"IS LIFE INSURANCE A GOOD INVESTMENT RIGHT NOW?"

PART 2 OF 2

by

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In the May 2017 issue of the *LMR*, I wrote the first part of this series. I began to tackle a common objection that Carlos and I get, when we talk to crowds familiar with Austrian economics. (Notice the quotation marks around the title of the article: These words are coming from the public, not from me.) Specifically, people wondered how Carlos and I could be in favor of the Infinite Banking Concept (IBC), after we had systematically explained that the Federal Reserve's actions since 2008 had set the U.S. economy up for another crash, and also threatened the U.S. dollar. In such an environment, why in the world would somebody want to load up on a dollar-denominated asset like life insurance?

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In that first article, I spent time *framing* the issue properly. It's important for our readers to understand exactly what Carlos and I are saying, and the very question—"Is life insurance a good investment right now?"—skews the discussion. In this, the second article, I'll review some of the main points regarding the framing.

After that, I will highlight the most recent statistics on the life insurance industry, to show why it is in relatively good shape (compared to many other sectors) and should be adequately prepared to serve its role in the broader plan that Carlos and I have explained to our readers.

Review from the First Article: Clarifying Our Perspective

First and most important: Nelson Nash's IBC is not about "investing in life insurance," the way other financial people might tell you to "invest in real estate" or "invest in Bitcoin." On the contrary, IBC is about "becoming your own banker." IBC is a *process*, and the *platform* by which you implement IBC is a dividend-paying Whole Life insurance policy. *That's* why we spend so much time discussing life insurance. You need to understand the basic mechanics of a Whole Life policy, and in particular how cash surrender values and policy loans work, just so you feel comfortable in using one or more of these devices as a major pillar in your financial plan.

If you're a typical reader, just about all of your dollar-denominated income and expenditures flow through the commercial banking system. Nelson Nash is simply recommending that you set up an *alternative* "warehouse" for your wealth. This is a great idea in general, but it's particularly urgent now, when Carlos and I think that our banking system is vulnerable to another crisis. (To be clear, Carlos and I are warning about the condition of the economy based on our own understanding of central banking and Austrian business cycle theory. Nelson Nash is not responsible for our views or strategy on this broader topic.)

If you have not yet implemented IBC in your personal life, we urge you to investigate sooner rather than later. Start by listening to episodes 17 and 18 of the Lara-Murphy Show (exact links provided in the endnotes to this article).[1]

Carlos and Bob's Three-Pronged Strategy

To continue with my review from last time, recall that Carlos and I produced a video in September 2016 entitled, "How to Weather the Coming Financial Storms." If you didn't watch it, you can still find it featured at our main page: www.Lara-Murphy.com. (If you are reading this article long after its original publication, check the endnotes for a permanent location for the video.[2])

You need to understand the basic mechanics of a Whole Life policy, and in particular how cash surrender values and policy loans work, just so you feel comfortable in using one or more of these devices as a major pillar in your financial plan.

After explaining our economic views, we recommended a three-pronged strategy:

1. Obtain a month's worth (meaning how much you would have to spend to maintain your basic emergency needs) in actual currency on hand, in case the commercial banking system seizes up and you can't use the ATM or write checks.

2. Obtain many months' worth of physical gold and/or silver, in case the dollar crashes and you need an inflation-proof hedge to tide you over until your sources of income can at least partially adjust to the new reality.

3. Start an IBC policy, so that your dollar-denominated cashflows are segregated from the conventional banking system.

To be sure, there are many nuances to fully appreciate our simple recommendations, but the above list is a good summary. My point in reviewing the three prongs for this article is to remind you that *we handle the threat of (price) inflation by encouraging an accumulation of the precious metals.* So it's not an adequate rejection of IBC to say, "Well gee whiz, I thought you Austrian types were warning about a dollar crash?"

Even if the dollar takes a beating and (say) falls 50 percent against other major currencies, Americans are still going to use dollars when they go to Walmart or when they log into their online bank account to pay their electric bill. You are still going to want your own cashflow management system in the vehicle of an IBC-structured Whole Life insurance policy.

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Now that I've reviewed the role that an IBC policy (or policies) plays in the overall strategy that Carlos and I developed, let's analyze the underlying strength of the life insurance sector. After all, it does no good to be holding life insurance policies with hundreds of thousands of dollars in "cash surrender value," if the insurer goes belly up and can't make good on its liabilities.

So how confident should we be, that the life insurers will stay standing if another economic crisis hits? That's the question I seek to answer in the remainder of this article.

Exter's Pyramid

In Figure 1, I reproduce the pyramid made famous by John Exter.

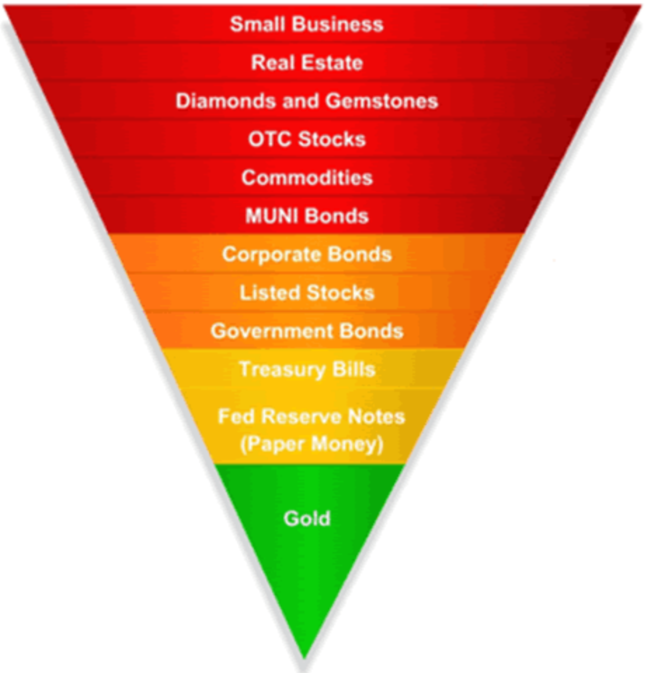

Figure 1. Exter's Pyramid of Collapsing Values

During his career, Exter worked for the Federal Reserve and also for commercial banks. He studied historical financial panics and concluded that during a crisis, investors rush to *liquidity*.

In Figure 1, the top of the pyramid represents the assets—such as real estate and municipal bonds—that have low liquidity and hence high risk, in the event of a crisis. If there is major uncertainty, investors will try to unload these assets and move down the pyramid.

Generally speaking, actual currency (Federal Reserve notes in the U.S.) is the most liquid of all assets. However, in the event of a currency collapse—and we are probably witnessing such an event in real-time in Venezuela—people no longer want to hold even the "money" as issued by the government. In such terrible circumstances, people flock to the *market's* money—gold—as the ultimate safe haven and asset of last resort.

Look again at Figure 1, but this time have in mind the three-pronged strategy that Carlos and I recommended. Notice that the tip of the pyramid is gold, which is one component of our plan. Moving up to the yellow region, we see actual currency—another component of our plan.

Finally, moving up another segment into the orange region, we see government bonds and corporate bonds. This is the third com-

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ponent of our strategy, because holding a large Whole Life insurance policy is effectively holding indirect claims on a portfolio of government and (investment-grade) corporate bonds, as I detail in the next section.

The Relative Strength of the Insurance Sector

In this section, I will summarize the most recent report on the life insurance sector's financial position, according to the American Council of Life Insurers (ACLI) 2016 Fact Book. (This report is available online,[3] and note that the data in this report only go up through 2015.)

Although the data won't be as recent, those interested in this topic should read previous ***LMR*** articles analyzing various indicators of the insurance industry's reliability. For example, consult the April 2012, August 2012, January 2013, April 2013, May 2014, October 2014, May 2016, and May 2017 issues of the ***LMR*** to see articles from either Carlos or me, on this topic.

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The "General Account" vs. the "Separate Account"

With all of the preliminaries out of the way, let's proceed to document some of the key facts concerning the financial position of the life insurers. Note that throughout this article, I will be focusing on what's called their general account, which refers to the assets the life insurers hold in order to "back up" their in-force policies. The assets held in the *general account* are the means by which the insurance companies can afford to pay out death benefit claims when insured people die.

In contrast, the *separate account* holds the assets related to special products that serve as investment pass-through vehicles, such as variable annuities or Variable Universal Life (VUL) insurance policies.

Nelson Nash *strongly* insists that it only makes sense to implement IBC using a dividend-paying **Whole Life** insurance policy, ideally issued by a mutual company (rather than a stock company). Since a life insurer's general account holds the assets that "back up" the traditional life insurance products (including Whole Life), that's the relevant metric for our purposes in this article. For someone practicing IBC, it doesn't matter if the stocks held by a life insurance company in the separate account crash, because that will simply affect the returns to the owners of VUL policies and the like. The people practicing IBC will be unaffected, because the assets "backing up" their cash values are kept distinct, both in the internal accounting and also quite literally in terms of regulatory requirements.

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Basic Facts of the Life Insurers' Financial Position, for 2015

At the end of 2015, the U.S. life insurance industry had 616 stock companies, 110 mutuals (and hybrids such as mutual holding companies), and 81 fraternal organizations. There was a total of $20.8 trillion in face value coverage in force, with $649 billion in total premiums paid. (Stock companies had issued $14.0 trillion of this coverage, while mutuals were responsible for $6.2 trillion.) Stock companies held total assets of $4.8 trillion, while mutuals held $1.5 trillion.[4]

(For newcomers, note that in any given year, only a small portion of the outstanding death benefit coverage will be claimed, since most people who have life insurance aren't going to die in that particular year. So it is not alarming that the total market value of life insurer assets is only a fraction of the total outstanding face value of their policies. In fact, the life insurers actually hold a substantial cushion to cover their actuarially expected death benefit claims, and then some.)

Table 1. Distribution of Life Insurer Assets in General Account, 2015 (millions)

Asset Type	Market Value (year end)	% of Total Assets
BONDS		
U.S. government securities	$349,507	8.7%
Foreign gov. securities	77,432	1.9
Corporate bonds	1,957,032	48.4
Mortgage-backed securities	449,748	11.1
Total long-term bonds	2,833,719	70.1
STOCKS	90,452	2.2
MORTGAGES		
Farm	17,947	0.4
Residential	13,632	0.3
Commercial	383,275	9.5
Total mortgages	414,854	10.3
POLICY LOANS	129,688	3.2
Short-term investments	60,043	1.5
Cash and equivalents	46,285	1.1
TOTAL	**$4,039,968**	**100%**

SOURCE: ACLI, 2016 Fact Book, Table 2.1 (p. 11)

As the data in Table 1 reveal, at this level of granularity the life insurance industry is in a fairly defensible position, vis-à-vis Exter's pyramid. Fully 48.4 percent of the general account assets consist of corporate bonds, an additional 8.7 percent are U.S. government bonds, 3.2 percent are policy loans (which are literally the safest investment possible for a life insurance company, since it guarantees the collateral itself), and another 2.6 percent are short-term assets including cash. Thus I would say some 63 percent of the general account assets would be classified as very liquid, possessing moderate to low risk in the event of another financial crisis.[5]

To be sure, a major crisis could knock out even Fortune 500 companies, causing them to default on their bonds, and if tax receipts collapse while requests for food stamps and other assistance skyrocket, even Uncle Sam might default. Even so, in terms of holding a collection of assets that will likely yield a modest return with as little risk as possible, the life insurers' general account is pretty balanced.

What About Interest Rate Risk?

An obvious concern in our present environment is that a rapid rise in interest rates might cause devastating losses to institutional bondholders. Remember that if interest rates go up, the market value of a bond goes down, and the longer the maturity of the bond (or the higher the "duration"), the more sensitive it is to this interest rate risk.

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Strictly speaking, a life insurance company is *not* a "bond fund" of the type managed by a conservative mutual fund. Remember, the ultimate purpose of a life insurance company is to pay death benefit claims when an insured party dies. If its actuaries and investment officers do their jobs properly, the life insurance company will choose its fixed-income assets in order to *match its liabilities.*

For example, suppose the Acme Life Co. knew for certain that in the year 2025, it would pay out a total of $100 million in death benefit claims. In order to cover itself, Acme would want to be holding right now bonds that would mature into $100 million by 2025. So long as the issuer of these bonds didn't default, and assuming Acme could meet its cashflow needs over time and thus hold the bonds to maturity, *it wouldn't matter* what happened to interest rates in the interim.

To be sure, if interest rates spiked in this scenario, then the market value of Acme's bonds would go down. But at the same time, the "present value" of the actuarially expected death benefit claims for 2025 would *also* go down, when the accountants plugged in the higher interest rates into the formulas. Therefore the fall in the market value of Acme's Assets would be matched by a fall in its Liabilities, leaving the equity in the company unchanged. In particular, Acme would still be able to meet its contractual obligations to the beneficiaries named in its policies, because (by construction) the bonds it holds will mature into at least $100 million, in time to pay the death benefit claims.

Thus we see that *if the life insurers engage in perfect maturity matching,* then they have nothing to fear from rising interest rates. However, we might worry that in practice the life insurers can't be *completely* matched in terms of asset-liability maturities. In that context, it's reassuring to see the following data in Table 2.

Table 2. Distribution by Remaining Maturities of Life Insurer Bonds in General Account, Year's End 2015

	1 year or less	1-5 years	5-10 years	10-20 years	> 20 years
Government	10.2%	19.1	18.2	24.8	27.7
Corporate	7.7%	26.2	34.4	13.0	18.7
Combined	8.3%	24.5	30.6	15.8	20.8

SOURCE: ACLI, 2016 Fact Book, Table 2.4 (p. 15)

As Table 2 demonstrates, the life insurers have a smooth mix of bond durations. If short-term rates spike, about a third of their total bond portfolio matures within five years, so they should be able to roll over into the higher yields without too much pain. It's true that the roughly 21 percent of very long maturities would take a beating, but again I remind the reader that these were acquired in order to fund the long-term liabilities represented by outstanding policies. By its very nature, a life insurance company needs to have long-lived assets so that it can confidently make promises to its clients.

While I'm discussing the bond portfolio, it's also worth noting that in 2015, 48 percent of general account private bonds were classified as "Class 1," while another 42 percent were "Class 2." These two classes together constitute "investment grade" bonds. So earlier, when we pointed out that almost *half* of the life insurers' general account consisted of corporate bonds, it's important to realize that 90 percent of these are *high-quality* corporate bonds.

A Trouble Spot

To show that I'm not merely doing a whitewash or suffering from confirmation bias, let me disclose one area of concern. As many of you probably noticed when you looked at Table 1, the life insurers hold some $450 billion—a bit more than 11 percent—of their general account assets in the form of mortgage-backed securities. Now for context, remember that the amount of corporate bonds is more than *four times* this amount, but even so, it troubles me that the life insurers have such a large exposure to these derivative assets.

In fairness, not all mortgage-backed securities (MBS) are created equal. In *theory*, a properly designed mortgage-backed security is safer than a conventional mortgage, because it ostensibly spreads the risk of default out among hundreds or thousands of mortgages, covering a wide range of locations.

Yet as we know all too well, the alleged safety of mortgage-backed securities did not hold up in 2007 and 2008. Since Carlos and I think the American financial markets have repeated the same types of mistakes that led to the 2008 crisis, we cannot ignore the MBS sitting on life insurer balance sheets.

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In particular, in just last month's issue, Carlos wrote an article talking about the Fed's desires to unload its MBS, and the possible regulatory means by which the feds would induce private institutions to absorb more of these assets than they really want to hold.

Conclusion

Naturally, someone practicing IBC is first and foremost concerned with the financial health of the *specific company* that has issued the policy or policies. Use the list of previous ***LMR*** articles (which I gave earlier in this article) to learn how you can go about researching companies for the maximum amount of due diligence.

Yet if we look at the life insurance industry as a whole, in general it has behaved fairly conservatively. As part of the three-pronged strategy that Carlos and I outlined in our 2016 video, "How to Weather the Coming Financial Storms," the IBC component—which addresses your need to manage cash-flows denominated in dollars—should hold up in all but the most extreme scenarios.

For maximum protection, of course, people following our guidelines would also obtain holdings of actual currency as well as physical possession of gold and/or silver.

Carlos and I are both Christians, meaning that our ultimate security does not rest on material things. But to the extent that you want to be a wise steward of the resources entrusted to you, we recommend that you review our very defensive strategy to help ensure that you don't get financially wiped out by the coming storms.

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References

1. If you're new to IBC, listen to episodes 17 and 18 of our podcast, available at: https://lara-murphy.com/podcast/episode-17-guide-starting-ibc-part-1/ and https://lara-murphy.com/podcast/episode-18-guide-starting-ibc-part-2/.
2. Our video, "How to Weather the Coming Financial Storms" is available at: https://lara-murphy.com/video0916/.
3. Data obtained from ACLI's Life Insurers Fact Book: 2016, available at: https://www.acli.com/-/media/ACLI/Files/Fact-Books-Public/2016LIFactBook.ashx?la=en.
4. ACLI, pp. 2-3.
5. A purist might insist that we include "listed stocks" in our list of moderate-risk assets according to the Exter pyramid, and this is correct, if we are just using pure liquidity as our guide. However, since Carlos and I think that the stock market has been blown up by the various rounds of QE, it would be inconsistent for me to praise the life insurers' holdings of corporate equities as a moderately safe investment.