of it?"

A number of banking institutions own life insurance with aggregate cash surrender value in excess of 25% of Tier I capital.

But this article should be especially informative for those who have recently developed a growing interest in Nelson Nash's *Infinite Banking Concept (IBC).*

I should point out from the start that there are significant differences in how Nash sees permanent cash value life insurance and the way banks evaluate it. The perspectives differ drastically simply because their end purpose is not the same. Long time readers of the ***LMR*** and *Authorized IBC Practitioners* should be able to spot these differences right away.



For the benefit of newcomers, I will make sure to point those differences out as we progress further into this analysis. But I also want to make clear that there are some new weighty aspects in this study that even I didn't know before I began. If you will stay with me as I unpack each element of BOLI we will all learn something fresh about permanent cash value life insurance.

THERE ARE SIGNIFICANT DIFFERENCES IN HOW NASH SEES PERMANENT CASH VALUE LIFE INSURANCE AND THE WAY BANKS EVALUATE IT.

BACKGROUND

Banks, like so many other large enterprises, often enter into deferred compensation agreements with selected "key" employees as part of executive retention programs. These programs are nonqualified retirement plans, which contain "excess earnings" for employees that can become available to them after a certain vested period. Until they are actually paid out, usually at retirement, these earnings accrue on the bank's balance sheet as liabilities. When they are eventually paid out they are sent to the employee over a set number of years (10 or 15 years), or in some cases until his or her death—a form of lifetime benefit after retirement age.

Obviously these agreements represent substantial costs to the bank. Since BOLI is a life insurance policy on these key employees whereby the bank is both the owner and (in most cases) also the beneficiary of the death benefit, the employee's death produces attractive tax-free mortality yields for the

bank that offset these deferred compensation costs. Legally, there is no direct right of offset to these deferred compensation liabilities. Consequently, an investment in BOLI is reported as an asset on the books of the bank separately from the deferred compensation liability.

Although banks frequently own *term* life insurance on individuals, this usually occurs with bank *customers* (not employees) who take out loans from the bank; in these typical cases the term policy acts as an extra layer of collateral against the loan. However, most BOLI is on bank employees primarily and is of the permanent cash value variety.

Once we recognize the purpose of this strategy we can see why BOLI is ideally suited for the banking industry simply because it employs so many individuals. The banking industry has approximately 1.5 million employees according to 2014 statistics[3] of which approximately 500,000 are management level executives who fall into the category of "key" employees.

(It is important to note that hundreds of other large employers, such as Walmart, Walt Disney, Dow Chemical and Proctor & Gamble just to name a few, utilize this same life insurance investment strategy, however, instead of BOLI it is referred to as COLI—Corporate Owned Life Insurance.)

(Notice also the emphasis placed by the banks on the death benefit of BOLI. Nash's IBC strategy emphasizes just the opposite— the cash values—and for completely different uses. The BOLI Plan is all about the income tax free death benefit. This emphasis on the death benefit of BOLI explains many of the special precautions outlined in this article that banks must take in order for their BOLI Plan to achieve its end results.)

THE MAIN ADVANTAGES OF BOLI[4]

- **BOLI Is A Tax Favored Asset** with returns that typically exceed after-tax returns of more traditional bank investments such as Muni-Funds, Mortgage-Backed Securities, and 5 & 10 Year Treasuries by 150 to 300 basis. Due to our low interest rate environment, BOLI has increased in attractiveness.
- **Cash Values Grow Tax-Deferred** (Tax-Free if held until death)
- **Death Benefits Are Tax Free**
- **Ability To Efficiently Generate Gains** to offset costs associated with long-term employee benefit programs
- **Products Institutionally Priced** and designed specifically for financial buyers with an insurable interest with their employees
- **Immediately Accretive To Earnings**
- **Risks That Are Well Within Standard Business Risks** in the bank's investment portfolio
- **No Surrender Charges**

- **Diversifies Investment Portfolio**
- **Ability To Immediately Increase ROE** (Return on Equity) **and ROA** (Return On Assets)

THE MAIN DISADVANTAGES OF BOLI

Most BOLI is a *single* premium payment life insurance policy. *(The Nelson Nash crowd will instantly recognize this as major disadvantage even before I even state what it is.)* This means that most BOLI are Modified Endowment Contracts (MEC). A BOLI product qualifying as a Modified Endowment Contract (MEC) for tax purposes has particular liquidity disadvantages.

MOST BOLI IS A SINGLE PREMIUM PAYMENT LIFE INSURANCE POLICY.

If a banking institution surrenders a MEC, it will incur tax liability on the increase in the policy's cash surrender value from earnings on the policy since its inception and may incur an additional tax penalty for early surrender. *(This is the main reason an IBC Policy is a specially designed contract that avoids this MEC classification. For an in-depth discussion on the Modified Endowment Contract vs. the IBC design SEE:* ***LMR*** *August 2014 "The Modified Endowment Contract AKA The MEC.")*

Since most BOLI are MECs it is considered a long-term *illiquid* asset from the standpoint of bank regulating agencies. Note that this is not due to its lack of liquidity since it can easily be surrendered for its cash value at any time without surrender charges, but mostly because surrenders (even borrowing against its cash values) defeats the BOLI Plan all together. Surrenders cause the policy's gains to become taxable and incur a 10% IRS penalty similar to surrendering an IRA, 401-K, 403-B, or any qualified plan before age 59½.

Furthermore, from the bank's perspective, this illiquidity issue spills over into a second major concern for bank regulators. This has to do with the credit quality of the BOLI insurance carrier. Although most life insurance companies in the marketplace are of the highest credit ratings, it is true that over an extended period of time this creditworthiness is subject to change. The concern

for regulating agencies is that their banks must hold these policies on their employees for decades before they can collect the tax-free death benefits to complete the strategy.

SINCE MOST BOLI ARE MECS IT IS CONSIDERED A LONG-TERM ILLIQUID ASSET FROM THE STANDPOINT OF BANK REGULATING AGENCIES.

Finally there is the issue of the competitiveness of the crediting interest rate to the market. Some life insurance products are more interest rate competitive than others, however, obtaining a higher crediting rate can also expose the bank to greater risk.

(When you think about it, these are all concerns an average life insurance policy owner might have. For a more in-depth analysis of these types of responsibilities SEE: ***LMR*** *October 2014, "Why Evaluating Life Insurer Financial Strength Is Important.")*

Regardless of these disadvantages banks have stepped up heavily in their purchases of BOLI. There seems to be common sense recognition that the liquidity concern and the credit quality issue, under dire circumstances, can be rectified. The bank can either surrender the policy (and pay the tax), or it can execute an IRC Section 1035 exchange of the policy to another carrier. The 1035 exchange is similar to a tax-free IRA rollover. What is mostly required to provide the right comfort level for these concerns is due diligence and frequent mtonitoring.

THE MOTIVATION TO ACQUIRE BOLI IS STRONG

According to Executive Benefits Network[5] a leading provider of BOLI product states that even concerns about changes in the tax treatment of bank owned life insurance are minimal since tax benefits have been successfully challenged over the years. If the tax treatment is changed, existing plans tend to be grandfathered. However, if existing policies are not grandfathered, they may be surrendered for their cash surrender values. Obviously, the comfort level of banks towards BOLI is being demonstrated in the amounts being held on their balance sheets

irrespective of this and all the other concerns.

Still, the bank regulating agencies, such as the the Federal Reserve, the FDIC, and the Office of the Controller of the Currency (OCC) are concerned that over the past several years, especially after the 2008 financial crisis, a growing number of banking institutions have aggressively increased their holdings of BOLI. As mentioned in the introduction, a number of banking institutions own life insurance with aggregate cash surrender value in excess of 25% of Tier I capital, which is the guideline limit for BOLI investments as a whole. They also limit the amounts to be no more than 15% of Tier I capital to be held with one individual carrier.

Banks, like everyone else, are chasing yields in a low interest rate environment and BOLI presents itself as an ideal method for solving that issue. But regulators are extra concerned and frustrated "because bank institutions normally fund BOLI purchases through the sale of liquid assets (e.g., marketable securities)."[6]

IT'S ALL ABOUT THE DODD-FRANK ACT

On July 2, 2013 the Federal Reserve Board approved the final rule on strong capital positions specifically for banks. These increased capital requirement needs became apparent during the recent financial crisis and were embodied into law in 2010. The rules implemented in the United States were the Basel III regulatory capital reforms and certain key rulings in the Dodd-Frank Wall Street Reform and Consumer Protection Act.

OBVIOUSLY, THE COMFORT LEVEL OF BANKS TOWARDS BOLI IS BEING DEMONSTRATED IN THE AMOUNTS BEING HELD ON THEIR BALANCE SHEETS IRRESPECTIVE OF THIS AND ALL THE OTHER CONCERNS.

A NUMBER OF BANKING INSTITUTIONS OWN LIFE INSURANCE WITH AGGREGATE CASH SURRENDER VALUE IN EXCESS OF 25% OF TIER I CAPITAL.

The final rule minimizes the increased capital requirement burden on smaller banks, but it establishes a more stringent framework requirement for banks with assets in excess of $50 billion. In Chairman Bernanke's own words, "The framework requires banking organizations to hold more and higher quality capital, which acts as a financial cushion to absorb losses, while reducing the incentive for firms to take excessive risks."[7]

The security of choice of most banking regulators is the "contingent convertible bond (cocos)"—a debt instrument that flips to equity at the moment of a bank crisis.

Consistent with the International Basel III framework, *quality capital* actually means capital that is raised by issuing common equity instead of issuing bonds, which are debt instruments. The security of choice of most banking regulators is the *"contingent convertible bond (cocos)"*—a debt instrument that flips to equity at the moment of a bank crisis.

Yet it appears that banks here in the U.S. have opted for significant portions of their Tier I capital to be loaded up in the form of BOLI in one of the three products currently offered to banks.

I General Account: This is the oldest and most common product in the market today. The bank's single premium payment becomes part of the general account of the insurance carrier. The product has a current crediting rate that can be changed by the carrier, but contains a guaranteed minimum-crediting rate that it cannot fall below.

II Separate Account: The carrier segregates the asset holdings from the general account and well-known fund managers manage the portfolio where the plan returns are subject to more direct market fluctuations. The policy owner, however, bears the risk of default on the assets in the separate account.

III Hybrid Account: This is a combination of separate account assets with both current and guaranteed crediting rate of a general account product. Separate and hybrid products are not subject to creditors of the insurance carrier and can be viewed as a level of protection to the bank. Although, the bank does bear the risk of default on the assets as well as interest rate risk related to these products, SVP wrap contracts with a qualified fund

manager, can be used to secure and smooth out overtrading discrepancies. Alternatively, the presence of an SVP wrap further complicates the calculation of risk-based capital for separate account BOLI.

To better understand the significance and differences between an insurance company's *general account* and its assets to those of the *separate account* study **Table 2.**[8] This is a composite of the entire life insurance industry aggregate assets as of 2012. Notice the size in asset distribution and in particular how much is invested in equities in the separate account compared to the general account.

TABLE 2

Life insurance industry's aggregate assets, 2012

	General-account (GA) assets			Separate-account (SA) assets	
	Billions of dollars	Percentage of GA investments	Weighted average maturity (years)	Billions of dollars	Percentage of SA investments
Bonds	2,545.4	74.8	10.2	292.3	14.5
Treasury and federal government bonds	177.8	5.2	11.9	—	—
State and municipal bonds	125.8	3.7	14.3	—	—
Foreign government bonds	75.8	2.2	13.4	—	—
Agency mortgage-backed securities	229.6	6.7	10.0	—	—
Nonagency mortgage-backed securities	237.5	7.0	6.8	—	—
Asset-backed securities	170.9	5.0	9.1	—	—
Corporate bonds	1,504.4	44.2	10.1	—	—
Affiliated bonds	23.6	0.7	5.9	—	—
Equities	77.4	2.3	—	1,620.1	80.4
Mortgages	335.3	9.9	—	8.5	0.4
Real estate	21.3	0.6	—	7.6	0.4
Policy loans	127.5	3.7	—	0.5	0.0
Cash and short-term investments	106.4	3.1	—	18.1	0.9
Derivatives	41.6	1.2	—	0.7	0.0
Other investments	149.2	4.4	—	67.5	3.4
Total investments	3,404.1	100.0	—	2,015.3	100.0
Total assets	3,590.0	—	—	2,053.2	—

Notes: All values are for year-end 2012. Agency refers to a U.S. government-sponsored agency, such as the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac). Policy loans are loans originated to policyholders that are financed by cash that has accrued in their policies. The percentages of various bond classes in the general account do not total to the overall percentage of bonds because of rounding. Total assets also comprise reinsurance recoverables, premiums due, and other receivables (not listed).
Source: Authors' calculations based on data from SNL Financial.

SOURCE: Chicago Federal Reserve

Table 5 shows that separate account BOLI assets (SALI) were most heavily concentrated among the largest banks with assets in excess of $10 billion. They also accounted for the largest dollar increase ($4.2 billion) in BOLI in 2015. Alternatively, the type of BOLI assets most widely held by banks in 2015 was general account (GALI) policies. (SEE: **Tables 5 & 6**)[9]— 96% of the 3,577 of the 3,739 banks reporting BOLI assets had $67.45 billion in general account life insurance assets, representing 43.2% of total BOLI assets in 2015.

Table 5. Total BOLI Assets (in billions) Held by Banks in 2015

Banks by Asset Size	GALI	SALI	HALI	TOTAL
Over $10 billion	$ 40.48	$ 67.73	$ 10.90	$ 119.11
$1 billion - $10 billion	$ 14.40	$ 3.62	$ 3.38	$ 21.40
$500 million - $1 billion	$ 4.63	$ 0.33	$ 1.05	$ 6.01
$300 million - $500 million	$ 3.20	$ 0.09	$ 0.64	$ 3,93
$100 million - $300 million	$ 3.98	$ 0.13	$ 0.75	$ 4.86
Under $100 million	$ 0.76	$ 0.04	$ 0.07	$ 0.87
Total BOLI assets	$ 67.45	$ 71.95	$ 16.78	$ 156.18
Percentage growth since 2014	8.0%	1.0%	5.8%	4.4%
Source: Equias Alliance / Michael White BOLI Holdings Report—2016 Edition				

Table 6. Number of Banks Reporting BOLI Assets in 2015

Banks by Asset Size	GALI	SALI	HALI	TOTAL
Over $10 billion	75	65	49	78 of 107 (73%)
$1 billion - $10 billion	477	156	263	491 of 595 (83%)
$500 million - $1 billion	476	75	224	498 of 673 (74%)
$300 million - $500 million	566	50	212	588 of 809 (73%)
$100 million - $300 million	1,357	91	438	1,425 of 2,310 (62%)
Under $100 million	626	43	94	659 of 1,688 (39%)
All banks	3,577	480	1,280	3,739 of 6,182 (60%)
Percentage change since 2014	-0.3%	-11.1%	0.5%	-1.7%

The total number of commercial banks and savings associations in the U.S. is 6,182. Of this number 3,739 banks or 60.5% reported holding BOLI assets in 2105 increasing their BOLI holdings by 4.4% from $149.57 billion in 2014 to $156.18 billion in 2015. (SEE: **Tables 1 & 4**)

Table 1. Total BOLI Assets (in billions) Held by Banks

Banks by Asset Size	2015	2014	Percent Change In BOLI Assets	Percent Change in Total No. of Banks
Over $10 billion	$119.11 billion	$114.92 billion	3.6%	0.0%
$1 billion - $10 billion	$21.40 billion	$18.78 billion	13.9%	3.7%
$500 million - $1 billion	$6.01 billion	$6.02 billion	-0.07%	0.0%
$300 million - $500 million	$3.93 billion	$4.14 billion	-5.0%	-4.9%
$100 million - $300 million	$4.86 billion	$4.81 billion	1.1%	-5.0%
Under $100 million	$872.9 million	$898.1 million	-2.8%	-9.8%
Industry Total	$156.18 billion	$149.57 billion	4.4%	-5.0%

Table 4. Number and Percent of Banks Reporting BOLI Assets by Bank Asset Size

Banks by Asset Size	Number of Banks		Percent of Banks	
	2015	2014	2015	2014
Over $10 billion	78	76	72.9%	71.0%
$1 billion - $10 billion	491	460	82.5%	80.1%
$500 million - $1 billion	498	493	74.0%	73.3%
$300 million - $500 million	588	615	72.7%	72.3%
$100 million - $300 million	1,425	1,451	61.7%	59.7%
Under $100 million	659	708	39.0%	37.8%
Industry Total	3,739	3,803	60.5%	58.4%

CONCLUSION

The U.S. has been in a low interest rate environment since 2008. It was supposed to have achieved objectives that to this point have not materialized. In reality many analysts believe irreparable harm has been done across nearly all sectors of the economy. Some industries have obviously been affected more drastically than others.

In this article the spotlight has been placed on two very important sectors of the U.S. economy—banks and insurance companies. At the end of 2014, life insurance companies held $5.7 trillion in financial assets compared to $15.5 trillion in assets held by banks. But our central focus was about a rather unusual investment transaction between the two giant industries—*bank owned life insurance.*

Since life insurers generally invest mostly in fixed income securities, such as corporate bonds and U.S. Treasuries, there is a widespread belief that the current low interest rates are bad for life insurance firms. In a study done by the Federal Reserve of Chicago in 2012 to specifically analyze this particular concern *(The Sensitivity of Life Insurance Firms To Interest Rate Changes, By Berends, McMenamin, Thanases, Pletis, and Rosen)* the 78-page report compared life insurance company stock prices to bond prices for periods 2002-2012 *(this period includes the 2008 financial crisis)* to see if there were any negative correlations.

What the report revealed was that stock prices fell on only the largest (in terms of total assets) stock life insurers. "For the small life insurance firms, which are not that small because they have publicly traded stock—

AT THE END OF 2014, LIFE INSURANCE COMPANIES HELD $5.7 TRILLION IN FINANCIAL ASSETS COMPARED TO $15.5 TRILLION IN ASSETS HELD BY BANKS.

THE 78-PAGE REPORT COMPARED LIFE INSURANCE COMPANY STOCK PRICES TO BOND PRICES FOR PERIODS 2002-2012 (THIS PERIOD INCLUDES THE 2008 FINANCIAL CRISIS) TO SEE IF THERE WERE ANY NEGATIVE CORRELATIONS.

there was essentially no correlation between their stock prices and bond returns." *(Let me also remind our readers that in contrast, Nelson Nash's IBC stresses the use of a mutual carrier as opposed to stock life insurers to implement its strategy.)*

Banks obviously give their vote of confidence to permanent cash value life insurance.

Conversely, this year (2016) began with a global tumultuous stock market drop, but it was especially disastrous for shares in bank stocks, not insurance companies. In the U.S., financial stocks are still down 19%. What correlations can we draw from this?

This article has attempted to uncover the phenomenon of why commercial banks and savings associations *en masse* have chosen to load up their Tier I capital with bank owned life insurance policies. Whether it is simply "yield-chasing" or merely the banks' attempt to follow the regulatory capital reforms of the Dodd-Frank Act, the investment numbers placed by banks into insurance companies speak for themselves. Banks obviously give their vote of confidence to permanent cash value life insurance.

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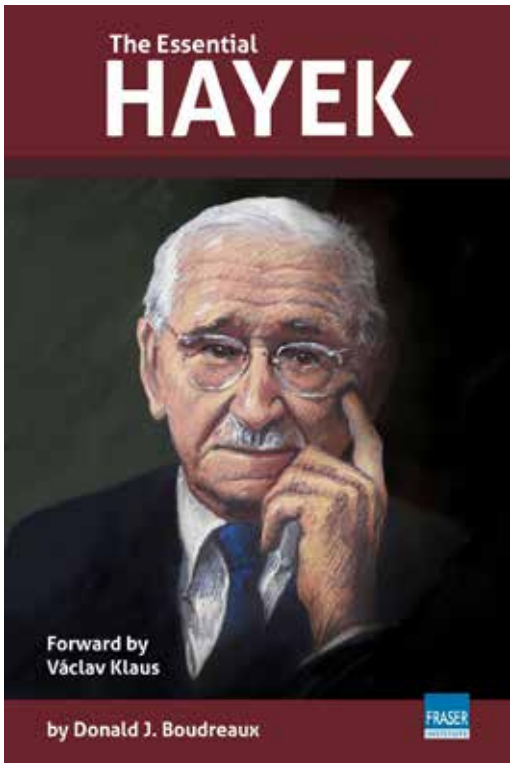
Do Actual Austrians Remember Hayek?

Interview With Richard Zundritsch

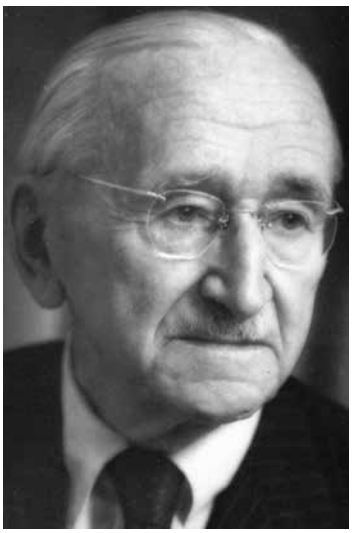
Richard Zundritsch is an Independent Financial Advisor based in Switzerland and specializes in Capital Markets, Wealth Management, Succession Planning and Venture Capital. Before founding his company he worked in International Banking and Corporate Finance for a number of global banks. He holds a Masters and PhD from the University of Vienna. Dr. Zundritsch, who is also a great nephew of F.A. Hayek, is a long-standing board member of the Hayek Institut and the Austrian Economics Center in Vienna, Austria.



Lara-Murphy Report: We think we can guess at least part of the answer, given your family background, but for the record: How did you get interested in Austrian economics?

Richard Zundritsch: For one of my economics exams in Vienna, I had to prepare an individual presentation for 50% of the grade. Since we had Hayek's works at home, I chose "The Denationalization of Money," which I used because it was the thinnest book on the shelf. The professor commended me for the topic and then, because Austrian Universities are dominated by Keynesians, challenged all the ideas. (He went on to become the leader of the Austrian Green Party and is currently running for President of Austria.) The discussion on money has followed me ever since and when I began working in banking the theories of the Austrian School just seemed so much more logical in practice than what we had been taught.

"The professor commended me for the topic and then, because Austrian Universities are dominated by Keynesians, challenged all the ideas."



Lara-Murphy Report: What is Hayek's legacy in Austria and Europe more generally? Obviously when you appear at specifically free-market and libertarian events, people would recognize the name, but in general do Europeans know Hayek?

RZ: Unfortunately Hayek has not had a great impact

on policy in Austria. In other parts of Europe especially the UK (if that is part of Europe) and partially in Germany his thinking has been used more. The recent financial crisis has lead to Austrian Economic Theories being discussed more as an alternative explanation. There is an ongoing debate on government expansionary policies and austerity.

"The US system is better funded and has smaller classes as well as more engagement between professors and students."

LMR: You studied in both the United States and Europe. How would you compare their different educational systems, especially at higher levels?

RZ: As you know from the US presidential campaign, much of Europe has "free," that is, government funded, higher education with minimal fees. Anyone with a high school diploma can go to college and until recently there where no other entrance qualifications. This has led to certain subjects being overrun and lack of space and the difficulty in getting into mandatory classes caused longer times to complete studies.

Now there are additional entrance exams for instance in medical fields and knockout exams at the

beginning of others to reduce the number of students. Tight government budgets for higher education and these restrictions are making students pursue their studies in other countries within Europe and the USA. The US system is better funded and has smaller classes as well as more engagement between professors and students.

LMR: In your work in financial markets, how does your knowledge of Austrian economics help?

RZ: Austrian business cycle theory helps in long term planning, and the originally Austrian concepts of "opportunity cost" and "marginal utility" have even become mainstream. Austrian economics has a slightly

"The two things most important in investing however are in my opinion the importance of local knowledge and the strong influence of government and central bank intervention in markets."

bearish bias so usually underperforms in the final stages of a bull market but helps to avoid costly mistakes as well. The two things most important in investing however are in my opinion the importance of local knowledge and the strong influence of government and central bank intervention in markets. For instance, subprime mortgages became so popular in Germany because of basic differences in mortgages between Germany and the US. Germany does not have non-recourse mortgages and so many understood the products even less than their US counterparts.

Thanks to my speaking engagements I am on record as warning of the subprime bubble in 1999 and the decline of oil prices due to new technologies in early 2013. So obviously being right alone is not the key to investing success. One could have lost heavily if one had put on trades too early; a balanced portfolio strategy is important.

In the last two years, being underweight government bonds has harmed performance since few predicted that rates would go negative due to central bank action but I am sure that this trade will pay off in the long run.

"Seeing how much these economies and standard of living improved during the 1990s with more free market ideas was probably one of the highlights of my professional career."

LMR: Finally, you have seen the fall of the Soviet Union and the relative liberalization of Eastern European countries. What has happened now with the prospects for economic liberty in Europe?

RZ: Covering Eastern Europe for Bank of America in the 1980s and seeing how much these economies and standard of living improved during the 1990s with more free market ideas was probably one of the highlights of my professional career. Some regions prospered even more with the introduction of low, flat tax codes not even used in the West. The city of Bratislava in Slovakia is now the 6th richest region in the EU, even surpassing Vienna (which is only a few miles to the west but with more Keynesian policies).

After the financial crisis some of these newly free economies began rolling back some of the liberalization and went back to more protectionism but that can be felt in more developed countries as well. I hope that in the long run they will see the progress made due to free markets and continue on this path.

◆◆◆

EVENTS & ENGAGEMENTS

APRIL 9, 2016
SAN ANTONIO, TX

Murphy discusses sound money at Texas LP State Convention

APRIL 12, 2016
BRENTWOOD, TN

Lara presents on Facing The Economic Dangers of 2016, for CCC Corporation

APRIL 14, 2016
LOCK HAVEN, PA

Murphy presents on economic distortions at Lock Haven University

MAY 21, 2016
SEATTLE, WA

Murphy presents at Mises Circle

MAY 10-12, 2016
ST. LOUIS, MO

Nelson Nash, Lara, and Murphy present on IBC at Freedom Advisers

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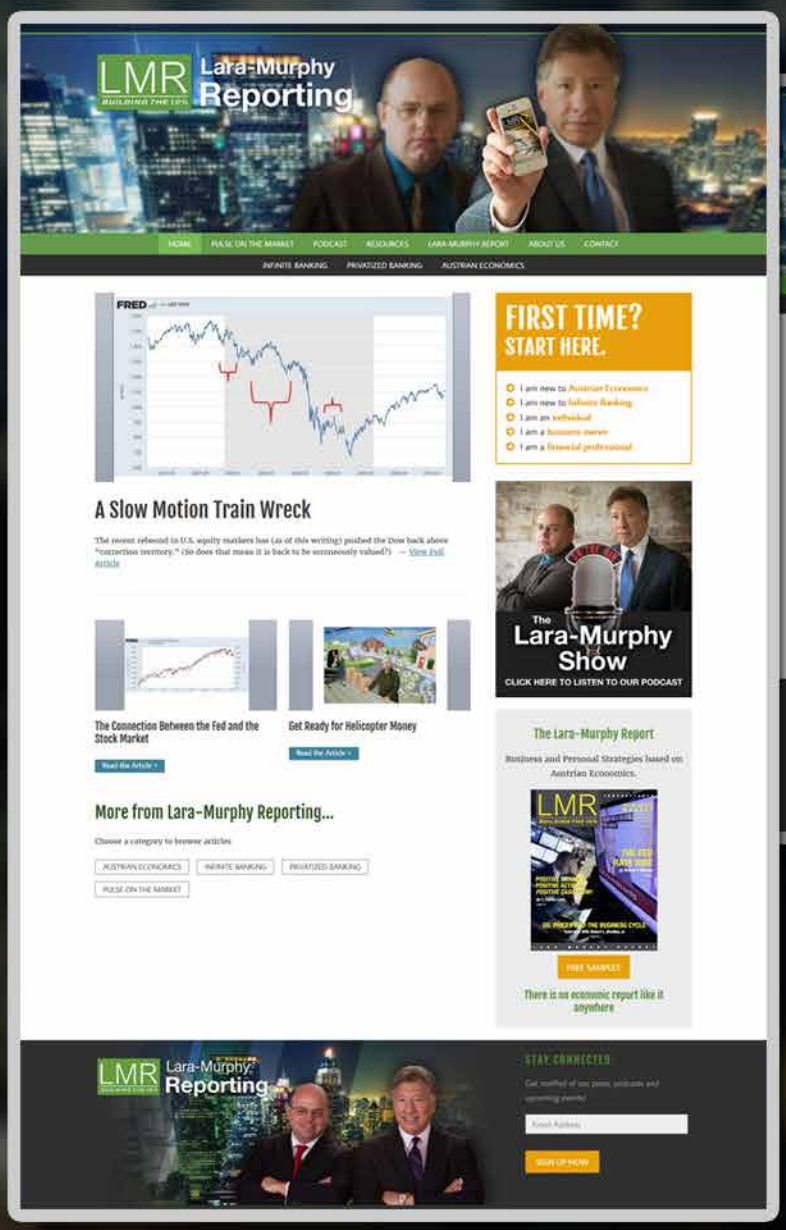

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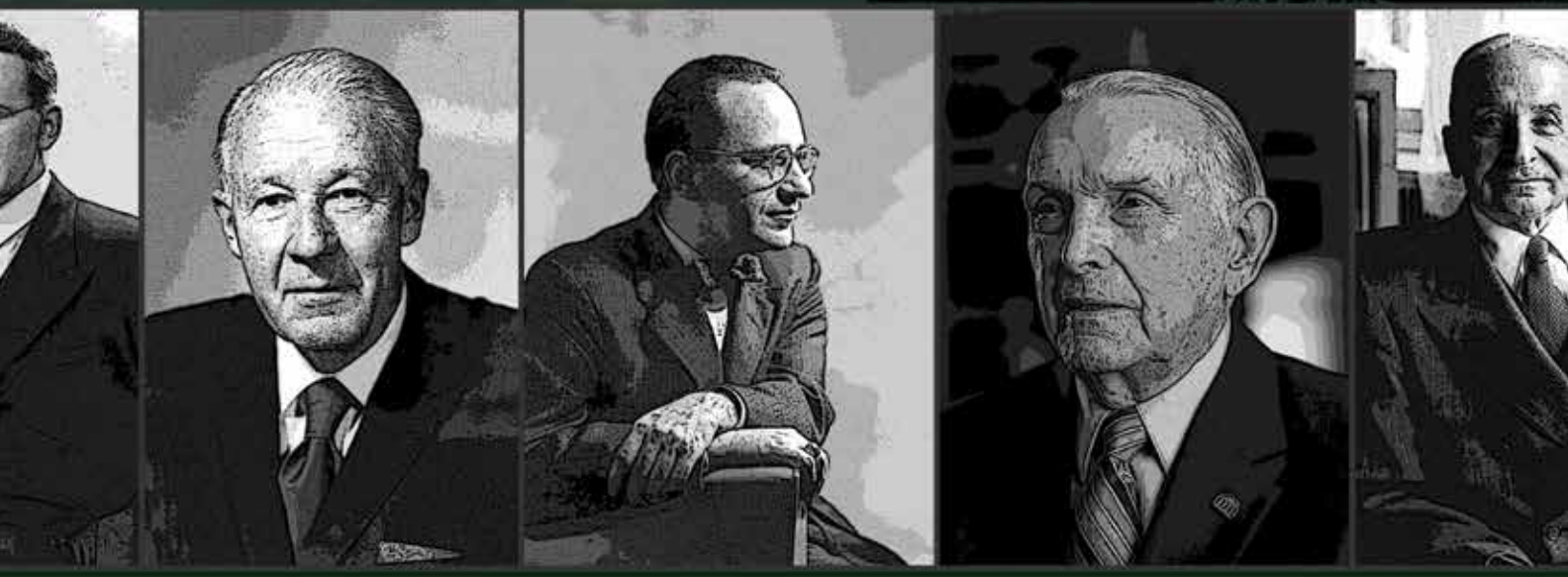

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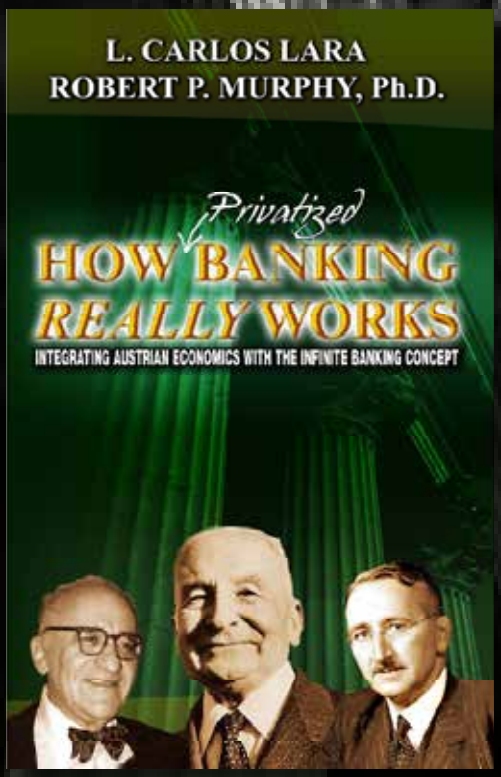

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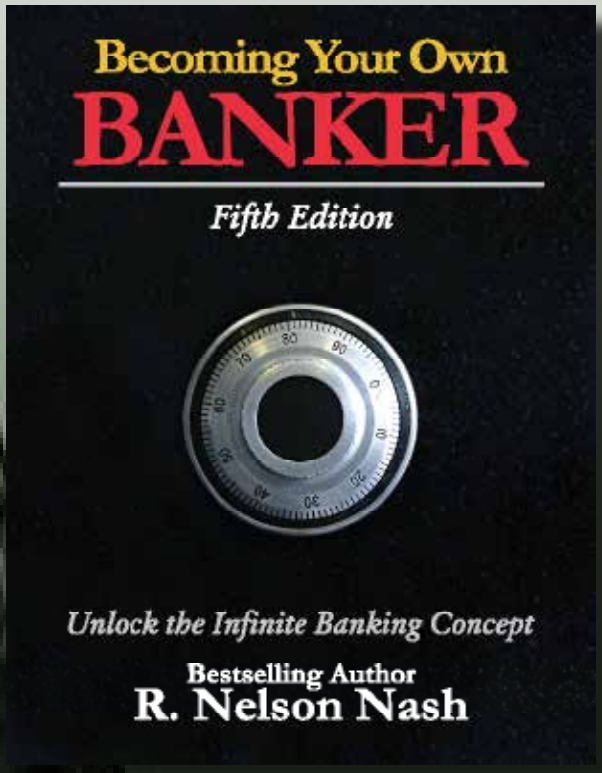

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