

# THE SOLUTION

## LECTURE IV:

### IMPORTANT EPISODES IN THE HISTORY OF WHOLE LIFE

#### Lecture Summary

Nelson Nash's IBC is a process that is fundamentally about "banking"—that is what the "B" stands for in the name. However, it just so happens that the best *platform* or vehicle for implementing IBC is a dividend-paying whole life insurance policy. It is important for IBC Practitioners to understand the basic history of the whole life product, in order to educate their clients and to defuse skepticism of IBC that is derived from (erroneous) criticisms of whole life insurance.

Traditionally, whole life insurance played an important and respected role in the savings of typical American households. By the late 1970s, the tide was turning, with the public growing dissatisfied with the relatively meager growth inside of whole life policies, in the context of high interest rates driven by price inflation. In 1979 a bombshell FTC report harshly criticized whole life policies, not only for their poor rates of return but also for the lack of transparency to the policyholder. The share of traditional whole life fell from about 85% of the market in 1979 to about 50% by 1986; its fall was almost perfectly counterbalanced by the rise of Universal Life, which was marketed as a more flexible and transparent permanent life insurance product.

The 1986 Tax Reform Act involved a major overhaul that lowered marginal tax rates while "closing loopholes" and thus broadening the tax base. Many tax shelters disappeared, which had devastating effects on the real estate market. In the new environment, many wealthy investors began buying single-premium whole life insurance policies as the new, best place to park their money. Indeed, this financial strategy became so popular that Congress amended the tax code in 1988 (in the Technical and Miscellaneous Revenue Act or TAMRA) to place stricter limits on the transfer of money into whole life policies. These limitations are what we know today as the "MEC rules."

A popular objection to whole life insurance—and hence to IBC—is the apparent superiority of a strategy of “buy term, invest the difference.” However, there are several problems with these typical comparisons, showing that they are downplaying the advantages of whole life. Some of the crucial differences are:

- 1) Ignoring the “Option Value” of Maintaining Coverage With Whole Life Policy
- 2) A Whole Life Policy’s Cash Value Is Guaranteed to Grow, While a “Side Fund” Can Fall
- 3) The “Rate of Return” Statistics Can Be Very Misleading
- 4) Depending on the Setup of the “Side Fund,” Its Market Value May Be Inaccessible for Decades

## Main Lecture

### *Introduction*

In the other lectures of THE SOLUTION—coming from the perspective of Austrian economics—we have explained how sound money and privatized banking will solve THE PROBLEM that we diagnosed in the first section of this course. However, the restoration of sound money and freedom in the banking sector ultimately require legislative changes, bringing up all of the problems associated with political action. In this context, the beauty of Nelson Nash’s Infinite Banking Concept (IBC) is that it allows households and firms to effectively implement a form of privatized banking unilaterally and immediately, without waiting for a change in public opinion.

Nash’s IBC is fundamentally about “banking”—that’s the “B” in the title, after all—but it just so happens that the best way to *implement* IBC is through the use of a dividend-paying whole life insurance policy. In short: the *process* of IBC is banking, but the *platform* is whole life.

Unfortunately, many people (at least in the United States) have a negative attitude toward whole life insurance. These preconceptions hinder the sober evaluation of the merits of IBC. This state of affairs is ironic, because historically whole life insurance was a primary saving vehicle for the average

American. In this lecture we will give the historical context to explain the decline in popularity of whole life. In addition, we provide an appendix to evaluate the common claim that “buy term, invest the difference” is a superior strategy to the purchase of a whole life policy. At the completion of this lecture, the student will understand the essential history of the whole life product and will be equipped to answer some standard objections that often disrupt the broader discussion of IBC.

### *Whole Life as Traditional Saving Vehicle for the Common Household*

During the first half of the 20<sup>th</sup> century, it was quite common for households to rely on a whole life insurance policy as a major component of its saving plan. Consider that it was quite natural in the classic Frank Capra film *It's a Wonderful Life*—released in 1946—for the protagonist, George Bailey, to use his personal life insurance policy as a bargaining chip when negotiating with the hardhearted Henry Potter. Writing in 1949, the famous Austrian economist Ludwig von Mises stated matter-of-factly: “For those not personally engaged in business and not familiar with the conditions of the stock market, the main vehicle of saving is the accumulation of savings deposits, the purchase of bonds and life insurance.”<sup>1</sup>

Although Mises’ claim may sound odd to the modern reader, permanent life insurance is in fact an ideal vehicle for saving. As Jesús Huerta de Soto, arguably the world’s leading scholar on Austrian business cycle theory, explains:

The social significance of life insurance companies sets them apart from other true financial intermediaries. In fact the contracts offered by these institutions make it possible for broad layers of society to undertake a genuine, disciplined effort to save for the long term. Indeed life insurance provides the perfect way to save, since it is the only method which guarantees, precisely at those moments when households experience the greatest need (in other words, in the case of death, disability, or retirement), the immediate availability of a large sum of money which, by other saving methods, could only be accumulated following a very prolonged period of time. With the payment of the first premium, the policyholder’s beneficiaries acquire the right to receive, in the event of this person’s death, for instance, a

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<sup>1</sup> Ludwig von Mises, *Human Action* (Auburn, AL: The Ludwig von Mises Institute, [1949] 1998), Scholar’s Edition, p. 547.

substantial amount of money which would have taken the policyholder many years to save via other methods.<sup>2</sup>

The primary purpose of the present lecture is to explain the historical process by which this original, favored position of whole life deteriorated. However, to avoid confusion we must reiterate that the discussion here necessarily focuses on the standard features of whole life insurance—such as its traditional use as a savings vehicle—rather than the application to “banking” discovered by Nelson Nash. To repeat, the only reason this is necessary in a course devoted to IBC is that members of the public often cannot consider IBC itself if they have (erroneous) preconceptions about whole life insurance.

### *Refresher: Mechanics of the Policy Loan*

As we explained in a previous lecture, the *policy loan* is a loan granted from the life insurance company to the policyholder, with the policy’s underlying cash surrender value serving as collateral. In contrast to loans granted by other financial institutions, the policy loan is a guaranteed option, and is made without regard to the borrower’s credit score, income, or purpose of the loan. Indeed, the life insurance company does not even specify a payback schedule for the loan.

The reason for this unusual treatment of the policy loan is that the life insurance company itself guarantees the value of the underlying collateral, namely the life insurance policy itself. It is impossible for the borrower (the policyholder) to “default” on the loan, because even if he or she never pays it back, the outstanding loan balance (which includes any unpaid interest that has accumulated) will be implicitly paid off whenever the terms of the life insurance policy would have required payment from the company to the named beneficiary (upon death) or to the policyholder (upon surrender). In this respect, from the point of view of the life insurance company, a policy loan is the safest investment imaginable.

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<sup>2</sup> Jesús Huerta de Soto, *Money, Bank Credit, and Economic Cycles* (Auburn, AL: The Ludwig von Mises Institute, 2009), p. 586.

However, despite their unrivaled safety as investments, life insurance companies *typically* do not rely heavily on policy loans in their portfolios. As of year-end 2012, the life insurance industry held some \$2.5 trillion in bonds, which represented 78.4 percent of its “general account” assets. Of this, \$1.5 trillion were corporate bonds, while \$127.5 billion were held in the form of outstanding policy loan balances—representing only 3.7 percent of the industry’s general account assets.<sup>3</sup>

Part of the explanation for this low proportion of policy loans among life insurer assets is that—despite their impeccable safety—policy loans have some undesirable features from an insurer’s perspective. For one thing, they do not offer a predictable cashflow to the owner of the asset (namely, the insurance company). The borrower may pay off the loan in full one week later, he may make modest payments periodically over the course of decades, or he may never pay it down at all until death (at which point it is fully paid by subtracting the outstanding balance from the death benefit payment). Another drawback to policy loans as an asset (from the insurer’s perspective) is that they are not liquid assets, easily transferable to another institution as, say, corporate bonds would be.

However, another factor at work is that the policy loan must be initiated by the policyholder, and it is difficult for the insurer to control the “demand” for such loans, because their terms are locked in (within limits, which may vary as market indices move) by the original life insurance contract. As a leading insurance textbook writes:

Policy loans are unique among life insurance investments for two reasons. First, they are not made as the result of an investment management decision. They are options exercised at the discretion of the policyowner. Second, because loans should never exceed their cash values and unpaid principal amounts may be deducted from cash surrender or policy death proceeds, the safety of principal associated with most loans is absolute.<sup>4</sup>

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<sup>3</sup> See Berends, McMenaim, Plestis, and Rosen. (2013) “The Sensitivity of Life Insurance Firms To Interest Rate Changes,” Federal Reserve Bank of Chicago, 2q 2013, Table 2. Available at: [http://www.chicagofed.org/digital\\_assets/publications/economic\\_perspectives/2013/2Q2013\\_part2\\_berends\\_mcmenamin\\_plestis\\_rosen.pdf](http://www.chicagofed.org/digital_assets/publications/economic_perspectives/2013/2Q2013_part2_berends_mcmenamin_plestis_rosen.pdf)

<sup>4</sup> Kenneth Black, Jr., Harold D. Skipper, and Kenneth Black III. (2013) *Life Insurance* (Lucretian, LLC), 14<sup>th</sup> edition.

The life insurance policy loan is thus a very strange financial instrument, making it difficult for outsiders to casually evaluate. As one actuary put it, “A policy loan then is really a cash-value withdrawal, temporary or permanent. We probably make an analytical mistake if we view it in the traditional way (as an investment or an asset).”<sup>5</sup> Further complicating matters, consider that in 1910 the Supreme Court ruled in *Board of Assessors of the Parish of Orleans v. New York Life Insurance Company* (216 U.S. 517) that “a policy loan creates no personal liability of the policy owner, so that it is not a debt, even though interest is charged.”<sup>6</sup>

Now that we have reviewed the mechanics of life insurance policy loans, we will explain their history.

### *The Origin and Troubles of Policy Loans*<sup>7</sup>

Policy loans on a “permissive basis” first occurred in the U.S. life insurance industry in 1848, but they did not become widely available on a contractual basis until about 1890. The purpose of the new feature was to dissuade policyholders from surrendering their policies when struck by a cash-crunch. In other words, the life insurance companies recognized that some of their customers would surrender policies *not* because they no longer desired death benefit protection, but rather because they had a cashflow problem and the cash surrender value in their life insurance policy was the only asset they could tap. By allowing their customers to borrow *against* the cash surrender value while keeping the policy in force, the insurance companies could cater to their clients’ needs without compromising the viability of the product.

Although the introduction of policy loans was voluntary and emerged in the industry, in 1906 New York became the first state to require contractual policy loans. Other states—though not all of them—followed suit in mandating contractual policy loan provisions, but eventually competition forced all whole life policies to carry such an option.

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<sup>5</sup> Kraegel, Wilfred A. and James F. Reiskytl. (1979) “Policy Loans and Equity,” *Transactions of Society of Actuaries*, Vol. 29, available at: <https://www.soa.org/library/research/transactions-of-society-of-actuaries/1977/january/tsa77v294.pdf>.

<sup>6</sup> Kraegel and Reiskytl. (1979) “Policy Loans and Equity.”

<sup>7</sup> Unless otherwise noted, the history of the policy loan draws upon Kraegel, Wilfred A. and James F. Reiskytl. (1979) “Policy Loans and Equity,” *Transactions of Society of Actuaries*, Vol. 29.

Over the years, there were different proposals for different structures of the policy loan rate. The simplest approach was that contracts would offer a fixed rate on any policy loans made during the life of the policy, specified in the original contract. There were also proposals for a policy loan rate that could vary depending on the circumstances. Yet even here, the laws against “usury” (i.e. excessively high interest rates) carried over from English law placed an upper ceiling of 6 percent on policy loan rates.

For decades, this legal barrier on policy loan rates was not an issue. Indeed, from 1890 through the early 1960s, policy loan rates were a percentage point or two higher than the prevailing long-term corporate prime rate. However, starting in the mid-1960s the pressure on price inflation from the Federal Reserve began pushing up long-term yields in the open (and relatively free) bond market. This opened up the opportunity for **arbitrage**, where policyholders could borrow from the life insurance sector at 6 percent and invest the funds in very safe corporate bonds yielding a higher return. The practice was particularly appealing because at that time—though it is no longer the case—individuals could routinely deduct policy loan interest on their income tax return.

As a Life Insurance Association of America (LIAA) study in 1966 explained: “It is evident...that cyclical fluctuations in the volume of policy loans by life insurance companies arise primarily because of the fixed statutory ceiling interest rate placed on such loans as compared with the free movement of interest rates generally in the money and capital markets.”<sup>8</sup>

This situation was very problematic for the life insurance industry, as they had to keep their incoming premium payments in very short-term assets (because they could be called upon for policy loans at a moment’s notice) and an unusually higher proportion of their portfolio consisted of policy loans, which were earning only (at most) 6 percent while other financial institutions were enjoying much higher returns in the inflationary environment. By 1974, outstanding policy loans had a value of 18 percent of ordinary life insurance reserves, a height not seen since the early 1930s.

The fact of widespread arbitrage, coupled with the legal ceiling (which was slightly relaxed in the 1970s but not sufficiently) on policy loan rates, meant that the life insurance industry was left behind

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<sup>8</sup> Quoted in Kraegel and Reiskytl. (1979) “Policy Loans and Equity,” p. 54.

as other financial institutions invested in higher-yielding assets. This background sheds light on the next episode we will review.

### *Ralph Nader and the Bombshell FTC Report*<sup>9</sup>

In 1979 the Federal Trade Commission (FTC) issued a scathing report on the practices of the life insurance industry. Spurred on by consumer activist Ralph Nader—who had uttered catchy statements such as, “Policies are not sold on the basis of consumer need, but on the basis of industry greed”<sup>10</sup>—the government agency claimed that whole life insurance policyholders were earning very paltry rates of return on the cash value in their policies, especially considering the high interest and price inflation rates of the late 1970s. Industry representatives and actuaries tried to minimize the negative publicity, complaining that the FTC report was very misleading, used faulty methods to deduce incorrect rates of return, and generally cast whole life policies in an unfair light. Nonetheless, the press had had a field day when the FTC report came out, and the damage was done.

The share of traditional whole life fell from about 85% of the market in 1979 to about 50% by 1986; its fall was almost perfectly counterbalanced by the rise of Universal Life.<sup>11</sup> Universal Life (UL) policies were ostensibly designed to correct the shortcomings of whole life as detailed in the FTC report. Rather than being a “black box” that confused customers, a UL policy was supposed to be very transparent, with a clear delineation of the mortality and other expenses, and a distinct “side fund” that grew at a specified credited interest rate. In addition to its claimed transparency, another major selling point in the early 1980s was that the high interest rates at that time allowed new UL policyholders to achieve a better internal rate of return on their “side fund” than was yet available to traditional whole life policyholders, because the latter relied on portfolio averages and thus responded more sluggishly to the upswing in interest rates.<sup>12</sup>

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<sup>9</sup> We cover some of this same material in the lecture IMPLEMENTATION—II, which compares whole life to other products.

<sup>10</sup> Ralph Nader quote available at: [http://en.wikiquote.org/wiki/Talk:Ralph\\_Nader](http://en.wikiquote.org/wiki/Talk:Ralph_Nader).

<sup>11</sup> Kenneth Black and Harold D. Skipper, *Life Insurance* (12<sup>th</sup> Edition), p. 83.

<sup>12</sup> Refer to IMP—II for a more detailed comparison of whole life versus Universal Life.



Armed with the apparently objective FTC report, as well as the relatively poor performance of whole life policies (which were constrained by policy loan arbitrage and the regulatory limits on their policy loan rates, as discussed earlier), a wave of agents spread over the country, convincing Americans that life insurance and investing were two different animals. These agents popularized snappy slogans such as “buy term and invest the difference,” and motivated themselves by referring to their enemy as “trash value life insurance” (a denigration of “cash value” life insurance, meaning permanent life insurance that also served as a store of wealth).<sup>13</sup> The growing accessibility of “no-load” mutual funds, as well as special tax-qualified plans—the traditional IRA was made popular by the Economic Recovery Tax Act of 1981—meant that the average American was now interested in the stock market as never before.

### *The Tax Reform Act of 1986*

The “supply-side” tax reforms of the Reagan Administration were tied to the economic theory that (other things equal) it was efficient to lower marginal tax rates and eliminate deductions and credits. The rationale was that a “flatter and broader” tax code would raise a desired amount of revenue while minimizing the harm to the economy. When economists analyze tax policy, they don’t like to see people altering their behavior because of (arbitrary) features of the tax code that exist merely to raise revenue. (In contrast, a “sin tax” on cigarettes is *designed* to reduce smoking.)

The Tax Reform Act of 1986 greatly simplified and flattened the structure of the federal personal income tax. Before the Act, there were *sixteen* brackets (based on income) with marginal rates ranging from 0% to 50%. By 1988, there were only *two* brackets, of 15% and 28%.<sup>14</sup>

However, in order to avoid a sharp drop in tax receipts (because of the lower marginal rates applicable to the higher income earners), the 1986 reform also eliminated many tax shelters or “loopholes” as they were disparagingly called. Furthermore, in order to eliminate the disparity

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<sup>13</sup> Williams, A.L. *Coach*, Chapter 15, pages 12-13. (A PDF version of chapter 15 can be found through Google.)

<sup>14</sup> There are several websites that maintain a history of the U.S. federal income tax structure. See for example the Tax Foundation’s at: [http://taxfoundation.org/sites/taxfoundation.org/files/docs/fed\\_individual\\_rate\\_history\\_nominal.pdf](http://taxfoundation.org/sites/taxfoundation.org/files/docs/fed_individual_rate_history_nominal.pdf).

between taxation of business and personal income (which can lead to inefficient “gaming” of the system by shifting income between entities), the 1986 Act also increased the tax rate on capital gains (from its original value of 20%) to 28%.

As a result of this massive overhaul, many assets suddenly plunged in value. Indeed, the real estate market experienced its largest crash since the Great Depression. (The U.S. also suffered the worst stock market crash in history in percentage terms, on “Black Monday,” October 19, 1987.) Wealthy individuals needed a new mechanism to protect their assets and new income from the federal tax as much as possible, within the bounds of the (newly revised) tax code.

After studying the situation, many tax attorneys advised their clients to buy a single-premium permanent life insurance policy. In other words, they advised their clients to drop one big check into cash value life insurance, because of its relatively favorable tax treatment, accessibility, safety, privacy, diversification away from the market, guaranteed growth, stability, and all of the other reasons that we discuss elsewhere in this section of the Manual. Indeed, there was such a rush of wealthy individuals into permanent life insurance that the Congress once again amended the tax code—this time with the 1988 Technical and Miscellaneous Revenue Act or TAMRA—to specifically curb these actions. It was under TAMRA that the federal government denied much of the favorable tax treatment to life insurance policies that were ruled a Modified Endowment Contract (MEC).

The specific criteria for a policy avoiding MEC status—such as the “7-pay test”—are carefully discussed elsewhere in this Manual (including the lectures SOLUTION—I and IMPLEMENTATION—I). Our purpose here is to give the historical context in which the MEC rules were created. One obvious lesson from the story is that it’s a bit odd why the government would have to limit so many rich people from moving their wealth into a “terrible investment.”

#### *Appendix: Evaluating “Buy Term and Invest the Difference” Correctly*

To reiterate, even though IBC is not “about” life insurance, nonetheless popular arguments purportedly demonstrating that whole life is a poor vehicle for savings can sabotage the attempt to

educate people on the benefits of IBC. In this appendix, we will help properly frame the popular comparison of a whole life policy with the alternate strategy of “buy term and invest the difference.”

Typically, the critic of whole life (or other forms of permanent, “cash value” life insurance) will look at the cheaper premium quote for a term policy carrying the same death benefit as the whole life policy, and then will show how this “difference”—in other words, the cost saving on the lower premium payment for the term policy—can be invested in a “side fund” that will grow faster than the internal rate of return on the surrender cash value of the whole life policy. The apparent result is that over time, the wealth in the side fund will be greater than the cash value available in the life insurance policy, while the pure death benefit protection is the same (because the term policy was designed to have the same death benefit as the whole life policy in the beginning). It thus seems “obvious” that a client can achieve the dual goals of life insurance protection as well as investment growth by splitting up the goals into different vehicles—an inexpensive and simple term policy for the life insurance, with a mutual fund for the retirement planning (or other financial objective).

The fundamental problem with the popular versions of such (allegedly) “head-to-head” comparisons is that they ignore significant differences between the two strategies, which (on those dimensions) give the advantage to whole life. In this appendix, we will outline some of these important omissions from the typical “buy term and invest the difference” analysis.<sup>15</sup>

Before proceeding to our list of considerations, we should stress that we are *not* arguing here that purchasing a whole life insurance policy is *always* the best decision for *every* client.<sup>16</sup> To repeat, we are merely showing how poorly structured are the typical discussions on this topic, and how the critics of whole life insurance often ignore some of its key virtues. In order to make an informed decision, clients must see the pros and cons evaluated fairly and consistently.

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<sup>15</sup> For a specific example of the popular (and very misleading) comparison of whole life versus “buy term and invest the difference,” see Dave Ramsey’s blog post, “The Truth About Life Insurance,” available at: <http://www.daveramsey.com/article/the-truth-about-life-insurance/>.

<sup>16</sup> For example, if a young family has a sole breadwinner and several young children, the breadwinner may need to buy a term life insurance policy for adequate death benefit protection, at least until the death benefit has grown enough in a separate whole life policy or policies designed for “banking” purposes.

Problems With the Typical Comparison of Whole Life vs. “Buy Term and Invest the Difference”

1) Ignores the “Option Value” of Maintaining Coverage With Whole Life Policy

One enormous difference in the two strategies is that by buying whole life, the individual has the option of keeping the life insurance coverage in force indefinitely, with a guaranteed fixed premium. In contrast, the term policy—whether it is 10, 20, or 30 years in duration—will eventually expire. At that point, the individual at best can apply for another term policy with a higher premium, or (at worst) will be uninsurable because of a health condition that developed in the meantime.

One way to drive home the significance of whole life’s continuation value is to gather quotes on *term* policies of varying lengths, to see how the premium increases. For example, suppose the client is a 30-year-old male. The financial professional could show him quotes for level-premium term policies (for a given death benefit) of 5 years, 10 years, 20 years, and 30 years. Naturally, the annual, level premium quoted will increase with the duration of the policy.

After showing these actual price quotes to the client, the financial professional can ask him to speculate as to *why* the term policies get so much more expensive, as they move from 5 years to 30 years in duration of the contract. The client should have no trouble in answering that he (as the insured) is more likely to die, the older he gets. Once the client is comfortable that it is entirely reasonable for the insurer to charge a higher premium on a 30-year term policy versus a 5-year term policy, the financial professional can point out that a whole life policy for this particular man is equivalent to a *90-year* term policy with a level premium. At the end of this exercise, the client should no longer be surprised that a whole life policy premium is much higher than the premium on an “equivalent” term policy—they’re not “equivalent” at all, even if they start out with the same death benefit. The insurance company is taking on much more liability by issuing a whole life policy, which is why its actuaries insist that it charge a higher premium for it.

## 2) A Whole Life Policy's Cash Value Is Guaranteed to Grow, While a "Side Fund" Can Fall

In the typical demonstration that allegedly shows the superiority of "buy term and invest the difference," the money put into the "side fund" grows at a faster rate than the internal buildup of cash surrender value in the whole life policy. The critic of whole life can make it look very paltry by using an equity-based mutual fund as the "side fund."

But this is an illegitimate comparison, because the two assets (a whole life policy versus an equity-based mutual fund) carry different levels of risk. The whole life policy comes with contractually guaranteed growth in the cash surrender value; it can't go down (barring a default on the contract). In contrast, in order to get the impressive "high historical rates of return" touted by its boosters, the "side fund" must be heavily exposed to the vagaries of the stock market. Yes, this means on average that the side fund will experience a higher rate of return than the cash value in a whole life policy, but that greater expected return comes with greater volatility. It is entirely possible for the stock market to experience a very sharp decline in a short period of time. Stocks may be an attractive component of one's portfolio, but their volatility makes them a poor foundation for cashflow management. In other words, an equity-based mutual fund is hardly the ideal "warehouse" for one's cash.

One way to drive home this point to the client is to show the historical rates of return on equity-based mutual funds versus short-term AAA corporate bonds. Typically, over a long horizon the return to someone investing in the stock market will be greater than someone rolling his funds over in short-term AAA bonds. Does this demonstration "prove" that nobody should ever hold bonds in his portfolio? Of course not. Any client should immediately be able to tell that the different levels of *risk* between stocks and bonds is important to the comparison.

## 3) The "Rate of Return" Statistics Can Be Very Misleading

The distinction between risk and return may lead some clients to believe that as long as they are willing to leave their wealth alone for many years, then they will enjoy the quoted statistics about long-term "historical rates of return" on the side fund—such as an equity-based mutual fund.

However, even putting aside the higher volatility of a stock fund and just focusing on the statistics, they can be very misleading.

For one thing, the promotional literature of such funds may not include management fees or other drags that reduce the actual performance versus the appreciation of the underlying stocks themselves. Just because “the market” goes up by 10 percent in a certain year, it doesn’t follow that everyone in a diversified equity fund saw their account rise by the same amount, when all is said and done. (In contrast, the illustrations for a whole life policy already take into account agent commissions and other overhead expenses—what the client sees on the guaranteed side is what he or she will get; that is part of the contractual arrangement.)

Another very important consideration is that a stock fund’s “long-term average rate of return” may be calculated as the *arithmetic mean* (simple average) of the annual rates of return during the period, which is not the same thing as the *compound average growth rate* during the entire period. Clients who actually put money at risk during the entire period would find that they ended up with a less wealth than the “average rate of return” would have suggested.

We can illustrate this distinction with an exaggerated example first, in order to make it clear. Suppose the stock market doubles in Year 1, but then in Year 2 it falls in half. In other words, the annual rates of return are +100% and then -50%. Taking the arithmetic mean, the “average rate of return” over this period is 25% per year—that sounds great, doesn’t it? Who wouldn’t want to put his money into the market, when it’s yielding 25% on average per year?

And yet, if someone actually plunked \$1,000 into the market, it would first rise to \$2,000 after Year 1. Then by the end of Year 2, it would be down to \$1,000 again, for a return of precisely *zero* over the two years.

To take more realistic numbers, suppose that over a five-year span, the stock market yields annual returns of +25%, -15%, +20%, +25%, -20%. The arithmetic mean of these numbers is  $(+35\% / 5 \text{ years}) = +7\%$  per year. That sounds like a pretty healthy rate of return, at least for someone who’s willing to not touch his money for five years at a time.

However, such a statistic is very misleading. Someone who started out with \$1,000 and placed it in the market, subject to the above rates of return, would end up with \$1,275 after five years, for a compound average growth rate of just below 5% per year.<sup>17</sup> In other words, the actual rate of return—just from the math, we’re not even talking about management fees—is 2 percentage points lower than what the “historical average rate of return” statistic would have one believe.

What this discussion means is that clients should be very cautious when looking at a mutual fund’s touted “historical rate of return” and comparing it with the (smaller) internal rate of return on the cash surrender value of a whole life policy. In practice, the two may be closer than the statistics suggest. Furthermore, if the growth in the “side fund” is subject to income tax, then this is yet another important difference between the two vehicles.

#### 4) Depending on the Setup of the “Side Fund,” Its Market Value May Be Inaccessible for Decades

Among its virtues, a *properly designed and utilized* whole life policy enjoys growth in the cash surrender value that is not subject to income taxation.<sup>18</sup> Proponents of the “buy term and invest the difference” approach may respond that if the “side fund” is a tax-qualified plan such as a 401(k) or an IRA, then it too has excellent tax-planning advantages, with the main difference being the *timing* of the tax hit.

However, putting aside the thorny analysis of whether it is better for a client to pay the tax upfront (as with funds moving into a whole life policy) or upon withdrawal (as with an IRA), there is the important consideration that the cash surrender value is *always accessible*, whereas the market value of the “side fund” in the case of a tax-qualified plan is locked up possibly for decades, subject to penalties for early withdrawal.

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<sup>17</sup> Specifically, we compute  $(1.275)^{(1/5)} = 1.0498$ , which is just a hair beneath a 5 percent annualized growth rate.

<sup>18</sup> Financial practitioners must be very careful in how they describe this feature to their clients. It can be misleading to call it “tax-free” because, under certain circumstances—such as taking out large loan balances and then surrendering the policy—the growth in the policy can be effectively subject to income tax. We cover these subtleties in greater detail in the Lecture IMPLEMENTATION—I.

In other words, someone who buys a whole life policy can *use* the growing cash value it represents during the entire life of the policy. In contrast, someone who “buys term and invests the difference” may indeed see a “side fund” growing faster than the cash value of the whole life policy, but that number refers to wealth that the client will be able to enjoy later in life. It is not an asset comparable to the cash that is immediately obtainable from the whole life policy.

In summary, we have outlined four separate reasons showing that the two rival strategies of buying a whole life policy versus “buy term and invest the difference” are not comparable. In particular, there are advantages to the whole life policy—such as its coverage through life, lower volatility, and accessibility—that the typical comparisons do not mention. The point of our analysis in this appendix was not to say that clients should *never* buy a term policy, but rather to help financial professionals properly frame the comparison for their clients.

### New Terms Introduced in This Lecture

**Arbitrage** In the context of life insurance, a situation where policyholders can take out policy loans at a specified interest rate and then invest the funds in a safe asset (such as prime corporate bonds) yielding a higher return.

### Study Questions (answers in back of Manual)

- 1) Which statement best explains the relationship of life insurance to IBC?
  - a) IBC is fundamentally about life insurance.
  - b) Life insurance is the ideal platform on which to implement IBC.
  - c) Life insurance as an asset class enjoys the most tax advantages.
  - d) All of the above.



2) According to Ludwig von Mises, typical Americans in the early 20<sup>th</sup> century used what vehicle to save?

- a) Savings deposits.
- b) Bonds.
- c) Life insurance.
- d) All of the above.

3) At year-end 2012, what proportion of life insurer (general account) assets consisted of policy loans?

- a) None; policy loans are liabilities to the insurance company.
- b) 6 percent, the maximum allowed by law.
- c) 3.7 percent.
- d) 25 percent.

4) Which statement describes the way a life insurance company would view a policy loan?

- a) Very safe and very liquid.
- b) Very risky and very illiquid.
- c) Very risky and very liquid.
- d) Very safe and very illiquid.

5) Why did life insurance companies begin offering the option of policy loans to policyholders?

- a) To dissuade cash-strapped customers from surrendering their policies.
- b) It was mandated by state regulators.
- c) It was necessary to compete with the flexible premiums of a UL policy.
- d) It was a way to avoid usury laws.

6) Which famous activist and which federal organization were involved with a scathing report on life insurance in 1979?

- a) Gloria Steinem and the SEC.
- b) Paul Ehrlich and the Federal Reserve.
- c) Ralph Nader and the FTC.
- d) Cesar Chavez and the Department of Justice.

7) Which statement best summarizes the predicament of life insurance companies in the late 1970s?

- a) They suffered from a change in the tax code that penalized policy loans.
- b) They had a large portion of their portfolios locked in policy loans that were not earning market rates.
- c) Policy lapses became more common because of arbitrage.
- d) Mortality rates were much higher than anticipated.

8) What is a typical goal of revenue-neutral tax reform?

- a) Increase marginal rates and narrow the tax base.
- b) Decrease marginal rates and narrow the tax base.
- c) Decrease marginal rates and widen the tax base.
- d) Increase marginal rates and widen the tax base.

9) Does the IBC Practitioner's Program discourage the purchase of term life insurance?

- a) Yes, whole life is always a superior product for a client.
- b) No, a term policy might make sense for a certain client.
- c) Term policies are acceptable, but only if they come from a mutual insurer.
- d) No, a term policy may sometimes be the best vehicle for banking.

10) Which of the following concepts is most appropriate for conveying how a client's wealth would have grown if exposed to the stock market over a period of years?

- a) The compound average growth rate.
- b) The arithmetic mean of annual growth rates.
- c) The median growth rate.
- d) The mode of annual growth rates.

### Reading From Course Textbooks

The historical material in this lecture draws heavily on various issues of the *Lara-Murphy Report*. However, the discussion of life insurance as a saving vehicle draws on Chapter 15 of *How Privatized Banking **Really** Works*, while some of the discussion in response to “buy term, invest the difference” is covered in Chapter 19 of that text.

### Outside Reading to Supplement Course Materials

The following selections are not mandatory, but provide additional context for this lecture:

- Berends, McMenaam, Plestis, and Rosen. (2013) “The Sensitivity of Life Insurance Firms To Interest Rate Changes,” Federal Reserve Bank of Chicago, 2q 2013, Table 2. Available at: [http://www.chicagofed.org/digital\\_assets/publications/economic\\_perspectives/2013/2Q2013\\_part2\\_berends\\_mcmenamain\\_plestis\\_rosen.pdf](http://www.chicagofed.org/digital_assets/publications/economic_perspectives/2013/2Q2013_part2_berends_mcmenamain_plestis_rosen.pdf)
- Kraegel, Wilfred A. and James F. Reiskytl. (1979) “Policy Loans and Equity,” Transactions of Society of Actuaries, Vol. 29, available at: <https://www.soa.org/library/research/transactions-of-society-of-actuaries/1977/january/tsa77v294.pdf>.