When people first hear about the advantages of the Infinite Banking Concept (IBC), a typical reaction is to say, “That’s too good to be true.”

For example, the IBC agent might tell his or her client that in order to take out a loan against the cash values in a whole life policy, the policyholder simply needs to call the insurance company up and tell them the amount and the address. The person on the phone won’t ask what the loan will be used for, what the income of the borrower (i.e. policyholder) is, what other assets the person might have to serve as collateral, and what timeframe the person intends to take in paying back the loan. Nope, the insurance company employee will simply take down the information and the check might literally go out in the next day’s mail.

In contrast, try pulling the same stunt with a commercial bank or credit union. Even when applying for a secured loan, with (say) a house with lots of equity serving as collateral, a borrower will need to jump through all sorts of hoops and fill out a few forms before getting approval. The process could be quite time consuming, even for someone with impeccable credit and sizable assets.

So are the IBC agents simply lying? And if not, what gives? Are the insurance companies staffed by magic elves while the banks are staffed by grumpy trolls?

No, the IBC agents are not lying. I personally have taken out several policy loans, and have seen firsthand just how easy the process is. At the same time, I have also tried at several points to obtain lines of credit from different commercial banks, and the process is a serious hassle. I can thus verify the amazing descriptions of IBC painted by its enthusiastic fans.

As an economist, I can also explain what’s going on. The difference in the treatment given clients by insurers versus conventional lending institutions is the nature of the underlying collateral on the loans. Once we understand how a whole life policy works, and what a policy loan really is, then it becomes obvious why the insurer doesn’t have the policyholder fill out paperwork to take out a loan.

In the present article I’ll sketch the argument. For a fuller treatment, I encourage interested readers to come to Nashville on July 22-23 for the “Night of Clarity.” (Full details at http://www.usatrustonline.com.) In my talk for the Saturday workshop, I’ll elaborate on the contents of this article, as well as making other points about the mechanics of whole life policies and why IBC works so well.

TERM VERSUS WHOLE LIFE INSURANCE

Term life insurance is “pure” insurance. The policyholder pays a certain amount of money as a premium, so that if he happens to die during the period in question (say, six months or a year), then and only then will the insurer cut a check to his estate. If the term of the policy runs out and the policyholder is still alive, then he gets nothing from the insurer. It’s analogous to buying fire insurance on one’s house. If there’s no fire, then nothing happens, and the money spent on premiums is totally gone.

In contrast, a whole life policy (as the name suggests) is designed to last for a person's entire life. As long as the person keeps paying premiums, the policy stays in force; there is no predetermined expiration, as is the case with a term policy, which might be designed for (say) a 20-year term.

As the critics of whole life are quick to point out, the premiums needed to keep a whole life policy in force are much higher than those for a term policy with a comparable death benefit. Part of the difference is due to the continuation option described above. In other words, since the insurer is agreeing to a level premium for as long as the policyholder wants to keep a whole life policy in force, the insurer has to set the premium high enough to cover the additional expectation that the policyholder will die while the policy is in force. In contrast, the vast majority of term life policies expire without the person dying.

In fact, things are even bleaker for the insurance company. At a certain point, the owner of a whole life policy gets a huge check from the insurer even if he is still alive. Nowadays the cutoff age might be 121 years. For example, a person might sign up for a $1 million death benefit whole life policy when he's 25. So long as that person continues to make his premium payments, he can go on paying the same premium, even as he ages and becomes a much higher risk. Ultimately, if and when the person reaches 121 years, the insurer company sends him a check for at least $1 million. (In practice it may be more, since the person will have purchased more "death benefit" along the way.)

Now we see why whole life policies are so much more expensive than term policies with the same initial death benefit. A useful analogy is to real estate: The policyholder of a term policy is like someone renting an apartment. He pays the rent month after month, and receives shelter in exchange. But after the term of the lease expires, and the landlord raises the rent, the person moves out of the apartment. He has nothing to show for the money he spent over the years, except the memories.

In contrast, someone might buy an apartment unit with a mortgage from a bank. This person's monthly mortgage payments will be higher than what the renter had to pay each month, assuming they live in comparable apartments. However, with each month's payment, the buyer acquires more and more equity in the property. After keeping up with his payments for (say) 30 years, the mortgage is paid off and the person owns the apartment outright.

The analogy with life insurance should be clear. The term policy in effect is just rented insurance. In contrast, the person who starts a whole life policy gains equity in the policy with each successive payment. Specifically, the cash surrender value grows over time. This is analogous to a homeowner calculating how much equity he has in his property, i.e. asking how much it's worth minus how much he still owes on it.

For whole life, the cash surrender value is defined as the (present discounted value) of the expected death benefit payout minus the flow of future premium payments. As time passes, the looming death benefit becomes more and more certain, because the person will either die or attain age 121. On the other hand, with each successive premium payment, the remaining number of such payments dwindles, meaning that the policyholder has a freer and freer claim on the death benefit. This is why the cash value of a policy grows over time.

When critics declare that whole life is "obviously" a terrible financial product, because one can get "the same" insurance from a term policy at a much cheaper rate, this is akin to someone saying that buying a house is "obviously" a dumb move because one can rent the same living space for much lower monthly payments. The famous "buy term and invest the difference" strategy ignores other differences too, but in the present article I want to focus on policy loans.

POLICY LOANS

In order to fulfill its contractual obligations to a whole life policyholder, the insurer must take a portion of each premium payment and invest it conservatively. As a whole life policy ages, the insurer had better have a growing stockpile of financial assets earmarked for the policyholder, so that if and when he reaches age 121, the insurer can hand over the assets now worth (say) $1 million.

From the insurer's perspective, then, there are numerous streams of income every month flowing from the various policyholders. Some of them actually die, and thus payments must be made in accordance with the contractual death benefits. Beyond that, there are salaries and other overhead expenses to be paid. After these expenses, what's left can be plowed into investments so that the total assets of the insurer grow over time, just as the policyholders all think that their cash values are growing.

When a whole life policyholder applies for a loan, the insurer does not "take it out" of the policy. Rather, the insurance company takes some of the money that it otherwise would have invested in outside assets, and instead loans it to the policyholder. Strictly speaking, in terms of the cash flow a policy loan doesn't "touch" the whole life policy at all. Rather, the insurer makes a loan on the side to the policyholder.

The insurance company is quite happy to make such a loan, because the policyholder pledges the cash value of his own whole life policy as collateral. To repeat, strictly speaking the policy loan doesn't "suck out" the cash value of a policy, but rather the outstanding loan (depending on its size) offsets some of the cash value. In the same way, if a homeowner applies for a home equity loan, he doesn't literally sell off the guest bedroom to the bank. Rather, he takes out a loan from the bank and pledges the equity in his house as collateral.

A MATTER OF LIQUIDITY

Now we see why insurers are so free-wheeling when it comes to policy loans, whereas commercial banks and credit unions are much more uptight: the collateral on policy loans is much more liquid than on conventional secured loans.

Consider what happens if a whole life policyholder has taken out a $10,000 loan at 5% interest. Suppose he never makes any payments on it, so that the outstanding loan balance has grown to $10,500 a year later. Then the policyholder is hit by a bus and dies.

Does the insurance company care? Not at all (unless the employees knew the policyholder personally!). Because the man owned a whole life policy, the company now owes his estate a check for the death benefit. Suppose the death benefit originally would have been $500,000. Now, because of the outstanding policy loan, the insurer subtracts the balance and only sends the man's widow a check for $489,500.

In contrast, suppose the man had gone to a commercial bank, asking for a secured loan of $10,000 with his new boat serving as collateral. If the man missed his payment on the loan, the bank would start to worry. As the loan rolled over at interest, it might eventually grow to be more than the underlying collateral was worth. (This isn't likely to happen with a well- structured whole life policy loan, because the underlying cash value grows predictably over time too.)

Another problem for the commercial bank is that if the man defaults and the bank seizes his boat, the bank might discover that the man didn't take good care of the asset, especially when he saw the default coming. (Again in contrast, there's nothing that the policyholder can do to ruin the cash value in his policy. The insurer doesn't allow him to borrow more against it, than the cash value at any given time. There is no need for the policyholder to do anything "responsible" to keep the collateral in good shape.)

Finally, even if the boat has been kept in good condition, such that its market value is more than the balance on the loan, the bank still has to go through the hassle of selling it. This can be a major problem, especially in our current situation where banks are the reluctant owners of millions of foreclosed homes. (Again in contrast, the insurer doesn't have to do anything to "seize" the collateral of the policyholder who defaults on a policy loan. It simply subtracts the relevant amount from the check it otherwise would have sent.)

CONCLUSION

Once we understand the nature of a whole life policy and how policy loans actually work, it becomes clear why insurers offer loans at such attractive interest rates and almost unbelievable terms. The explanation is that the underlying collateral—the cash value of the policy itself—makes such loans the safest investments imaginable for the insurer. No matter what, they are going to be repaid, because they are already contractually obligated to pay a death benefit to the policyholder. The outstanding loan balance, if any, can just be subtracted before the check is sent out.

Many of the criticisms of whole life policies likewise fall away once we explore the nature of these policies. Carlos Lara, Nelson Nash, Paul Cleveland, and I will explore these ideas more fully in the Saturday workshop at this year's Night of Clarity. (Full details at http://www.usatrustonline.com.) We will provide an introduction to IBC appropriate for the beginner, but along the way we'll also explain many nuances that even a seasoned agent may never have fully understood. The end result will be to demystify IBC, and show that its amazing results and flexibility don't depend on any gimmicks, but are the result of the nature of the arrangement.