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The Mechanics of Policy Loans

By Robert P. Murphy

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One of the nicest features of whole life insurance is the ability of a policyholder to “get at his money” during the entire life of the policy, as opposed to tax-qualified investment vehicles that typically assess severe penalties for early withdrawals. Specifically, the whole life owner can take out a policy loan, gaining the use of his cash value, at any time. It is through taking out (and paying back!) policy loans that a person can use a whole life policy for “banking” purposes.

Unfortunately, it has come to our attention that some policyholders are misunderstanding this aspect of Nelson Nash’s philosophy. Indeed there have even been lawsuits, in which a policyholder claims that his agent misled him about how policy loans actually work. For example, some people claim that they were told that interest payments on policy loans go right back into their policy, as opposed to the insurance company.

This is an important and subtle issue that an insurance agent must understand completely, in order to properly explain whole life policies to potential clients. To reiterate, this isn’t a mere pedantic quibble over sales pitches; there have actually been lawsuits filed because of such confusion.

In the present article we’ll walk through a very simplified example of financing a new car purchase, with and without policy loans. The primary goals are to show the advantage of self-financing through policy loans, but also to show the sense in which it is true—and the sense in which it is FALSE—to say a policyholder “just pays himself back” the loan.

BUYING A CAR THE AMERICAN WAY

Table 1 at the back of the article [page 6] illustrates a hypothetical purchase of an \$18,000 new car. The new buyer goes to an outside financial institution (such as a conventional bank) and borrows the entire \$18,000 at an 8% annual interest rate. If he takes out a 3-year loan, the borrower must make 36 monthly payments of \$561.73 monthly in order to retire this debt. In Table 1, you can see the outstanding Auto Loan Balance start at \$18,000 (the initial price) and gradually get knocked down to \$0 by the last month.

Meanwhile, the car buyer also has a whole life insurance policy, with a monthly premium of \$300. For the purposes of this article on policy loans, I have modeled the Surrender Cash Value of the policy as if it were a simple savings account, rolling over at a 4% annual rate. In reality, things are a lot more complicated than that, because the rate of cash value appreciation depends on many factors. However, in this article I want to keep things as simple as possible, in order to focus on policy loans. (Future articles will explain more accurately how “surrender cash value” is calculated and what factors affect its growth.)

As each payment on the car is made, our hypothetical man’s net financial assets increase. For example, in Month 10, the man’s cash value is \$23,709, while his outstanding auto loan balance is \$13,409, meaning his net financial assets are \$10,300.

After the 36th payment is made, the man owns his

car free and clear, and his \$33,940 in cash value is no longer offset by any outstanding loan. (The bottom right cell of Table 1 shows a figure of \$33,939, which is due to the vagaries of rounding to the nearest dollar.)

GETTING SMARTER...

As most readers undoubtedly recognize, there is a different option available to finance the car purchase. Our hypothetical man can borrow \$18,000 from the insurance company to buy his new car. Since he has an initial \$20,000 in cash value, the insurer will be willing to cut him the check—no questions asked. Moreover, the interest rate on the policy loan will be lower; in this example I'm picking the round number of 5%. (See Table 2. [page 7])

Already we see the tremendous advantages of self-financing through a whole life policy loan, rather than seeking funds from a conventional lender. When our man approached a bank to buy the car in the first scenario, they would have required him to fill out paperwork, report his income, let them check his credit, tell them about the vehicle, explain his payback schedule, etc. etc. In contrast, the insurer company doesn't care in the slightest what the \$18,000 loan is for, and doesn't care how (or if!) he plans to pay back the loan. (However, there are some slight complications with large policy loans, as I'll explain in the last section of this article.)

As we explain in our book, *How Privatized Banking Really Works*, and as I stress in presentations on the topic, the explanation for this vast difference in treatment is the nature of the collateral. When a conventional bank lends someone \$18,000 to buy a new car, if the person defaults then the bank has to seize the vehicle. This is a messy process that the bank wants to avoid. That's why it will take steps to make sure the \$18,000 is likely to be paid back by the borrower.

In contrast, when a person takes out a policy loan, HE IS BORROWING MONEY FROM THE INSURANCE COMPANY, but the collateral on the loan is the cash value of his policy. To repeat, the borrower is indeed taking a loan of the insurance company's money; his own cash values are still "in" his policy.

The nature of the collateral explains why the insurer gives out loans to policyholders on such convenient terms. If our man doesn't pay back the \$18,000, the insurance company isn't going to seize his car—remember, they don't even know that he *bought* a car with the money. Instead, the insurer will "get its money back" whenever it otherwise would have owed a payment on the policy. For example, if the policyholder dies, then the death benefit to his beneficiary will have the outstanding policy loan balance deducted, before going out.

Looking at Table 2, we can see that the lower interest rate on the policy loan (versus the conventional auto loan) frees up an extra \$23 per month in cashflow. This is because an \$18,000 loan amortized over 36 months at a 5% interest rate only requires a monthly payment of \$538.57.

In other words, if our man buys his new car using a policy loan, then every month he will find himself with an extra \$23 (roughly) because of the lower payment, made possible simply because of the lower interest rate.

In this intermediate scenario, our man takes that extra \$23 and spends it on ice cream each month. By the end of the 3 years, he is in a similar situation as we depicted in the first scenario—he has the car, no outstanding loan, and about \$33,939 in available cash balance.

But clearly our man has benefited from going the policy loan route, since he enjoyed 3 years of ice cream treats that didn't affect his cashflow in other areas. Another benefit is that his net financial assets—his surrender cash value minus his outstanding loan balance at any given time—were higher during the life of the loan.

For example, look at Month 10. Recall that in Table 1, the net financial assets were \$10,300. Yet in Table 2, we see that in Month 10 our man has net financial assets of \$10,448, a difference of \$148. In this particular example, the difference between the two columns grows to \$190 by Months 18 and 19, and then shrinks back to \$0 by Month 36.

I am an economist, so I want to stress that even

when it comes to the magic of whole life insurance, there are no free lunches. Thus far, it seems that it's a no-brainer for the man to finance the car via a policy loan, as opposed to a conventional auto loan. In the overwhelming majority of cases, that's probably true.

However, just to underscore the nature of policy loans, let me bring up one type of case where a family might regret this approach. Specifically, suppose the man has a heart attack and dies three months after buying his new car. His wife (now widow) gets the death benefit check from the insurance company, and sees that they have deducted \$16,599 from what it otherwise would have been. Now she owns the car free and clear.

Yet maybe she doesn't want the car, and has to sell it very quickly at a rock bottom price to raise cash. This is because she's up to her eyeballs in other debts that she and her husband had accumulated. Because her husband hadn't taken out a very big policy, even with the insurance company's check, the widow still can't satisfy the outside creditors. She realizes that if her husband had taken out a conventional auto loan, as opposed to borrowing money from the insurance company using his cash value as collateral, then the widow could have "stuck it" to the bank and let them impound the car. In that case, she would have had a higher death benefit check, and would have offloaded the hassle of selling the used car to the bank.

I should point out that this is a very contrived example; it took me a few minutes to even think through how it would be *possible* for someone to regret using a policy loan to finance a car purchase. Nonetheless, those using whole life policy loans should understand the pros and the cons. Remember, the reason the insurer gives such good terms on the loan is that they have very liquid collateral—namely, the cash building up in the policy. In our contrived example, it was the widow who ended up with the illiquid asset (the used car) that the conventional bank didn't want to get stuck with, either. (And remember, it was precisely to avoid being stuck with the used car that the conventional bank charged a higher interest rate, and asked a lot more questions, before granting the loan.)

There's one more point to make about our second scenario, where the man buys the car (and ice cream) using a policy loan. Look at the columns for the Surrender Cash Value in Tables 1 and 2. They are identical. The policy loan in both cases sits in the corner, chugging along, growing with the internal appreciation as well as the stream of \$300 monthly premium payments.

To a first approximation, an insurance policy isn't affected by a policy loan, if the borrower simply pays back the loan without kicking any more money into his policy. (This actually isn't quite right, because there are complications. For example, some insurers adjust dividend payments based on whether a policyholder has a loan out; this is the direct versus non-direct recognition issue. Also, to the extent that policy loans redirect the assets into which the insurer invests, its earnings could change and therefore influence dividends. But these are very subtle points that we can safely ignore in this introductory article.)

Therefore, in this intermediate scenario where the man buys a car with a policy loan, and just pays the bare minimum to retire the loan over 36 months—using the freed-up cashflow to buy ice cream—it's a bit misleading to say he's "paying the interest to himself." What *is* true is that his prior history of premium payments into his policy are still doing their thing, chugging along and raising the cash value. In contrast, if he had had \$20,000 in a savings account at the bank, and withdrew \$18,000 to pay cash for the car, then he would only have had \$2,000 rolling over in the savings account, not the full \$20,000. This is the distinction financial advisors have in mind, when they stress the "opportunity cost" of buying an asset by drawing down other savings vehicles, versus borrowing against a whole life policy.

To reiterate, everyone should be clear that the man in this second scenario is contractually obligated to pay interest to the insurance company. *They* lent him the money, and merely used his cash value as collateral on the loan. He is literally paying the interest *to the insurance company*.

Before leaving this section, we should make one final clarification. The "loan payment" in this second

scenario consists *mostly* of principal repayment, *not* interest. For example, in Month 10, the man pays \$539 to the insurer to knock down the loan balance. Of that amount, \$483 went towards reducing the principal on the loan (from \$13,744 to \$13,261). The remaining \$56 was a pure interest payment to the insurance company. Of course, as the loan matures, a higher a higher portion of each monthly payment goes toward knocking out the principal, as opposed to paying the pure interest charged by the insurance company.

It is defensible if someone wants to say that our man is *mostly* “paying himself back” each month, in this second scenario. After all, to the extent that a monthly payment of \$539 knocks down the outstanding policy loan balance, then it reduces the insurer’s lien on the man’s cash value. Thus it is correct to say that the man is replenishing his net financial assets with every dollar he knocks off of the loan balance, and in that sense he is “paying himself back.”

But to be absolutely clear, the pure interest component of each monthly payment, does indeed go to the insurer. (The only way it accrues to the policyholder is in the broad sense that his dividend payments are a reflection of the insurer’s return on its investments, one of which is its loan to him. Yet here his particular interest payment is getting spread out over all policyholders; he’s certainly not just “paying himself” the interest.)

BUYING A CAR THE NELSON NASH WAY

In his classic *Becoming Your Own Banker*, Nelson Nash recommends that people finance their large purchases using policy loans, but that they pay them back at the interest rate a conventional lender would have charged.

I’ve sketched this approach in Table 3 [page 8]. Here we see that instead of spending his extra \$23 each month on ice cream, our man devotes it to paying off his policy loan more quickly. In other words, each month the man sends $(\$539 + \$23) = \$562$ to the insurer to reduce his loan balance, just as in Table 1 he sent \$562 to the conventional bank each month for his auto loan.

Yet compare Tables 1 and 3. Notice that the

outstanding loan balance shrinks more quickly in Table 3. This is for the obvious reason that the man is making the same monthly payments, yet the policy loan balance is rolling over at a lower rate (5% versus 8%).

By Month 34, the man only owes \$228 on his policy loan, after making his normal payment. In Month 35, he pays \$229 to knock it out completely, and then takes the extra \$333 and uses it to buy more insurance. Then in Month 36, his entire cashflow of \$562 goes to the same purpose.

Using the Nelson Nash approach, our man ends up with a paid off car, but also an extra \$896 in financial assets. Moreover, during the life of the loan, his net financial assets (cash value minus loan balance) were always higher than in Table 2, with the advantage reaching \$896 by Month 36.

In this last scenario, everything we said before about the nuances of “paying yourself back” still applies. On top of that, we have the obvious “paying it to yourself” of the additional purchase of insurance in Months 35 and 36.

LOANS OUTFRONTING CASH VALUES

One last topic we should address is the possibility of an “overloan” situation, in which an owner takes out so many policy loans that their outstanding balance threatens to overtake the surrender cash value. Since the cash value serves as the collateral on the loan, an overloan situation is somewhat analogous to being “underwater” on a home mortgage.

An overloan situation could arise if, say, someone decides (perhaps because of a job loss) to stop funding a whole life policy with premium payments, but wants to retain the death benefit coverage for as long as possible. This person might then start using policy loans to make the contractual premium payments. If the person made this decision relatively early in the life of the policy, it would eventually “eat itself up” and shut down with no net cash.

Financial advisers must be sure their clients understand how policy loans operate, especially those who plan on borrowing heavily to fund retirement income. Rather than allowing a policyholder to

become “underwater,” the insurance company will simply shut down the policy if the owner doesn’t want to at least keep up with the pure interest payments on outstanding policy loans, in order to keep the balance less than the surrender cash value. This is an important point because if a policy collapses, the IRS at that point views policy loans taken out above the cost basis as taxable income. (So long as the policy is in force, the IRS treats outstanding loans as simply that—loans—and not subject to taxation, since a loan per se doesn’t constitute income.)

CONCLUSION

One of the most compelling features of whole life insurance is the use of policy loans to obtain access to the growing cash value in the policy. There are several advantages to financing large purchases through policy loans, rather than seeking loans from traditional lenders such as commercial banks.

However, financial advisors and insurance agents should be careful when telling their clients that with a policy loan they are “paying it back to themselves.” In a certain sense this is basically correct, but strictly speaking the policyholder really is borrowing the money from the insurance company, and the pure interest on the loan is going to the insurer, not “into” the policy.

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Table 1. Car Purchase Using Conventional Auto Loan @ 8%

Month	Premium	Surrender CV	Car Payment	Auto Loan Balance	CV - Loan
0	\$300	\$20,000		\$18,000	
1	\$300	\$20,365	\$562	\$17,554	\$2,811
2	\$300	\$20,732	\$562	\$17,105	\$3,627
3	\$300	\$21,100	\$562	\$16,654	\$4,446
4	\$300	\$21,469	\$562	\$16,199	\$5,270
5	\$300	\$21,839	\$562	\$15,742	\$6,098
6	\$300	\$22,211	\$562	\$15,281	\$6,930
7	\$300	\$22,584	\$562	\$14,818	\$7,766
8	\$300	\$22,958	\$562	\$14,351	\$8,606
9	\$300	\$23,333	\$562	\$13,882	\$9,451
10	\$300	\$23,709	\$562	\$13,409	\$10,300
11	\$300	\$24,087	\$562	\$12,934	\$11,153
12	\$300	\$24,466	\$562	\$12,456	\$12,010
13	\$300	\$24,846	\$562	\$11,974	\$12,872
14	\$300	\$25,227	\$562	\$11,489	\$13,738
15	\$300	\$25,610	\$562	\$11,001	\$14,608
16	\$300	\$25,993	\$562	\$10,510	\$15,483
17	\$300	\$26,378	\$562	\$10,016	\$16,362
18	\$300	\$26,765	\$562	\$9,519	\$17,246
19	\$300	\$27,152	\$562	\$9,019	\$18,134
20	\$300	\$27,541	\$562	\$8,515	\$19,026
21	\$300	\$27,932	\$562	\$8,008	\$19,924
22	\$300	\$28,323	\$562	\$7,498	\$20,825
23	\$300	\$28,716	\$562	\$6,984	\$21,731
24	\$300	\$29,110	\$562	\$6,467	\$22,642
25	\$300	\$29,505	\$562	\$5,947	\$23,558
26	\$300	\$29,902	\$562	\$5,424	\$24,478
27	\$300	\$30,299	\$562	\$4,897	\$25,402
28	\$300	\$30,699	\$562	\$4,367	\$26,332
29	\$300	\$31,099	\$562	\$3,833	\$27,266
30	\$300	\$31,501	\$562	\$3,296	\$28,205
31	\$300	\$31,904	\$562	\$2,756	\$29,148
32	\$300	\$32,309	\$562	\$2,212	\$30,097
33	\$300	\$32,714	\$562	\$1,664	\$31,050
34	\$300	\$33,121	\$562	\$1,113	
35	\$300	\$33,530	\$562	\$559	
36	\$300	\$33,940	\$562	\$0	

Table 2. Car Purchase (and Ice Cream) Using Policy Loan @ 5%

Month	Ice Cream	Premium	Surrender CV	Policy Loan Pmt	Policy Loan Balance	CV - Loan
0		\$300	\$20,000		\$18,000	
1	\$23	\$300	\$20,365	\$539	\$17,535	\$2,831
2	\$23	\$300	\$20,732	\$539	\$17,068	\$3,665
3	\$23	\$300	\$21,100	\$539	\$16,599	\$4,501
4	\$23	\$300	\$21,469	\$539	\$16,128	\$5,341
5	\$23	\$300	\$21,839	\$539	\$15,655	\$6,185
6	\$23	\$300	\$22,211	\$539	\$15,180	\$7,031
7	\$23	\$300	\$22,584	\$539	\$14,703	\$7,880
8	\$23	\$300	\$22,958	\$539	\$14,225	\$8,733
9	\$23	\$300	\$23,333	\$539	\$13,744	\$9,589
10	\$23	\$300	\$23,709	\$539	\$13,261	\$10,448
11	\$23	\$300	\$24,087	\$539	\$12,777	\$11,310
12	\$23	\$300	\$24,466	\$539	\$12,290	\$12,175
13	\$23	\$300	\$24,846	\$539	\$11,802	\$13,044
14	\$23	\$300	\$25,227	\$539	\$11,311	\$13,916
15	\$23	\$300	\$25,610	\$539	\$10,819	\$14,791
16	\$23	\$300	\$25,993	\$539	\$10,324	\$15,669
17	\$23	\$300	\$26,378	\$539	\$9,828	\$16,551
18	\$23	\$300	\$26,765	\$539	\$9,329	\$17,435
19	\$23	\$300	\$27,152	\$539	\$8,829	\$18,324
20	\$23	\$300	\$27,541	\$539	\$8,326	\$19,215
21	\$23	\$300	\$27,932	\$539	\$7,822	\$20,110
22	\$23	\$300	\$28,323	\$539	\$7,315	\$21,008
23	\$23	\$300	\$28,716	\$539	\$6,806	\$21,910
24	\$23	\$300	\$29,110	\$539	\$6,295	\$22,814
25	\$23	\$300	\$29,505	\$539	\$5,782	\$23,723
26	\$23	\$300	\$29,902	\$539	\$5,267	\$24,634
27	\$23	\$300	\$30,299	\$539	\$4,750	\$25,549
28	\$23	\$300	\$30,699	\$539	\$4,231	\$26,468
29	\$23	\$300	\$31,099	\$539	\$3,710	\$27,390
30	\$23	\$300	\$31,501	\$539	\$3,186	\$28,315
31	\$23	\$300	\$31,904	\$539	\$2,661	\$29,244
32	\$23	\$300	\$32,309	\$539	\$2,133	\$30,176
33	\$23	\$300	\$32,714	\$539	\$1,603	\$31,111
34	\$23	\$300	\$33,121	\$539	\$1,071	\$32,050
35	\$23	\$300	\$33,530	\$539	\$537	\$32,993
36	\$23	\$300	\$33,940	\$539	\$0	\$33,939

Table 3. Car Purchase (and Faster Loan Repayment) Using Policy Loan @ 5%

Month	Extra Loan Pmt	PUA	Premium	Surrender CV	Policy Loan Pmt	Policy Loan Balance	CV - Loan
0			\$300	\$20,000		\$18,000	
1	\$23		\$300	\$20,365	\$539	\$17,512	\$2,854
2	\$23		\$300	\$20,732	\$539	\$17,021	\$3,711
3	\$23		\$300	\$21,100	\$539	\$16,529	\$4,571
4	\$23		\$300	\$21,469	\$539	\$16,034	\$5,435
5	\$23		\$300	\$21,839	\$539	\$15,538	\$6,301
6	\$23		\$300	\$22,211	\$539	\$15,040	\$7,171
7	\$23		\$300	\$22,584	\$539	\$14,539	\$8,044
8	\$23		\$300	\$22,958	\$539	\$14,037	\$8,921
9	\$23		\$300	\$23,333	\$539	\$13,532	\$9,801
10	\$23		\$300	\$23,709	\$539	\$13,026	\$10,684
11	\$23		\$300	\$24,087	\$539	\$12,517	\$11,570
12	\$23		\$300	\$24,466	\$539	\$12,006	\$12,459
13	\$23		\$300	\$24,846	\$539	\$11,493	\$13,352
14	\$23		\$300	\$25,227	\$539	\$10,978	\$14,249
15	\$23		\$300	\$25,610	\$539	\$10,461	\$15,148
16	\$23		\$300	\$25,993	\$539	\$9,942	\$16,051
17	\$23		\$300	\$26,378	\$539	\$9,421	\$16,957
18	\$23		\$300	\$26,765	\$539	\$8,898	\$17,867
19	\$23		\$300	\$27,152	\$539	\$8,372	\$18,780
20	\$23		\$300	\$27,541	\$539	\$7,845	\$19,697
21	\$23		\$300	\$27,932	\$539	\$7,315	\$20,617
22	\$23		\$300	\$28,323	\$539	\$6,783	\$21,540
23	\$23		\$300	\$28,716	\$539	\$6,249	\$22,467
24	\$23		\$300	\$29,110	\$539	\$5,713	\$23,397
25	\$23		\$300	\$29,505	\$539	\$5,174	\$24,331
26	\$23		\$300	\$29,902	\$539	\$4,633	\$25,268
27	\$23		\$300	\$30,299	\$539	\$4,091	\$26,209
28	\$23		\$300	\$30,699	\$539	\$3,546	\$27,153
29	\$23		\$300	\$31,099	\$539	\$2,998	\$28,101
30	\$23		\$300	\$31,501	\$539	\$2,449	\$29,052
31	\$23		\$300	\$31,904	\$539	\$1,897	\$30,007
32	\$23		\$300	\$32,309	\$539	\$1,343	\$30,966
33	\$23		\$300	\$32,714	\$539	\$787	\$31,928
34	\$23		\$300	\$33,121	\$539	\$228	\$32,893
35		\$333	\$300	\$33,863	\$229	\$0	\$33,862
36		\$562	\$300	\$34,835	\$0	\$0	\$34,835

The Seven Rules of Bureaucracy (cont'd)

by Loyd S. Pettegrew and Carol A. Vance

Harry E. Teasley Jr

This is a continuation of the article from last month's BankNotes.

Rule #2: Use crisis and perceived crisis to increase your power and control.

The 2001 World Trade Center attack is the quintessential, but only the latest, in a series of crises that have been used to increase government power and control. Numerous terrorist attacks had been executed on US sovereign interests before September 11, 2001. These include but are not limited to the 2000 USS Cole attack, the 1998 US embassy bombing in Kenya, the 1996 Kobar Towers bombing, housing the 4404th wing of the US Air Force in Saudi Arabia, the 1995 Oklahoma City bombing of a federal building, the 1993 World Trade Center bombing in New York City, and the 1988 Pan Am flight 103 over Lockerbie, Scotland.

On the heels of the first World Trade Center bombing, the Antiterrorism and Effective Death Penalty Act of 1996, Pub. L. No. 104-132, 110 Stat. 1214 (a.k.a. AEDPA) was passed by a substantial majority of Congress and signed into law by President Bill Clinton. On October 26, 2001, having only minor opposition by Congress, the Patriot Act was quickly signed into law by President George W. Bush and abridges US citizens' constitutional rights with little judicial review if you are suspected of terrorist activities or even of providing "material support" to terrorist groups. Muslims point to the fact that the Patriot Act diminishes one's Fourth Amendment rights against unlawful search and seizure and also directly abridges amendments 5, 6, and 8 (Ghazali, 2004).

The Department of Homeland Security is a new and expensive federal bureaucracy that increases the government's right to search airline passengers and their luggage, physically pat them down and confiscate items they believe may be hazardous, whether or not

they have any links to terrorism. Travelers have no right to protest or to have a higher level of authority review a TSA decision. As a personal note, we were once traveling from my home in Tampa, Florida, to California. A TSA agent spotted the insulin pump I was wearing on my belt and called for a complete screening including swabbing my pump and my hands for traces of explosive, hand searched everything in my carryon bag, and frisked me. When he was finished, another TSA agent quietly apologized and told me that no other agent has authority to stop a TSA agent if he or she wants to execute a detailed and time-consuming search of a passenger. Even with the influence from a new president who criticized the Patriot Act during his election campaign, the law of the land remains securely in place, as does the prison in Guantanamo Bay.

Rule 2a. Force 11th-hour decisions, threaten the loss of options and opportunities, and limit the opposition's opportunity to review and critique.

In the first year of the Obama presidency, the fact that approximately 12 to 32 million Americans, depending on whose numbers were believed, were without healthcare coverage was turned into a crisis that the US Congress rushed in to fix. Little if any attention was given to the fact that millions of Americans didn't have health insurance when they could afford it simply because they chose not to purchase it (Wall Street Journal, 2011). It turns out that emergency rooms across the United States treat a great many of these people when sick.

By all accounts of the legislative process, few if any members of Congress had fully read the bill before being forced to vote it into law. Congress and President Obama chose to ignore the pending collapse of Social Security and Medicare, both well-studied and acknowledged crises, to spend a trillion dollars on universal health coverage that the majority of Americans didn't want or need. The unintended consequences of this action are a flawed piece of legislation that several federal courts have struck down as unconstitutional. Its effects on the economic recovery were harshly negative, driving up the cost of healthcare and creating enough ambiguity among

small-business owners to ensure any job creation is stifled.

Rule #3: If there are not enough crises, manufacture them, even from nature, where none exist.

Bureaucracies are always on the lookout for a new crisis. In his "Guiding Principles of Politicians, Bureaucrats, and Bureaucracies," Harry Teasley points to three examples:

1. The Gulf of Tonkin incident, where an alleged attack took place on two US naval destroyers by a North Vietnamese torpedo boat, allowing President Johnson to deploy conventional military forces to Vietnam without congressional approval.

2. The attribution of weapons of mass destruction (WMDs) to Saddam Hussein permitted President George Bush to invade Iraq (again, without the need of congressional approval), after which no WMDs were found.

3. Man-made global warming. The first two resulted in loss of life and a terrible toll of people maimed and injured. We are still in the throes of discovering the effects of the third crisis.

We do know that under President Obama the power of the EPA is at a zenith, growing in size and power as a regulatory agency with all the prosecutorial powers to fine and even imprison violators (and the latitude to ignore violations as fits their interest). Alternative and renewable fuels have become a lightning rod for the EPA. Bill Gates was quoted recently in the Wall Street Journal as saying this about EPA solar-energy subsidies:

I think people deeply underestimate what a huge problem this day-night issue is if you're trying to design an energy system involving solar technology that's more than just a hobby. You know the sun shines during the day, and people turn their air conditioners on during the day, so you can catch some of that peaking load, particularly if you get enough subsidies. It's cute you know, it's nice. But the economics are so, so far from making sense.... And so unfortunately you get technologies that, no matter how much of them you buy, there's no path to being economical.

The EPA has also teamed up with the Justice Department and Fish & Wildlife in prosecuting musical-instrument manufacturers and musicians deemed to have endangered hardwoods in their instruments. Musicians who play older instruments that used such hardwoods before it was illegal can no longer safely take their instruments across US borders without "adequate" documentation and hope to return with the instruments back in to the United States without Customs agents seizing their instruments and fining or even imprisoning them. Gibson Guitars, makers of classic instruments, has been singled out in federal raids, and there is now a criminal case, "United States of America v. Ebony Wood in Various Forms" (Felten, 2011). The EPA has enlisted US Customs to enforce problematic environmental policy.

Diversity is another example of creating a social crisis where none had existed. The ongoing need for diversity, never explicitly defined, haunts government bureaucracies particularly. James Taranto (2011) points to a "Diversity bureaucracy" that state universities continue to populate when teachers are laid off. No matter how much progress is made, there are new groups that emerge representing the nation's continued failure to embrace the crisis of diversity. On campuses these days we must spend scarce resources on glorifying the transgendered; international students (particularly graduate students, because they bring greater monetary reward); gays, lesbians, and bisexuals; Muslims, etc. Like political correctness, diversity has become a primary orthodoxy and a perpetual goal of government that simply cannot be achieved. Once crises are created, they become self-sustaining.

Despite monumental gains in the status of women and minorities in what has always been a diverse nation, the diversity crisis is perpetuated. A series of New York Times articles documents that on college campuses, where women outnumber men by 57 percent to 43 percent, female gender issues remain an imbedded hallmark of diversity worthy of sizable resource expenditure. The American Association of Medical Colleges reported that more than 20 years ago, the number of women equaled the number

of men in America's 40 medical schools (AAMC, 1999). According to a story in the Boston Globe (2007), by 2007 women represented 79 percent of the students in American schools of veterinary medicine and the Journal of Accountancy (2011) reported that half of both undergraduate and masters students in accountancy were women. Despite the rise of women to now be the dominant gender in most professional schools, the government has allowed diversity to be whatever bureaucrats want it to be, no matter what the costs. Heather Mac Donald reported in the City Journal how an entrenched gender bureaucracy in the University of California system has grown despite the majority of students being female:

California's budget crisis has reduced the University of California to near-penury, claimed its spokesmen. "Our campuses and the UC Office of the President have cut to the bone...." Well, not exactly to the bone.... The University of California at San Diego, for example is creating a new full-time "vice chancellor for equity, diversity, and inclusion." This position would augment UC San Diego's already massive diversity apparatus, which includes the Chancellor's Diversity Office, the associate vice chancellor for faculty equity, the assistant vice chancellor for diversity, the faculty equity advisors, the graduate diversity coordinators, the staff diversity liaison, the undergraduate student diversity liaison, the graduate student diversity liaison, the chief diversity officer, the director of development for diversity initiatives, the Office of Academic Diversity and Equal Opportunity, the Committee on Gender Identity and Sexual Orientation Issues, the Committee on the Status of Women, the Campus Council on Climate, Culture and Inclusion, the Diversity Council, and the directors of the Cross-Cultural Center, the Lesbian Gay Bisexual Transgender Resource Center, and the Women's Center.

Race and gender not only continue to flourish at public universities, but often escape accountability. During the height of the 2000 recession, the president and provost of our university created a committee to look for ways to pare their academic budget. Every academic department and school had to produce a

report from which cuts would be made that would allegedly save the university and state money. The lowest-scoring academic departments by these performance data, across a wide array of metrics, provided by their own faculty, were Women's Studies and Africana Studies. The president and provost quickly ignored the need to cut academic programs based on their performance and the two programs were retained.

BankNotes will continue the article next month with Rule #4: Control the flow and release of information while feigning openness, and Rule #5: Maximize public-relations exposure by creating a cover story that appeals to the universal need to help people.

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This essay was developed from a bullet point presentation originated by Harry E. Teasley Jr.

Teasley has spent his life confronting and triumphing over bureaucracy. His business career was spent at The Coca-Cola Company as head of various lines of business. His nickname was "Thor" for his willingness to confront the evils of bureaucracy and its mindless agents. Teasley's experience with bureaucracy included federal, state, and local government, labor unions, nongovernmental organizations (NGOs), environmental protectionists, Coca-Cola itself and other corporations. Since retiring, Teasley has served as the chairman of the Reason Foundation and has successfully defeated numerous government attempts to infringe on the free market and usurp private-property rights in Tampa, Florida.

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Wall Street Math

by Doug French

There's plenty of blame for the financial crisis being spread around. Those on the left say Wall Street wasn't regulated enough, while those on the right claim government mandates required lenders to make bad loans. The argument is made that the Federal Reserve was too loose, while the other side says Bernanke wasn't loose enough. Some blame greed. Others blame Wall Street's investment products. And then there's mathematics.

Wall Street has become a numbers game played at high speed by powerful computers trading complex derivatives utilizing even more complex mathematical modeling. Writing for the Huffington Post, Théo Le Bret asks the reader to

Take the Black-Scholes equation, used to estimate the value of a derivative: it is actually no more than a partial differential equation of the financial derivative's value, as a function of four variables, including time and "volatility" of the underlying asset (the derivative being a 'bet' on the future value of the asset). Differential equations are well-known to physicists, since such fundamental properties of nature as the wave equation or Schrodinger's equation for quantum mechanics are given in the form of differential equations, and in physics their solutions seem to be very reliable: so why is this not always the case in finance?

Mr. Le Bret quotes Albert Einstein for his answer: "as far as the laws of mathematics refer to reality, they are not certain; and as far as they are certain, they do not refer to reality."

Murray Rothbard put it another way:

In physics, the facts of nature are given to us. They may be broken down into their simple elements in the laboratory and their movements observed. On the other hand, we do not know the laws explaining the movements of physical particles; they are unmotivated.

Rothbard goes on to make the point that human action is motivated and thus economics is built on

the basis of axioms. We can then deduce laws from these axioms, but, as Rothbard explains, "there are no simple elements of 'facts' in human action; the events of history are complex phenomena, which cannot 'test' anything."

Using the models that work so well for physicists, mathematicians on Wall Street got it spectacularly wrong in the mortgage and derivatives markets, just as mathematical economists can never predict the future with any accuracy. Motivated human behavior cannot be modeled.

But the mathematicians or "quants" underscore all of Wall Street's financial engineering, a process that takes a few pieces of paper and folds their attributes together to make new products, most times hoping to avoid taxes and regulation. Author Brendan Moynihan describes this engineering in his book *Financial Origami: How the Wall Street Model Broke*.

Origami is the traditional Japanese art of paper folding wherein amazing shapes and animals are created with just a few simple folds to a piece of paper. Moynihan cleverly extends the metaphor to the financial arena, pointing out that stocks, bonds, and insurance are pieces of paper simply folded by the Wall Street sales force into swaps, options, futures, derivatives of derivatives, and the like.

The author is adept at describing derivatives in terms a person can understand. Health-insurance premiums are a call option to have the insurance company pay for our medical care. Auto insurance premiums are like put options, allowing the insured to sell (put) his or her car, if it's totaled, to the insurer at blue-book value.

Nobel Prize winners have played a big hand in the creation of derivatives. Milton Friedman's paper on the need for futures markets in currencies paved the way for that market in 1971. But as Moynihan points out, it was Nixon's shutting of the gold window that created the need to mitigate currency and inflation risk.

Nobel Laureate Myron Scholes was cocreator of the Black-Scholes-Merton option-pricing model. He and cowinner Robert Merton used their model to

blow-up Long Term Capital Management.

But it was little-known economist David X. Li's paper in the Journal of Fixed Income that would provide the intellectual foundation for Wall Street's flurry into mortgages. "On Default Correlation: A Copula Function Approach" became "the academic study used to support Wall Street's turning subprime mortgage pools into AAA-rated securities," writes Moynihan. "By the time it was over, the Street would create 64,000 AAA-rated securities, even though only 12 companies in the world had that rating."

Robert Stowe England, in his book Black Box Casino: How Wall Street's Risky Shadow Banking Crashed Global Finance, says Li's model "relied on the price history of credit default swaps against a given asset to determine the degree of correlation rather than rely on historical loan performance data."

"People got very excited about the Gaussian copula because of its mathematical elegance," says Nassim Nicholas Taleb, "but the thing never worked." Taleb, the author of The Black Swan, claims any attempt to measure correlation based on past history to be "charlatanism."

Subprime mortgages were bundled to become collateralized mortgage obligations (CMOs), which are a form of collateralized debt obligation (CDO). CDOs weren't new; the first rated CDO was assembled by Michael Milken in 1987. But instead of a mixture of investment-grade and junk corporate bonds, in the housing bubble, CDOs were rated AAA based upon Li's work.

Mr. England wryly points out, "A cynic might say that the CDO was invented to create a place to dump lower credit quality or junk bonds and hide them among better credits."

England quotes Michael Lewis, author of The Big Short: "The CDO was, in effect, a credit laundering service for the residents of Lower Middle Class America." For Wall Street it was a machine that "turned lead into gold."

Wall Street's CDO mania served to pump up investment-bank leverage. England explains that if level-3 securities were included (level-3 assets, which

include CDOs, cannot be valued by using observable measures, such as market prices and models) then Bear Stearns sported leverage of 262 to 1 just before the crash. Lehman was close behind at 225, Morgan Stanley at 222, Citigroup at 212, and Goldman Sachs was levered at 200 to 1.

Leverage like that requires either perfection or eventual government bailout for survival.

The CDO market created the need for a way to bet against the CDOs and the credit-default-swap (CDS) market was born. Bundling the CDS together created synthetic CDOs. "With synthetic CDOs, Wall Street crossed over to The Matrix," writes England, "a world where reality is simulated by computers."

It's England's view that the CDO market "was the casino where the bets were placed. Wall Street became bigger and chancier than Las Vegas and Atlantic City combined — and more." According to Richard Zabel, the total notional value of the entire CDS market was \$45 trillion by the end of 2007, at the same time the bond and structured vehicle markets totaled only \$25 trillion.

So the speculative portion of the CDS market was at least \$20 trillion with speculators betting on the possibility of a credit event for securities not owned by either party. England does not see this as a good thing. It's Mr. England's view that credit default swaps concentrated risk in certain financial institutions, instead of disbursing risk.

In "Credit Default Swaps from the Viewpoint of Libertarian Property Rights and Contract Credit Default Swaps Theory," published in Libertarian Papers, authors Thorsten Polleit and Jonathan Mariano contend, "The truth is that CDS provide investors with an efficient and effective instrument for exposing economically unsound and unsustainable fiat money regimes and the economic production structure it creates."

Polleit and Mariano explain that credit default swaps make a borrower's credit risk tradable. CDS is like an insurance policy written against the potential of a negative credit event. These derivatives, while being demonized by many observers, serve to increase

"the disciplinary pressure on borrowers who are about to build up unsustainable debt levels to consolidate; or it makes borrowers who have become financially overstretched go into default."

Mr. England concludes his book saying, "We need a way forward to a safer, sounder financial system where the power of sunlight on financial institutions and markets helps enable free market discipline to work its invisible hand for the good of all."

Polleit and Mariano explain that it is the CDS market that provides that sunlight.

The panic of 2008 was the inevitable collapse of an increasingly rickety fiat-money and banking system — a system where the central bank attempts to direct and manipulate the nation's investment and production with an eye to maximize employment. In a speech delivered to the Federal Reserve Bank of New York, Jim Grant told the central bankers that interest rates should convey information. "But the only information conveyed in a manipulated yield curve is what the Fed wants."

Wall Street's math wizards convinced the Masters of the Universe that their numbers don't lie, believing they could model the Federal Reserve's house-of-mirrors market. Maybe the numbers don't lie, but the assumptions do.

Advising about mathematical economics, Rothbard wrote, "ignore the fancy welter of equations and look for the assumptions underneath. Invariably they are few in number, simple, and wrong." The same could be said for Dr. Li's model and Scholes's model before him.

Until the era of unstable fiat-money regimes ends, the search for scapegoats will continue — because the crashes will never end.

Douglas French is president of the Mises Institute and author of *Early Speculative Bubbles & Increases in the Money Supply* and *Walk Away: The Rise and Fall of the Home-Ownership Myth*.

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**Becoming Your Own
BANKER**

Number Twenty-five in a monthly series of Nelson's lessons, right out of Becoming Your Own Banker® We will continue until we have gone through the entire book.

Part III, Lesson 25: How to Start Building Your Own Banking System

Content: Page 41, *Becoming Your Own Banker: The Infinite Banking Concept*® Fifth Edition, Sixth Printing

About 20 years ago, during the formative years of the development of the Infinite Banking Concept, interest rates were rather high and I had been involved in the real estate business for several years. Because of that background and the painful experience of getting caught owing a lot of money at 23% interest, I developed some scenarios that demonstrated how one could phase out the high interest mortgages that were common at that time through the use of dividend-paying whole life insurance. It involved paying large life insurance premiums for four years and then borrowing annual mortgage payments from the policy at 8% to pay off the mortgage payments at 15%. Meanwhile, making premium payments to the policy that were the equivalent of what was being paid to the mortgage company.

People were fascinated with the idea but very few took any action because it required rather large premiums to make the transition, plus taking about 15 years to complete the process. It dawned on me later that, in the budgets of most folks, monthly payments on two automobiles plus comprehensive and collision insurance on them equaled their house payment! So, I built a scenario where one could finance cars through life insurance and sales picked up dramatically. This was something that was attainable in about four years and required less than half the premium to get the program going.

There are five legitimate methods of having the use

of an automobile over the lifetime of a person. The graph on page 44 of BECOMING YOUR OWN BANKER assumes that the car will be replaced at four-year intervals and that the financing package will be \$10,550 at 8.5% interest for 48 months (\$260.00 per month) and we will be looking at a 44-year time frame in which to compare the results of the methods.

METHOD A – The first, and most expensive method, is to lease the cars each year for 44 years. It is somewhat difficult to calculate the total cost in this case. We must resort to reason and logic and use the second method as a starting point. At the end of each 4-year period the lessee has no equity to show for the expenditure and at the end of the 44 years he has nothing to drive – he is on his feet!

METHOD B – In the second method we are using a commercial bank or finance company to do the job. Calculating the cost here is easy – \$260.00 per month for 528 months = \$137,280.00. At the end of each 4-year period, this person has a 4-year old car to use as a trade-in on the next one. Reason tells you that the first method must be more costly than this one. If leasing were cheaper than buying, no one would ever buy – everyone would lease. That's absurd because one has to lease from an owner. Why would an owner lease something for less than he paid for it? Therefore, let's assign an arbitrary 44-year total cost of Method A at \$175,000.00. By the way, the annual equivalent of \$260.00 per month is \$3,030.00.

METHOD C – The third method is to pay cash for each new car every four years. This person has a severe case of “The Arrival Syndrome” and thinks that there is no better method than paying cash for cars. This results in a total cost of \$116,050 (10,550 for each trade-in package times 11 cars). He had to defer the use of the first new car for four years to achieve this result. He had to save up money for the first four years and immediately start accumulating money again in the same savings account to prepare for the next purchase. This is the classical “sinking fund” method of having the continuous use of machinery that will wear out periodically.

This method involves car payments just like the first two methods. It is all a matter of where the payments

are made – to the leasing company, the commercial bank, or to his savings account. When the results of the three methods are drawn to scale on the graph, notice that there is not very much difference in them. As we move to the right on the graph the results are getting somewhat better – but the American buying habits are going the other way on the scale! Any number of radio and TV commercials report that leasing is up over 35% in the last 5 years.

For some real insight into what is really going on in the automobile world, go to the luxury car dealerships and ask the sales managers what percentage of their cars are leased. You will find that most of them are in this category.

We will save Methods D and E for the next lesson. I'll see you then.

Nelson's Favorite Quotes

Sometimes people don't want to hear the truth because they don't want their illusions destroyed.
-- Friedrich Nietzsche

...It must be remembered that there is nothing more difficult to plan, more doubtful of success, nor more dangerous to manage than the creation of a new system.

The initiator has the enmity of all who would profit by the preservations of old institutions and merely lukewarm defenders in those who would gain by the new... -- Machiavelli, 1513

Nelson's Newly Added Book Recommendations

<http://infinitebanking.org/reading-list/>

Seven Days in Utopia: Golf's Sacred Journey by David L. Cook, PhD

The Bubble That Broke The World by Garet Garrett

New Book Warns Student Loans With Over \$1 Trillion are Likely One of the Next Hindenburg Zeppelin Financial Infernos

(Hampton, NH, May 22, 2012). Barry James Dyke, author of *The Pirates of Manhattan II: Highway to Serfdom* predicts that student loans, in excess of \$1 trillion, will likely be one of the country's next financial infernos. www.thepiratesofmanhattan.com.

Federal student loans interest rates will rise to 6.8% on July 1st 2012 from their current 3.4% base if Congress does not act. Banking lobbies oppose any reduction in interest rates. If Congress does nothing, the average student \$23 thousand subsidized loan costs will increase an additional \$5,000 over a ten year period.

The author states, "Student loans are a treacherous minefield. Faculty and admission staffs urge students to pursue their dreams rather than focus on the sticker price of college. Student loans are a form of indentured servitude as student loans cannot be discharged in bankruptcy. Student loans do not die with death. Collection agencies can call day and night to collect student loan debts. Garnishment to pay student loan debt is common. Students are not getting enough well-paying jobs to pay back these enormous loans, yet The Department of Education through the Department of Treasury can attach tax refunds to pay off student loans. What is more, our Congress drove the getaway car for academia and the banks in 2005 with the Bankruptcy Abuse and Consumer Protection Act of 2005—which turned student loans into non-dischargeable debt."

According to the Department of Education, two thirds of students who earn a bachelor degree use some type of loan to finance their education with an average loan of roughly \$23 thousand. The New York Times recently reported that as much as 94% of students borrow to get a college degree.

The taxpayer underwrites roughly \$105 billion a year in Title IV student loans a year, with \$24 billion

going to for profit schools owned by Wall Street asset managers. Student loans guaranteed by the taxpayer are a major source of revenue for the U.S. higher educational system and if default rates accelerate, it could bring about a Greece like debt problem to the nation's colleges.

"Excessive borrowing for an education will be a dark cloud hanging over this generation for decades," claims Dyke. "Default rates on student loans for traditional undergraduate and graduate rates are currently as high as 15.8%, and as high as 48% for for-profit colleges. The New York Fed reports that nearly one in four student loan holders are falling behind on their student loan payments. Make no mistake, the exorbitant cost of college coupled with large student debt loads is another financial inferno in the making—with students and regular Americans holding the bag. In many ways the student loan problem is worse than the recent real estate bubble—at least with real estate there is some tangible collateral. Please tell me, how many families in America can readily afford \$50 thousand plus a year to attend one of America's schools of higher learning?" [For the list of the highest priced colleges in the U.S. see this link. <http://www.campusgrotto.com/top-100-colleges-with-the-highest-total-cost-2011-2012.html>]

Like mutual funds, credit cards, subprime mortgages, derivatives, 401(k)s and other complex financial products designed, packaged and sold on Wall Street, student loan complexity, economic hazards and the true cost of college is hidden from public view.

College pricing and funding a college education is complicated by a myriad of factors; constant tuition increases, a vast array of grants and numerous opaque formulas. Financial aid letters generated by colleges for families are often confusing and misleading.

The author laments, "Our institutions of higher learning are failure factories. Higher education continues to devour a larger portion of the overall portion gross domestic product (GDP) with little improved job prospects for graduates. High college tuitions funded with large loans do not consistently create jobs. American colleges graduate only about

half of their students within six years at traditional schools. Start digging into for-profit college graduation rates, and success falls off a cliff. No one is held accountable. The biggest winners in this student loan mess are Wall Street and a bloated Vichy like educational system which is more concerned about academic tenure entitlement than in living in an extremely competitive global economy.” For further information, visit <http://www.collegeresults.org/default.aspx>

Though the federal government is now the major direct lender for student loans, for years student loans and for-profit schools have been signature Wall Street industries. Sallie Mae—[a former Government Sponsored Enterprise (GSE) like failed Fannie Mae], is the 800 pound gorilla in the student loan industry. Citigroup, Regions Bank, JPMorgan Chase, U.S. Bank, Goldman Sachs, Nelnet, Wells Fargo, Bank of America and others have all participated in the student loan business as well debt collection for student loans. JPMorgan Chase’s private equity arm One Equity owns The NCO Group, one of the world’s largest debt collectors which specializes in collecting debts such as student loans. Goldman Sachs is a major shareholder in Education Management Corporation (EMC) the country’s second largest for-profit educator. [EMC is currently being investigated by the Department of Justice and attorney generals in four states (California, Illinois, Florida & Indiana) over an \$11 billion recruiting fraud which involves student loans].

Dyke concludes, “For years I believed the Federal Reserve System in the United States to be the greatest financial scam. My views are now changing. I now believe our antiquated inefficient educational system, coupled with the student loan tsunami, is even a greater scam than the Fed. The American educational system is not so much an educational system, but an indoctrination system which supports failed systems like the Federal Reserve System—our private central bank which is at the heart of this country’s economic woes.” The author documents the lobbying efforts which led up to the student loan crisis in *The Pirates of Manhattan II: Highway to Serfdom* with U.S.

Senate voting records and other research. www.thepiratesofmanhattan.com. You can reach the author at castleassetmgmt@comcast.net or via the telephone at 603-929-7891.

Nelson’s Live Seminars & Events for June & July 2012 <http://infinitebanking.org/seminars/>

Our comprehensive *Becoming Your Own Banker*[®] seminar is organized into a five-part, ten-hour consumer-oriented study of *The Infinite Banking Concept*[®] and uses our book *Becoming Your Own Banker*[®] as the guide. Nelson covers the concept’s fundamentals in a two-hour introductory block the first day. He then covers the “how to” over an eight-hour block the final day. These seminars are sponsored by IBC Think Tank Members, therefore attendance is dictated by the seminar sponsor. If you are interested in attending one of these events, please call or email the contact person listed with the seminar.

Nelson Live in Westlake Village, CA, Saturday, 9 June, contact Ken Phillips, 805 915-7644, ken@marketingpromotionsnetwork.com

Nelson Live in Birmingham, AL, Saturday, 23 June, contact Stacy Brasher, 205-871-9993 x 248, stacybrasher@nowlinandassociates.com

Nelson Live in Logan, UT, Friday-Saturday, 29-30 June, contact Dan Rust, 435-753-5249, dan@yourfamilybank.com

Nelson Live in Logan, UT, Friday-Saturday, 27-28 July, contact Dan Rust, 435-753-5249, dan@yourfamilybank.com