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"Nobody can go back and start a new beginning, but anyone can start today and make a new ending."
Maria Robinson

An Antidote to the Sub-Prime Crisis

Unless you are oblivious to all financial news, you have no doubt heard about the sub-prime mortgage crisis. Without delving too deeply, the **essentials** *are as follows:*

Seeking to expand their business, lending institutions made mortgage loans with unconventional features to people who might not ordinarily qualify to buy a home. These features included little or no down payment requirements, interest-only or optional minimum monthly payment plans, and adjustable-rate mortgages. In exchange for making these options available to "sub-prime" borrowers, i.e., consumers with less-than-stellar financial standing, the lending institutions collected higher fees and interest.

In a booming housing and employment market, many of these more-risky bets paid off. But when the economy turned, defaults rose rapidly. Unemployed or downsized homeowners who had stretched to make even the minimum payments found they could no longer afford to live in the house, yet couldn't find anyone to buy it at a price that would clear the mortgage.

Defaults and the subsequent foreclosures obviously hurt the financial institutions that made the loans; the Mortgage Lender Implode-O-Meter web site (ml-implode.com) notes that since late 2006, "160 major U.S. lending operations have 'imploded.'" The defaults also have a ripple effect on investors who bought the mortgage notes, thinking they would be safe, high-yielding investments. The repercussions from these losses have global implications, and have prompted government involvement, along with pleas that somebody – central banks, legislators, the president – "do something" before the situation gets worse.

In the meantime, a lot of people are looking for someone to blame for the mess. In a September 15, 2007 opinion piece for *World*, Joel Belz said the greed of both the borrowers and lenders was the root cause. The Implode-O-Meter site characterized the breakdown as "a saga of corruption, stupidity, and government complicity." Others point fingers at hedge funds, the Federal Reserve chairman, and Congress (for not enacting better consumer protection legislation). When the list of villains gets this long, the problem must be pretty big.

Q. So who's really at fault?
A. As an individual consumer, does it matter?

The sub-prime problem is what it is. The fall-out from it may affect you – whether it is government bail-outs funded by higher taxes, or restrictive lending regulations that make it harder to get a loan, or a massive crash in housing values, or whatever else. Regardless who is ultimately at fault, you are going to have to deal with the consequences. And while it's natural to be angry at circumstances that befall you because of the actions of others, it's not necessarily profitable.

Risk Management – Focusing on the Foundation

The long-term stability of a building depends greatly on its foundation. The participants in the sub-prime crisis, both consumers and lenders, were trying to execute financial transactions without laying a solid foundation. As soon as the first financial tremor came along, the transactions collapsed.

Laying a solid financial foundation is really about risk management. And as a financial task, risk management is boring – until you need it. No homeowner brags "hey you

ought to come over and see my foundation! You won't believe how solid the concrete is! I could build a house ten stories high if I wanted to!" But when there's an accident or a needed repair, no one wants to hear, "Sorry, Bud. You're going to have to level the house. The foundation's not solid enough to build on."

For individuals, a financial foundation is typically *cash reserves, income protection* in the form of life and disability insurance, and a *solid credit history*. With those three items properly positioned, most individuals can successfully undertake almost any financial objective.

For the financially-stretched-then-foreclosed home-buyers, part of their risk management should have been cash reserves. Cash reserves would have made it possible to make a reasonable down payment, so that even in a down market they would have a reasonable chance of selling the home and clearing the mortgage. Cash reserves would have allowed unemployed owners to continue making monthly payments until they either found new employment or sold the house.

The over-zealous lenders rationalized their risks. While acknowledging the borrowers were sub-prime customers, they believed the higher risk of default would be covered by increasing property values. When their risk assessment proved wrong on both counts – the borrowers couldn't pay and the properties weren't worth as much – there was no way to withstand the losses.

The Time to Check Your Financial Foundation is Now!

As mentioned earlier, the repercussions from the sub-prime mess may have a large spill-over. Directly or indirectly, ***your*** financial life could be impacted. It might be a declining market value for your home. It may impact your 401(k) balance. It might even mean the loss of a job, or the need to relocate. It's hard to tell who will be touched by the economic ripple, and how it will affect them. But knowing there might be trouble on the horizon, **isn't now a good time to assess your financial foundation, and act on it?**

Apparently, some people already are. Justin Lenhart, in his "Ahead of the Tape" column in the September 10, 2007 *Wall Street Journal* wrote that "after a long period of unusual stability in stock and bond markets, the wrenching losses of the past few months have brought investors' perceptions of risk back to where they should have been in the first place." Two days later, M.P. McQueen's *WSJ* article "Volatile Markets Add Luster to Dull Choices" begins with "market turmoil is prompting more people to buy stodgy insurance products like immediate fixed-income annuities and whole life insurance…"

This is not a financial doom-and-gloom, the-end-is-near warning. The sub-prime crisis is simply a reminder that you can't expect to ignore financial fundamentals. Individuals and institutions need a solid financial foundation in order to weather the inevitable hiccups that will occur.

How solid is your financial foundation?

- ☞ **Is there a reserve of safe, liquid cash to carry you through a financial emergency?**
- ☞ **Do you have adequate income protection in the form of life and disability insurance?**
- ☞ **Are there debts (like credit card balances) that should be cleared?**

Proactive risk management isn't a glamorous project, but it is the perfect antidote for the problems caused by the sub-prime crisis.

Do you feel comfortable with whatever you have in place to help provide income to you if you should truly become disabled and can no longer work?

Disability Income Insurance: A Common Foundation Flaw

In consideration of the previous article, here's a stunning finding:

"Though the odds of disability run high for American workers, only 3% have enough disability insurance to replace all of their income, according to a new survey by COUNTRY Insurance & Financial Services. Further, more than one-third (35%) say none of their income would be replaced if they were unable to work."

The quote above is the lead paragraph from a September 18, 2007 *PR Newswire* article titled "Americans Not Planning for Disability Despite Odds." Some additional statistical information from the same article highlights the odd disconnect many Americans have regarding disability. For example:

- ☞Even though the Social Security Administration reports that 30% of American workers will suffer some type of disability during their lifetime, 62% of those surveyed considered homeowner's and auto insurance more important. In other words,

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these people would rather pay insurance premiums to protect the economic value of their home and automobile as opposed to insuring the economic value of their ability to earn a living.

- ☞This disinclination to secure disability protection, either through group insurance provided by an employer, or individually, is particularly puzzling since more than half of the respondents said they could not maintain their lifestyle if disabled and out of work for more than 90 days.
- ☞Although the survey doesn't make an explicit statement, part of the reason disability insurance is ignored may be the expectation that disability benefits from Social Security provide sufficient protection. However, the SSA reports that less than half of all disability claims are approved.
- ☞Keith Brannan, a spokesperson for the survey's sponsors, stated that "research shows disability causes nearly half of all mortgage foreclosures."

One of the challenges of disability is the subjective definition many people have for it. When they think disability, they often think of an accident. An accident at work would most likely be covered by an employer's insurance. And most auto insurance policies provide some protection for a disability incurred while driving. Then you hear the stories about disability fraud, of those on claim, playing golf or snorkeling on vacation, and it makes you wonder if you really need additional income protection. After all, you're a person of ambition and integrity, and, "If I'm disabled, I'll still work."

But a real disabling incident isn't one you can overcome by simply declaring "I'll still work." Disability isn't only caused by accident, but also health problems. And accidents don't happen just in the workplace or on the highway. Given the reality of the risks, and the financial importance most people have to maintain their income it's hard to imagine the best solution is to do nothing.

BOLI: Why Banks Own (a lot of) Life Insurance

Most of the time when life insurance is discussed, the context is individual and personal. The main concern is protecting a family from the untimely loss of a provider, or preserving an estate for heirs. But in the past two decades, the business world has found other applications for life insurance. While your personal financial circumstances may or may not be those of a business, understanding how businesses use life insurance can be instructive.

Bank-owned Life Insurance and Corporate-owned Life Insurance (known as BOLI and COLI, respectively) represent an increasing percentage of life insurance purchases. In fact, the increase in use of life insurance as a corporate financial tool has resulted in the establishment of specific regulatory guidelines. Although BOLI and COLI are somewhat similar, this article will focus on how banks use life insurance.

The Basic Idea

BOLI insures the lives of a group of bank employees (usually officers) and/or directors, typically the top 35% of their employees in terms of compensation. The financial institution pays the premiums on the policies, owns the policies, and is the beneficiary of the increase in the policies' cash value, as well as the death benefit. The typical BOLI policy is a permanent contract – i.e., it has cash values and a death benefit – most often in the form of a single-premium policy.

Why Do Banks Buy BOLI?

Banks find life insurance to be a multi-purpose financial tool. The Todd Organization (toddorg.com) notes that BOLI can "help financial institutions retain and attract quality executives and increase shareholder value. It can also achieve other business purposes, such as reducing rising health care costs and related employee benefit expenses." BOLI (and COLI) has great appeal because the death benefit allows the employer to recoup much of the cost of providing benefits.

NYLEX, a division of New York Life, writes that "by reinvesting funds from traditional portfolio investments into BOLI, a bank can typically increase its yield by 100 to 350 basis points depending upon marginal tax rates, the size of the transaction, the type of policies selected and the demographics of the key employees to be insured."

In addition to boosting returns through favorable tax treatment, regulators allow banks to classify the cash values in policies as "**Tier One assets**" on their balance sheets. The larger the Tier One capital, the stronger the bank, because Tier One assets cushion the bank in times of adversity and support other balance sheet assets. A strong Tier One is what all banks strive for, since this number determines how much money they can lend to the public. Only gold bullion, cash and government loans have a higher Tier One rating than life insurance cash values.

How much BOLI do Banks Own?

Barry J. Dyke, pension consultant and author of several articles about BOLI, provides details. In his book *Pirates of Manhattan*, he writes "According to the Federal Deposit Insurance Corporation, at least 4,082 of the nation's commercial and savings banks owned bank-owned life insurance (BOLI) in 2006; whereas only 3,474 banks owned BOLI in 2004. As of December 31, 2006 the aggregate cash surrender value in these policies was an astounding $106,825 billion; whereas at the end of 2004 aggregate cash surrender value was only $65.8 billion."

$106,825 billion sounds like a lot of money. But when the numbers get that big, it's hard to grasp their significance. So Dyke provides another reference: Life insurance as a percentage of the bank's Tier One Assets. A select listing from Dyke's research follows:

Institution	Total Tier One Capital Assets in $ Billions	Total BOLI Assets in $ Billions	BOLI as a % of Tier One of the Bank
Bank of America	$95,348	$14,402	15%
Wachovia	$32,919	$12,874	39%
JP Morgan Chase	$68,726	$ 7,874	10%
Washington Mutual	$21,081	$ 4,285	20%
Citibank	$59,860	$ 3,281	5.4%
Key Bank, NA	$ 6,809	$ 2,602	38%
Harris National	$ 3,297	$ 1,155	35%
Huntington National	$ 1,989	$ 1,155	56%

Now the numbers begin to make sense. A significant percentage of a bank's "safe" assets are held in life insurance policies! To summarize, Dyke quotes a General Accounting Office report: "…on average, for the banks that owned BOLI, the cash surrender value of life insurance generally accounted for up to 25% of Tier One capital."

Dyke concludes:

"Banks buy a great deal of life insurance because it provides immeasurable economic benefits, financial stability and safety, which is superior to the banks themselves… Bankers have wholeheartedly embraced high cash value life insurance as a safe economic power tool and have found the product to be healthy for the bottom line."

"But I'm not a Bank"

Three comments to put this information in perspective:

1. **The primary reason banks buy cash-value life insurance is for its value as an asset, not for protection against loss of life.** If banks, with all of their financial expertise, have this perspective toward life insurance, perhaps individuals should as well.
2. **Banks buy permanent life insurance because they have a long-term perspective.** Because we all require money to survive, and because most of us plan to live as long as possible, some sort of long-term financial perspective is necessary for individuals as well.
3. **Banks see an advantage in the safety, flexibility and tax-favored status of permanent life insurance**. While the media darlings of personal finance often tout high rates of return as the pre-eminent advantage of a particular financial vehicle, safety, flexibility and tax status should also be considered.

Everyone's situation is different, but with the assistance of a qualified financial professional, it is possible to develop a personal permanent life insurance program that delivers many of the same benefits that BOLI provides for banks.

Lost Opportunity Costs for Football Fanatics

Regular readers of this publication know that opportunity cost is a frequent point of discussion in our articles. Opportunity cost is an attempt to calculate the financial cost of a particular decision in comparison to other financial alternatives that could have been chosen instead.

(An example: You are contemplating the purchase of a second car using $15,000 from your savings account. By paying cash, you will avoid any financing costs, but you will incur opportunity costs because the $15,000 is no longer in your savings account earning interest.)

Opportunity costs are real, but somewhat of a guess. What represents a suitable financial alternative? Who knows if the alternative options for using the money will deliver the anticipated returns, especially if some of the benefits can't be quantified financially? (In the example above, how can you determine the economic value of a second car? Is it the income that comes from being able to travel to a second job? Or the flexibility in family scheduling that means less overall gasoline use?) The uncertainty inherent in calculating opportunity costs often makes their consideration quite subjective.

Subjectivity not withstanding, the intriguing part of opportunity cost is that it can be applied to almost any financial decision. A great illustration is the opportunity cost of entertainment. Opportunity cost can be an interesting way to determine if your "fun" is really worth the price you're paying for it.

NFL tickets – a million dollars of enjoyment?

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Team Marketing Report (TMR), a consulting firm from Chicago, publishes an annual report on the cost of attending sporting events in the United States. One of the sports covered by the report is professional football. In 2006, TMR reported the average ticket price for a National Football League game was $62.38, an increase of 5.6% over the previous year. Some prices were much higher, particularly for the New England Patriots and Washington Redskins, with $41.29 the lowest average price for the Buffalo Bills. A 2004 report from TMR noted that the average cost for a family of four to attend a game, have a few snacks, and buy a souvenir was $312.62. (Things add up quickly when a beer costs $5 or more.)

TMR's calculations don't include ancillary costs such as parking or transportation. So even if you don't buy a bobble-head, it's easy to see that each trip to the game could total up to $350. Since NFL teams have eight regular-season home games, that's $2,800.

Suppose a 30-year-old decides to purchase four season tickets. Suppose he/she keeps those tickets for 35 years, sharing them with family and friends. Assuming the price of tickets increases 4% annually, and that the money spent on tickets could have earned 8%, what would be the opportunity cost of enjoying NFL games over a lifetime?

See the chart below for the math:

Ticket Inflation Rate: 4.00% **Opportunity Cost Rate: 8.00%**

YR	AGE	1-GAME COST	SEASON TOTAL	VALUE w/INTEREST
1	30	$350	$2,800	$3,024
2	31	364	2,912	6,411
3	32	379	3,028	10,195
4	33	394	3,150	14,412
5	34	409	3,276	19,102
6	35	426	3,407	24,310
7	36	443	3,543	30,081
8	37	461	3,685	36,467
9	38	479	3,832	43,522
10	39	498	3,985	51,308
11	40	518	4,145	59,889
12	41	539	4,310	69,336
13	42	560	4,483	79,724
14	43	583	4,662	91,137
15	44	606	4,849	103,665
16	45	630	5,043	117,404
17	46	656	5,244	132,460
18	47	682	5,454	148,947
19	48	709	5,672	166,989

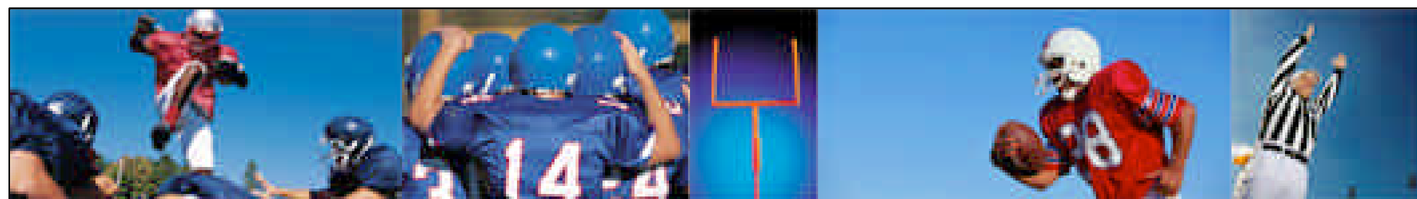
YR	AGE	1-GAME COST	SEASON TOTAL	VALUE w/INTEREST
20	49	$737	$5,899	$186,719
21	50	767	6,135	208,283
22	51	798	6,381	231,837
23	52	829	6,636	257,550
24	53	863	6,901	285,607
25	54	897	7,177	316,207
26	55	933	7,464	349,566
27	56	970	7,763	385,915
28	57	1,009	8,073	425,507
29	58	1,050	8,396	468,616
30	59	1,092	8,732	515,536
31	60	1,135	9,082	566,587
32	61	1,181	9,445	622,114
33	62	1,228	9,823	682,492
34	63	1,277	10,215	748,124
35	64	1,328	10,624	819,448

As you approach age 65, the total opportunity cost is over $800,000. Carry the example forward another two years, and the total opportunity costs are over $1 million!

In theory, this means that if you had decided to forgo the NFL tickets and save the money, there could have been an extra $800,000 for you to use elsewhere – perhaps to buy a vacation home, add to your retirement, or maybe just take a nice weekend vacation (if 4 NFL tickets are $1300, who knows what inflation will do to other purchases?).

Right now, we can see some beleaguered NFL fan being tormented by a less-interested spouse: "So how does it feel to know you're giving up a million dollars to watch football games in person? We could have had a vacation home in Aspen, but oh no, you had to watch the Steelers!"

However, remember that opportunity costs can apply to *everything,* because in one way or another, every financial decision has an opportunity cost. Every day, we make financial decisions that indicate we believe the value we will receive in some way exceeds the opportunity cost we will incur. Some transactions offer fairly direct comparisons of opportunity costs, while the evaluation in other cases is much more subjective.



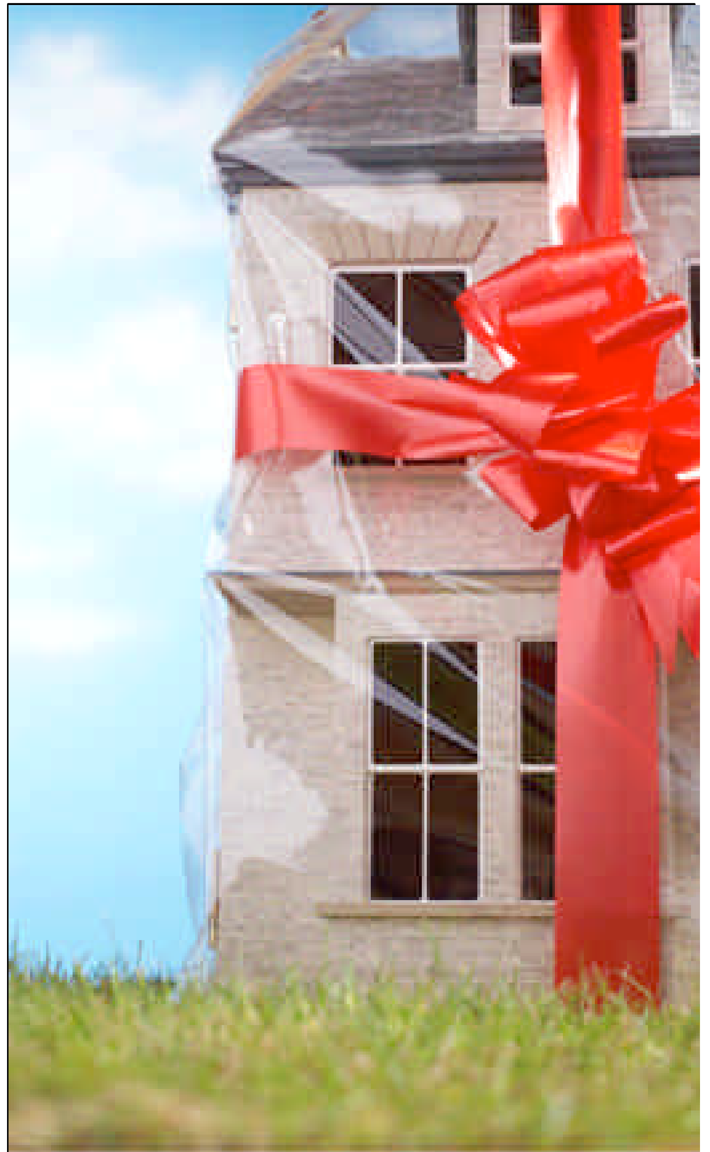
PSYCHOLOGICAL VALUE OF A HOME IS OFTEN GREATER THAN FINANCIAL VALUE

Some financial pundits consider home equity a "dead" asset because the equity isn't available to spend or be invested in other places. For these experts, it is better to draw equity from the home, usually in the form of home equity line of credit, and place the money in a higher-performing alternative. While this strategy may make sense on paper, it apparently ignores some human realities. The longer homeowners have their homes, the more they value the security of having a place they own.

A recent survey by the Principal Financial Group found that 73% of retirees wanted to keep their homes in retirement, as opposed to selling and/or downsizing. 78% of retirees said they had not considered selling their home, taking a reverse mortgage, or borrowing against their accumulated equity as a way to improve their retirement funding.

Since the survey also found that 60% of the retirees owned their homes free and clear, this means a large number of retirees place a high intangible value on their "dead asset." The emotional security of having a place to live outweighs any financially-driven argument, even if property values decline, or other alternatives present themselves.

The longer homeowners have their homes, the more they value the security of having a place they own.



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