

Teaching Notes

GREED, NEGLIGENCE, OR SYSTEM FAILURE?

Credit Rating Agencies and the Financial Crisis

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Credit rating agencies rank the credit-worthiness of a wide variety of investment opportunities. Moody's and others have been accused of massively understating the risk of the many complex financial products that may have sparked the financial meltdown of 2008. While the company's failure (out of greed or negligence) to properly assess the risk of these instruments is well-known, more encompassing systemic factors affecting financial markets were crucial to the crisis. Conflicts of interest, shifts in corporate culture, heightened competitive pressures, and lack of regulatory oversight created a perfect storm that enveloped Moody's and the entire economy.

This case examines the structure of the credit rating industry and its place in the financial system to shed light on the factors contributing to failures in the credit rating system, failures that helped bring about a global financial crisis.

The case text and teaching notes for this case were completed under the direction of Dr. Rebecca Dunning, the Kenan Institute for Ethics

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Teaching Notes

Target Audience

Organizational Studies
Organizational Ethics
Competitive Ethics
Sociology
Economics
Management
Public Policy Studies

Learning Objectives

1. Debate the merits of regulation and deregulation.
2. Explore the externalities, both positive and negative, that accompany corporate competition.
3. Examine the implications of shareholder capitalism for credit rating agencies and the financial system as a whole.

Discussion Questions

1. Topic: The merits of regulation in general.

How did the lessons learned from the Great Depression regarding the merits of regulation manifest themselves in the financial reforms of the 1930s? How have those reforms changed over the course of the century? How are the lessons learned from the Great Depression applicable to the Global Financial Crisis of 2008 and the financial regulatory overhauls emerging around the world today? In your opinion, is stringent regulation or deregulation more likely to produce a healthier economy over the long-term?

Notes for the instructor: Students can draw initially from information provided in the case study, and they may answer the questions in a variety of ways. For example, a student might talk about the merit of public opinion and how there are similar sentiments today, as there were in the 1930s, to punish Wall Street in the hopes teaching future fiscal responsibility. Or a student might answer with very specific economic examples: for instance, how increased leverage and stock market dependence can lead to capital shortages in a financial crunch. The discussion will likely evolve into a debate over the general merits and demerits of government economic regulation.

2. Topic: Wall Street and Accountability

“Accountability” refers to the obligation to explain, justify, and answer questions about how resources have been used and to what effect.¹

To who or what is Wall Street and the financial services industry accountable? To whom are credit rating agencies accountable? What tensions result when entities have different stakeholders to whom they are accountable?

¹ Trow, Martin. 1996. “Trust, Markets & Accountability in Higher Education: A Comparative Perspective.” *Research and Occasional Paper Series: CSHE.1.96*. University of California Berkeley: Center for Studies in Higher Education.

Notes for the instructor: Students can draw on information in the case to compare the differing stakeholders in the financial services industry, from lenders and investors to consumers and the general citizen (the latter of whom were subject to the harm of the global financial crisis, and thus arguably a stakeholder in the industry). Using this question the class can discuss the responsibilities and obligations that exist between government, business, and civil society, as well as the tensions that naturally result when stakeholder desires differ.

3. Topic: The externalities of corporate competition and shareholder capitalism.

“Externalities” refers to a cost or benefit not directly reflected in pricing. “Shareholder capitalism,” as discussed in the case, refers to the rise of the publicly traded corporation. Publicly traded corporations have become complicated nexuses of shared ownership and complex financial liability.²

What are some of the benefits of corporate competition that do not show up on a company’s balance sheet (i.e., that do not directly translate into profitability)? What are some of the costs of competition that cannot be accounted for in dollars? How has shareholder capitalism affected the way business competitors in the financial sector interact with each other? Are there any implications of this for institutions outside of the financial sector?

Notes for the instructor: Students can begin by tracing the evolution of the corporation in the financial sector as described in the case study while focusing on assessing the differences between the changing missions of corporations and the way corporations deal with competition. Ask the students to brainstorm other types of organizational structures and compare corporations to how those organizations deal with competition. For example, how are humanitarian-aid organizations different from for-profit corporations? How do non-profits and for-profit companies compete?

As an interesting aside that may be brought up during the discussion of this topic, philosopher Joseph Heath notes interesting differences in classical ethical theory and adversarial or competitive ethics. For example, some markets are institutions that are set up to directly reject classical ethical intuitions such as cooperation and altruism (much like competitive rules in sports).³ Some of the best players are the players who come closest to breaking the rules without actually breaking them/getting caught.

4. Topic: Incentive structures, motivation, and personal accountability in an organization.

Recall what Mark Froeba said about the evolution of Moody’s employees’ motivation over his 10-year stay at the firm:

“When I joined Moody’s in late 1997, an analyst’s worst fear was that he would contribute to the assignment of a rating that was wrong, damage Moody’s reputation for getting the answer right, and lose his job as a result. When I left Moody’s [in 2007], an analyst’s worst fear was that he would do something that would allow him to be singled out for jeopardizing Moody’s market share, for impairing Moody’s revenue or for damaging Moody’s relationships with its clients, and lose his job as a result.”⁴

² Davis, Gerald F. *Managed by the Markets: How Finance Re-Shaped America*. New York: Oxford UP, 2009. Print.

³ Heath, Joseph. 2007. “An Adversarial Ethic for Business: Or When Sun-Tzu Met the Stakeholder.” *Journal of Business Ethics* 72: 359-374.

⁴ “Testimony of Mark Froeba.” Testimony before The Financial Crisis Inquiry Commission. 2 June 2010. Report available at <http://www.fcic.law.stanford.edu/>

Note that the consistent motivation behind an analyst’s productivity is the fear that he might lose his job at any time. Is fear the most effective incentive to be productive? How did fear affect both the effectiveness of the analysts and their accountability to their organization? In your opinion, would providing motivation through different means have changed the outcome of the crisis at Moody’s?

Compensation structures on Wall Street have come under heavy political scrutiny since the financial crisis. Firms continue to give out seemingly outlandish bonuses to employees despite public protest. They defend the bonuses on the grounds that they help provide the proper incentive for talented individuals to stay with the same firm.⁵ What does this say about the motivation and accountability individuals have to improve their firm? What are the implications incentives like the large bonuses have on the identity of an individual or an organization?

Notes for the instructor: Some of these questions touch on issues not fully addressed in this case study, specifically the effect of incentives on an individual’s effectiveness within an organization. This provides an opportunity to discuss the relationship between incentives and employee motivation and employee identity. Some students may note that higher incentives may increase motivation because productivity is rewarded. Other students may note that cash incentives can negatively impact individual and organizational integrity and other less tangible sources of motivation.

It may help to include a discussion of *market* and *social norms*. “Market norms” refer to financial or market based incentives and “social norms” refer to social incentives (recognition, shared insights, etc).⁶

⁵ Dodge, Catherine. “Banning Big Wall Street Bonuses Favored by 70% of Americans.” *BusinessWeek*. 13 Dec. 2010. Web. 15 Dec. 2010. <http://www.businessweek.com/news/2010-12-13/banning-big-wall-street-bonuses-favored-by-70-of-americans.html>

⁶ For more material to enrich this discussion, see: Ariely, Dan. *Predictably Irrational: The Hidden Forces That Shape Our Decisions*. New York, NY: Harper, 2008. Print.