

Virtue In Action

Lack of Virtue Worsens Economic Decline

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FOSTERING CITIZENSHIP THROUGH CHARACTER EDUCATION



The long-term strength of our economy is greatly dependent on virtues such as responsibility, prudence, integrity and wisdom. In this issue, we will examine how a lack of these virtues in some key areas of our economy and government significantly worsened the present economic decline.



Did Lack of Virtue Contribute to The Economic Collapse?



It will no doubt be a sobering holiday for mother Maria Stephens and her four boys. The Virginia family very nearly spent it in a shelter after Stephens lost a high-paying job and then met with even more misfortune after not one, but two landlords were foreclosed on, leaving her family homeless. “I went from having my own bathroom to having to share a bathroom with five families,” Stephens told Reuters of her time in a homeless shelter before receiving assistance with a temporary home and a job, though less lucrative, working in a restaurant.

The Stephens are just one of many U.S. families who have been hurt – both directly and indirectly – by a declining economy beset by staggering job losses and declining home values. To put it in perspective, 1.2 million Americans have lost their jobs since the start of this year, and economists project an even bumpier road ahead with broad based declines in jobs, income and production. The bleak outlook may be most noticeable this holiday with economists predicting that 60% of consumers are planning on spending less this season, according to Deloitte’s 23rd Annual Holiday Survey of retail spending.

The decline of our **economy** is so severe that it became the dominant issue in the presidential election, even overshadowing the wars in Iraq and Afghanistan. You may be wondering: “what does the economy have to do with virtues in action?” Well the reality is that the long-term strength of our economy is greatly dependent on virtues such as **responsibility, prudence** and **wisdom**. Let’s examine how a lack of these virtues in some key areas of our economy and government significantly worsened the present economic decline.

It All Started With Housing

For most American families their largest asset is their home. This worked well for most families, especially from 2000 – 2006 when housing prices **appreciated** in many areas of America by 50 to 100%. But, since the peak in 2006, housing has actually declined in value by 15-20%. By itself, this would be bad for our economy, but not enough to generate the level of fear and general economic decline that we are now experiencing.

The decline in housing values became a much larger problem due to the intersection of five powerful forces:

- 1** A significant number of homeowners borrowed more money than they were able to pay back in buying their homes.
- 2** The government encouraged through incentives and demanded through legislation that banks and savings and loans provide more loans to high-risk borrowers, those with poor credit or lower personal savings.
- 3** Financial services firms (“Wall Street”) created and sold Mortgage Backed Securities that bring together thousands of homeowners’ mortgages into one security/ financial instrument. Too many of these mortgage securities contained high risk loans from “sub-prime” borrowers who couldn’t afford to pay back their loans.
- 4** Credit ratings agencies that assess the level of safety of securities gave too many mortgage securities “investment grade” ratings indicating that they were safe investments. In reality many of these securities turned out to be unsafe or “junk”.
- 5** Banks, other financial institutions and private investment funds called hedge funds bought many housing related securities with borrowed money, and thus were at great risk if housing values declined and homeowners stopped paying off their loans.

The Way it Used to Be

Historically, **aspiring** homeowners would save until they had 10 to 20% of a home’s value in savings (the “down payment”) and then go to a bank or savings and loan and borrow the remaining 90 to 80% of the home’s value. The money a homeowner borrows to buy a home is called a mortgage. These mortgage loans are normally paid off over a 10 -30 year period. Historically, banks kept a significant

portion of these loans on their own books, and accepted any losses from homeowners who didn't pay back their mortgage loans. So banks were generally conservative in determining whom they would lend to and for how much money. In most cases this approach to homeownership worked in that most homeowners didn't borrow more money than they could pay back, and banks didn't offer to lend money to borrowers who couldn't reasonably afford to pay off their mortgages.



Government and Wall Street – a Dangerous Partnership?

In 1977, the federal government enacted the Community Reinvestment Act, which required that banks and savings and loans institutions provide more loans to lower income individuals. Over time the government became more aggressive in enforcing this law. More importantly, since 1999 the federal government began pressuring two government sponsored enterprises, Fannie Mae and Freddie Mac, to buy higher risk loans from banks. The theory was that with Fannie and Freddie buying more of these loans, the banks wouldn't have to keep the risk of these loans, and they would then extend more loans to lower income borrowers.

It worked. Lower income families had greater access to loans and home ownership rates increased. The risk for these loans was assumed by Fannie or Freddie, by securities firms such as Bear Stearns and Lehman Brothers, and by private investors. The securities firms bought the loans, kept some of them as investments, and often packaged them together in mortgage securities and sold them to other investors.

With some of these mortgage securities, Fannie and Freddie even guaranteed their value for the investors. These guarantees were a powerful incentive for investors to buy mortgage securities since the US government established Fannie and Freddie and investors assumed that the US government would ultimately back these securities, which meant that if people couldn't pay back their loans on their home mortgages then the government would step in and cover the mortgage.”

Many mortgage securities not guaranteed by Fannie or Freddie were also deemed to be safe investments due to the actions of the credit ratings agencies. Recall that it is the job of these agencies to assess the safety of securities. The main ratings agencies, Standard and Poor and Moody's assigned investment grade ratings to many mortgage backed securities not guaranteed by Freddie or Fannie, which told investors that these securities were safe. It is interesting to note that the ratings agencies weren't paid for their work by investors, but by the securities firms creating the mortgage securities.

Government demands and incentives to lend more money to higher risk borrowers combined with Wall Street talent's creating and marketing mortgage securities, and finally investment grade ratings proved to be a dangerous combination. Banks and securities firms saw that they could earn significant commissions and investment profits, sometimes without having to assume any risk. And for those securities not guaranteed by Fannie or Freddie, they assumed that the amount of sub-prime loans in these securities was small enough that the securities as a whole would still be safe.

“Free” Money and the Loss of Virtue

Investors were so eager to buy these mortgage securities that banks and mortgage brokers had access to the money to offer mortgages to almost anyone with a job. This **perception** of free money laid the foundation for many dangerous attitudes and practices, and sadly undermined important virtues.

Many mortgage brokers and the banks they represented no longer asked for verification of sub-prime borrowers' income and told them to simply write on the application any amount they desired. This undermining of the basic virtue of **honesty** has today enacted a severe hit to the economy as we discovered how many borrowers are unable to pay back their mortgage loans. Some mortgage brokers and banks engaged in this type of dishonesty because they knew they could pass the risk to someone else and simply wanted to collect their commission for creating the loan.

In many other cases the problem wasn't a lack of honesty but rather a lack of **wisdom** and **prudence**. Many skilled professionals working at securities firms and banks assumed that housing prices would continue going up and so borrowers didn't need to have a down payment since the house would increase in value and would give the homeowner equity in their home. In the housing market, equity is the difference between what a home is worth and what the borrower owes. With the assumption that values would keep rising, banks and mortgage brokers offered borrowers “teaser rates” that were unusually low rates of interest for the first couple of years with the agreement that the interest rate on the loan would go up at a later date.

Many borrowers were able to afford the teaser rate, but not the higher rate the mortgage would eventually reset to. The borrowers, banks and investors in mortgage securities assumed that if home prices kept trending higher then when the interest rate reset at a higher level, the homeowner could simply take out another mortgage with another teaser rate and pay off the first mortgage. Eventually, the homeowner could sell the home for a higher price, pay off the mortgage and keep as profit the amount the home appreciated in value. As long as home prices kept going higher, everyone was making money.

The assumption that home prices would continue rising was reckless and unwise. Throughout America's history there have been many instances of home prices declining significantly in individual areas. Although the Wall Street analysts and investors making these assumptions were intelligent and skilled individuals, they did not use their skills effectively in deciding to ignore the long-term history of markets. Millions of individual homeowners also demonstrated a lack of wisdom in borrowing much more money than they could afford to pay back with the hope that increasing home values would bail them out.

When home values began falling, homeowners found that banks would no longer offer them new loans, and so they had to live with the terms of the original loan which meant paying much higher interest rates than they could afford. Millions of homeowners simply stopped making payments on their loans and the banks then foreclosed on them, taking possession of these homes and selling them to someone else. Across America today, 30-40% of all home sales are for values less than the amount owed by the homeowner to the bank. The human and financial costs are devastating. It is estimated that 1-2 million American families will likely lose their homes to foreclosure. For these families it is emotionally traumatic to be forced out of their homes. For the investors in mortgage securities the losses have been staggering. We won't know the full extent of the losses for many months but the banks and securities firms have already written off over \$900 billion in losses over the past year.

Losses can only become this great when a significant number of participants in an industry and our culture lose a sense of **prudence** in not thinking through the implications of their decisions. How many homeowners didn't give enough thought to the implications for their families of borrowing more money than they could afford to pay back? How many mortgage brokers offered these loans to people that they knew could only afford them if housing prices kept going higher? How many Wall Street professionals who created mortgage securities with too many risky loans still promoted them as being safe investments? And finally, how many of our elected representatives in Congress knew that the government through Fannie and Freddie should not have been assuming this much risk in the housing market? Have our elected representatives lived up to their **responsibility** to protect taxpayers' money from undue risk?

It is interesting to note that many of our elected representatives benefited from the campaign contributions from Freddie and Fannie. Elected representatives also had the incentive of wanting to be able to say to voters in their districts that they were working to make housing more affordable for people with low incomes. Although many parties had a hand in the present housing **debacle**, it is important to realize that some people working in government, Fannie and Freddie, and the Wall Street firms warned of the serious financial risks that would occur if housing prices declined. Unfortunately, these warnings were too easy to ignore as so much money was being made.

Jack McCabe, a real estate consultant spoke to the New York Times and summarized the housing boom and bust in this way: "The rocket has run out of fuel, and now it's plunged back down to earth." Many people in the industry and government honestly believed they would be right in assuming that housing values would continue increasing and didn't intend to cause harm; however, it was imprudent for the government and private industry to take on so much risk based on this assumption. Hopefully, private companies, the government, and we as individuals will learn from this experience and more fully dedicate ourselves to living out the virtues of prudence, wisdom and responsibility.

Vocabulary

Responsibility: accepting and meeting the demands of our duty in life, being accountable, pursuing excellence

Prudence: thinking through the implications of our actions and decisions.

Integrity: steadfast adherence to a moral or ethical code.

Wisdom: ability to apply knowledge, experience, understanding in ways that are effective and good. The ability to discern or judge what is true, right, or lasting

Appreciate: to raise in value or price, especially over time

Assess: to estimate or judge the value, character, etc., of

Aspiring: to long, aim, or seek ambitiously; be eagerly desirous, esp. for something great or of high value

Honesty: truthfulness, sincerity, or frankness

Perception: becoming aware of something via the senses
Debacle: a complete collapse or failure

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Lesson Goals

- Educate students as to the importance of prudence, responsibility and wisdom for our economy as a whole, and in making individual decisions.
- Educate students on some of the forces in the private sector and government that have caused the current economic crisis
- Educate students on the importance of economic policy and business for our nation as a whole, individual families and communities.
- Develop understanding that when government provides artificial incentives to the economy as a means of achieving positive goals, there are often unexpected outcomes and risks.
- Educate students on the economic and regulatory relationships that exist between government and the private sector.

Highlighted Virtues

Prudence: thinking through the implications of our actions and decisions.

Responsibility: accepting and meeting the demands of our duty in life, being accountable, pursuing excellence

Wisdom: ability to apply knowledge, experience, understanding in ways that are effective and good. The ability to discern or judge what is true, right, or lasting

Discussion Question Options

1. What are some of the economic statistics and stories that you have read about in this lesson, learned about in the news and through conversations that reflect the weakening of our economy?
2. Let's write on the board the primary factors that have contributed to the present weakness in the housing market and economy as a whole?

For each of these underlying factors let's discuss how they contributed to the present economic weakness, and specifically what virtues were lacking that enabled each of these factors to cause so much damage.





3. Many families now can't afford all the things they were previously able to purchase. Although this is clearly a negative if it means not being able to afford necessary goods and services, what positive virtues can come from less consumption and a lesser focus on material goods?
4. If called upon by our parents, how specifically can we help our families in saving money? Have you as a family talked about maybe scaling back your holiday purchases this year? If so, how?
5. How did elected politicians, Fannie and Freddie, and Wall Street firms mutually benefit each other? What virtues were lacking in these relationships?
6. Should the government provide incentives to the economy to achieve positive goals? If yes, what has the present situation taught is in terms of the degree of government regulation, if any, when the government does intervene in the economy?

Journal Writing

1. Write about how the poor state of the economy has affected your life? Are you or your family making changes in the way you spend and save? Explain what those changes are and the virtues that these changes require of you.
2. Write out your own personal guide on how you would like to approach this holiday season. Do you want to focus as much on material things, or focus on other values? Also, write about whether the weak state of the economy will affect your approach to the holidays

Extended Learning:

1. Organize students into teams, and based on what they have learned in this lesson and from their own knowledge, ask each team to perform a skit where they play out various scenarios that led to the present housing crisis.

Example Scenarios:

- a. Individual applying for a mortgage with a mortgage broker for much more money than they can afford. Both parties discuss it will work out if housing values continue to increase.
 - b. Securities firm executives discussing among themselves the profit opportunities and risks of creating mortgage securities containing risky loans.
 - c. US Senator out for dinner with a Fannie or Freddie executive discussing how they want that company to buy and guarantee more loans from low income borrowers. The discussion includes the benefits both sides would enjoy as well as the risk to the taxpayers.
 - d. Credit ratings agency analyst arguing with their boss on whether they should give an investment grade rating to a mortgage backed security that contains subprime loans.
2. U.S. food pantries are reporting record shortages as the holidays approach. Select a charity and have students bring in one canned good or perishable item for pick-up or delivery to the pantry of their choosing.

Internet Links:

“Family Homelessness Rising in the United States”: <http://www.reuters.com/article/newsOne/idUSTRE4AB18120081112?sp=true>

“Hard Times and Long Lines for Southern Californians”: <http://www.latimes.com/business/investing/la-me-foodbank23-2008nov23,0,4856689.story>

“Financial Crisis Threatens Holiday Shopping Season”: <http://www.foxnews.com/story/0,2933,432063,00.html>



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