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L. CARLOS LARA

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ABOUT LARA & MURPHY

L. CARLOS LARA is CEO of United Services and Trust Corporation, a consulting firm specializing in in business advisory services with a primary focus on working with companies in financial crisis. His background in capital formation and business rehabilitation makes him a regular speaker at credit and business conferences.

In 2010 he co-authored the highly acclaimed book, *How Privatized Banking Really Works* with economist Robert P. Murphy.

He is a co-creator of the IBC Practitioner Program for financial professionals and sits on the board of the Nelson Nash Institute.

ROBERT P. MURPHY is Research Assistant Professor with the Free Market Institute at Texas Tech University. He is co-author of *How Privatized Banking Really Works*. He is the author of *Choice: Cooperation, Enterprise, and Human Action* (Independent Institute 2015) and co-host with Tom Woods of the popular podcast Contra Krugman.

Murphy has a Ph.D. in economics from New York University. After spending three years teaching at Hillsdale College, he went into the financial sector working for Laffer Associates. With Nelson Nash, Carlos Lara, and David Stearns, Murphy is co-developer of the IBC Practitioner Program.

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"The main lesson which the true liberal must learn from the success of the socialists is that it was their courage to be Utopian which gained them the support of the intellectuals and therefore was an influence on public opinion which is daily making possible what only recently seemed remote."

— F.A. Hayek

The Intellectuals: A Controversial Portrait, 1960

Friedrich Hayek, in much the same way as Mises and every great economist going back to Adam Smith and beyond, had to defend the principles of the capitalist system to his own generation anew. Is that because once a free society is achieved we take it for granted and we no longer value it? Must we sink into totalitarian darkness before we can realize what we have lost?

Hayek concluded that this might actually be the case, even though he wished that it weren't true. What he could not ignore was the fact that so long as there were people who were continually attracted to socialist ideals the socialist trend would persist. Hayek determined that the people principally responsible for the spread of socialism to the masses over the last one hundred years were the *intellectuals* in society.

Socialism, wherever it exists, is not a movement that first begins among the working class of people who see it as an obvious solution to their problems. Instead, it is a *"construction of theorists"* whose strategies captivate the minds of the intellectual class of people in society and they in turn spread socialism to the ordinary man. This occurs even though the intellectual is not the original thinker, scholar, or expert on the subject.

Hayek described the intellectuals as merely *"professional secondhand dealers in ideas."* His point being that although these people may be masters of the technique of conveying ideas, they are usually amateurs so far as the substance of what they preach is concerned. Yet this is the primary channel that modern society has developed for the spreading of knowledge and ideas to the ordinary person.

By wielding the power of the spoken and written word, socialist intellectual forces are today undermining the foundations of our free society. These intellectuals—so long as they concern themselves with only the immediate political issues of the day and do not seriously indulge in debates with real experts and scholars with regards to the long run consequences of their speculations— *"are rewarded with influence, material success, and popularity with all those who, up to a point, share their general views."*

Hayek believed that if we are to avoid being completely overrun by socialism in the near future we needed to offer a freedom program that would fire up the imagination all over again. In effect, we needed our own form of Utopia! We don't mean, of course, an impossible society that defies the laws of economics or ignores the fallen nature of man. No, we mean "Utopia" in the sense of a beautiful vision showing what's *possible* if we achieved our full potential.

And, to be able to secure our Utopia's realization, we needed our own principled army of intellectuals to help spread our idea to its final fulfillment no matter how far off it may now seem. As he boldly put it: *"If we can regain that belief in the power of ideas, which was the mark of liberalism at its best, the battle is not lost."*

This is why we fervently believe in the need to build the ten percent. With each individual that embraces Nelson Nash's idea of the *Infinite Banking Concept (IBC),* we not only provide individuals a means of escape from the present corrupt monetary regime, but we also provide them the principles of sound money management that can be passed on to the next generation. With the help of our growing ranks of *Authorized IBC Practitioners,* and the households and businesses they serve, this powerful idea will eventually bring us the victory.

Yours truly,

Carlos and Bob

PULSE ON THE MARKET

CA Carbon Charge

In late April, the "Perennial Farming" initiative was launched in which participating restaurants in California would add a voluntary 1% "CO2 Offset" to their bills, so that their customers could provide money to local farmers to switch to "healthy soil" that absorbs more carbon dioxide.

Now to be sure, to the extent that this initiative really *is* voluntary, without any background political coercion involved, then it is certainly within the legal rights of the restaurant owners to latch on to whatever cause they wish. Some grocery stores ask their customers at check-out if they want to donate $1 to fight hunger, and now (apparently) some restaurants in the Golden State are asking if diners want to pay farmers to switch soils.

However, even though it's within their *right* to ask, we have to point out the futility of regional initiatives that ostensibly fight human-caused climate change. Whether it's funding farmers, taxing carbon dioxide emissions, or mandating renewables in the electricity mix, these localized measures have a glaring problem: leakage. In the climate change literature, "leakage" refers to the fact that businesses and households will migrate out of highly regulated jurisdictions and *into* less regulated ones. For example, even if California placed an outright ban on the use of gasoline, that would just mean—over time—fewer people would live in California and fewer manufacturing operations would take place there. So yes, California emissions would drop significantly, but emissions in "the-world-minus-California" would go up by a lot. On net, *global* emissions would not be affected nearly as much as one might suppose.

When it comes to climate change, there is an enormous mismatch between most of the suggested remedies and the ostensible problem—even if we stipulate for the sake of argument that there *is* a "problem" needing to be solved quickly. Here as with the so-called Green New Deal, it's hard to avoid the conclusion that the underlying motivations aren't so much about the "science" but about the pre-existing distaste of capitalism.

Bernanke Broke Laws

So concludes George Mason University economics professor Alex Tabarrok. In his April 24 review (at the blog MarginalRevolution.com) of the new book *Firefighting* from Ben Bernanke, Timothy Geithner, and Henry Paulson, Tabarrok first quotes the authors as saying: *"The Fed also reinterpreted its emergency lending authority in creative ways to avert catastrophic collapses of Bear Stearns and AIG…"*

To this self-serving formulation Tabarrok replies: *"In other words, the Fed broke the law. That, at least, is how many in Congress saw it after the fact…"*

Indeed, beyond the question of the *wisdom* of the Fed's "extraordinary" lending operations following the 2008 crisis, we can inquire as to their *legality*. For example, the Fed only had the statutory authority to buy certain types of assets. Presumably, when Congress wrote the legislation creating (and then later amending) the powers of the central bank, they didn't want it to, for example, buy shares of common stock from a major corporation. Such discretion would obviously be very dangerous and invite corruption.

So the way in practice the Fed skirted such issues is that it created shell companies, such as Maiden Lane LLC. (Alexander Mehra devoted a 53-page paper in the U. of Pennsylvania Journal of Business Law to whether these vehicles were legal. See: https://www.law.upenn.edu/journals/jbl/articles/volume13/issue1/Mehra13U.Pa.J.Bus.L.221(2010).pdf.)

More generally, the Fed didn't let the crisis go to waste, and expanded its powers in unprecedented ways. See Murphy's article, "Ben Bernanke: The FDR of Central Bankers," in the 2014 collection *The Fed at One Hundred* (edited by David Howden and Joe Salerno).

Regulators Flat-Footed

Carlos' article in this month's issue focuses on his growing concerns over the mortgage-backed securities (MBS) being packaged by non-bank lenders. The "shadow banking system" now provides more than half of the funding for home purchases in the United States. Among other lessons, this episode illustrates the futility of relying on political regulation to keep investors and the general public safe. Even if the regulators were angels, they are perpetually fighting "the last war" and laying down rules that, at best, would prevent an exact repeat of the last crisis.

However, this is redundant. Everybody *lived through* the last crisis and so won't repeat those exact same mistakes. Things adapt and the foolishness seeps in through other channels.

However, the problem is worse because there is a revolving door among regulators and the industries they oversee. If someone in a position of political authority "plays ball" or "is a stand-up guy" while at the SEC, Federal Reserve, or other such entity, then some investment bank or hedge fund might give the person a plush consulting position upon leaving "public service." This is how the game works.

The only way to stop our recurring boom-bust cycle is to halt the engine of credit inflation, namely the Federal Reserve and its cartel of private banks that have the legal authority to create money through their lending process. In the meantime, households and businesses can stop contributing to the problem by learning and implementing the Infinite Banking Concept (IBC).

APRIL 2019

WHY TRUMP'S FED NOMINATIONS ARE SO RADICAL

BY ROBERT P. MURPHY

Say what you will about the presidency of Donald Trump, but he has shown all open-minded Americans just how truly bipartisan the DC Establishment—what some have dubbed "the Deep State"—really is. The fact that National Review dedicated an entire issue to repudiating Trump[1] shows just how much he threatened the status quo. When the leading neoconservatives such as David Frum, Bill Kristol, and Max Boot need their swooning couches over the Donald's latest offensive tweet, you know the real issue is that Trump threatens funding for the military-industrial complex.

We see a similar pattern now when it comes to monetary policy. At first most DC-based conservatives and libertarians were pleasantly surprised with Trump's handling of Federal Reserve vacancies, and in particular his choice of Jay Powell to replace Janet Yellen as chair. But when Trump recently floated the names of Herman Cain and Stephen Moore, all hell broke loose.

Let me be crystal clear: I am not a fan of Donald Trump, whether we're talking about his personal behavior, many of his official policies, or even his rhetoric supporting his policies. (In fairness, I *do* support any and all tax rate reductions, and the Trump Administration really has followed through on his promise to deregulate industry quite substantially.) Even on monetary policy, I don't think Herman Cain or Stephen Moore would be particularly brilliant members of the Federal Reserve Board.

I am not a fan of Donald Trump, whether we're talking about his personal behavior, many of his official policies, or even his rhetoric supporting his policies.

But that's not really the point of my article. What I want to focus on is how threat-

ened the establishment feels. What is truly "radical" about Trump is that he's appointing people who are outside the club, who don't know how to "play the game" like the other Washington elite. Precisely because Trump is so uncouth and so "un-presidential," he threatens to forever shatter the illusion that *both parties* have constructed to fool average Americans into thinking that the federal government and its organs represent the cutting edge in scientific management and humanitarian concern.

This is balderdash. As Murray Rothbard wrote, the State is a gang of thieves writ large. In the case of the Federal Reserve, it is a cartel of big bankers. Indeed, the Fed is *literally owned* by private banks. (Imagine the shock if the public found out that all of the major pharmaceutical companies owned shares of stock in the FDA, and that the agency ostensibly regulating drug safety paid Merck, Pfizer, etc. regular dividends. Yet that's how the Fed works with respect to the banks it oversees.)

Greg Mankiw Declares His Love for the Fed

You probably think I'm exaggerating with that section header, don't you? But nope, this is how Greg Mankiw—Harvard economist, leading textbook author, and head of George W. Bush's Council of Economic Advisers—described his feelings in his April 11 New York Times column[2]:

> I have a confession to make: **I love the Federal Reserve. And I suspect that, in their heart of hearts, most other economists love the Federal Reserve, too.**

> **But I fear our love may be in peril.**
>
> We live in a time when many public institutions seem to be failing us. The White House is in constant turmoil, with extraordinarily high turnover among top staff members. Congress is as polarized as ever, not having done much over the past two years other than pass the mess of the 2017 tax bill. Even the Supreme Court appears less dispassionate and more partisan than it should be.
>
> I used to think that our system of higher education had pride of place among our institutions. But now I am less sure…
>
> Which brings me back to the Federal Reserve. **The nation's central bank employs about 20,000 Americans. They monitor the economy, develop analyses to help set monetary policy and regulate the banking system. None are paid the extraordinary salaries found at the nation's private banks. But they do their jobs with solemnity and tenacity and without a whiff of scandal. And, most important, they do their jobs well.** [Greg Mankiw, bold added.]

If this had been a geologist with a career of sending students to work for large oil companies, and he wrote a glowing article lauding the integrity and track record of this industry, everybody would take his over-the-top praise with a healthy dose of skepticism. Yet Mankiw explains in his NYT piece that he has sent many of his students to work for the Fed, and this somehow is supposed to make us love that fine institution even more.

Contrary to Mankiw's assertions, the Fed's track record has been terrible.

The Fed's Track Record

Contrary to Mankiw's assertions, the Fed's track record has been terrible. Most obvious, the two worst economic disasters in the nation's history—the Great Depression and so-called Great Recession—happened on the Fed's watch. (The Fed was founded in late 1913, and the great stock market crash that kicked off the Great Depression was in late 1929.)

But the Fed has a *dual* mandate, as they say. It is supposed to promote macroeconomic stability (which in practice means keeping the unemployment rate from getting too high) *and* stable prices. We've already seen that the Fed did a terrible job in smoothing

out the business cycle, since the worst two such cycles occurred well *after* the Fed came on the scene. But what about price stability?

Here the case against the Fed is even more blatant. As David R. Henderson noted, in his own (more nuanced) reaction to Mankiw's article[3]:

> [O]n inflation, the Fed has done a much worse job than the pre-Fed gold standard. During the period of the classical gold standard, 1880 to 1914, inflation averaged 0.1 percent annually. Between 1947 and 2018, annual inflation has average 3.5 percent. Since the Fed began, the value of the dollar has fallen by 96 percent. [David R. Henderson]

For those interested in the technical details, Henderson in his piece also quotes from Christina Romer—who recall was Obama's first head of the Council of Economic Advisers—who showed in a 1986 paper that when we adjust for the limitations of older economic data sets, the performance of the Fed in battling recessions during the period after World War II was comparable to the pre-Fed period. In other words, even when she *left out the Great Depression* Christina Romer (in the mid-1980s) couldn't conclude that the Fed had done anything to smooth out the business cycle.

Fed Not Political?

Beyond the absurdity of Mankiw praising the technical competence of the Fed, is his claim that this institution is somehow free from corruption. Sure, sometimes the guys (and gals) in white lab coats might solve the wrong calculus problem and set interest rates at an improper level, but gosh darn it they are scientists! How dare Donald Trump come along and "politicize the Fed"!

Let me refute this notion with a simple graph, showing the year/year percentage changes in the "monetary base" as well as the Consumer Price Index (CPI):

Figure 1. Year/Year Percentage Change in Monetary Base (Blue) and CPI (Red)

As the chart shows, some of the biggest surges in the monetary base (blue line) occurred during World Wars I and II. And yet that's also when consumer price inflation went through the roof, blowing through 20% annually in the first war and well above 10% in the second—even *with* explicit price controls in place! (Note that the official monetary base data from the St. Louis Fed's standard database only go back to January 1918, so we haven't taken the graph back to cover the whole war period, but CPI was rising at 20+ percent in the middle of the war, even though you can't see it in Figure 1.)

Some of the biggest surges in the monetary base (blue line) occurred during World Wars I and II. And yet that's also when consumer price inflation went through the roof.

How can this be? Why would we see extreme bouts of price inflation when the U.S. federal government also happens to need to pay for expensive wars? If Mankiw is right, then the people running the Fed should conduct monetary policy without any regard to the political situation or the financing needs of the government.

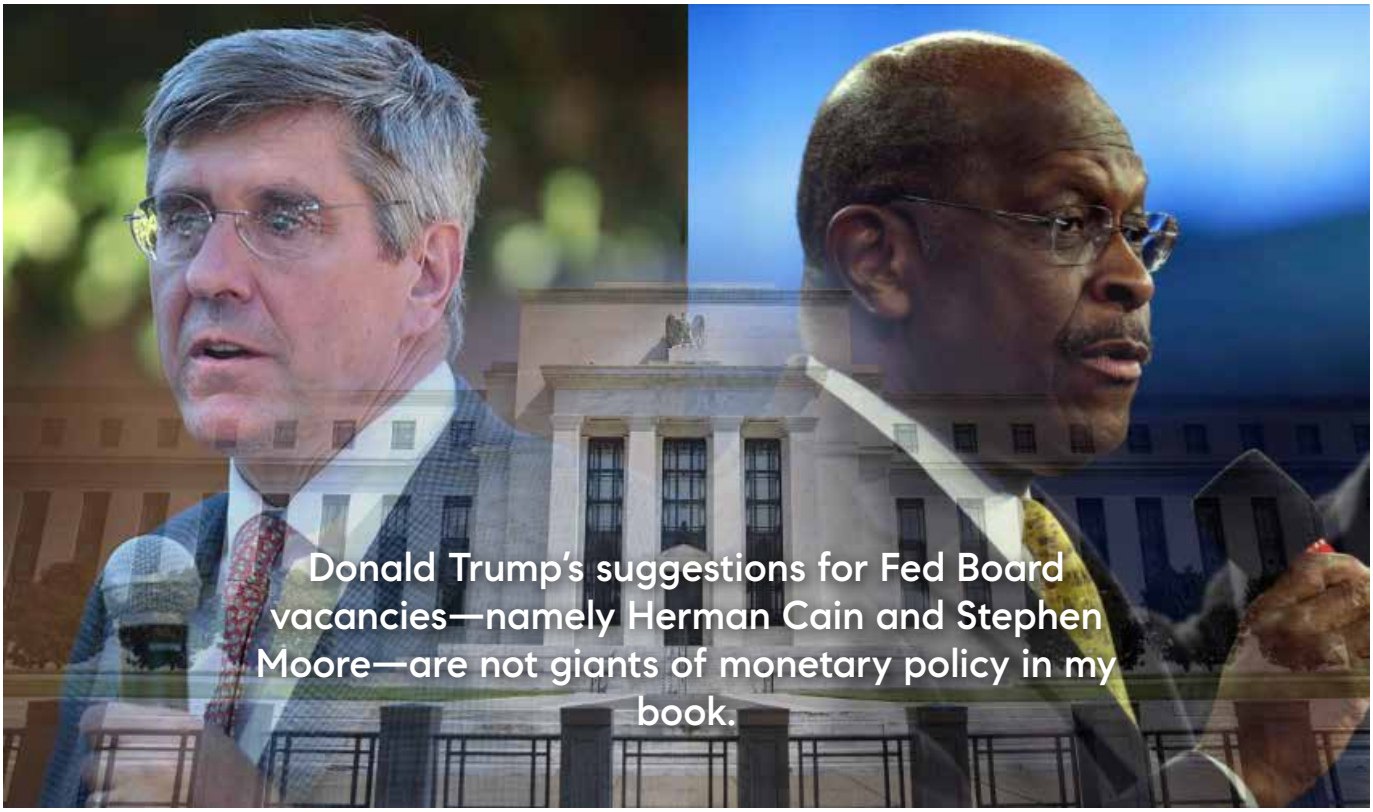
Yet of course that is ludicrous. The whole *point* of the political authority to give special cartel (or even monopoly in some cases) privileges to particular banks is that the bankers agree to finance the government's deficits. That's why the Fed "happened to" engage in various rounds of Quantitative Easing right when the Obama Administration was running trillion-dollar budget deficits several years in a row.

Conclusion

Donald Trump's suggestions for Fed Board vacancies—namely Herman Cain and Stephen Moore—are not giants of monetary policy in my book. For me, their past statements (particularly Moore's) in defense of "hard money" are fine; what troubles me is how easily they started preaching the gospel of low interest rates once Trump took office.

Nonetheless, we can appreciate Trump's "reckless" suggestions because they forced the DC establishment to reveal its true position: Both left and right, Democrat and Republican, came out swinging, reassuring the public that the Federal Reserve is a venerable, scientific institution with a great track record.

This is nonsense. The Fed was literally designed at a secret meeting of major bankers and politicians—see G. Edward Griffin's provocatively titled *Creature from Jekyll Island* or Murray Rothbard's *The Case Against the Fed*. It has funded the welfare-warfare state since its inception, and after the 2008 crisis it bailed out the insiders who had made terrible bets on real estate, while letting the



average homeowner fall behind in his mortgage payments.

Indeed, the real "problem" with Trump is that he doesn't play the standard game. He is so reckless and crude in his commentary that he threatens to shatter the myth of the "independent Fed." And that's probably a very good thing, in the long run.

No matter what Trump's legacy ultimately becomes, regular households and businesses should begin weaning themselves from reliance on the commercial banking / Wall Street nexus, by investigating Nelson Nash's *Infinite Banking Concept*. Our book *The Case for IBC*[4] is a short yet comprehensive introduction to his revolutionary approach.

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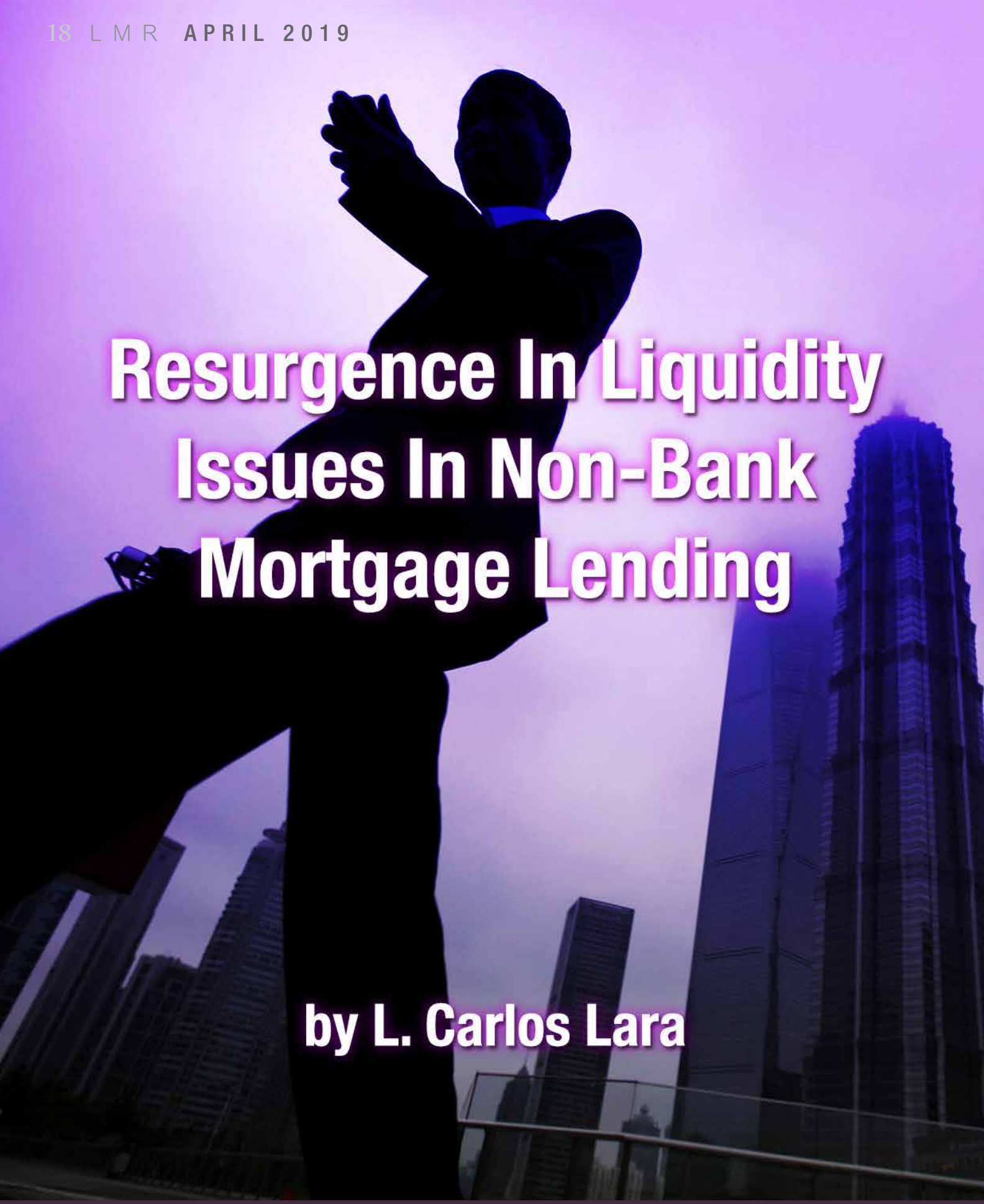


Resurgence In Liquidity Issues In Non-Bank Mortgage Lending

by L. Carlos Lara

Paper assets such as stocks, bonds, and mutual funds are said to be liquid investments because they can be sold and converted to cash fairly quickly. Real estate is an entirely different matter. Whether it's raw land, or brick and mortar construction, they can take much longer to sell and for that reason are considered to be investments that are not as liquid.

Nevertheless, in recent decades the concept of securitizing real estate into a paper asset in order to sell to a broader investor market has taken hold since it was first introduced in the 1970s and has grown exponentially. In this type of investment the real estate asset is secured by a mortgage, but now we have a packaged collection of mortgages that is offered to investors worldwide.

At the core of this type of investment, and what investors like about it, is the emotional responsibility of the homeowner to continue to make his principal and interest payments on time in order to protect the equity in his dwelling. By pooling together several of these mortgages and then adding to it a U.S. government guarantee, you wind up with a very ideal investment. Ideal, that is, until the rate of interest rises, or until a recession strikes. These are negative market conditions that affect most investments.

In this ***LMR*** article I want to highlight real estate investments and in particular the mortgage-lending environment after the 2008 financial crisis. There is new evidence indicating that big changes in this market sector are on the way. Specifically, the levered up financial engineering that has been going on in this financial arena that is strikingly similar to what we had going on immediately prior to the financial crisis and now it too has reached a critical apex.

At the core of this type of investment, and what investors like about it, is the emotional responsibility of the homeowner to continue to make his principal and interest payments on time.

In essence, while commercial banks remained somewhat cautious in their mortgage lending practices coming out of the 2008 financial crisis, *non-bank lenders* were not as timid. The result is that, unbeknownst to many analysts, *non-bank mortgage lending* has been quietly but steadily growing into a colossus over the last ten years. Their resurgence in this industry has now surpassed that of *conventional* commercial mortgage banking and coming with that enormous growth are mounting concerns about their financial

structures and capital reserves.

Shadow Banking Is Back

The concern is warranted because these *non-bank lenders* are the same financial institutions that were at the center of the *subprime* mortgage market collapse in 2008 right along side the commercial banking system. In the aftermath of that crisis many non-bank lenders bankrupted unceremoniously without taxpayer bailout assistance, but the industry survived. I featured this mysterious sector in the June 2014 issue of the ***LMR*** entitled, "The Rise of Shadow Banks", at a time when people were still trying to wrap their heads around the definition of these shadowy businesses.

The primary distinction between non-bank lenders and commercial banking lenders is that non-bank lenders do not take in customer deposits. Consequently, they do not have FDIC protection and are not as stringently regulated by the Federal Reserve, the Securities and Exchange Commission (SEC), and the FDIC under the mandates of the Dodd-Frank Act.

In that sense the term "non-bank lender" can and does include financial institutions, such as insurance companies, pensions, and private equity firms, all of which are capable of lending money for large real estate investment ventures. But here in this article we are specifically targeting non-bank lenders principally involved in mortgages for housing averaging $300,000.00 and less. At that price point, they originate loans to low- to moderate-income borrowers, which includes first time homebuyers, small real estate entrepreneurial investors, and "house flippers." Their growth since the 2008 financial crisis has eclipsed that of commercial banks and are today the predominant mortgage lenders in the U.S.

While commercial banks remained somewhat cautious in their mortgage lending practices coming out of the 2008 financial crisis, *non-bank lenders* were not as timid.

In the years post-crisis non-bank lenders remained somewhat nebulous outfits due to lack of information about them and their activities. Also, as the economy moved further into its current boom phase they soon fell out of the news limelight. However, just this

month *DBRS*, a global rating agency out of Toronto, Canada, published a dire warning about shadow banking that was picked up by most financial news sources around the world and the subject of shadow banks is once again a hot topic.

In summary, "DBRS sees significant risks stemming from continued growth in shadow banking globally. Assets are now at $52 trillion, up from $30 trillion in 2010 according to the *Financial Stability Board (FSB)*. Weaknesses in these nonbank financial institutions arising in their maturity intermediation, liquidity, leverage and credit transformation could result in runs that would exacerbate financial market stress. The U.S. has the largest concentration with 29% of global shadow banking assets. But, this is down from 48% in 2010, as other regions are growing faster. Fixed income funds, mixed funds, hedge funds and other collective investment vehicles are driving this shadow banking growth."[1]

The primary distinction between non-bank lenders and commercial banking lenders is that non-bank lenders do not take in customer deposits.

Small Outfits Doing Big Risky Financial Maneuverings

According to the *Mortgage Banking Association (MBA)*[2] non-bank lenders are properly defined as *Independent Mortgage Brokers (IMB)*. The industry is made up of principally small, privately held companies. In 2017 there were nearly 900 U.S. independent mortgage banks, with *Quicken Loans* being the largest, and originated an estimated $86 billion in mortgages with a U.S. market share of less than 5%. This percentage is small compared to the overall number of mortgage originations by Independent Mortgage Brokers.

As a whole, the Independent Mortgage Broker industry is the primary source of single-family mortgage credit, particularly for low-and moderate-income families. In terms of mortgage originations, they have grown from 25% in 2008 to 54% by 2017 and account for 80% of FHA loans, 70% of VA loans, and 64% of Rural Housing Loans, according to a February 2019 report from the *Mortgage Banker Association (MBA)*.[3]

The most significant aspect of the way In-

dependent Mortgage Brokers transact business is that they sell the majority of their mortgage originations to be securitized into *Mortgaged Backed Securities (MBS)* in order for them to be sold to investors in the secondary market. Consequently, these packaged instruments find their way into hedge funds, fixed income funds, and various varieties of mutual funds, which are helping to fuel the industry's growth.

According to a report published in March 2018 by the *Brookings Institute*[4] these nonbank mortgage originators represented "close to half of all mortgage originations sold to *Government-Sponsored Enterprises (GSEs) Fannie Mae* and *Freddie Mac* in 2016 as well as 75% of all originations sold to Ginnie Mae. The striking rise in the Ginnie Mae nonbank share appears to have continued in 2017; data from the *Urban Institute* pins the nonbank share of Ginnie originations at 80% in December 2017."

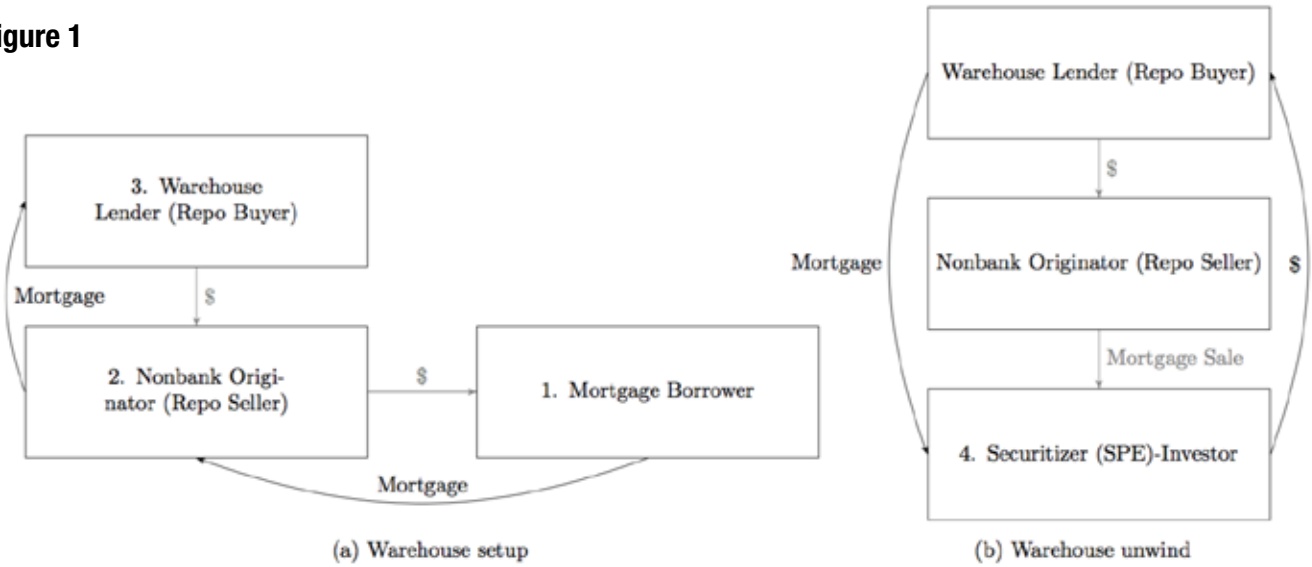
A statement made by Ted Tozer, President of Ginnie Mae in 2017, sums up the concern about the financial activities of *Independent Mortgage Brokers* this way:

> "...Today almost two thirds of Ginnie Mae guaranteed securities are issued by independent mortgage banks. And independent mortgage bankers are using some of the most sophisticated financial engineering that this industry has ever seen. We are also seeing greater dependence on credit lines, securitization involving multiple players, and more frequent trading of servicing rights and all of these things have created a new and challenging environment for Ginnie Mae.... In other words, the risk is a lot higher and business models of our issuers are a lot more complex. Add in sharply higher annual volumes, and these risks are amplified many times over... Also, we have depended on sheer luck. Luck that the economy does not fall into recession and increase mortgage delinquencies. Luck that our independent mortgage bankers remain able to access their lines of credit. And luck that nothing critical falls through the cracks..."[5]

The fact that *Independent Mortgage Brokers (IMBs)* are small entities without much published information makes accessing data on their financial structures problematic. The servicing models of government agencies assume that IMBs have the potential to absorb a share of credit losses before the government has to step in, but in reality there is no evidence of their ability to deal with periods of weakening credit conditions. IMBs' only source of revenue is the sale of their packaged mortgages to investors, so their lack of earnings diversification is creating doubts and concerns about their ability to deal with periods of low liquidity and heavy withdrawals.

The U.S. mortgage lending market has two different facets after the 2008 crisis.

Figure 1



How Independent Mortgage Banking Really Works

The U.S. mortgage lending market has two different facets after the 2008 crisis. There is the conventional side of mortgage lending, which consists of the commercial banking system handling the three main mortgage components—origination, funding, and servicing—all done "in-house." They will either hold the loans in portfolio or securitize them in pools guaranteed by Ginnie Mae or the GSEs, namely Fannie Mae and Freddie Mac. But after the 2008 financial crises, commercial banks exited subprime lending practices altogether, and pared down significantly their conventional side of mortgage lending.

The other side of mortgage lending is less transparent, and not often discussed in detail in financial literature, therefore, is least understood. This is the non-bank mortgage lending business performed by independent mortgage brokers. What is critically important to understand is that commercial banks have not left the mortgage business entirely and are still very much involved in the lending process, but in a completely different capacity. For the most part they no longer lend directly to the mortgage borrower. Their role has shifted to one referred to today as warehouse- lending (not to be confused with 100% reserves in the fractional reserve debate) This is merely the term currently being used by the industry for providing short-term funding to non-banks by granting them lines of credit in order for them to perform the functions commercial banks once performed.

In **Figure 1** (adapted from the Brookings Institute Report 2018), the initial stage of warehouse-lending is shown in **SUBFIGURE (a).** The mortgage borrower (1) is approved for a mortgage from the non-bank

originator (2) who funds the mortgage using a draw from a line of credit provided by a commercial bank in the role of a "warehouse-lender" (3). The collateral on the loan is the mortgage on the house, and the non-bank in turn transfers the mortgage to the warehouse-lender to collateralize the draw on its line of credit. Mortgage-collateralized warehouse lending is eligible for accounting and legal treatment as *"repurchase agreements."* The non-bank originator is said to be the "repo seller" and the warehouse-lender is the "repo buyer" in the origination transaction.

SUBFIGURE (b) shows the warehouse unwind. The non-bank (4) must sell the mortgage note to a securitizer-investor. In the case of the GSEs this would be a loan sale for cash (or cash equivalents) that will flow directly to the warehouse-lender who then releases the collateral (deed of trust and promissory note) to the securitizer-investor. The warehouse-lender then pays down the dollar value of the draw to the non-bank's line of credit. In essence, the commercial bank role in the mortgage-lending process has morphed into a short term in and out loan transaction with minimal, if any risk. They have created a wall of protection between themselves and the *Government-Sponsored Enterprises (GSEs)* and the *Department of Justice (DOJ)* if future financial breakdowns occur.

Figure 2

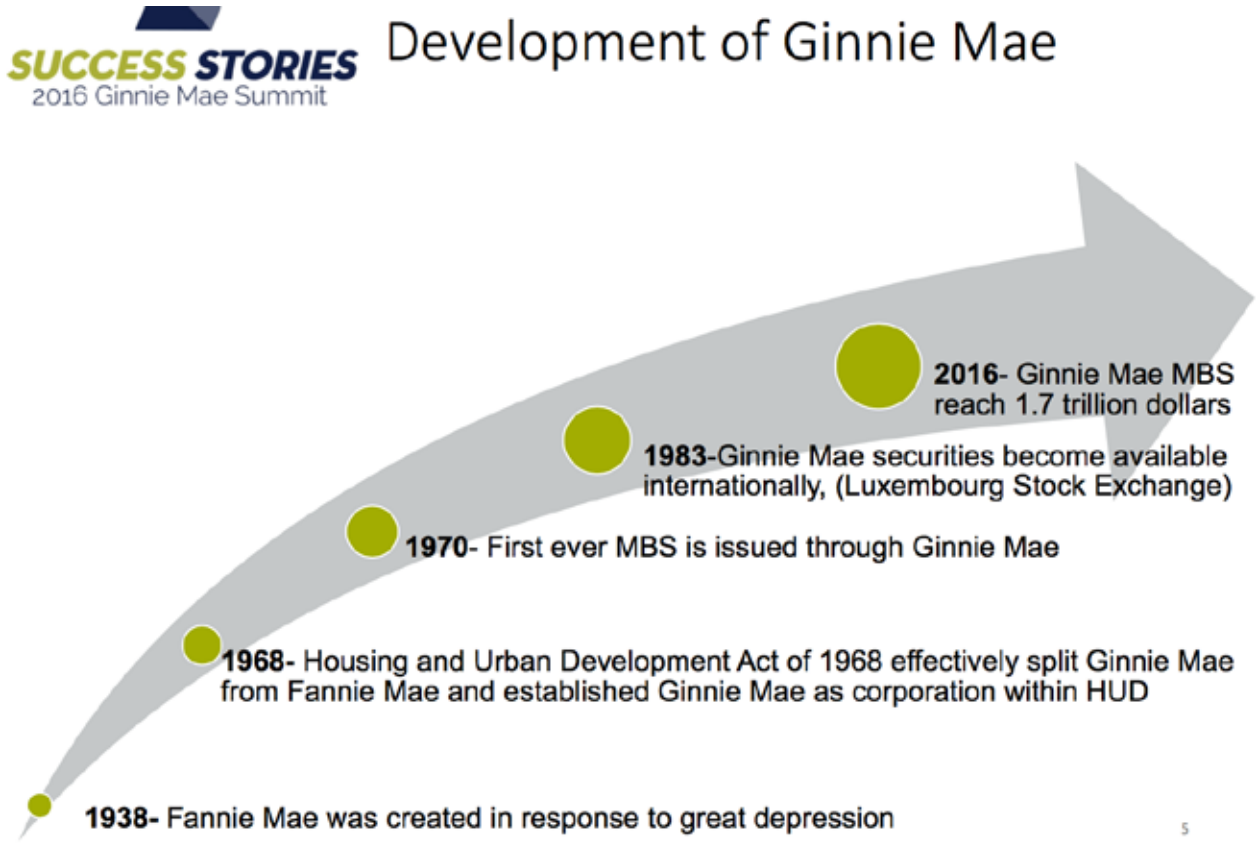


Figure 3

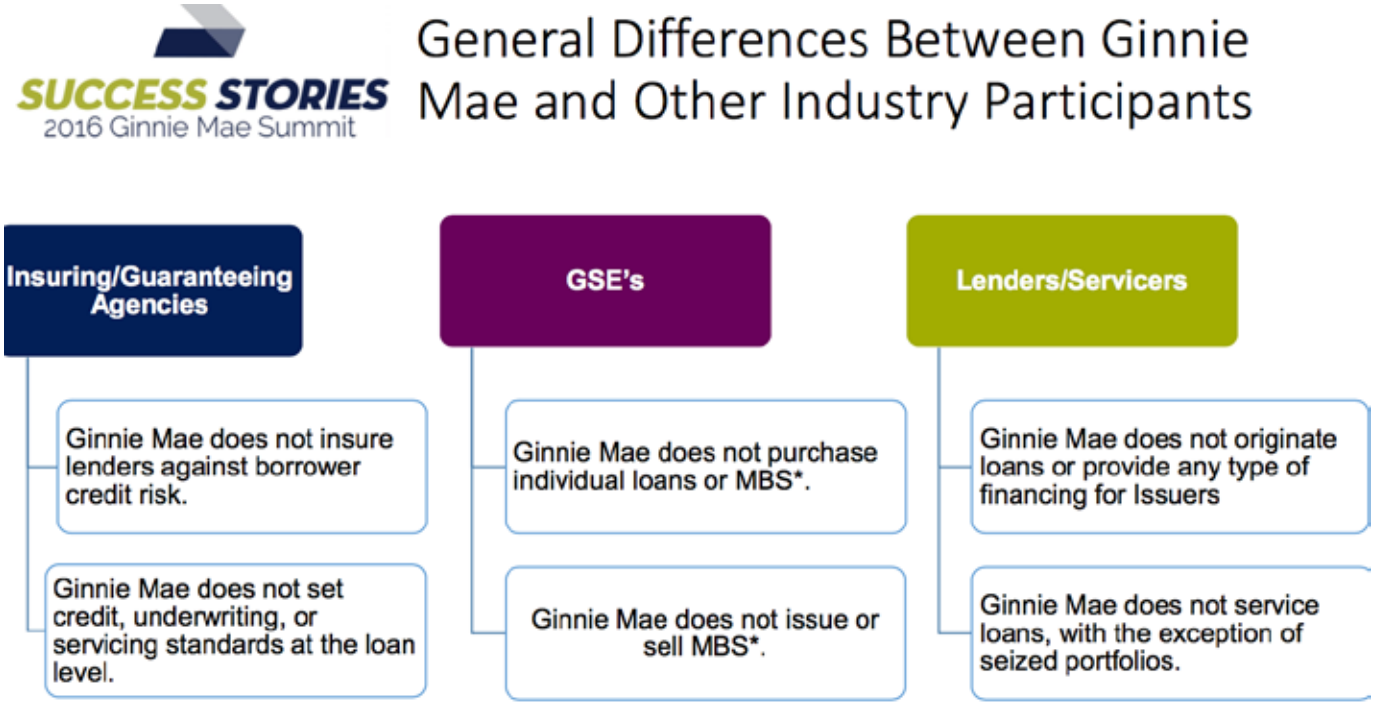


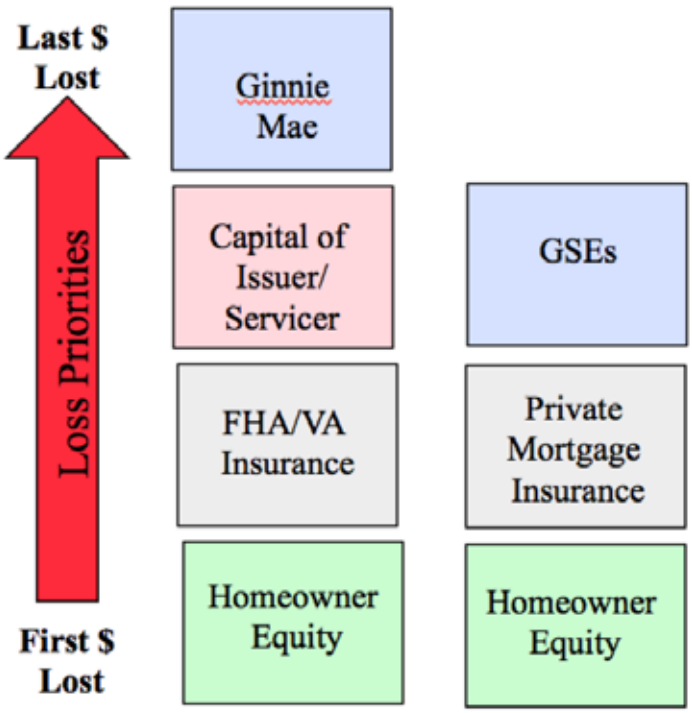
Figure 4

Homeowners and Taxpayers Are On The Hook

Government-Sponsored Enterprises (GSEs) do not lend money directly to the public. What they actually do is purchase loans in the secondary market thereby providing money to lenders and financial institutions in order to enhance credit to certain sectors of the economy. Although they are privately owned corporations, they have an implicit guarantee (which was made *explicit* during the recent crisis) from the U.S. government that they will not be allowed to fail. Consequently, GSEs are often referred to as quasi-government institutions.

The Ginnie Mae Summit[6] held in 2016 reported the following highlights about the differences between the GSEs and Ginnie Mae. The GSEs and Ginnie Mae both guarantee *Mortgage-Backed Securities (MBS)*. However, Ginnie Mae is exposed to greater liquidity problems and is at greater risk of having to absorb the credit loss more so than the GSEs. The GSEs and Ginnie Mae both provide guarantees to the MBS investors that they will receive their payments of principal and interest payments on time. But the crucial difference is that GSEs purchase loans from the non-bank mortgage originators and issue the securities themselves. For Ginnie Mae, financial institutions (including non-banks) originate or purchase mortgages and then issue securities through the Ginnie Mae platform. **SEE Figure 2, 3, and 4** (adapted from the Ginnie Mae Summit 2016).

Figure 5



As shown in **Figure 5** (adapted from the Ginnie Mae Summit 2016), in a mortgage default the mortgage borrower takes the initial credit loss, which is the equity in the house. This is followed by the government insurance agencies, which provide some credit risk coverage, but only up to a point and in certain circumstances, so in a very real sense the U.S. government eventually takes the final loss. This is what actually happened in the 2008 financial crisis with respect to non-banks. Obviously, the non-bank originator can be sued by the *Department of Justice (DOJ)* in an attempt to recover government losses. However, in a collapsing market, non-banks may go out of business without any assets to recover. In such an environment, Ginnie Mae's remaining remedy, when all else fails, is to continue servicing the MBS without compensation.

Government-Sponsored Enterprises (GSEs) do not lend money directly to the public. What they actually do is purchase loans in the secondary market.

What we must not overlook and what concerns many is the enormous fall-out damage that could occur in the event of another mortgage market collapse to millions of small investors. Many of these investors have invested in these securitized investments via employer-sponsored retirement plans, which mostly consist of mutual funds and other collective investment vehicles. The runs on these funds that such an event could trigger would magnify the current overall financial market stress.

Conclusion

Even after what happened during the 2008 financial collapse of the residential mortgage market, there still remain limited insights into the fundamental characteristics of non-bank mortgage lenders and their financial structures. This is the main reason they are called "shadow banks."

Since very few of these entities are publicly traded companies, very little is known about their ability to sustain economic shocks. Most of their eligible assets appear to be tied up collateralizing secured lending facilities. The small amount of information that is indirectly available about this industry has more to do with how large the size of the *warehouse lending* market (the amount commercial banks lend to non-bank mortgage

lenders) has grown in recent years.

The primary concern and vulnerability of non-bank mortgage lenders is their sole reliance on this warehouse-lending from commercial and Wall Street investment banks in the form of lines of credit that can easily close up in the wake of a financial crisis.

Finally, non-banks are also susceptible to increases in interest rates. In the concluding paragraphs of the extensive 2018 Brookings Institute Report it asks a very disconcerting set of questions that pretty much say it all. *"What happens if interest rates rise and non-bank revenue drops? What happens next?"*[7]

The motivation for writing this article is the concern that Bob and I have had about the vulnerability of investors in the real estate market at this particular time. We are aware that many students of IBC discovered that they could easily tap the cash value in their IBC policies in order to enter the booming real estate market as an investment opportunity. But while we agree that this is certainly possible, we caution fans of IBC that they must never lose sight of the fact that artificially created booms are in the end unsustainable. When the markets finally do crash these investments crash right along with them. You have to be ready for this outcome and remain liquid.

The motivation for writing this article is the concern that Bob and I have had about the vulnerability of investors in the real estate market at this particular time.

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PUTTING ENTREPRENEURSHIP FRONT & CENTER

INTERVIEW WITH PETER KLEIN

Peter Klein is the W. W. Caruth Chair and Professor of Entrepreneurship at Baylor University's Hankamer School of Business. He also directs Baylor's PhD program in entrepreneurship and is faculty director of the Baugh Center for Entrepreneurship and Free Enterprise. His research focuses on entrepreneurship, strategic management, and the economics of organization. He taught previously at the University of Missouri, the University of Georgia, and the University of California, Berkeley (where he earned his PhD in economics), and served as a Senior Economist with the Council of Economic Advisers.

Klein is a Senior Scholar at the Ludwig von Mises. He is author or editor of four books and over 150 scholarly articles, chapters and reviews.

Editors' Note: *The first interview with Peter Klein appeared in the January 2012 edition of the LMR. His answer to our (standard) first question is reproduced below, but the remainder of his answers are new to this issue.*

LARA-MURPHY REPORT: How did you discover Austrian economics?

PETER KLEIN: A high-school friend got me interested in Ayn Rand's novels, which I enjoyed, and I later read Rand's *Capitalism: The Unknown Ideal,* which contained a list of recommended readings, including books by Mises and [Henry] Hazlitt. I eventually discovered Hayek, Rothbard, [Israel] Kirzner, and other Austrians. There was no internet in those days, so I must have stumbled upon various books and articles at the public, and later the university, libraries. I never had any formal training in Austrian economics from a teacher or college professor, even though I was an econom-

ics major. By the time I started the economics PhD program at Berkeley, I was a thoroughgoing Austrian—though this certainly didn't make my life any easier as a graduate student.

LMR: In the aftermath of the tragic death of economist Alan Krueger, many of his colleagues were praising his revisionist work on the minimum wage and in particular for his commitment to letting the data "speak for themselves." Yet you pushed back against this common reaction. Can you explain?

PK: I didn't know Krueger personally but, by all accounts, he was a thoughtful scholar and a kind and generous person. Reflections on his life and career have emphasized his critical role in the recent turn in mainstream economics away from grand theories that sought to explain general relationships which could then be applied to specific problems, and towards a new kind of economics that is inductive, incremental, data-driven, and largely devoid of theory.

"While some of these techniques are indeed improvements over the previous approaches to structural econometrics, this new wave has come at a cost."

Krueger's famous minimum-wage study with David Card challenged the conventional wisdom that minimum wages increase unemployment, not by offering any new theory, but with a clever quasi-experimental design in which they compared low-wage employment in two neighboring states, one of which raised its minimum wage while the other did not. Their work helped to launch the "credibility revolution" which emphasizes natural experiments, randomized controlled trials, and similar empirical techniques to identify causal relationships between economic variables.

While some of these techniques are indeed improvements over the previous approaches to structural econometrics, this new wave has come at a cost. First, it has directed economists' attention away from difficult and complex problems like what causes economic growth or the business cycle, how prices coordinate economic activities, and the like, and toward smaller problems like, how can we motivate students to study for a test?

Second, and related, it has demoted theory to an afterthought. Doesn't the Card-Krueger result contradict the standard idea of a downward-sloping demand curve for labor? Indeed, attempts to replicate the Card-Krueger experiment generally failed, most likely because the underlying data were inaccurately collected and reported. But few labor economists seem to care *why* some studies find conflicting results. Last week I read a comprehensive and detailed study of the effects of state and local minimum-wage increases on employment, forthcoming in the prestigious Quarterly Journal of Economics. The paper presents an exhausting set of empirical tests, but doesn't attempt to interpret its findings in light of any theories of the labor market. I asked one of the authors (via Twitter) for help in interpreting the findings, but didn't receive a reply from him or other commentators on the article. No one seems to think that's even an interesting question.

"Few labor economists seem to care why some studies find conflicting results."

LMR: One of your research specialties is entrepreneurship. Do you think it can be taught, as is claimed by certain programs in business schools?

PK: Mises famously described entrepreneurship as a "specific anticipative understanding of the conditions of the uncertain future [that] defies any

rules and systematization" and which "can be neither learned nor taught." I agree—we can't teach people how to judge the future correctly. At the same time, there are aspects of the entrepreneurial process that are teachable. Consider the analogy with art or music. Can we teach music theory, music history, the technical aspects of playing various musical instruments, music appreciation, and the like? Sure. But no amount of formal training will make the average music student into the next Mozart. Likewise, we can teach entrepreneurship theory, entrepreneurial history, and the technical aspects of running an enterprise (accounting, finance, marketing, etc.). We can explain why the entrepreneurial role is so important and try to persuade those of us who are not professional entrepreneurs to appreciate the economic significance of those who are. None of this teaching will make the student the next Steve Jobs. But it is still useful knowledge.

"Can we teach music theory, music history, the technical aspects of playing various musical instruments, music appreciation, and the like? Sure. But no amount of formal training will make the average music student into the next Mozart."

LMR: What do the Austrian economists have to offer the rest of the profession regarding entrepreneurship?

PK: Most economists define entrepreneurship narrowly as something like small-business management or the act of starting a new company. As such, it is a minor add-on to the curriculum, an application of their existing theories. In contrast, the Austrians have always defined entrepreneurship as a generalized function (in Mises's case, the act of taking responsibility for productive resources and allocating them in the way that best satisfies consumer wants) and placed it front and center in their explanations of the market system. Economists and business researchers interested in entrepreneurship can learn from appreciating this general role. Some specific interpretations of the entrepreneurial function developed within the Aus-

trian tradition—Mises's idea of judgment under uncertainty, Schumpeter's notion of creation destruction, Israel Kirzner's metaphor of alertness to opportunities—are also useful in understanding entrepreneurship.

LMR: What do you think up and coming Austrian economists should study in their research? Are there any gaping holes in the Austrian approach for young pioneers to fill?

PK: There is always room for further development of what I call the hard core of "mundane" Austrian economics—price theory, capital theory, business cycle theory, competition theory, models of economic growth, regulation, etc. Applications of Austrian economics to entrepreneurship and other business disciplines like management, finance, and accounting are particularly hot right now. And Austrian economics has a lot to say about problems in law, political science, public administration, and other related fields. There is plenty of space for new work!

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Note: The economists and financial professionals interviewed in the LMR are given the freedom to express their views, without necessarily implying endorsement from the editors.

EVENTS & ENGAGEMENTS

NOTE: MANY OF THESE EVENTS ARE OPEN TO THE PUBLIC. CONTACT US FOR FURTHER DETAILS.

APRIL 12, 2019
DALLAS, TX

Murphy presents on health care at the Free Market Medical Association.

APRIL 26, 2019
NEW LONDON, CT

Murphy presents on climate change economics at Connecticut College.

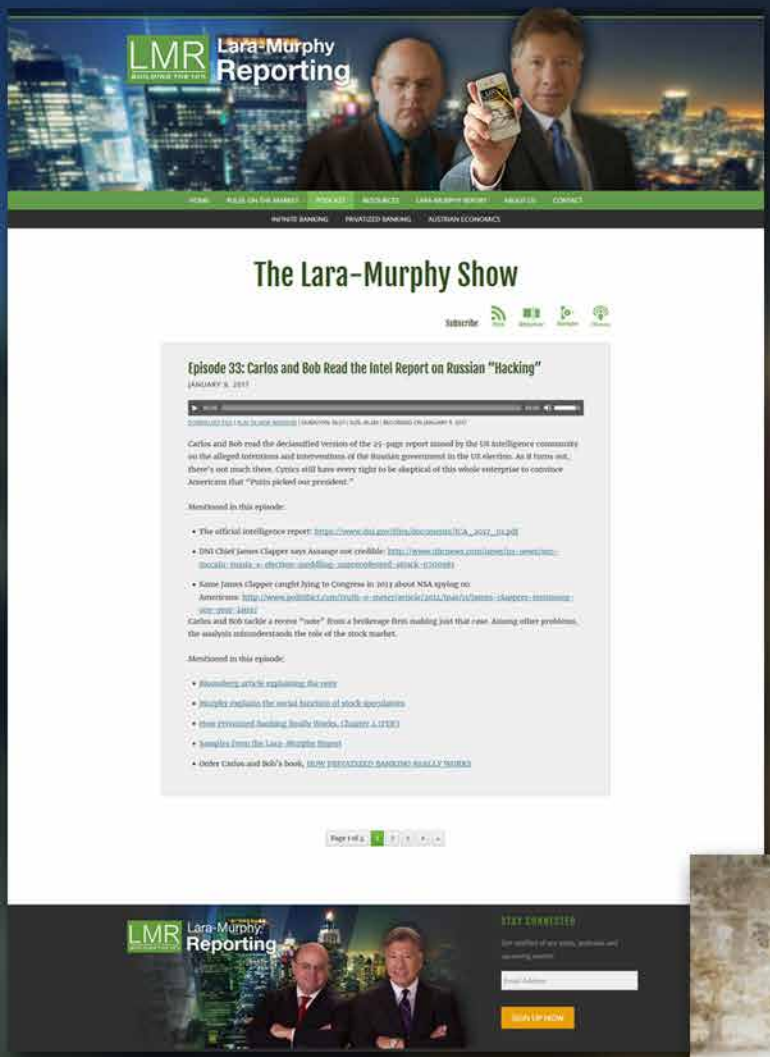
APRIL 29, 2019
LOCK HAVEN, PA

Murphy presents on free market health care at Lock Haven University.

MAY 10, 2019
NASHVILLE, TN

Nelson Nash Institute presents seminar on IBC and the business owner. Details at:
www.InfiniteBanking.org/BizOwner

SOME EVENTS MAY BE CLOSED TO GENERAL PUBLIC.
FOR MORE INFORMATION ON EVENTS CONTACT: RPM@CONSULTINGBYRPM.COM



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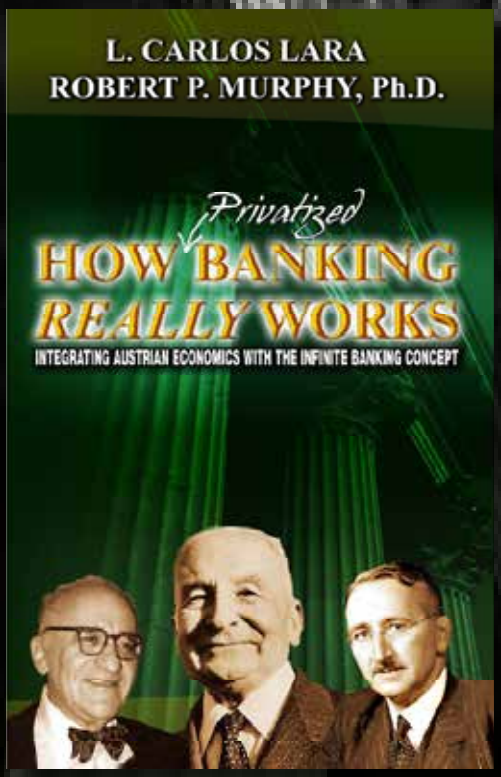

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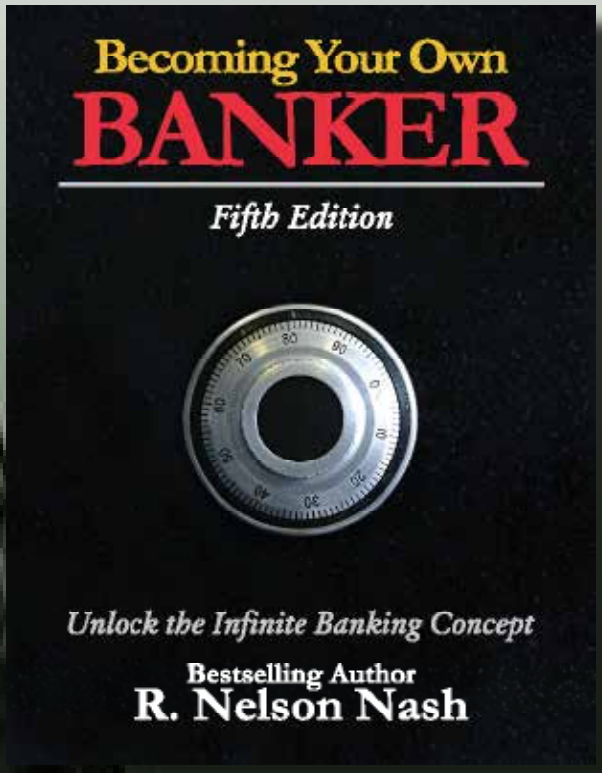

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