The Big Bailout

GRADE 12

Should taxpayers' money be used to save a collapsing business? In this lesson, students explore the pros and cons of government bailouts and develop a fundamental understanding of how borrowing and lending impact the overall economy.

Subject

BAT4M – Financial Accounting Principles
BDV4C – Entrepreneurship

Suggested Timing

70 minutes

Financial Literacy Objectives

At the end of this lesson, students will:

- use financial terminology fluently;
- compare the costs associated with various spending scenarios, including those with debt;
- analyze the correlations between income and factors such as education, economy, worker supply and demand;
- analyze the role of individual responsibility in saving;
- compare the advantages and disadvantages of various savings and investment vehicles for their own purposes.

Curriculum Expectations

Business Studies, Grades 11 and 12 (2006)
Entrepreneurship (BDV4C)

Venture Concept

- Summarize the factors that contribute to the success or failure of a new venture (e.g., adequacy of capitalization; management and risk-management skills; ability to adapt to changes in economic conditions; government policies).
- Analyze the conditions (e.g., competitive, regulatory, economic, social, technological) facing ventures starting up in various markets.

Financial Accounting Principles (BAT4M)

Financial Analysis and Decision Making

- Explain the characteristics of debt financing (e.g., bonds, notes payable, loans) and equity financing (e.g., sale of common or preferred shares) as methods of financing.
- Evaluate the role and impact of accounting information in decision making.

Assessment

Evaluate/take up questions to gauge student comprehension.

What You Need

- Plastic bailing pail or image
- The Big Bailout (Appendix A)
- Further Reflection Activity 1 (Appendix B)
- Further Reflection Activity 2 (Appendix C)

Minds On

Begin by holding up or showing an image of a bailing pan or pail to make an analogy between bailing out a sinking boat and bailing out a company that has become flooded and overwhelmed with debt.

Explain that the topic of the lesson will focus on government bailouts and that students will be examining the pros and cons of using public funds to rescue a business that is about to fail.

Prompt a discussion by asking students to provide examples of companies that have, in recent years, suffered financial difficulty or have had to close down (Nortel, Lehman Brothers, Sam the Record Man, local businesses in the community, etc.).

Provoking questions could include:

- What do you think is the cause of the financial difficulties experienced by many of the companies described?
- If your sister or brother had a business and he or she needed an infusion of cash to stay afloat, would you give it to him or her? What if he/she kept coming back for more? At what point would you say, “No”?

Context for Learning

Bill Fold is a character who is constantly getting himself into financial scrapes. Use the scenario below to provide students with a context for learning.

Bill Fold has set up a painting business and asks you if he can borrow some money to get things started. He already has five clients and things look promising. Since Bill seems to be a trustworthy, hard-working guy, you decide to lend him some money. A month into Bill’s summer painting business, he comes to tell you that the business is in financial distress. He has accidentally overspent on supplies. Are you willing to bail him out so he can try to get the business back on track? Under what circumstances would you decide to invest more money?

Action

Jigsaw

Create cooperative groups of 4-6 students.

Distribute "The Big Bailout" handout (Appendix A) and read it with the class. Pause when reading to explain key terms and to answer any questions students might have.

Assign a section of the "Big Bailout" reading to each cooperative group. Ask each group to re-read their assigned section together, this time writing down five key points and five key terms. Instruct groups to discuss and prepare a response to the thinking question in their section of the handout.

Designate a number for each group. Instruct the students to form new groups by getting together with others who have been assigned a number different from their own. Ensure that the newly formed groups include at least one expert from each section of the reading.

Instruct students that each expert should take about 2 minutes to explain to the members of their newly formed group the five key points and terms from their section of the reading. Next, have groups address all four discussion questions in the reading.

Consolidation/ Debrief

Whole Class Discussion

Discuss the questions below to check for understanding.

1. Is a bailout the same as a loan?
2. What terms are sometimes imposed upon companies receiving bailouts?
3. What spin-off effects do overspending and over-lending have on individuals, companies, and banks?
4. Why would the government choose to bail out a large company?
5. What are the pros and cons of giving and receiving a bailout?
6. What should be done to prevent such an economic crisis from happening again?

Flyswatter Terminology Quiz

Assign two students to come to a desk at the front of the room. Provide each with a flyswatter. Read aloud a vocabulary word from the handout. The first person who slaps the flyswatter on the desk and provides the correct definition of that word earns a point for their team. Continue the game until all of the vocabulary terms have been addressed (see Appendix A for a list of terms).

Homework

Assign students one of the Reflection questions (Appendix B or C). Take up and/or discuss as a class.

The Big Bailout

Section 1

Your friend Bill decides to set up a painting business for the summer. He doesn't have any customers yet but thinks it's a good idea to have some basic paint materials on hand in case someone calls him to do some work. To get set up, Bill needs money. He comes to you for help. He's a good guy and fairly reliable so you decide to lend him some cash from your savings account.

Question 1: How much money would you be willing to lend to Bill? What criteria would you use to make such a decision?

By lending Bill money, what you are actually doing is **financing** Bill's business with the hope that he will provide you with a **return on your investment (ROI)**. While you expect Bill to pay you back the **principal** (or the initial money that you loaned him), you could also choose to charge him **interest**. Interest is a form of income that a lender receives for loaning money.

These kinds of financial transactions happen all the time in North American business practices. The process is called **lending and borrowing**. It is common for banks to lend money to individuals in order to purchase homes, and it is common for banks to lend companies money to help provide the cash needed to run the business, pay for expenses, and expand the business.

Section 2

What happens when too much money is loaned out to people or businesses?

In Canada, but even more so in the United States, a trend developed in which banks began lending big companies larger and larger amounts of money. Many of the businesses could not afford to pay their expenses and were becoming increasingly reliant on banks to provide them with **bridge** financing.
Banks continued to lend money (banks are motivated to lend because they make money on interest from loans) with the expectation that the economy would turn around and the businesses would once again become **profitable** and able to repay its debts.

At the same time as banks were extending loans to businesses, banks and other financial institutions were also loaning more and more money to homeowners to help them buy properties. Consumers were permitted to buy homes with very little money down, and many bought homes with the expectation that this investment would go up in value. Many individuals rationalized holding high levels of debt to the banks for their properties in the form of **mortgages** by believing that the home could act as **collateral**. In other words, homeowners believed that if they needed to immediately pay back the money the bank had lent them, they could easily do so by selling their homes.

But guess what happened as this pattern of excessive lending and borrowing increased?

The Big Bailout

In 2008, a **recession** hit. A recession is a slowing of the economy. During this time, homes in certain parts of North America started to lose value. With companies closing down, people were losing jobs and some were no longer able to make their loan payments on the house they had purchased through the bank. This is often referred to as the **housing crisis**. When these individuals went to sell their homes out of necessity, they could no longer get anyone to buy the house (or condominium) at the purchase price they needed in order to pay back the amount they owed to the bank. In other words, because housing prices had dropped, these home owners owed the bank more money than their house could sell for on the open market. If they sold their house in that situation, they would not receive any profit from the sale; in fact, they would have to pay the bank a substantial amount of money to make up for the gap between the amount the bank had lent them originally and the amount received on the sale. This debt situation is sometimes referred to as being **"under water"**.

During this time, company profits continued to slow, and these same people were not buying as many cars or consumer products. Banks and investors were helping the companies stay afloat, hoping for that big turnaround in the economy. But as the engine of commerce slowed, even the banks and investors were running out of money.

Question 2: In your opinion, who should be held responsible for the housing crisis? Individuals, banks, other?

Section 3

Bankruptcy Explained

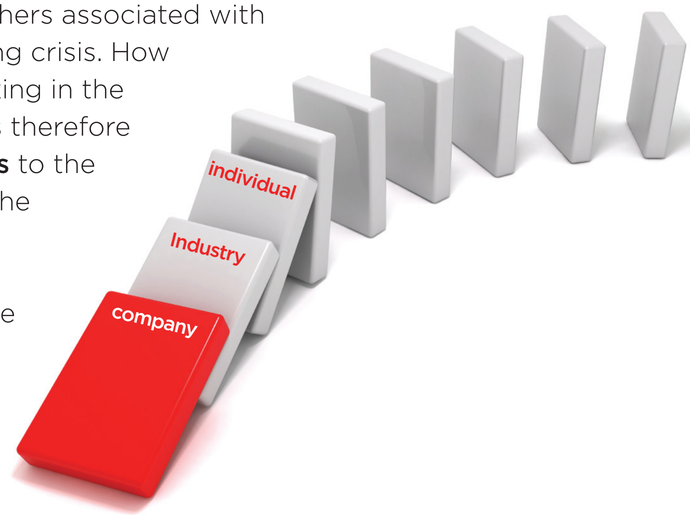
When companies or individuals cannot pay their bills, including the money borrowed, they enter what is called **bankruptcy**. Since a company cannot function without money, it must close.

For the first half of 2011, General Motors (GM) was reported as the world's largest auto maker, employing over 202,000 people in 158 facilities touching six continents. According to the Canadian Vehicle Manufacturers' Association (CVMA), the auto industry directly supports over 550,000 jobs across Canada in assembly plants, over 540 Other Equipment Manufacturers, 3949 dealerships, as well as other directly-related industries. The CVMA estimates that the auto sector directly and indirectly employs one out of every seven Canadians.

The auto industry is like a constellation. If a big company like GM were to close, think about all the ways this would affect those connected to or working for the business.

The Big Bailout

What would happen to all the car dealerships selling GM cars? What would happen to all the salespeople? What about the mechanics, and others associated with the auto industry? Job loss is closely related to the housing crisis. How so? These same individuals who no longer have jobs working in the automotive industry are no longer earning an income. It is therefore unlikely that they will be able to pay their **mortgage debts** to the bank or make purchases in the **marketplace**. As a result, the **economy** continues to slow down.



Question 3: Describe how business and individual debt are connected to each other and how excessive lending and borrowing can impact the overall economy.

Section 4

Bailouts Explained

One solution for companies that are in severe financial difficulty is to seek help in the form of a **bailout**. Private individuals and investment firms sometimes offer bailouts. In order to avoid the closure of large companies. The government will, in rare instances, decide to step in and provide the money (in the form of the public's tax dollars) needed to revive a dying company or bank.

A bailout is the act of giving or loaning **capital** (money) to an individual, company, or country that is in danger of failing. It is an attempt to save that failing entity from **insolvency**, which is another term for bankruptcy. In a bailout, money can be given without any expectation of it being paid back. This money can be given with **interest** or no interest payments. Stipulations can also be placed on the entity needing the bailout. The company receiving the capital (money) may have to limit **executive salaries** and **severance packages**; provide weekly reports on the company's finances; report any business transactions worth more than a designated amount; and extend **accounts-receivable** and **insurance coverage**.

In 2008, the federal and Ontario governments provided a $4-billion **bailout package** for the Canadian subsidiaries of the "Big Three" automakers. The terms of the package included renewable loans, interest at a rate of 5.3 percent, and the placement of a **lien** on some Chrysler and GM assets in Canada. A **lien** gives the loaning agent the right to take and hold or sell the property of a debtor should the company fail to re-pay the government. The two governments were also placed first in line for repayment of their loans.

Question 4: Why would the government give away or lend money to such high-risk entities? Is the government really losing money on this deal?

The Big Bailout

Although some people think of bailouts as giving money away, the consequences of not doing so could be catastrophic. The closure of some companies might mean financial disaster for millions of people—an amount greater than the bailout money given. How much money would citizens and society as a whole lose? How much would the government lose were a company to go bankrupt? Think of the government's lost tax revenues, assistance that would have to be paid to unemployed workers, etc.

Three reasons for a bailout:

1. For profit: One company purchases another at a cheap price.
2. For social improvement: A wealthy investor transforms a floundering company into something better for the good of society.
3. As a necessity: Bailing out a company for the greater good and security of society in general.

Discuss the following:

1. Is a bailout the same as a loan? Explain.
2. What terms are sometimes imposed upon companies receiving bailouts?
3. What spin-off effects do overspending and over-lending have on individuals, companies, and banks?
4. Why would the government choose to bail out a large company?
5. What are the pros and cons of giving and receiving a bailout?
6. What can be done to prevent such an economic crisis from happening again?

Vocabulary:

- Interest
- Principal
- Housing crisis
- Mortgage
- Collateral
- Recession
- Bankrupt
- Accounts
- Financing
- Capital
- Lending
- Cash flow
- Expense
- Bridge
- Bailout package
- ROI
- Insolvency
- Borrowing
- Lien
- Bailout
- Profitable
- Renewable loans

Sources:
http://www.gm.com/company/aboutGM/our_company.html
http://www.cvma.ca/

Further Reflection – Activity 1

One theory put forth to prevent a financial crisis is to allow the economy to take its course. No one interferes with any economic assistance. According to this position, failure makes one stronger, and having government agencies take care of individuals, companies, and banks does not allow for personal responsibility of one's condition. Explain why you agree or disagree with this theory.

Further Reflection – Activity 2

A **"seized credit market"** occurs when entities that lend money become afraid to do so and stop giving loans.

Think of what would happen if you didn't lend Wally money to begin his business. Explain how a seized credit market could be compared to the grease on the wheels of a car. Explain what the government might do to "grease the wheels" of the economy so that the credit market will start spinning again.