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BY L. CARLOS LARA

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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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"The wavelike movement affecting the economic system, the recurrence of periods of boom which are followed by periods of depression is the unavoidable outcome of the attempts, repeated again and again, to lower the gross market rate of interest by means of credit expansion."

—Mises

Credit expansion is mysterious to the masses of society because they simply do not understand the nature of credit nor do they understand the nature of money. But among the masses there is an even lesser understanding of central banking and its role in creating both money and credit in the economy.

Yet this ignorance cannot really be held against them. The mechanics of the credit expansion process are so obscure that even the best minds can struggle piecing it all together. Unless one is in the business of staying abreast of financial markets and monetary policy it's virtually impossible to grasp. Ultimately the average person must rely on trusted sources to explain it all—if they can find those credible resources.

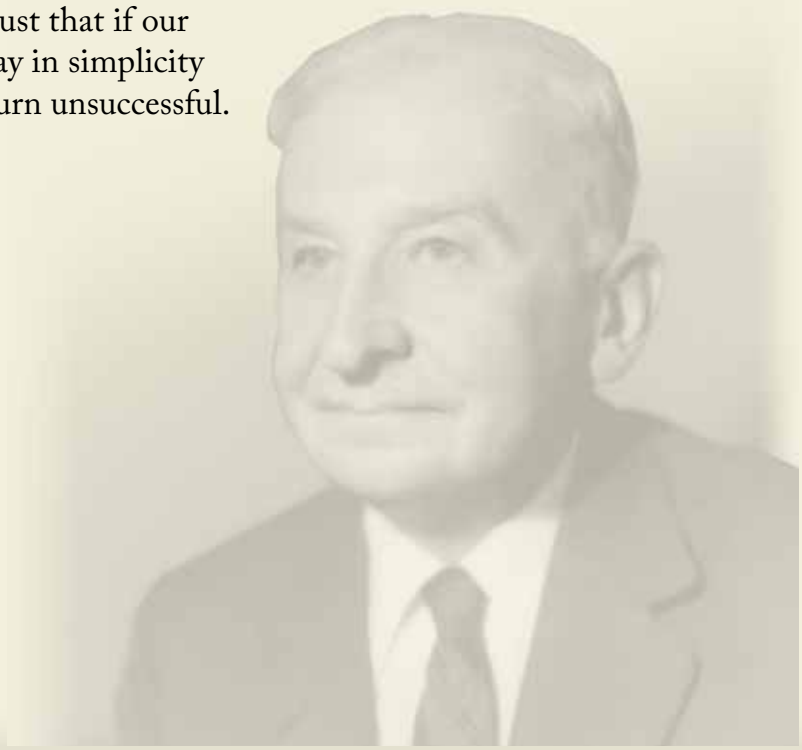
The common misconception that everyday people hold as to the power of the Federal Reserve is that it exists legally in order to fine-tune the economy and to ultimately protect them as bank depositors through its tremendous lending powers. Combined with the guarantees of the *Federal Deposit Insurance Corporation (FDIC)*, most believe that the banking system is sound.

Less than a decade ago the banks were bailed out with taxpayer money because they were deemed "too-big-to-fail." You would think that this landmark event should have left a searing impression in people's minds warning them to stay clear of commercial banks. But the direct effects of the taxpayer bailout on the people's own wallets is just as difficult for them to trace, nor do they recognize the central source of money that the treasury used to pay for the bailouts in the first place.

What individuals can easily understand is their natural motivation to borrow money when the rate of interest is low. When you are working hard to make a living this makes perfect sense. Their comprehensions of the low interest rate environment extends only to the point of a belief that banks must be flush with money and are eager to lend it at rock bottom prices. Who can pass up such a deal?

But to gull the public in their innocence in this way is both hypocritical and deceptive. Left unexposed the fraud of government and central banking will only continue. Our ultimate drive for true reform in our monetary system rests on the remnant, that faithful 10% who hears our message and carries it to others, one person at a time. We trust that if our message is delivered this way in simplicity and sincerity, it will not return unsuccessful.

Yours truly,
Carlos and Bob



PULSE ON THE MARKET

QE FOR THE ECB

ECB CUTS BUT EXTENDS BOND BUYING PROGRAM

CNBC reports that the European Central Bank (ECB) plans to reduce its monthly bond purchases (from 60 billion euros down to 30 billion) starting in January, but on the other hand the horizon of the program has been extended to (at least) September 2018.

At this point it's useful to remind readers that at the tail end of Bernanke's tenure, the Fed began its so-called "taper" in which it gradually reduced its third and last quantitative easing (QE) program. Indeed, by the fall of 2014, the Fed wrapped up its bond-buying altogether, and its balance sheet has been treading water ever since. This explains why the dollar strengthened more than 20% against major currencies since 2014 (though it has pulled back more recently).

Although we've been warning of inflationary asset bubbles ever since central banks around the world opened up the monetary spigots, it's important to realize that the major printing presses are only very timidly beginning to tighten (or in the case of the ECB, to simply *slow* the printing down). It's amazing how long the monetary central planners have been pumping in liquidity, but even they are starting to end the party.

If you haven't already done so, we strongly encourage you to review our video, "How to Weather the Coming Financial Storms," available at: www.Lara-Murphy.com.

MUTUAL FUNDS CASH OUT

DANGEROUSLY LOW CASH HOLDINGS AMONG MUTUAL FUNDS

An ominous article at ZeroHedge gives the scoop (as well as a revealing chart) on the fact that "Mutual Fund Cash Hits All Time Lows" (available at: http://www.zerohedge.com/news/2017-10-25/mutual-fund-cash-hits-all-time-lows). The article reports: *"[M]oney market funds assets account for just 17% of the assets of long-term funds, a historical low. Similarly, the cash balance of equity mutual funds is at an all-time low 3.3%."*

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For context, MMF assets ranged between ~30% and 60% of total assets for long-term funds from the 1990s up until 2010. (The value is now at an all-time low of 17%.) And the cash balance of equity mutual funds—now at an all-time low of 3.3%—was above 5% for most of the 1990s.

To avoid confusion, we should point out that the *absolute holdings* of cash are at record *highs*—the Fed and commercial banks created gobs of money (in the form of commercial bank deposits and paper currency) for the public to sop up after the financial crisis. Furthermore, rock-bottom interest rates means that there is little opportunity cost in holding actual cash as opposed to other safe but less liquid assets.

Even so, the ZeroHedge figures are showing that *other asset classes* have blown up even more, such that the *percentage* in the form of "cash" (which in investor parlance of course is a broader term than literal currency and bank deposits) is now at all-time lows. ZeroHedge's take—with which we are sympathetic—is that the average Joe doesn't want to be a sucker and so he's piling into the other asset classes, not wanting to be left behind as stocks, real estate, etc. all continue their upward march.

Naturally, this is just what it feels like before the bubble bursts.

Tax Wars

GOP COMES CLOSER TO REVAMP OF TAX CODE

As of this writing, the Republicans have not released an actual bill, but after much delay and grandstanding, it seems that we might actually see a serious push for an overhaul of the tax code, not seen since the Tax Reform Act of 1986. If and when more details come out—especially in the form of an actual bill—we can be more specific, but for now permit us some general observations:

First, as Carlos explains in his public lectures on IBC, the Tax Reform Act of 1986 crashed the real estate market. When legislators "close loopholes" they change the investment landscape and cause previously viable strategies to collapse.

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Second, it is naïve to think that a "simplified" tax code will stay that way. Yes, eliminating brackets and applying a general rate—rather than policymakers picking winners and losers with special deductions and exemptions—is the most efficient way to raise a desired target of revenue. But the convoluted tax code is convoluted for a reason: It allows political officials to curry favor with favored interest groups. The only lasting way to get rid of "inefficient" taxation is to get rid of taxation, period.

Third, as we can see from the current jockeying over which deductions to retain, in practice there are going to be massive winners and losers from any "tax simplification," *unless* the rule is simply: Reduce marginal tax rates across the board. If instead the rate reductions are coupled with "closing loopholes," then some taxpayers could be hit severely. Although there may be a certain logic to the measure, it nonetheless means that Congress is giving tax cuts to some people while hiking taxes on others. From an ethical as well as a political perspective, it is much more straightforward for conservative and libertarian Republicans to call for scaling back the rates on various taxes (or eliminating them altogether, such as the estate tax).

The federal government currently takes in almost 18 percent of GDP in the form of tax receipts, which is above the postwar average. There is no reason to engage in "deficit-neutral tax reform." Instead the American people should be given a large tax cut, and if people are worried about the deficit—as they should be—then the feds can cut their spending, too.

IBC AND CONSTANT COMPOUNDING

BY ROBERT P. MURPHY

A common method of showing the public the power of Nelson Nash's "Infinite Banking Concept" (ICB) is to stress its feature of "constant compounding." In contrast to many other asset classes, dividend-paying Whole Life insurance always increases in value. Indeed, some proponents of IBC enthusiastically declare: "There's nothing else like it!"

In this article I will explain what Nash's fans have in mind. As we will see, there really *is* something special about IBC; it allows households and business owners to enjoy "constant compounding" in a very safe and convenient way, which *cannot* be matched by other (standard) assets. However, as with most claims, there are some caveats involved (particularly the interest accruing on outstanding policy loans), and I want to make sure the readers of the ***LMR*** understand all of the nuances on this powerful topic.

IBC AND POLICY LOANS: THE BASICS

In order to focus on the specific issue of constant compounding, I am going to assume in this article that the reader has a basic familiarity with IBC as a cashflow process, and how it uses a dividend-paying Whole Life insurance policy as the platform for implementing it. For those readers who need this foundation in a quick way, I refer you tothe podcast series that Carlos and I produce, in particular episodes 17, 18, and 19.[1] For those willing to put in more time, there is no substitute for reading Nelson Nash's classic book, *Becoming Your Own Banker.*

For our purposes in this article, let me review the essential mechanism: A dividend-paying Whole Life insurance policy comes with built-in, contractual guarantees on the growth of the "cash surrender value." This is the amount that the life insurance company will give the policyholder if he or she decides to collapse ("surrender") the policy and stop making premium payments. Of course, this dollar amount is lower than what the *death benefit* would have been, if the insured party had died, but with large policies the cash surrender value can grow quite large. Intuitively, it is how much the life insurance company

There really *is* something special about IBC; it allows households and business owners to enjoy "constant compounding" in a very safe and convenient way.

is willing to pay the policyholder to "walk away" from the contract, letting the insurance company off the hook from having to pay the looming death benefit (which gets closer every passing day, since the insured person will eventually die or reach the age—such as 121 years old—at which the contract matures).

Now rather than surrender the policy outright, a policyholder who needs money has another contractually guaranteed option: He or she can take out a *policy loan,* up to (almost) the cash surrender value. It's important to understand exactly what is happening here: The policy loan is a loan *made on the side,* from the life insurance company to the policyholder. It does not directly involve the life insurance policy itself; the customer isn't "taking money out of the policy." Rather, the life insurance company is simply directing some of its outgoing cashflows—which it otherwise might use to buy corporate bonds or other assets—into loans to its own customers.

These policy loans are actually *the safest investment possible* from the life insurance company's point of view, because the company itself is guaranteeing the underlying *collateral* on the policy loans: namely, the cash surrender value of the policies in question. Even if the borrower (i.e. the customer who is requesting the policy loan) never pays a penny on the outstanding policy loan, the life insurance company has no worries. The outstanding policy loan rolls over at compound interest (according to the interest rate on the policy loan, which is itself determined by a contractually-fixed formula), and it eventually gets "paid back" either when the insured dies or reaches the maturity age and the contract ends.

These policy loans are actually *the safest investment possible* from the life insurance company's point of view.

A CAR EXAMPLE

For example, suppose a fan of Nelson Nash has begun implementing IBC in his personal life, and is making large premium payments into a properly designed Whole Life policy. When it's time for this man to buy a new car, he doesn't need to rely on financing from the dealership or an outside lender. Instead, the man takes out a policy loan for (say) $25,000,

and pays the full purchase price to the car dealer to buy the car outright on the spot.

Now even though the man wrote one big check himself from the perspective of the car dealership, in reality the man obtained the financing for his purchase by borrowing *against* the cash surrender value in his well-funded IBC policy. In order to play "honest banker" with himself, the man starts making (at least) the same monthly "car payments" to the life insurance company, as if he had borrowed from a traditional lender and had to make car payments at a standard interest rate.

The life insurance company has no problem with this scenario. It won't send repo agents to seize the car.

However, even though the man intends on mirroring the same cashflows doing it the IBC way, in reality he is much more secure and can sleep soundly at night. If he suddenly loses his job, he has the option of *not* making his "monthly car payments" to the life insurance company. His outstanding policy loan of $25,000 *won't* get knocked out, and instead it will keep growing at interest.

Yet to repeat, the life insurance company has no problem with this scenario. It *won't* send repo agents to seize the car. Remember, legally speaking the man *bought the car outright from the dealership*. The car is *not* the

collateral on the policy loan; his life insurance policy's cash value is.

Suppose the man never makes a payment, and the policy loan grows to (say) $40,000, many years later. Further suppose the man dies of a heart attack, and at this point the death benefit on his policy is $500,000. In this case, his named beneficiary (let's say it's his widow) only gets a check for $460,000. This is because the life insurance company first "pays itself back" for the full value of the outstanding policy loan, before sending what it owes to the beneficiary.

I hope this simple example illustrates the advantages of financing major purchases with IBC (rather than traditional lenders), but also clarifies why the life insurance companies agree to this arrangement which at first seems too good to be true to some members of the public.

PAYING CASH VERSUS CONSTANT COMPOUNDING

The fans of IBC will often bring up the special feature of "constant compounding"

when contrasting the virtues of their approach with the strategy of "paying cash" for big purchases. In this section, I'll explain what the fans of IBC have in mind with this discussion.

Imagine a woman who follows a very conservative approach to money. She has been taught to avoid debt, and to only buy things "that she can afford." Consequently, if this woman wants to buy a $25,000 new car every few years, she sets up a sinking fund using certificates of deposit (CDs) issued from her local bank. (Alternatively we could imagine her putting money into a bank savings account, a money market mutual fund, etc.)

What happens is that the woman first figures out what (after-tax) interest rate she is likely to earn on her very conservative investment in bank CDs. Then, using an amortization calculator, she figures out how much money she needs to put into the sinking fund every month, so that when it's time to buy a new car, her growing stash of CDs has a total market value of $25,000 (less whatever trade-in value she'll get for her used car at that point).

This is a very conservative approach, pushed by the likes of "get out of debt" gurus such as Dave Ramsey. Compared to the typical American who "lives beyond his means" by running up credit card and other types of debt in order to fuel consumption, our hypothetical woman is behaving very responsibly.

However, the fan of IBC might point out to the woman that her strategy involves draining out her wealth fund every time she buys a new car. In other words, the value of her "car fund" grows over time, but whenever it hits $25,000, she redeems her bank CDs and hands over the $25,000 to the car dealer. At that point, the woman has no financial assets due to this enterprise, and she must start over from $0. In particular, the woman certainly can't earn interest income on her previous contributions into the "car fund," because that money is now gone forever—it was handed over to the car dealer.

In contrast, suppose the woman avoided bank CDs as her financial vehicle, and instead built up a well-funded dividend-paying Whole Life insurance policy. So long as she kept making the premium payments, this policy would continue to grow over time, with an ever-higher cash surrender value *and* death benefit (if designed according to IBC principles). When it was time for her to buy a new car, the woman would not "take money out of the policy"—the way she might cash in CDs or write a check drawn on a bank savings account—but instead she would take out a policy loan against the cash surrender value in her policy. The life insurance policy would not "fall in value" because of this move; it would keep chugging along on its own,[2] with the outstanding policy loan merely representing a lien against this asset.

AN ANALOGY WITH HOME EQUITY LOANS

In order to comprehend what's happen-

ing, it might help to use an analogy with home equity loans. Suppose our hypothetical woman never heard about cash-value life insurance, and she had been building up her bank CDs in the fashion that her very conservative parents had taught her.

At the same time, she also owns a paid-off house. (Remember, she avoids debt as a rule.) In Year 1, the house had a market value of $100,000. In Year 2 it rose to $105,000. In Year 3 it was $110,250, and so on. Every year, the house tended to rise about 5 percent in market value.

Now it was time for the woman to buy her new car, for $25,000. She originally planned on cashing in all of her bank CDs, depleting her sinking fund down to $0. But her friend points out that she could alternatively take out a home equity loan against the value of her house. In this case, she could still buy the car outright—there would be no lien against the automobile—with the equity in her house serving as the collateral. With this approach, the woman could retain her stash of bank CDs, which would continue to appreciate at the interest rate the bank offered.

Furthermore, *the house itself* would also continue to appreciate in market value, so long as real estate kept rising. In other words, the market value of the woman's house would not be "dragged down" because she decided to borrow against it, in order to finance the new car purchase. It is crystal clear that the market value of her home is a completely separate concept from the outstanding value of the home equity loan she takes out from the commercial bank.

In this context, the woman's friend might point out to her, "If you cash out your bank CDs, you will stop earning interest on them. But if you finance your new car purchase by borrowing against the equity in your house, then you continue to earn the CD interest *and* you still reap any appreciation in real estate on your house."

I hope that this analogy with a home equity loan sheds light on what is happening if the woman instead turns to a well-funded Whole Life policy. By obtaining the $25,000 from a policy loan, she doesn't need to "draw down" any of her other assets, and even her life insurance policy continues to chug along (subject to the technical caveat about "direct recognition" discussed in endnote 2). *This* is what fans of IBC have in mind when they warn people that "paying cash" for car purchases and other major expenses means that they will lose out on the ability to continue earning interest on their savings.

A commercial bank will not grant home equity lines on the same terms that a life insurance company will use for a policy loan.

Before leaving this section, let me address one loose end: If I can use an example of a home equity loan to illustrate the broad principle, why then do IBC fans insist that

It would be very misleading to tell the public about the virtues of constant compounding *without* keeping track of the corresponding liability due to the policy loan.

"there's nothing else like this" in the financial world? Why not, for example, just tell people to use home equity financing rather than building up a Whole Life insurance policy?

The crucial difference is that *the real estate market could collapse*. This is why a commercial bank will *not* grant home equity lines on the same terms that a life insurance company will use for a policy loan. In particular, if you apply to a bank for a home equity loan, it is a laborious process, where the bank will check your credit score and your income, it will ask what you are doing with the loan, and it will insist on a timely repayment schedule. The life insurance company does none of this. They simply check what your unencumbered cash surrender value is, in order to determine how much of a policy loan you can borrow. The check can literally be in the mail the next business day, and—to repeat—the life insurance company doesn't care what payback schedule you adopt, *if any*.

In light of these considerations, we can understand the enthusiasm of the fans of IBC, and why they insist that there is no other financing mechanism available that can match the process developed by Nelson Nash.

DON'T FORGET ABOUT POLICY LOAN INTEREST!

Before closing this article, it is important for me to address the issue of policy loan interest. It would be very misleading to tell the public about the virtues of constant compounding *without* keeping track of the corresponding liability due to the policy loan.

The best way for me to illustrate the problem is to contrast Sally, who is going to "pay cash" for a car using a sinking fund, with Jim, who is going to take out a policy loan from a life insurance policy. In this example, we will see the familiar point that IBC fans make about "lost opportunity cost" when paying cash, but we will also see how the policy loan growth offsets the apparent gain of the IBC approach.

In order to minimize the number of moving parts, I am going to assume that Sally earns 5% on her sinking fund, while Jim enjoys an internal rate of return (counting dividends etc.) on his cash surrender value of 5%, *and* that the life insurance policy loan inter-

est rate is 5%. In reality, these numbers may all be different, of course, but my example should help financial professionals and the public to refine their understanding of what factors are actually driving particular wealth outcomes from different strategies.

She repeats the whole process starting in Year 6. Because she had cashed out her fund the prior year, notice that the sinking fund is only worth $4,524 at the end of Year 6—the same as at the end of Year 1. There is no "memory" in her sinking fund of her earlier

Table 1. "Paying Cash" for a Car versus Policy Loan

	Sally Pays Cash		Jim Uses Policy Loans			
	Annual Contribution (BOY)	Sinking Fund Value (EOY)	Annual Contribution (BOY)	*Gross* Cash Surrender Value (EOY)	Policy Loan Balance (EOY)	*Net* CSV (EOY)
Year 1	$4,309	$4,524	$4,309	$4,524	$0	$4,524
Year 2	$4,309	$9,275	$4,309	$9,275	$0	$9,275
Year 3	$4,309	$14,263	$4,309	$14,263	$0	$14,263
Year 4	$4,309	$19,501	$4,309	$19,501	$0	$19,501
Year 5 (Buy 1st Car)	$4,309	$25,000	$4,309	$25,000	$25,000	$0
Year 6	$4,309	$4,524	$4,309	$30,775	$26,250	$4,525
Year 7	$4,309	$9,275	$4,309	$36,838	$27,563	$9,276
Year 8	$4,309	$14,263	$4,309	$43,204	$28,941	$14,264
Year 9	$4,309	$19,501	$4,309	$49,889	$30,388	$19,501
Year 10 (Buy 2nd Car)	$4,309	$25,000	$4,309	$56,908	$56,907	$1

NOTE: In Table 1, all rates of return and loan interest rates are 5%.
(BOY=Beginning of Year, EOY=End of Year, CSV=Cash Surrender Value.)

There's a lot going on in Table 1, so let's first concentrate just on Sally. By assumption, she has a sinking fund (composed of bank CDs, for example) that earns an internal rate of return of 5%. She wants to buy a new car for $25,000 at the end of Year 5. In order to achieve this goal, Sally puts $4,309 at the start of each year into her sinking fund. By the end of Year 5, her sinking fund has grown to a value of $25,000. She cashes in her CDs and pays cash for her new car.

contributions; she starts the cycle anew with each car purchase.

Now look at Jim's figures. We assume that he makes the same out-of-pocket contributions as premium payments into a Whole Life insurance policy. To keep things apples to apples, we are unrealistically assuming that there is no overhead and that all of the payments immediately become available as Cash Surrender Value (CSV). We further assume that with dividend reinvestment etc.,

the CSV of this policy grows with an internal rate of return of 5%.

For the first five years, the two approaches are identical. That is, the market value of Sally's sinking fund and the CSV of Jim's life insurance policy are the same. However, things diverge at the end of Year 5, when they make their first car purchase.

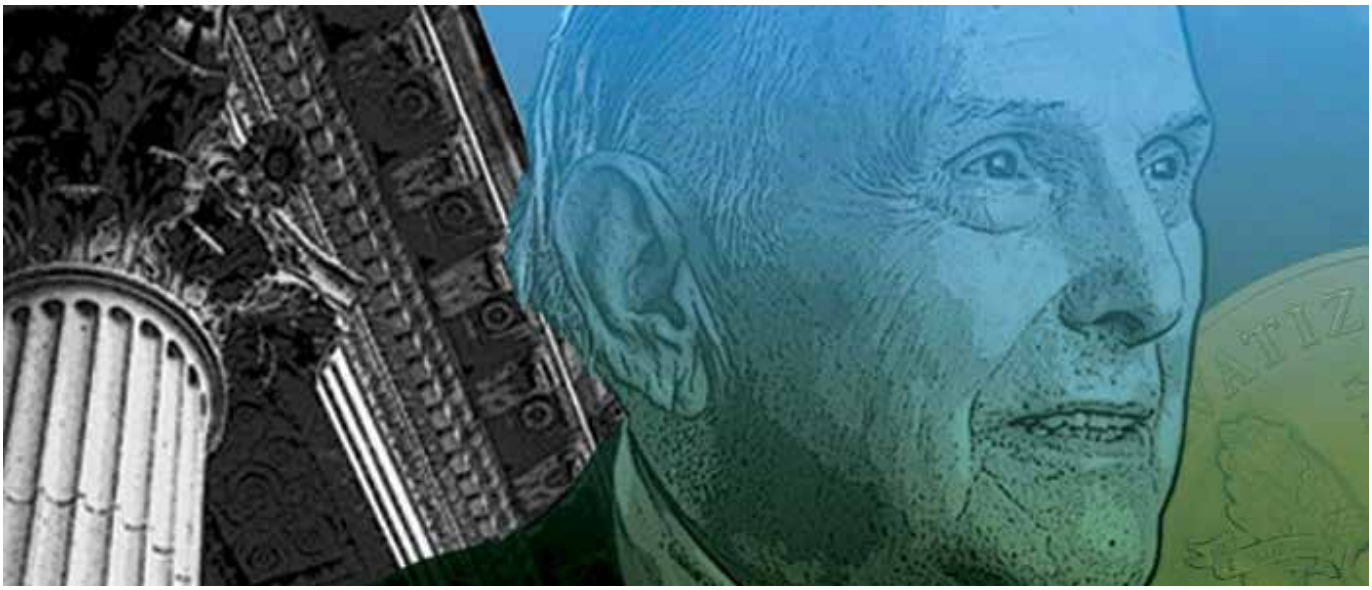
At this time, Sally wipes out her portfolio of bank CDs, in order to buy the $25,000 car. She has no debt, but she also has no financial assets. She has a brand new car, but financially she is back to $0 and has to start rebuilding from scratch.

In contrast, Jim's *gross* Cash Surrender Value is not affected by the fact that he takes out a policy loan of $25,000. He keeps making his premium payments, and his policy keeps chugging along, growing at an internal rate of return of 5%. By the end of Year 10, Jim's life insurance policy has grown to a gross cash value of $56,908, whereas Sally's bank CDs have only recovered to their previous high of $25,000—and they are just about to get knocked back down to $0 when she buys her second brand new car.

I believe this contrast—between the value of Sally's sinking fund and the gross Cash Surrender Value in Jim's life insurance policy—is what the typical IBC proponent has in mind when he teaches people the importance of "keeping your money working for you" and how paying cash "ignores opportunity cost." This is all true as far as it goes.

However, we must also take into account a very important fact: *If Jim is devoting the same out-of-pocket cashflow as Sally into his life insurance premiums, then he has no extra cashflow to pay down his policy loan.* After all, the *reason* Jim has the luxury of "keeping his money in his life insurance policy" when he buys the new car, is that Jim gets the $25,000—at the end of Year 5 and then again at the end of Year 10—by borrowing from the life insurance company.

Once we account for this extra cashflow and the liability it brings, we see that Jim's net Cash Surrender Value—which is the gross CSV minus the outstanding policy loan balance—leaves him in basically the same position as Sally. Yes, it is certainly true that Jim enjoys constant compounding on his cash values that "stay in the policy," but these are offset by the *constant compounding on the policy loan balance.* In this example, I made all of



the rates of return identical, so that the two forces perfectly offset each other. But even if the various interest rates are different (which they will be in the real world), the concept is still crucial. It would be an incomplete account of what is happening, to mention *only* the gross cash value and ignore the offsetting policy loan balance.

FINANCING THROUGH IBC IS A GOOD IDEA

I want to stress that I am a huge proponent of Nelson Nash's IBC, especially in our volatile economic environment. The principles Nelson teaches in his book are valid, and his numerical examples were based on real-world illustrations generated by home office software with interest rates that held when he wrote his book.

The simplistic example I discussed in Table 1 above was *not* intended to show the reader that "it's all a wash." On the contrary, I think it makes *much more* sense to finance large purchases using the IBC approach, rather than (say) building up a sinking fund through bank CDs, commercial savings accounts, money market funds, or other popular and "safe" assets. (For example, the combination of safety and after-tax yield afforded by a life insurance policy compares quite favorably to these other possibilities, *and* you get the kicker of a large death benefit.)

Financing large purchases via policy loans is a very robust strategy that is superior to more traditional methods of finance, *including* the conservative approach of "paying cash" and avoiding all debt.

Furthermore, I think the fans of IBC are correct to stress to the public the virtue of

"constant compounding" that is afforded by a dividend-paying Whole Life insurance policy. (For example, the "historical average rate of return" that is touted for the stock market can often mask years when losses occurred, giving a very misleading picture of what would really happen to your money in such investments. In contrast, you don't need to worry about your cash value going down during a "bad year" with life insurance.)

So rather than pooh-poohing the advantages of IBC, the purpose of my example in Table 1 was simply to make sure the public is presented with the full picture. I definitely agree that in practice, someone who uses a sinking fund approach and adopts an "always pay cash" mentality will not end up as wealthy as someone who adopts the IBC approach.

Yet as the figures in Table 1 reveal, the *reason* for the superior wealth accumulation under IBC isn't *merely* the fact that "you lose the opportunity to earn interest on your savings" when you pay cash. By itself, that consideration is counterbalanced by your need to take out a loan (growing exponentially) when you keep your money at work in a policy. There are *other* reasons that IBC is superior to paying cash, including the very real psychological tendency for people to "find more money" to pay down an outstanding policy loan. Another motivation is their willingness to divert large flows of cash into an IBC-structured policy when they see how large the death benefit jumps, even if it is partially offset by a growing policy loan balance.

CONCLUSION

All things considered, Nelson Nash's Infinite Banking Concept (IBC) is an ingenious process of managing cashflows using a dividend-paying Whole Life insurance policy. via policy loans is a very robust strategy that is superior to more traditional methods of finance, *including* the conservative approach of "paying cash" and avoiding all debt.

In the world of IBC, it is standard to teach newcomers the importance of opportunity cost, and to show that IBC allows your money to enjoy constant compounding. These principles are all correct, and the lessons are important. However, as I've shown in this article, evangelists for IBC should be clear to include the offsetting liability of a policy loan balance in their more elaborate discussions. This will provide the public with a full and accurate picture, so that they will hopefully see the superiority of IBC and embrace it in their own households and businesses.

◆◆◆

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1. Episodes 17, 18, and 19 of the Lara-Murphy Show are available at: https://lara-murphy.com/podcast/page/3/.

2. Strictly speaking, certain life insurance companies follow the practice of "direct recognition," in which case the size of the dividends generated by the policy (and hence its "internal rate of return") could be reduced by outstanding policy loans. However, that is a technical issue regarding how fast the policy grows, and even here, it is not correct to think that the policy loan "comes out" of the life insurance policy.

WILL BONDS TRIGGER THE NEXT BANKING CRISIS?

BY L. CARLOS LARA

Goldman Sachs Group Inc. and J.P Morgan Chase & Co., two of the largest global banking institutions, have just publicly announced that they are now offering investors a new way to bet on the next financial meltdown using a new brand of derivative and a new type of credit default swap (CDS) known as a *"total return swap."*[1]

This is a revealing announcement and a sign that we cannot overlook. We need to explore this one carefully because it is pointing directly at the bond market as being the next potential trigger that can lead to a systemic financial calamity and rocking the banking system all over again.

Although we already know the financial storms are coming, Bob and I spend a great deal of research time charting the exact point of ignition. We know that given the right timing and circumstances the panic can start almost anywhere, and that its full disastrous force becomes most apparent in the bank runs that result. By then people's life savings and investments have been lost and now it's all about getting what's left of their cash out of the bank.

I've actually had an inkling about the subject of this story for several years now. My intent in this article is to illustrate the facts behind it and use it to educate all of our *Authorized IBC Practitioners,* their IBC clients, and in general all interested individuals in *Nelson Nash's Infinite Banking Concept (IBC)* to continue to make informed decisions. I say this because probably the most often asked question posed to Bob and me after one of our live presentations, or by the listeners to our podcast who contact us by email is: *"Why would I want to put my money into a Whole-Life policy that is held together by dollar-denominated assets—most of which are bonds?"*

We know that given the right timing and circumstances the panic can start almost anywhere.

It's a good question and this recent development pointing to the bond market will only increase the number of questioners and feed the uncertainty about Whole Life insurance all the more, once it starts to circulate among the networks. Yet it's clear, even before I state my case in response to this question, that common sense is already telling many average folks, as well as professional financial analysts, that the prolonged low interest rate environment we have experienced here and abroad has only skewed the

economy toward disaster.

The deliberate implementation of low interest rates has created a financial market environment that runs from one euphoric high to another. Even the new Nobel laureate in economics, Richard Thaler, is confused by the current investor behavior, while adding that "this could be the riskiest moment of our lives."[2] But who can blame him? No one seems to really know how to best analyze our current situation.

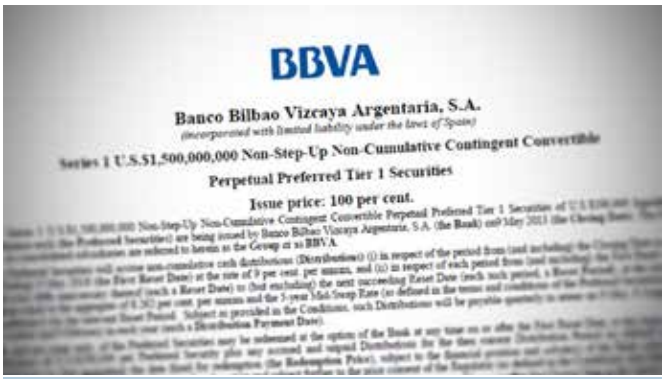
Even the new Nobel laureate in economics, Richard Thaler, is confused by the current investor behavior, while adding that "this could be the riskiest moment of our lives."

Yet even under these bizarre economic circumstances the relevancy of understanding the *Austrian Business Cycle Theory (ABCT)* can help bring order and clarity to an otherwise bewildering financial landscape—even if it's by simply letting people know where the low rates are coming from and why. What we do know for sure is that government intervention in the market is pervasive. Markets are not free.

COCO Bonds

My concern is not so much that big banks are creating a market in derivatives in debt instruments since this is not all that unusual. We all remember the result less than a decade ago, after they'd come up with credit-default swaps and derivatives tied to subprime mortgages. But in this recent Goldman Sach's story it's the underlying type of bonds that are specifically involved that worries me because I happen to know quite a bit about them and they are indeed risky. In essence they are a high yield investment with an explosive fuse that for all practical purposes is already lit and when it blows, it will totally wipe out the bond investor.

I first brought these instruments to your attention in the May 2014 issue of the ***LMR*** after having further researched the stress points of the Basel Accord "bail-in" experiment in Cypress the year prior when bank



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Issue price: 100 per cent.

What I am referencing here are the *"Contingent Capital Securities"*—commonly known as COCOs.

depositors got left holding the bag. What I am referencing here are the *"Contingent Capital Securities"*—commonly known as COCOs and now more currently known as "AT1s." This is what Goldman Sachs and J.P Morgan Chase are using to make "markets in derivatives that allow investors to bet on or against these high-risk investments that financial regulators can wipe out if a lender (a bank that has issued these) gets into trouble."[3]

As my 2014 article showed, regulators of the Basel Accord (and by extension the Dodd-Frank Act) approved these bonds as a way for financial institutions (primarily banks) to boost their Tier1 Capital requirements without diluting their shareholders. In effect they created and authorized a cheap way for banks to raise funds and banks made quick use of them. The lure for investors is their high yields, which average 6% or 10 times the return of senior bank bonds. This makes a big impression in a low interest rate environment, which is why hedge funds and asset managers starved for higher yields have purchased a substantial amount of them. Nevertheless it's a very risky high-yield investment with a ticking time bomb tied to it.

What makes these securities somewhat mysterious is that they are actually hybrids—a cross between two types of securities. They are bonds that convert to stock at the precise moment a bank becomes insolvent (that's the contingency part) at which point the interest payments are suspended and the bond flips to equity. That may not be all that bad for investors at first except that if the bank continues to deteriorate further, COCOs can lose their value entirely and leave the investor high and dry.

COCOs were primarily issued by European banks and did not actually start selling until around 2013. All too often they were sold to bank customers and unsophisticated bond investors who really did not understand how this particular debt instrument really worked. Since their release "the U.K and other countries have banned sales to individual investors."[4]

The very first COCO Bond scare came in early 2016 when Deutsche Bank announced massive losses for the previous year and sent the bank's shares into a free fall and almost halved their price of €21 euros a share to €13 euros. Deutsche's stock shares dropped 10% in a matter of a few hours. Investors in these

high-risk bonds panicked in fear that interest payments on these bonds would stop and convertibility would be triggered. (See my ***LMR*** article in the February 2016 issue.) However, Deutsche Bank, which was classified as a *Systemically Important Financial Institution (SIFI)* received help from the European Central Bank and was able to make its interest payments. This allowed the panic to eventually subside and banks resumed issuing them.

Lust For Yield

It's important to understand that regulators helped design these contingent convertibles for the express purpose of putting bondholders on the front line of a "bail-in" in order to avoid the need for a taxpayer bailout of a failed bank. However, the concern has always been that when investors realized the inherent risk of these COCOs they would flee them, thereby destabilizing the corporate bond market altogether and triggering a much more serious debacle. Those concerns have escalated as this section of the bond market has continued to grow and is now approaching $200 billion, all within less than 5 years.

In March of this year there was a global stampede to buy these Tier1 securities. "Investors put in orders for 16 times the $750 million of bonds that Australia's Macquarie Group was selling. Citigroup Inc., J.P. Morgan Chase & Co., HSBC Holdings Plc., and Bank of America Corp., led the sale."[5]

Regulators helped design these contingent convertibles for the express purpose of putting bondholders on the front line of a "bail-in" in order to avoid the need for a taxpayer bailout of a failed bank.

Clearly the risk appetite of bond investors these days demonstrates how starved they are for yield despite the havoc these instruments can create.

Wake-Up Call

However, a real test of their built-in danger occurred this past June when "regulators wiped out bond investors in 1.25 billion euros ($1.40 billion) in COCO Bonds as part of a rescue of Spain's *Banco Poplar Espanol SA.*"[6] In this case regulators did not hesitate to totally gut the COCOs and their investors in order to avoid a taxpayer bailout. The

All to say that we need to keep a close watch on this particular sector of the bond market as it continues to grow in size and threat.

remaining assets of the bank along with its depositors were swallowed up by a rival bank to prevent a total collapse.

But then again, Banco Popular didn't pose a clear threat to the broader financial system so it became possible for regulators to take these steps.. It would be a completely different matter if this type of thing happened to a global SIFI institution, in which case regulators would be nearly powerless to prevent a financial system contagion. This must be exactly what Goldman Sachs and J.P Morgan Chase & Co. must have in mind and why they are setting up shop to sell swaps and derivatives within this bond space.

More specifically they seem to be targeting the known European weakened institutions such as Deutsche Bank AG, Banco Sander SA and HSBC Holdings Plc., all of which are *Systemically Important Financial Institutions (SIFIs)* "Obviously some participants in this new market will be looking to expose themselves to the high-yield asset class while others will definitely be buying in order to hedge their positions,"[7] according to Max Rusher, the London based Director of Credit Indexes at HIS Markit Ltd.

All to say that we need to keep a close watch on this particular sector of the bond market as it continues to grow in size and

threat. In the end the switch may be flipped in Europe this time around instead of the U.S.

Conclusion—Not All Bonds Are Created Equal

Despite the fact that bonds have long played a vital role in the structure of our global economy and are still considered one the most liquid assets in our entire financial system, turbulent economic events of the last forty years have caused people to question their long-term security and credit worthiness in comparison to other asset classes. Individuals have learned through painful experiences that some bonds are not necessarily safer than stocks and other investments, as this article has demonstrated.

Additionally, bond prices can move violently when interest rates change even when the change is ever so slight. This fact is what drives much of the trading volume in the bond market—about $200 billion per day. The tension created between issuers seeking to minimize costs of financing and investors who want as much income as possible can create big moves in bond prices. Of course, bond losses can occur if interest rates suddenly spike.

What is most interesting is the explosive growth in bonds within the last fifteen years. The long-term trend of low interest rates has made financing cheaper than ever for governments and corporate borrowers, hence the size of the global bond market has tripled to an excess of $100 trillion. The global stock market, which is about $64 trillion, pales in size to the bond market. Does this mean that we are in a huge bond bubble that will soon burst? What about bonds and Whole-Life insurance?

The long-term trend of low interest rates has made financing cheaper than ever for governments and corporate borrowers, hence the size of the global bond market has tripled to an excess of $100 trillion.

Yes, I would say that world economies have a lot of unsustainable debt outstanding, much of which has been generated by government intervention into the financial markets as we have seen. In previous articles we have written about the massive bond (QE)

unwinding, which is about to begin. Also, many corporations have issued bonds to buy back their own stock as a means to prop up their own stock values and cover up anemic company performance this past decade. Still others are issues of the lower quality high yield or junk bond variety of debt. At some point soon there will be a day of reckoning for some of these instruments and when they collapse there is no doubt that tremendous shock waves will be sent throughout the financial system and millions will be hurt financially.

Please remember that not all bonds issued by a given company or government are created equal.

It's also true that life insurance companies, like most money intermediaries, have a substantial portion of their invested assets in bonds, not only to match against their liabilities and build up excess reserves, but also for the liquidity they afford. In the aggregate, life insurance companies have approximately 70% of their invested assets in bonds with 48% being corporate bonds. But the good news and what we have often stressed, is that these bonds are all of the higher quality investment grade debt, which typically have less chance of default. (Bob's article in the August 2017 issue of the ***LMR*** is an excellent up-to-date resource for an in-depth view of life insurance portfolios that is worth study.)

Also, please remember that not all bonds issued by a given company or government are created equal. For example, maturity dates make a difference in being able to project recovery of principal in case the issuing entity runs into trouble. Some provide a higher liquidity spectrum than others. Still others provide collateral that goes along with the bonds, or an "imbedded leverage" and still others are "senior" or "subordinated" bonds that determine the pecking order for payment in bankruptcy proceedings. Obviously bond ratings can make a big difference in determining which bonds to purchase, but statutory rules mandate that life companies

invest in only high quality investment grade debt.

But the main thing to keep in mind is that you as a life insurance policy owner are not investing in bonds, the life insurance company does that. What you should do is to use the rating agencies to guide you towards the most highly rated mutual or mutual holding company to obtain your dividend paying Whole-Life policy and then use an *Authorized IBC Practitioner* to make sure it is properly designed according to Nelson Nash's IBC specifications. Once you are set up with one of these alternate cash flow systems we recommend that you keep all of your fiat money stored here and do all of your financing from here. Keep very little cash in commercial banks, especially during these turbulent times.

Supplement this strategy with cash in your possession to cover at least one month of bare minimum expenses just in case your bank goes down and you can't withdraw your money. Add to this several months of "emergency money" (physical gold or silver) just in case the dollar crashes and all hell breaks lose.

The main thing to keep in mind is that you as a life insurance policy owner are not investing in bonds, the life insurance company does that.

As to whether or not bonds will trigger the next banking crisis, it's hard to know. As I have said before, the trigger can be pulled anywhere. Many think it will be the stock market, others think it will be real estate. But what I do know is that with our three-pronged defensive strategy, you will have the best-balanced financial protection for weathering the coming financial storms.

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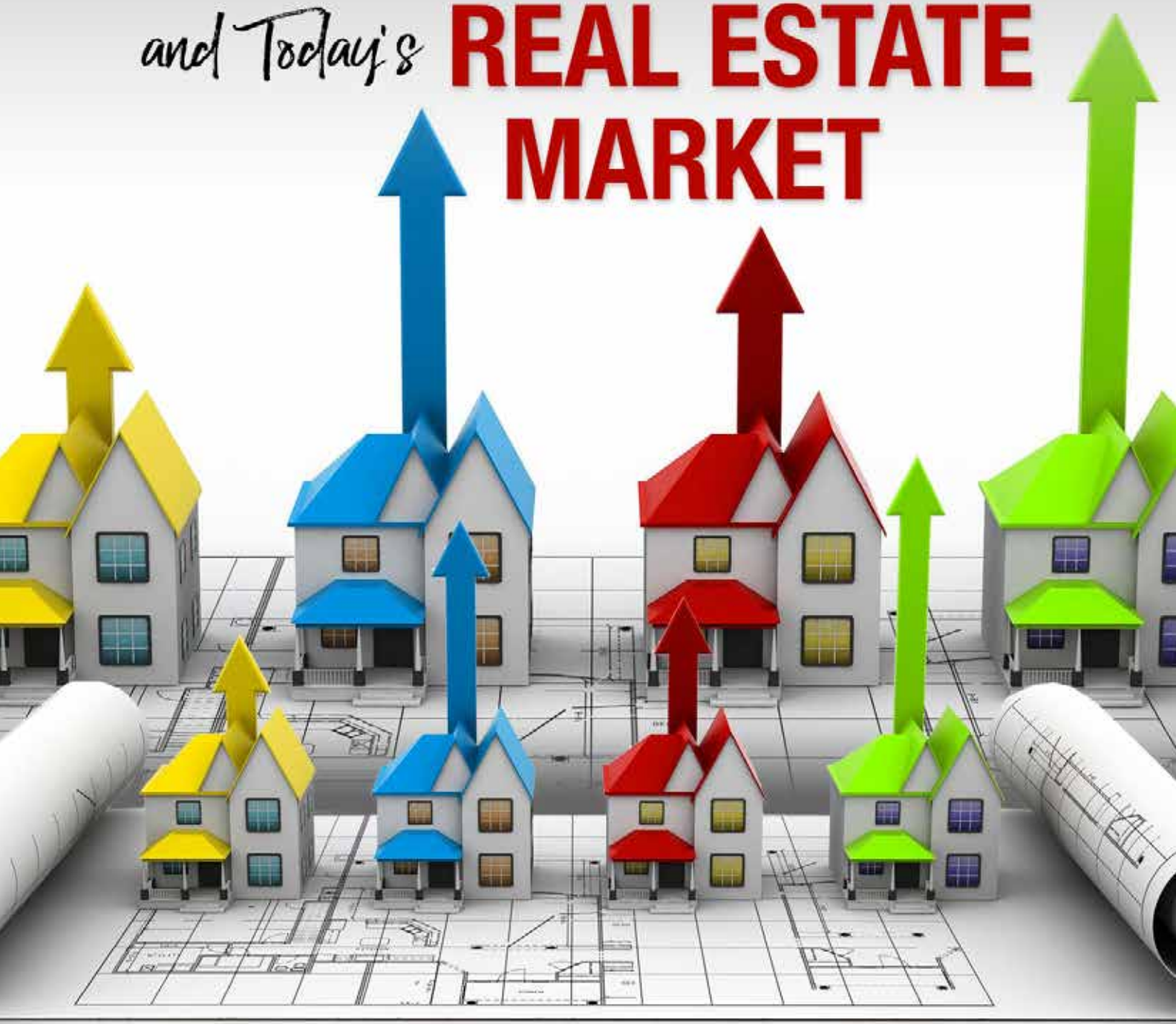
AUSTRIAN BUSINESS CYCLE THEORY and Today's REAL ESTATE MARKET



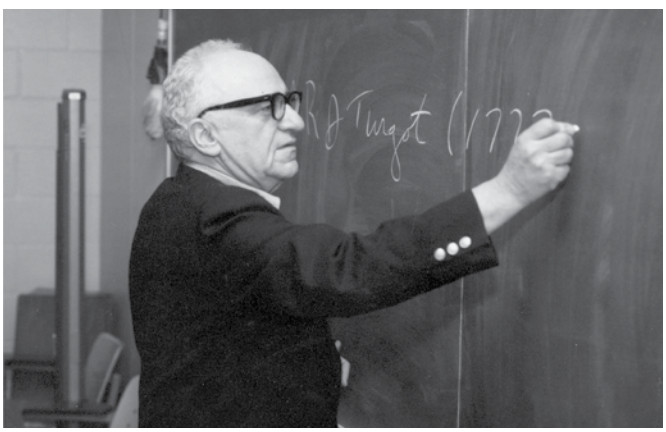
Interview with DOUG FRENCH

Doug French works as a consultant for a real estate developer and is a private moneylender in Las Vegas. He has authored three book: *Early Speculative Bubbles and Increases in the Supply of Money, The Failure of Common Knowledge,* and *Walk Away: The Rise and Fall of the Home-Ownership Myth.* French is the former president of the Ludwig von Mises Institute. He writes about economics and markets at douglasinvegas.com.

[**Editors' Note:** French was previously interviewed in the November 2010 issue of the *Lara-Murphy Report.*]

Lara-Murphy Report: How did you become interested in Austrian economics?

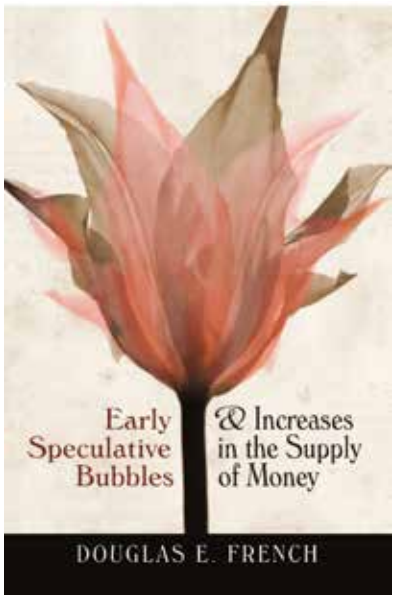
Doug French: I began work on a Masters in economics at UNLV in Las Vegas in 1989. After taking a couple of classes, I noticed in the course catalog, EC742-History of Economic Thought, Rothbard. I asked a fellow student about Rothbard, and was told he was a kook: "Don't take the class with him." I ignored the advice, and decided to give Murray Rothbard a try and was



"I asked a fellow student about Rothbard, and was told *he was a kook."*

captivated the first night. Although Murray didn't teach Austrian economics per se, I was especially interested in financial history and began to read and absorb the Austrian business cycle theory in particular. To me as a construction lender at the time, Austrian business cycle theory (ABCT) just made sense as opposed to the other schools of thought. Murray constantly provided reading suggestions.

Ultimately, I wrote my Master's thesis under Murray, with Hans Hoppe also on my committee. The thesis, "Early Speculative Bubbles and Increases in the Supply of Money" is still being sold by the Mises Institute, Amazon, and other booksellers. Murray told me I had made a contribution with my ABCT analysis of "Tulipmania." At the time I didn't think much about it. Twenty-five years later he's been proven right. It's been cited in a number of books and this year by Ball State's James McClure and David Chandler Thomas in their academic article on the timing of Tulipmania that was published in the *Financial History Review*.



"To me as a construction lender at the time, Austrian business cycle theory (ABCT) *just made sense* **as opposed to the other schools of thought."**

LMR: You recently spoke in NYC at the 35th anniversary of the Mises Institute, where the event was dedicated to the legacy of Murray Rothbard. Do you have any anecdotes about Rothbard that you can share with our readers?

DF: Murray was not only brilliant, but a wonderful, and in many ways, humble, guy. For instance, Murray required a 10-page paper, which could be on most anything, except we had to approve the subject with him. I went to Murray and said, I'd like to write a paper on the Great Depression. He said, "That's great Douglas!" He then gave me a list of books to use as references, beginning

with Lionel Robbins's *The Great Depression*. Then, almost as an afterthought he said, "Oh, and I wrote a book about the Depression. It might be of some use."

I was too naive to be embarrassed, but should have been. Rothbard's *America's Great Depression* is THE book on the Great Depression.

The other guys and I on the panel in New York were reminiscing about Murray's lectures which began with whatever was going on in the news that particular day. His lectures were free-wheeling monologues, where he would go off on tangents, but would return to where he had left off. This made note-taking challenging. If students took everything down, lecture notes might start with Aristotle, then veer off to Hillary Clinton, then maybe to the New York City mayoral race, and back to Aristotle.

We all were very lucky.

"Murray told me I had made a contribution with my ABCT analysis of 'Tulipmania.' At the time I didn't think much about it. Twenty-five years later *he's been proven right."*

LMR: You had first-hand experience with the housing bubble in Las Vegas. Can you summarize what happened?

DF: With the 9/11 attacks, many conventions cancelled, the hotels panicked and laid off employees. Home builders in turn stopped pulling permits. Of course the Fed lowered rates, mortgage rates declined, people kept moving to town and buying homes, and the supply of homes dwindled to nothing. With plenty of cheap money and limited supply, house prices soared, and then land prices jumped and so on. I remember a customer telling me, "Interest rates are so low I have to do something."

Vegas home builders responded by building over 35,000 homes at the peak. Buyers took advantage of the no money down, negative amortization, and no documentation ("liar") loans. There were stories aplenty about retired cops buying dozens of homes. Strippers, cocktail waitresses, and bartenders—it seemed like everyone either become realtors, mortgage agents, or home flippers. A classic

case of labor being malinvested in a bubble at the same time as capital.

While Fed Chairs Greenspan and Bernanke pooh-poohed the idea of a housing bubble with their comments, the Fed ratcheted up rates and home values peaked in 2006. However, casino companies had $30 billion in new projects underway on the Strip and lenders believed the market was just pausing before taking off again when those projects would be finished.

When the subprime mortgage market unraveled, home values in Las Vegas crashed (ultimately by 65%) and land prices plunged by 90% in some cases. Most all the community banks in Las Vegas failed, while larger lenders like Zions Bank and Western Alliance survived due to the Treasury's TARP bailout. As for those hotel/casino projects, many still haven't been completed or in some cases even started.

"There were stories aplenty about retired cops buying dozens of homes. Strippers, cocktail waitresses, and bartenders—it seemed like everyone either become realtors, mortgage agents, or home flippers. A classic case of labor being malinvested in a bubble at the same time as capital."

Last decade's boom and bust followed Austrian business cycle theory perfectly.

LMR: What are your thoughts on the real estate market right now?

DF: I wrote recently the housing market is "distorted and dysfunctional." With the Fed flooding the markets with liquidity and bailing out lenders in 2008, the crash did not fully clear out the malinvestment in housing. Then, the Blackstones of the world borrowed at just over zero percent and bought up foreclosured houses by the thousands.

> "When the subprime mortgage market unraveled, **home values in Las Vegas crashed (ultimately by 65%) and land prices plunged by 90% in some cases. Most all the community banks in Las Vegas failed, while larger lenders like Zions Bank and Western Alliance survived due to the Treasury's TARP bailout."**

The result is, there is now a shortage of low-priced homes, while a number of homeowners are still underwater, and in Las Vegas, over 10,000 homes are vacant with squatters living in them. Rising construction and land costs make it nearly impossible to build homes for first-time buyers. This was made worse by the hurricanes and Trump's threatened softwood tariff this year. For instance, on a tract my employer is building, construction costs have increased 50% in

just a few months. Houston, Florida, and now northern California are bidding up the price of labor, drywall, and other materials. The shortage of skilled labor is a frequent topic in building trade magazines. The higher education bubble has turned people who would be in high demand as carpenters or plumbers into the underemployed with business degrees.

We have this big affordability problem with mortgage rates around 3.5% to 4%. There are plenty of no-money-down loan products out there, but, if rates return to a more normal 6% to 7% range, the housing market will likely be in serious trouble as potential buyers, burdened with record levels of subprime auto debt and student loan debt, won't be able to afford to buy.

Fannie Mae and Freddie Mac have created another bubble in apartments. These wards of the state have provided over 60% of the apartment construction financing around the country. Seattle has 50 high-rise cranes downtown as they build

"An appraiser friend of mine says, 'It's like I've been asleep for 10 years. Developers are making the same crazy claims about the value of their land or projects as they did *before the crash.'"*

high-rise apartments everywhere for incoming (they think) tech workers. Reno, Nevada is booming due to Elon Musk's Tesla plant, which is being financed by Nevada taxpayers. Musk has never made a profit and will put a man on Mars before he ever does. When he crashes, he'll take all of northern Nevada with him.

Low interest rates have driven CAP (capitalization) rates to absurd lows, making all commercial real estate historically expensive. For your readers, a 4% CAP is equivalent to a 25 times price-to-earnings ratio. When I was lender 25 years ago, we would assume CAP rates of 10-12%. These low CAP rates make extraordinarily dangerous leverage possible.

An appraiser friend of mine says, "It's like I've been asleep for 10 years. Developers are making the same crazy claims about the value of their land or projects as they did before the crash."

"Bankers and investors who lived through 2008 don't know what happened,

they just know it did happen."

If Congress does away with like-kind 1031 exchanges it would crush this real estate ebullience. These exchanges allow real estate investors to postpone capital gains taxes if they invest proceeds of a real estate sale in a like-kind property. This provision in the tax code has propped up investment real estate for years as investor roll their money tax-free from one property to another. It's believed 10% to 20% of real estate sales involve 1031 exchanges. "The odds have increased that like-kind exchanges are eliminated with no offsetting provision," said Green Street Advisors earlier this year.

It's a whole new world and a treacherous one for real estate investors and lenders.

LMR: Would you say the banking and investment community is more aware of

the possibility of asset bubbles now, than they were ten years ago?

DF: Maybe. However, the reality is that regulators have kept banks out of the speculative financing game. And, as one of my borrowers once told me, "Builders build, when lenders lend." Other sources have picked up some of the slack, but, this mini-boom, unlike say the 2000s boom, has not been fueled by the banks. As I mentioned earlier, Fannie and Freddie are doing their part, both in the apartment and housing markets. In markets like New York and Miami, foreign money has driven prices higher.

The average banker isn't familiar with Austrian theory or the history of asset bubbles: senior management and the regulators either let them make loans or not. Bankers and investors who lived through 2008 don't know what happened, they just know it *did* happen. And they hope it doesn't happen again. If Janet Yellen says there won't be another crash like 2008 in our lifetime, that's good enough for them. Bankers and investors will continue on believing this boom is different. The newest bubble is always different.

I tend to think Ms. Yellen is as good a prognosticator as her predecessors, who couldn't understand what was happening right in front of them, let alone, what might happen in the future.

There will always be a desire to use leverage. As long as we have central banks and fractional reserve banking, investors will want to borrow, lenders will overdo it, and the makings of the next panic will be made. ◆◆◆

EVENTS & ENGAGEMENTS

NOTE: MANY OF THESE EVENTS ARE OPEN TO THE PUBLIC. CONTACT US FOR FURTHER DETAILS.

OCTOBER 7, 2017
NEW YORK CITY, NY

Murphy speaks at 35th Anniversary Gala for Mises Institute.

OCTOBER 15-22, 2017
THE CARIBBEAN

Murphy and Tom Woods host the "Contra Cruise."

NOVEMBER 4, 2017
MORRISTOWN, NJ

Nash, Lara, and Murphy present the IBC Seminar.

SOME EVENTS MAY BE CLOSED TO GENERAL PUBLIC.
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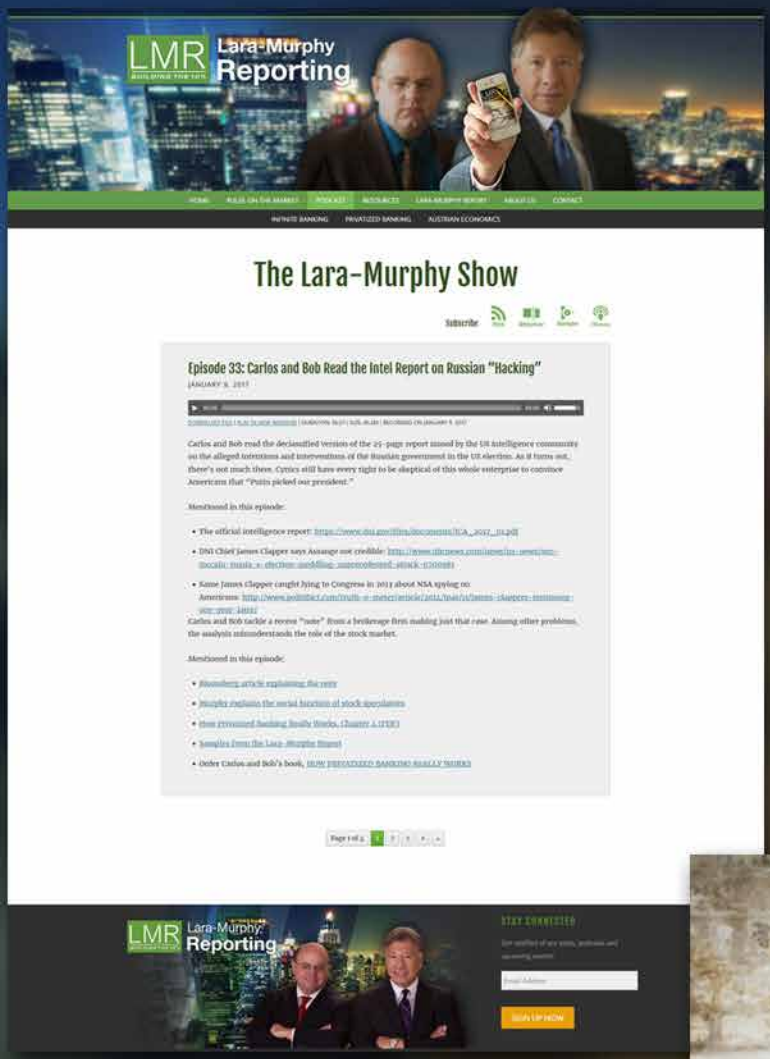

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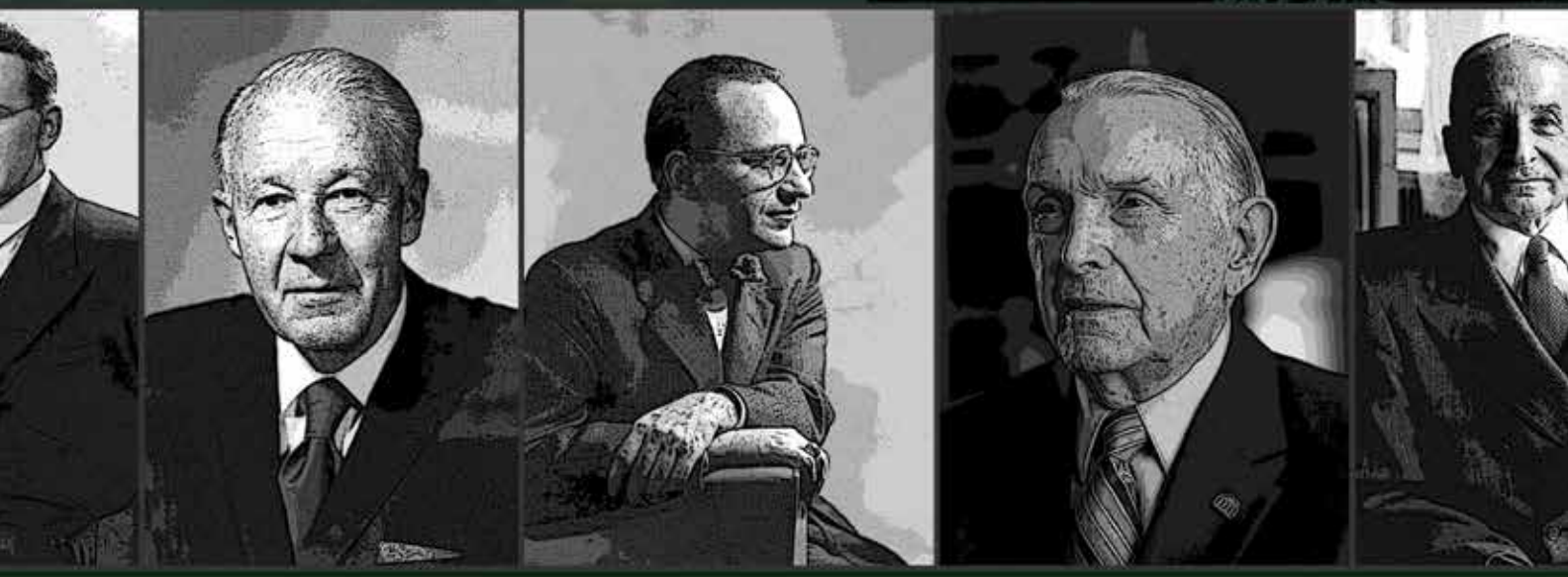

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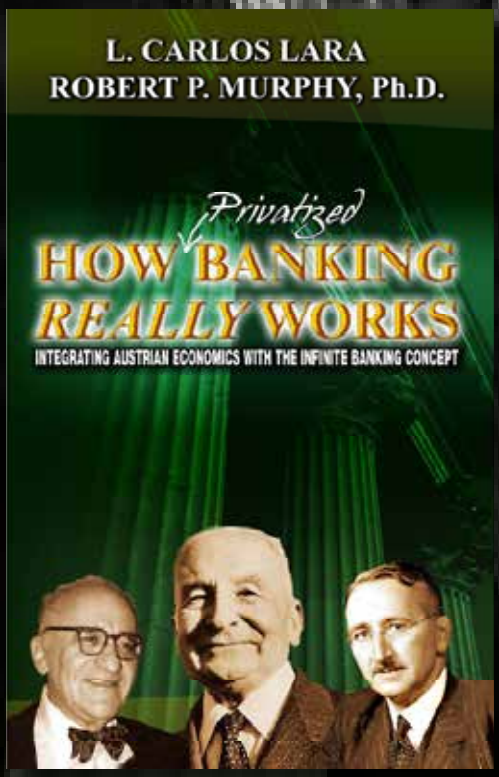

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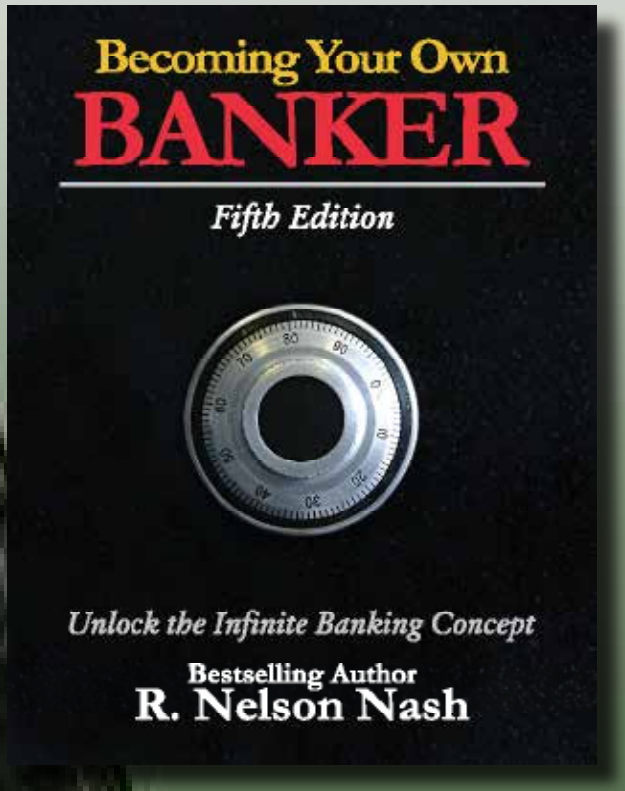

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