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"The rich rules over the poor, and the borrower is slave to the lender."
– Proverbs 22:7

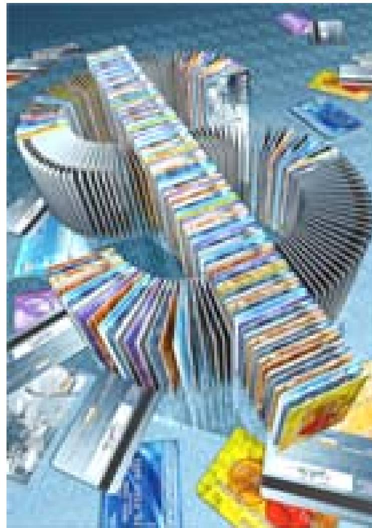
"He who refuses to rule is liable to be ruled by one who is worse than himself."
— from Plato's *Republic*

Divided by Debt

Where You Stand Today May Determine Where You End Up Tomorrow

The ripple effect of the financial crisis that originated in the sub-prime mortgage sector in 2007 is still reverberating through the global economy. The shakeout is far from over, but recent responses of both individuals and institutions in the aftermath of the first waves of financial distress are likely indicators of some long-lasting changes in the financial culture of the United States.

Among the issues that most likely will see major change: the use of credit, and the business of lending and borrowing.



Assessing the Credit Landscape

Ch-ch-changes
Don't want to be a richer man
Ch-ch-changes
Just gonna have to be a different man
- David Bowie

Today, on a global basis, we are feeling the aftershocks of too much credit gone bad. After a boom period of easy credit when almost anyone could buy anything, the bust is upon us. People are looking for strategies and actions that will stop the bleeding and lead to a recovery. Some responses to the current financial adversity are logical and self-explanatory, others are unexpected or unusual.

1. No surprise: Financial institutions have tightened their lending standards. It doesn't make sense to lend to people who can't make payments. With both credit card and mortgage default rates at all-time highs, lenders have become more conservative in their lending practices.

Citing information by the Federal Reserve, Sara Murray and Jon Hilsenrath wrote in the August 18, 2009 *Wall Street Journal* that "most banks reported that they expected their lending standards across all loan categories would remain tighter than their average levels over the past decade until at least the second half of 2010."

Remember how you used to get four or five offers a week for a new credit card – with no fees and no interest for 6 months? For most, such offers are things of the past. Now credit card companies are reducing limits, canceling cards and looking to clean out problem borrowers. Andrew Martin, writing in the May 18, 2009 *New York Times* says: "Banks are expected to look at reviving annual fees, curtailing cash-back and other rewards programs and charging interest immediately on a purchase instead of allowing a grace period of weeks, according to bank officials and trade groups."

The message: If you want to borrow, prove to us you can pay it back. We're no longer taking your word for it.

2. A bit of a surprise: Americans have decreased their borrowing and increased their saving. For years, financial commentators have lamented Americans' pathetic savings rate, which as little as two years ago was actually negative. Well, it didn't take long for that behavior to swing around.

Under the headline, **"Amid Recession, U.S. Savings Rate Hits Highest Mark Since 1993,"** a June 26, 2009 article posted on pbs.org stated:

> *As the longest recession since World War II drags on, Americans are responding by shying away from spending, opting instead to save money at the fastest pace in 15 years, a new report shows.*

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The Commerce Department reported Friday that consumer spending rose 0.3 percent last month, in line with expectations. Meanwhile, the savings rate that had hovered near zero in early 2008 surged to 6.9 percent, the highest level since December 1993.

It's somewhat remarkable that saving would spike so dramatically in the midst of a severe recession that includes high levels of unemployment and diminished incomes. The reduction in spending can be attributed to not having money, but an increase in savings indicates some people do have money but are choosing not to spend it.

3. Quite a surprise: Some financial commentators and politicians have been critical of *both* cautious financial institutions and thrifty individuals. Prudent lending practices and increased saving rates may seem like rational economic responses, but according to those who believe in the financial power of credit, these common-sense actions will not lead to a robust recovery.

When governments poured new money into lending institutions to stabilize the financial system, it was with the belief the institutions would then be able to continue making loans and allow the economy to keep spending. But lenders are understandably reluctant to use new money to make the type of loans that got them into trouble in the first place. They have the money, but are much more careful about lending it. This lack of new lending prompted Campbell Harvey, a finance professor at Duke University's business school, to observe "Basically we have dropped a huge amount of money ... and we have nothing to show for what we actually wanted to happen." (*Wall Street Journal*, 01/26/2009).

President Obama's comments in his *State of the Union Address* in February 2009 summarized the perspective of those who see renewed lending as necessary for recovery:

The concern is that if we do not re-start lending in this country, our recovery will be choked off before it even begins.

You see, the flow of credit is the lifeblood of our economy. The ability to get a loan is how you finance the purchase of everything from a home to a car to a college education; how stores stock their shelves, farms buy equipment, and businesses make payroll.

But credit has stopped flowing the way it should. Too many bad loans from the housing crisis have made their way onto the books of too many banks. With so much debt and so little confidence, these banks are now fearful of lending out any more money to households, to businesses, or to each other. When there is no lending, families can't afford to buy homes or cars. So businesses are forced to make layoffs. Our economy suffers even more, and credit dries up even further.

The flow of credit is the lifeblood of our economy.
- President Barack Obama

And it's not only lending institutions that need to loosen up. Every American must do his/her part by continuing to be a healthy consumer. Here's a February 12, 2009 headline from Chris Isidore, a senior writer at *CNNMoney.com*: **Why Saving is Killing the Economy.**

The opening paragraph:

It wasn't that long ago that many economists worried that Americans were saving too little.

Today, the growing concern is that Americans are starting to save too much.

It's not that the savings rate today is high by historic measures, or by comparisons to some other countries. But it has moved sharply higher in recent months -- at a time when what the economy needs most is for consumers to be spending more freely.

Later in the article, Isidore quotes Mark Zandi, chief economist for Moody's Economy.com who says increased saving is "a lot of spending that's not happening." Consumer spending is "the difference between an economy that is growing and one that is struggling mightily."

Isidore concludes:

Saving more and cutting debt might sound like a good plan to deal with the recession. But if everyone does that, it'll only make matters worse.

In brief, lenders are getting tighter, individuals are saving more and borrowing less, and experts want both groups to loosen their purse strings.

What's going on?

Understanding the Impact of Credit in the Economy

Most of us have a basic understanding of how credit works based on our personal experiences. We borrow someone else's money (the bank's, the mortgage company's, a friend's) to buy something today, and then repay the lender with interest. That's the basic formula whether credit is used to buy a house, a car, or dinner at a restaurant.

Likewise, our decision to take on a debt obligation is usually as simple as "who will lend me the money?" and "can I afford the payments?" Our assessment of our use

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of credit is often measured by our payment history and credit score. (i.e., "I have a credit score of 810, so I guess that shows I know how to borrow effectively.").

But lenders and economic policymakers have bigger agendas and different objectives. Here's how credit impacts the broader economy.

Credit is like lighter fluid on charcoal; it gets things started faster. Instead of having to save for long time in order to obtain a big-ticket item (like a house or an automobile), credit allows the borrower to have the item immediately, while using future earnings to make repayments over a period of time.

Credit expands purchasing power; i.e., it allows people to buy more things. And the more people buy, the more the economy expands.

Credit is like lighter fluid on charcoal; it gets things started faster.

In the short term, everyone likes the effects of credit. Buyers get what they want today, sales rise for businesses, and lenders add to their income streams by collecting more payments.

Of course, there are consequences to speeding up commerce and expanding purchasing power.

Borrowers may forfeit future financial opportunities. Using credit today predetermines how a portion of tomorrow's earnings will be spent, because borrowers are committed to making payments at a later date. Who knows what future opportunities will be forgone because of an outstanding loan obligation?

Abundant credit usually results in price increases. Wherever credit is used to purchase goods or services, the costs for those goods and services will usually increase as well, because when more people are potential buyers, the increased demand will result in higher prices.

The credit format works only as long as borrowers make payments. Having a few borrowers default is inevitable, but too many defaults make lending unworkable for both borrowers and lenders. If borrowers can't afford the interest rates and lenders can't afford to lend money, it won't be repaid. When the flow of credit slows or stops, the economic activity dependent on credit often contracts as well. This is why credit-driven economies have regular cycles of expansion and contraction.

Because of its lighter-fluid-like impact, politicians often enact legislation to facilitate credit in favored segments of the economy. For example:

- Government-approved student loans feature deferred payments and lower interest rates (because they are subsidized/supported by tax dollars) to encourage borrowing for higher education.

- FHA, Fannie Mae, Freddie Mac and other special programs for low-income and first-time home buyers provide additional incentives for both borrowers and lenders to enter into mortgages.
- The "cash-for-clunkers" rebates provoked a brief burst of automobile purchases, the majority of which were financed.

The perceived societal benefits of college education and home ownership may provide a rationale for making it easier for people to borrow. But a frequent unintended side effect of special borrowing programs is greater price distortion in those areas. In an August 24, 2009 *Atlantic* article, Niraj Chokshi writes that Labor Department statistics show "for 27 of the past 30 years, the price of education has grown at a faster rate than that of medical care. Education also grew faster than inflation for 29 of the past 30 years." Likewise, many financial commentators have stated that government programs which encouraged sub-prime lending bear some responsibility for the bubble in the housing market.

Credit may encourage reckless or undesirable behavior. Distorted prices and bad credit decisions by both lenders and borrowers can't be blamed on government policy alone. Many people simply can't handle debt responsibly – they borrow too much, spend recklessly, miss payments, lose the house and go broke. Some lenders prey on the weakness of borrowers. They charge exorbitant interest rates and fees, or keep offering credit cards to those who are already over their head. The flaws in human nature make any credit agreement a potentially dicey proposition. Here's financial analyst Ian Hodge's explanation from an April 26, 2009 blog commentary:

…you can see that the real problem is

Here's a quick quiz on a financial concept. Do you know the answer?

The homeownership rate is the percentage of residential single-family homes that are owner-occupied.

What is the approximate homeownership rate in the United States?

a. 47 percent
b. 53 percent
c. 59 percent
d. 67 percent

(Answer on Page 6)

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instant gratification. People don't like to wait for something in the future. They want it now.

Because their appetite is insatiable, the demand for instant gratification drives sellers in the marketplace to constantly increase their prices, and they don't care that ordinary folk have to go into debt to buy their goods. In fact, they have a vested interest in debt, because now they can get higher prices for their goods. This is especially true in the real estate market. This is why I have never heard any property developer complain about the high debt levels in the economy.

No home seller complained about Freddie Mae and Freddie Mac. They were happy to leave the problem to "other" people. They took their inflated prices and pocketed the huge increases in property values that were driven by debt.

Instant gratification. Sellers were not prepared to wait for higher prices that might come through supply and demand. Instead, they preferred the instant higher prices obtainable through debt.

Thus it is the greed of sellers – coupled with the… buyers who want to borrow – that is the cause of our economic problem.

Borrowing and lending has the potential to be a corrupting agent – financially and ethically. While most discussions today regarding credit focus only on financial particulars, there are important social and moral implications to the use of credit as well. Historically, many societies banned or stigmatized lending because of the potential for abuses. This particularly applied to lending to individuals (as opposed to business organizations or governments). Because credit is like lighter fluid, it can burn things up as well as get them started.

No Assets, No Credit?

For a long time, the way to climb the financial ladder was to accumulate wealth incrementally through diligence and thrift. People scrimped, saved, laid a financial foundation, and built their fortune over time. They left their heirs with assets to continue the process.

In the past half-century, the incremental, multi-generational method of wealth-building has been supplanted by a leveraged approach. Calculated borrowing (for a better education, for a home in an up-scale neighborhood, for a business opportunity, etc.) made it possible to acquire things today, pay for them tomorrow, and end up with substantial accumulated wealth as well (because the home appreciated in value, the college education brought a lifetime of higher income, and the business was sold to someone else). The leveraged approach makes it easier for more people to have more of the "good life" sooner, as long two conditions are present: first, borrowers faithfully make monthly payments for their mortgage, auto loans, and credit cards; second, the underlying assets continue to appreciate.

There are still financial instruments that can serve as safe and productive repositories for your dollars.

Many Americans and many American businesses, have taken the leveraged approach. Some borrowed because they had no other options. Others reasoned that rising income and future profitability would let them use credit as a financial shortcut. Today, they find themselves with limited savings, too much debt, and only one way to keep afloat: by deferring payments until a later date. The President is correct in stating that many Americans are dependent on lenders for their economic survival.

A leveraged approach makes it easier for more people to have more of the "good life" sooner.

But a revived credit economy will happen only if lenders believe their loans will be repaid. And there is the rub. Right now, lenders don't think the average American, or his/her business, is a good risk. The economy is in the tank, real estate values have plummeted, unemployment is up. Legislators can regulate lending practices and give institutions more money, but they can't force lenders to make risky loans.

Right now, lenders have a particular aversion to borrowers without assets. For those with assets (positive cash flow, savings, equity, etc.) credit is available, often on better terms than before the recession. But for those without assets, credit is either expensive or unavailable.

This separation of credit haves and have-nots based on accumulated assets was highlighted in the headline article from the August 29-30, 2009 *Wall Street Journal*, titled "**Halting Recovery Divides America in Two.**" On one end, the CEO of a national restaurant chain with $100 million in cash and no debt says, "For us, this is the best of times. Cash is king and this is a buyer's market." At the other end a high-tech irrigation company can't get financing to fill large orders because "these are the bumps in the road that are driven by being cash-poor."

At some point, individuals have to come to grips with these realities. Notwithstanding the big-picture perspectives of economists and policy-makers, **the only intelligent response to the contraction of credit is to accumulate assets – to save.** Otherwise, you run the risk of becoming a lifelong debt slave, with no

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guarantees that more credit will be available in the future. In the long run, credit-dependent individuals and businesses will be left behind.

Chris Isidore may think that a groundswell of saving and debt reduction will "only make matters worse." There are those who beg to differ. Steven Horwitz, an economics professor at St. Lawrence offers the following rebuttal in the September 2009 issue of *The Freeman:*

> *Most saving takes the form of financial instruments, including everything from basic checking accounts to the fanciest investment tools. If people are keeping higher checking account balances or putting more in savings accounts or money market balances, that wealth is not withdrawn from the economy. It is simply channelled elsewhere than into consumer goods.*
>
> *An increase in the savings rate represents a change in consumers' time preferences: They are saying; they are less interested in current consumption and more interested in future consumption… Restricting consumption does not hamper economic growth. In the long run, economic growth requires savings and the creation of new capital goods.*

Credit-fueled economies usually overheat, then flame out after many people have been burned. And the boom-bust cycle of credit always punishes greed and impatience.

The key action for financial recovery is **saving**. Even in this recession, there are still financial instruments that can serve as safe and productive repositories for your dollars. Find these instruments, and use them.

There are still legitimate, wealth-building reasons to borrow, but borrowers strike the best credit agreements when they can bring assets to the table. Even better, savers may eventually become lenders. If borrowers are debt slaves, then lenders are the masters. Plato is right: to refuse to master your finances puts you at risk of being mastered by others – and not liking it. Saving is the essential action that makes it possible for you to control your financial destiny.

- **WHERE DO YOU STAND ON THE DEBT DIVIDE? ARE YOU A BORROWER WITHOUT ASSETS?**
- **WHO CONTROLS YOUR FINANCIAL DESTINY?**
- **THERE ARE STILL GOOD PLACES TO SAVE!**

Whole Life Insurance: A Unique Asset Class

"Don't put all your eggs in one basket."

This old saying reflects a common-sense approach to long-term asset accumulation. Even if current returns from a particular investment are quite profitable, there's wisdom in not putting too much of your savings into a single financial asset or product, whether it's in the stock market, real estate, certificates of deposit, or countless other items.

Because each class of financial asset possesses unique characteristics, a well-rounded financial portfolio typically includes a mix of asset types. Some may be valued for their guarantees or liquidity, while others may be prized for their steady income or potential for long-term appreciation.

Where does whole life insurance fit as an "asset class"? It's an interesting question, one for which the answer seems to be changing.

One long-held conventional perspective regarding asset classification has been that "insurance is insurance and investments are investments, and the two should not mix." In this line of thinking, insurance (of any type) is a different type of asset. Insurance provides protection against loss, which is an important part of a well-rounded financial program. But insurance is not an accumulation asset – you cannot accumulate insurance, then "spend" it when you retire.

Whole life insurance blurs this distinction between protection and accumulation, in that it provides both an insurance benefit and accumulation in the form of cash values. This has led some financial commentators to evaluate only the cash value accumulation aspect of whole life, usually in comparison to other accumulation products. While life insurance cash values can deliver stable, conservative long-term returns, the accompanying life insurance costs have prompted some to proclaim "permanent life insurance is a poor investment."

But what if whole life insurance is neither insurance nor investment, but a unique asset class on its own? That's the position advanced by Richard M. Weber in a recent paper titled, ***"Life Insurance as an Asset Class: A Value Added Component of an Asset Allocation."*** In this 106-page document, Weber, an MBA and founder of an insurance consulting firm, concludes that whole life insurance (along with other versions of cash-value life insurance) is an asset with singular characteristics.

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In the May 2009 issue of *Financial Advisor* magazine, an article featuring Weber's ideas, writer Mary Rowland comments on how the investment in a permanent life policy "matures" at the insured's death, rather than a specified date or market event. While the timing of one's death is uncertain, the certainty of financial settlement at that moment can make estate and inheritance plans much more effective and secure, as well as establishing values in business plans.

In the period prior to death, cash values accumulate on a tax-deferred basis, yet policyholders can access funds through either loans or withdrawals at any time. According to Rowland, these characteristics mean that whole life insurance is "uncorrelated with nearly every other asset class."

Not only is whole life insurance different, Weber further states that owning it can "produce a return that is just as favorable, with less risk, than the same portfolio without life insurance." He provides an example where interest from an income-producing bond portfolio is used to pay the premiums for a permanent life insurance policy, as opposed to being reinvested in additional bonds. In the early years of the comparison, the reinvested bond account produces a greater asset value (but contains no insurance benefit). However, as the time goes on, the combination of cash values and bond values exceeds the bond-only account – and provides a guaranteed insurance benefit as well. In other words, having whole life insurance doesn't necessarily require a decrease in your total asset value – in the long run, you can have your cake and eat it too.

Weber goes on to make another interesting observation about whole life insurance: It is an asset that needs regular management. With its unique "maturity" features, a whole life insurance policy is a long-term holding in someone's financial portfolio – once you buy it, you are planning to have it for your whole life. But during your lifetime, the policy's design flexibility, which may include various riders and options1 as well as the liquidity of cash values through loans or withdrawals2 may prompt you to make adjustments to align with your current goals.

To take full advantage of these possibilities, a whole life insurance policy requires regular review and management: it is not a "set-it-and-forget-it" financial product.

1 Riders may incur additional costs.
2Policy benefits will be reduced by withdrawals, loans and loan interest.

- **IS WHOLE LIFE INSURANCE PART OF YOUR PORTFOLIO?**
- **IF SO, IS IT PROPERLY MANAGED?**
- **IF NOT, WHY NOT FIND OUT IF ADDING WHOLE LIFE CAN MAKE YOUR FINANCIAL PICTURE EVEN BETTER!**

FINANCIAL LITERACY QUESTION (from page 3)

Answer: d. Using the most recent statistics, the US homeownership rate peaked at 69 percent in 2004, but has been relatively steady over the past decade.

It is interesting to note that both homeownership and housing prices increased dramatically following World War II, when government initiatives made it easier for average Americans to buy homes. According to U.S. Census statistics, the homeownership rate in the 50 years prior to World War II (1890-1940) was never higher than 47 percent. As mentioned in the previous article, attractive credit policy both increased demand and raised prices.

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