RESEARCH ARTICLE

The "Iron Cage" Turned Inside Out: Emerging Evidence of the Effects of "Reverse Legitimacy" on Six Major Banks in the US (1999 to 2007) – A Case Study

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The "Iron Cage" Turned Inside Out: Emerging Evidence of the Effects of "Reverse Legitimacy" on Six Major Banks in the US (1999 to 2007) – A Case Study

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Abstract

This case study offers an insider's account of financial industry developments from 1999 to 2007 as emerging evidence of the global contagion of a mind-set and the effects of "reverse legitimacy", or undue influence of powerful financial firms embracing this mind-set, upon societal institutions. The study seeks to explain why, despite clear indications that housing prices had inflated over the first decade of the millennium, that the expansion of credit had exploded, and that financial models on Wall Street – which are by definition, mathematical simplifications of real-world complexities that assume "normal" market conditions and thus do not factor for speculative bubbles or unexpected shocks to the system – financial and regulatory institutions remained confident that everything was basically under control. Loan data are provided as emerging evidence of conformity in industry behavior. Selected excerpts from letters to shareholders in the 2007 annual reports of six major banks are presented as partial evidence of cognitive impairment in organizational thinking in the years leading up to the banks' financial collapse in 2008.

Keywords: New institutional theory; enactment; cultural hegemony; global financial crisis; mortgage banking.

"…we still believe that subprime mortgages are a good product…During the latter part of 2007, we set out to increase our home lending market share and have, so far, succeeded. By the end of the fourth quarter of 2007, our share had grown to 11% from 6% a year earlier. As a result of our liquidity and capital strength, we were able to underwrite these loans when others could not. Although we may pay for probably starting this expansion a little too early, we remain committed to the goal."

- Jamie Diamond, CEO of JP Morgan Chase, 2007 Annual Letter to Shareholders

"We did eat our own cooking, and we choked on it."

- John Mack, the CEO of Morgan Stanley, reflecting upon the growth of mortgage-related securities in his January 13, 2010 testimony to Congress

This case study offers an insider's account of financial industry and regulatory behaviors from 1999 to 2007 as emerging evidence of the effects of "reverse legitimacy" [1] p. 28, or undue influence of powerful organizations upon societal institutions.

The study frames the recent (2007-2008) global financial crisis as primarily a failure of institutions, spurred by the confluence of two trends: a) the self-interested embrace of a mind-set, Weltanschauung or "World View," (or "mania," [2] p. 173, in the infallibility of quantitative finance and the benefits of taking greater financial risk by the national elite of Wall Street and corporate business interests during in the early part of the first decade of the millennium, and b) the relatively newfound political power of this elite – due to the accumulation of wealth

on Wall Street and the dominance of the financial sector in America's economy – to unduly influence governmental and regulatory bodies, which helped drive the contagion of free market ideology in the global financial system (which, ironically, resulted in a socialist-like nationalization of the U.S. banking system in the later years of this same decade).

The study seeks to explain why, despite clear indications that housing prices had inflated over the first decade of the millennium, that the expansion of credit had exploded, and that financial models – which are by definition, mathematical simplifications of real-world complexities that assume "normal" market conditions and thus do not factor for speculative bubbles or unexpected shocks to the system – financial regulatory institutions remained confident that a) credit risk models were accurately pricing risk, based on time-tested geographic diversification factors and time-proven inverse correlations among different asset types and investment vehicles; b) credit agencies were accurately rating the tranches of the securitized credit structures, based on the cash-flow-waterfall-based protection of senior layers and historical default rates; c) risk transfer mechanisms such as credit default swaps and traditional forms of bond insurance were effectively reducing counter-party exposure to firms; and that d) position capture and limits management systems had sufficient look-through capabilities and transparency to identify, aggregate, and manage concentration risk and identify any serious interdependencies to other financial institutions or third parties.

1. Introduction

Consistent with the capital asset pricing model [3] that greater investment risks are correlated with greater expected returns, the prevailing mind-set on Wall Street during this time held that taking and managing greater amounts of risk were essential to satisfy institutional investor demand for greater returns. Capital in the new, hyper-competitive global economy was believed to be forever abundant and cheap; efficiency ruled (meaning low prices, low inflation, and thus low interest rates) were here to stay; and that innovation and the creative use of leverage – in the burgeoning fields of securitized products, leveraged finance, and structured products – were the key strategies to earn higher returns to meet the demands from institutional investors worldwide. Sophisticated quantitative financial models employing longitudinal data sets of time-tested/historically-proven correlations of asset classes, geographic diversification factors for real estate markets, and delinquency and default rates going back 30 years or more (largely boom times for the industry), were used to measure and price risk and return. To help manage these increased risks, the industry developed new types of financial contracts to price and transfer the credit risk exposure – and in the case of total rate and return swaps – market risk exposure as well, of underlying assets to counterparties. Sophisticated trade/position capture, netting and limits management systems were developed to provide look-through transparency for management to identify, aggregate/measure and manage concentration risk and identify dependencies or vulnerabilities to counterparties.

1.1 Reverse legitimacy

Building upon neo-institutional theory and the concept of "reverse legitimacy," the study proposes that regulatory institutions – instead of exercising prudence, fiduciary care and due diligence in their governance role to ensure the safety and soundness of the financial system on the behalf of the collective – acquiesced and adopted the mind-set and prevailing practices on Wall Street, in the regulators' desire to be perceived as enabling or creating the institutional construct that made possible or contributed to industry success in the 2000s [4]. In other words, institutions responsible for serving the public interest became increasingly aligned with the private interests and ideology of the powerful elite. In this new scheme of reverse legitimization, wealth generating/maximizing opportunities from taking greater risks by the few trumped the safety, soundness and transparency for the many, and hence resulting in the failure of these institutions to govern.

The study takes the inductive approach to theory using a case study with proposition definition and validation [5]. It is divided into five parts. The first section reviews the current body of literature on new or neo-institutional theory in the context of the recent global financial crisis, and sets forth three propositions. Secondly, the methodology section describes the process by which quarterly data on mortgages and loans, net of loss reserves, of the six major banks, as well as on housing prices, were sourced. Thirdly, a case study presents an insider's account of industry and regulatory developments, and examines the conformity of behavior of six of America's largest banks in the first decade of the millennium (1999 to 2007). This section also includes selected excerpts of the 2007 letter to shareholders, which were written by the executive leadership teams of the six banks

and published in early 2008, to illustrate conformity of view and impaired cognitive organizational reorientation – 2007 being the year in which five of the six banks continued to grow their mortgage and loan portfolios, despite overwhelming evidence of a downturn in market conditions. The fourth section discusses results to illustrate each of the three propositions, and lastly the fifth section discusses limitations and implications for future research.

1.2 Institutional theory

This study draws upon the recent developments in new or neo-institutional theory [6-9], in general, and the concept of "reverse legitimacy," specifically, as a unifying framework to understand the many complex underlying causes of the 2007-2008 global financial crises. This concept challenges the traditional view of institutions' granting of legitimacy – or appropriateness relative to the prevailing socially-constructed values, beliefs and norms – upon organizational practices, conventions, standards, structures or routines. Riaz [1] argues that the classic concept of organizations passively interacting with institutions' attempt to impose their constraints on organizations, organizations are busy twisting the iron cage inside-out over the institutions, i.e., determining through their actions which institutions survive and succeed in their domains" (p. 28).

Riaz [1] borrows the term "iron cage" from the institutional isomorphism propounded by DiMaggio and Powell [10], a reference to the rule-like norms that institutions bestow upon organizational structures and practices. DiMaggio and Powell [10] were in turn alluding to Weber's [11] imagery of the "iron cage" of rationality, his operating construct for the management and structure of modern-day formal industrial organization: bureaucracies are inherently bound, are organized, and operate according to the rigor of rational and normative rules. Riaz [1] cites as prime examples of such reverse legitimacy the implicit support provided by the Securities and Exchange Commission regarding organizations that were responsible for creating, securitizing, insuring and rating mortgage-backed securities, along with the Federal Reserve, in pursing an expansionist monetary policy.

In their own review of the body of academic research on the underlying causes of the recent global financial crisis, Hudson and Maioli [4] echo the culpability of the state in its causal role in the global financial meltdown, citing Aalbers [12] on the government's enablement of mortgage securitization and sub-prime lending, and Gotham [13] on the federal government's allowing lenders to securitize their portfolio holdings and use off-balance sheet vehicles to increase financial leverage. As per Hudson and Maioli [4], "…the U.S. state was at the origins of the crisis." (p. 54).

1.3 New institutional theory

In applying the concept of reverse-legitimacy, Riaz [1] draws upon neo-institutional theories [6], which take a more atomistic and Darwinian view of institutional actors and their interplay with organizations. Instead of faceless forces that define, embody and reflect the social order – including conventions, standards, expected behaviors, knowledge and culture of a society – institutions are viewed instead as loose confederations of self-interested actors operating both inside and outside the system to manipulate the rules or social norms to gain a disproportional share of resources or power. Other schools of neo-institutional theory [14] have tackled this same issue, known as the "paradox of embedded agency" (p. 226), by which self-motivated agents embedded within institutions to embody and enforce the status quo nonetheless attempt to change the rules to promote their own self interests. This view – of agency and power relations as multi-level social processes working across different levels of a system – helps explain how institutions evolve over time, despite their purported, definitional role in controlling or conditioning the collective intentions and actions of all actors and organizations within a given system [14]. Jepperson [9] terms this evolutionary process as the cycle of institutional formation, institutional development, de-institutionalism and re-institutionalization.

1.4 The rise of financialization

So how did governmental bodies and regulatory institutions become so infatuated with the success of, and beholden to, Wall Street and the financial industry? The macro-economic and cultural trend called "financialization," defined as "…a process whereby financial services, broadly construed, take over the dominant economic, cultural, and political role in a national economy," Phillips [15] (p. 268) suggests that financial speculation on global economic activities and developments – instead of the actual production of goods and services in the domestic economy – became a key preoccupation and source of wealth for America's best and brightest.

In this view, as the financial sector grew in economic, social and political significance in the 2000s, government policy makers increasingly embraced free market ideology (belief that markets are generally efficient and self-correcting) and the benefits of financial de-regulation, lowering capital requirements for financial institutions in the name of advancing their global competitiveness [4, 16]. Similarly, Yeoh [17] observes that during the 2000s, the political elite in Washington seemed mesmerized by Wall Street's success, and the unquestioned faith in, and glorification of, quantitative finance and the efficacy of financial models (which, by definition, oversimplify reality and do not factor for speculative bubbles or unexpected shocks to the system).

As do Hudson and Maioli [4], Tarr [18] also cites institutional factors – political, regulatory and governmental – that were responsible for the global financial crisis. Tarr [18] provides as two prime examples: Congress's decision to allow Fannie Mae and Freddie Mac to bypass conventional bank regulatory oversight, and the Administration's change to the enforcement of the Community Reinvestment Act that effectively encouraged banks to lower their mortgage underwriting standards to increase home ownership rates in low-income neighborhoods – both decisions that had systemic spill-over effects to other sectors of the real estate market.

Returning to Riaz [1], the formal and informal organization-institutional interplay of Wall Street and governing institutions helped disseminate American financial practices via a "contagion of legitimacy" (p. 27) [19] to major financial centers around the world. Stein [2] also examined the "…broader cultural changes that created the conditions for the credit crisis of 2008" (p. 173), noting that culture of mania – engendered by the decades-long triumph of capitalism over communism – set the stage for denial, omnipotence, triumphalism; and over-activity that resulted in the global financial crisis.

Thus, despite the inherent risk of new, unproved and often overtly complex and opaque products, regulators, examiners and internal control functions were unable or unwilling to challenge the soundness of these initiatives, as they already had been bestowed legitimacy and acceptability by governing institutions, and were already established as industry norms.

The first proposition is that reverse institutional legitimacy is positively associated with conformity in, and standardization of, business practices, as the legitimacy is based on initial market success, not on institutional governance or other normative criteria. Proposition one suggests that when regulatory institutions permissively endorse industry practices in seeking the "halo" of their success, the initial market acceptance of these strategies or products drive isomorphic conformity of behaviors as they become industry norms.

P1: "Reverse legitimacy" is initially positively associated with increased conformity of business practices.

In their explanation and description of the current political system of the U.S. as an oligarchy, Winters and Page [20] found that the sheer concentration of wealth of America's super rich relative to the rest of society provides this select group both the capacity and the motivations to exert undue influence to dominate domestic policy in key areas, even though they do not literally hold political office and/or openly engage in politics. The emergence of America as an "advanced oligarchy" [21] p. 4, "winner take all" political and economic system [22] p. 3, and rise of the "new upper class" [23] p. 19, argue that a new ruling class of inherited intelligence has effectively replaced the old white Anglo Saxon protestant (WASP) elite of inherited wealth.

As Murray [23] observes, high-achievers tend to marry one another, live in the same neighbors, and form relationship and social networks with each other. Consistent with social network analysis and theory of embeddedness [24], members of the new ruling class share their own personal contacts with others to expand their social networks, in which business and economic activity takes place.

1.6 Cultural hegemony

The embrace of financialization by the broader American social and political system is also consistent with the classic philosophic and sociological theory of "cultural hegemony" by Marxist philosopher Antonio Gramsci [25]. In his writings from the 1930s, Gramsci [25] argued that a ruling class can dominate a very socially and culturally diverse society by imposing its worldview as a societal norm, thus influencing and manipulating shared beliefs, explanations, perceptions, values of the collective. While the worldview held by the ruling class is believed by most as universally beneficial and equitable philosophy for all (in the context of the first decade of the 2000s, unshakable belief in the benefits of de-regulation, free trade, globalization, financial innovation, lower tax rates, and laissez-faire capitalism), this worldview operates primarily to the benefit of the ruling class. Consistent with this theme of an elite class creating a socially-constructed reality out of economic self-interest, the housing bubble

was enacted by a powerful elite to represent the inevitable outcome of a buoyant, relentless, consumption-driven global economy, albeit driven by cheap debt [26] – just as the dot.com bubble in the previous decade was at first widely believed as the emergence of the New Economy, offering the promise of near-frictionless e-commerce of unmatched price discovery, cost transparency, efficiency and customer accountability via the Internet – and, in the eyes of many Wall Street research analysts, rendering fundamental measures such as cash flow and positive earnings irrelevant to the assessment of business models and fairness of their market valuations for investors [26].

In this view, given the extreme polarization and concentration of wealth and power among the super-rich today, legitimacy-granting has been co-opted by a national elite or ruling class, by which wealth generation for the relative few trumps safety, soundness and transparency for the collective. This view suggests that the balance of power between organizations and institutions may be even more asymmetrical than Riaz [1] suggests, with organizations representing very powerful self-interested actors [organizations, while embedded in institutional environments, also help shape or define the institutional environment], and institutions critically dependent upon these organizations for their survival. In other words, institutions want and need approval and acceptance by the ruling class, largely by exposing and adhering to their prevailing values. Thus, the second proposition is that concentration of representation of the members of the super-rich or national elite within a given regulated industry is positively associated with reverse legitimacy, as regulatory institutions acquiesce to industry practices, in the regulators' self-interest to be regarded as successful, innovative, globally competitive, and/or aligned with the prevailing philosophy of this ruling class.

P2: Increased concentration of national elite within a regulated industry is positively associated with increased "reverse legitimacy".

The study's third proposition is that there is a negative relationship of mimetic behavior or institutional peer pressure with organizational ability to recognize and adapt to changes in the environment.

In the classic view of institutional theory [27], organizations are inherently social systems which adopt institutional processes that create both structural and cognitive constraints, defining not only organizational structure but the organizational members' way of thinking. As such, government, regulatory institutions and mass media legitimize practices as cultural rules, and the pressure to conform ensues, be they though a) coercion such as laws or government regulations, b) institutional peer pressure via imitation or mimetic borrowing, or c) normative influence through professionally-imposed standards of behavior. The consequences of such isomorphism are that organizations assume practices that, while widely accepted, are not necessarily productive or efficient (or even profitable, as was the case). These norms can take on mythical, instantiated rationality, grow in importance and become so elaborate that they ultimately impede an organizations' ability to overcome socially constructed realities.

Likewise, DiMaggio and Powell [10] propounded cognitive and cultural explanations for homogeneity in institutional practices and organizational routines. Supporting this view in the context of the recent global financial crisis is Haiss [28], who analogized the herding behavior of banks as a funnel-shape myopic narrowing of the scope of the banks' decision making capabilities. In his 2001 study, which begins with the classic question, "Why do good bankers sometimes respond with the same disastrous strategies?" (p. 30) Haiss [28] attributes the uncritical adoption of industry practices and innovations (as well as inconsistent decision rules, rigid bank regulations, short-term stakeholder-focused incentive structures) as key factors that result in sub-optimal decision making. Likewise, behavioral cognitive processes such as "sense-making," or the process by which people give meaning to experience [29], and "sense-giving" or "…process of attempting to influence the sense-making and meaning construction of others toward a preferred redefinition of organizational reality" [30] p. 442, have been established as critical factors that affect the probability and scope of strategic change in the face of crisis, changing or ambiguous situations.

The third proposition is that herding mentality resulting from the isomorphic pressure to conform to legitimized practices inhibits organizational adaptive learning and cognitive reorientation.

P3: Continued conformity of legitimized behavior is positively associated with increased impaired cognitive reorientation and organizational learning.

2. Methods

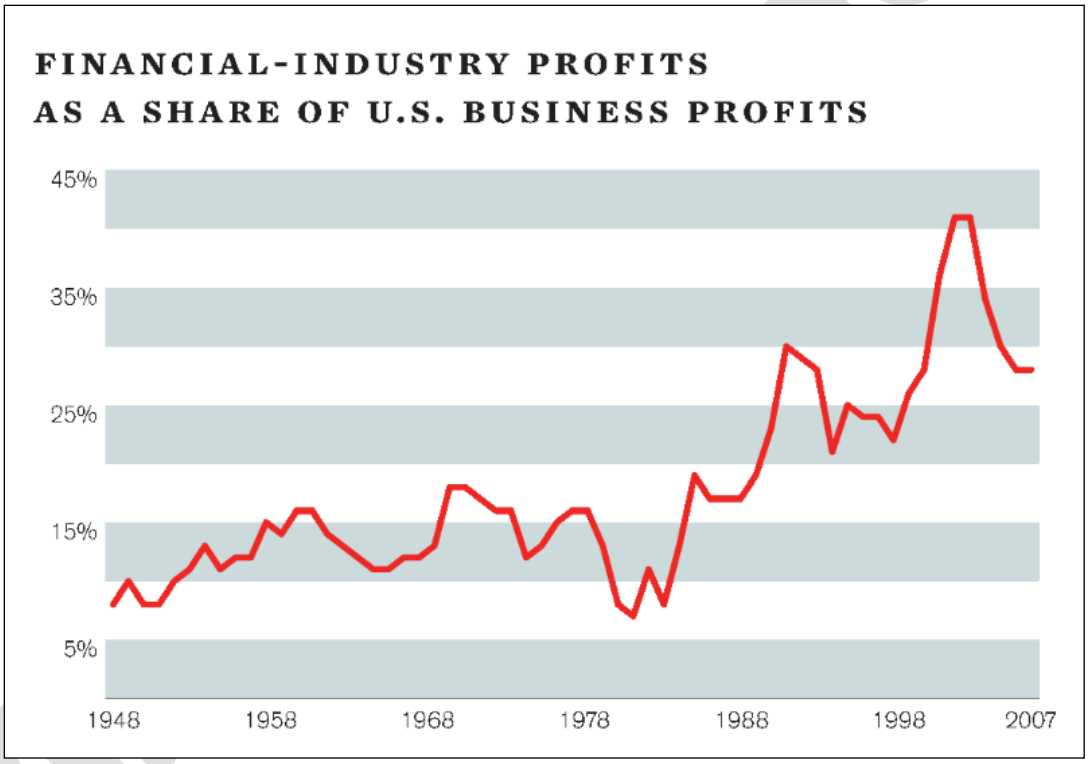
Mortgage and loan balances, net of loss reserves, for the six banks were sourced from publicly-available financial data filed with the Securities Exchange Commission (form 10-K's) and analyzed using IBM's PASW v18. Housing prices were sourced from the Federal Housing Finance Agency's Housing Price Index.

Letters to shareholders by the CEOs of the six banks published in their respective 2007 annual reports were content analyzed for evidence of enactment and impairment of cognitive reorientation and adaptive organizational learning.

3. Results and Discussion

In the past few decades, America's financial services industry has generated an increasing share of corporate profits in the U.S. From 1973 to 1985, the financial services industry represented no more than 16 percent of corporate profits in the U.S. But in 1986, that figure surged to 19 percent, and by the 1990s, the sector's share of domestic profits ranged between 20 and 30 percent: the highest it had ever been since WW II. In the 2000s, it surged to over 40 percent, as shown in Figure 1.

Figure 1: Financial industry profits as a percent of U.S. corporate profits (1948-2007).



Source: International Monetary Fund. http://www.clashofcurrencies.org/2011/06/25/the-triffin-dilemma

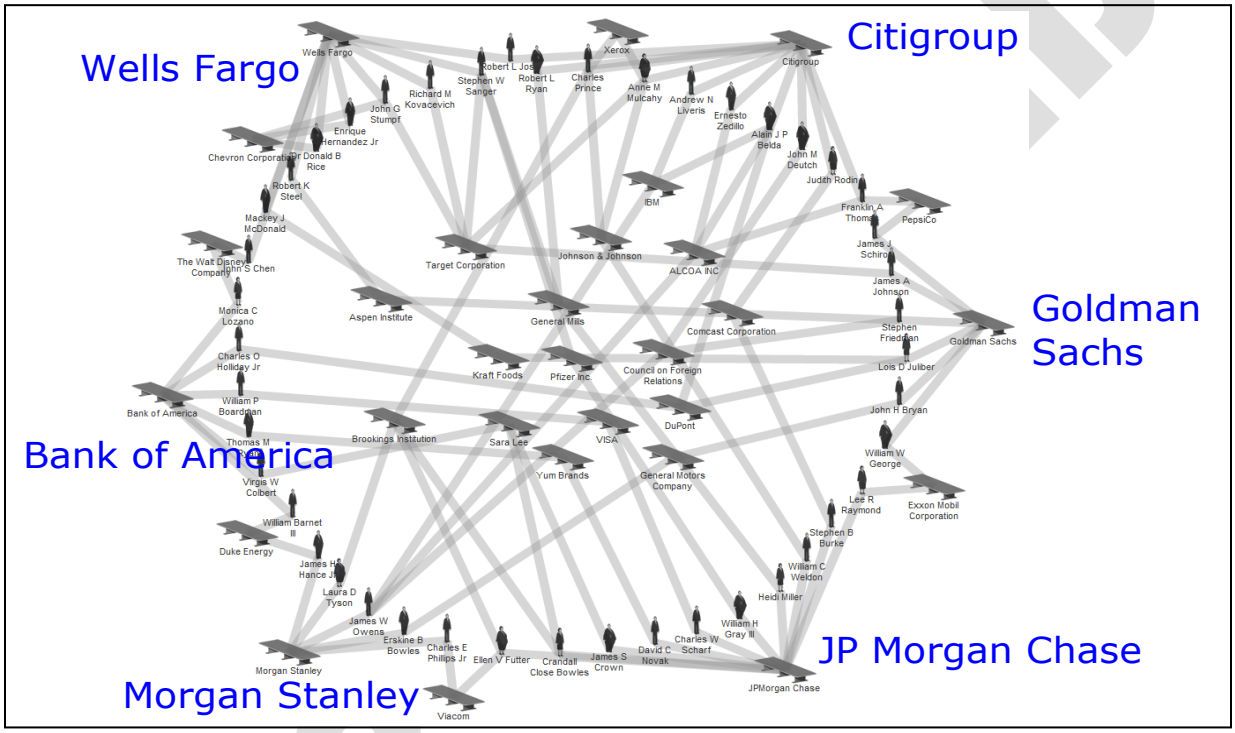
3.1 The rise of the Wall Street ruling class

In the 2000s, as the financial services share of total U.S. corporate profits increased to over 40 percent, Wall Street's economic, political and social influence grew, mortgage and loan volume grew substantially, reflecting de-regulation, lower capital requirements, and growing demand for underlying securities for mortgage-backed credit structures. Wall Street's political influence grew through social and business networking – most visibility via the revolving door of Wall Street executives who moved back and forth in key government and regulatory roles: Henry Paulson, Timothy Geithner, Peter Orszag, Robert Rubin, and Mark Patterson. Patterson's story is particularly emblematic of the phenomenon. Prior to serving as chief of staff to Treasury Secretary Geithner in 2009, Patterson had left as policy director for Senator Tom Daschle to become a vice president at Goldman Sachs in 2004 after

marrying Jennifer Leete, an attorney in the enforcement division of the Securities and Exchange Commission the year before.

Figure 2 provides a real-world example of what such a corporate peer network of national elites looks like: it depicts the personal and professional connections of board members of six major Wall Street banks (Bank of America, Citigroup, Goldman Sachs, Morgan Stanley, J.P. Morgan and Wells Fargo) with those from 23 major corporations and institutions: Chevron, Walt Disney, Aspen Institute, Target, Brookings Institute, Sara Lee, Duke Energy, Viacom, Yum Brands, General Motors, DuPont, VISA, Exxon, Comcast, General Mills, Pfizer, Council on Foreign Relations, Johnson & Johnson, Alcoa, IBM, Xerox, PepsiCo and Kraft Foods.

Figure 2: Corporate peer network map of banking executives.



Source: "Too Big to Fail Banks", posted on theyrule.com 8/12/2011: http://www.theyrule.net

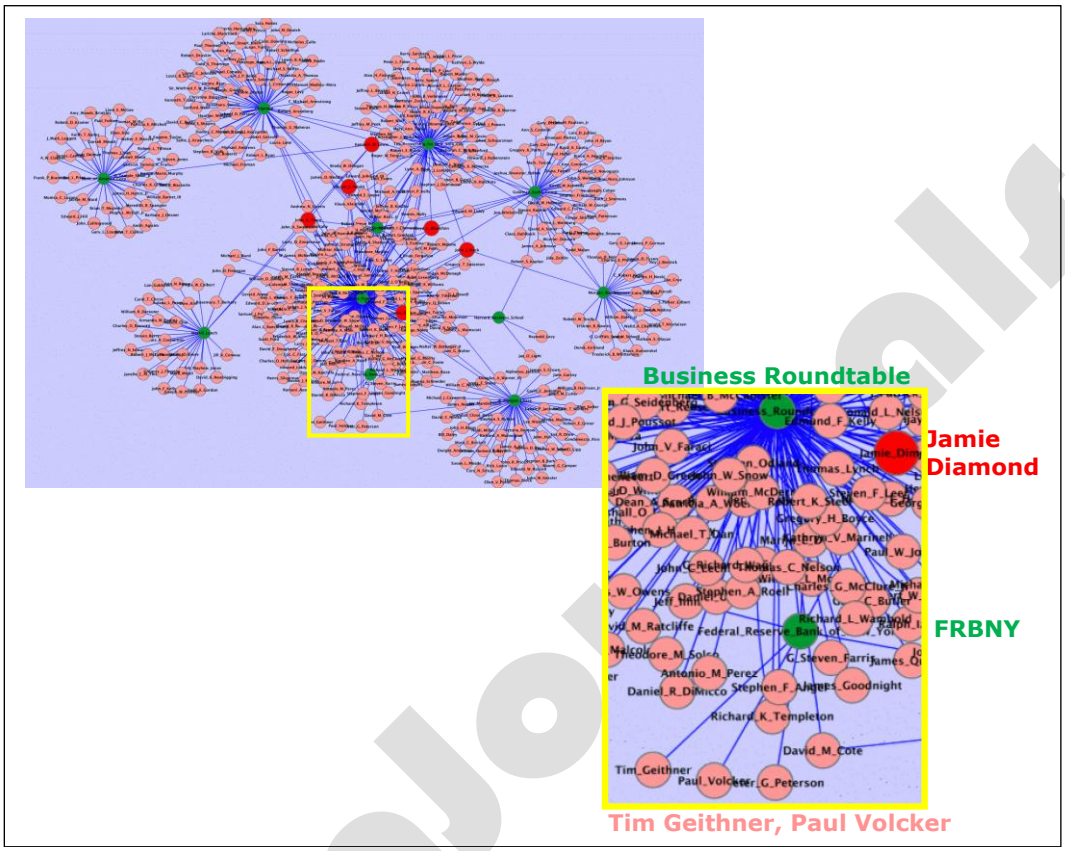
Figure 3 provides real-world but partial example of what such a social network of Wall Street executives to social and regulatory institutions. The map depicts social connections and relationships of the executives of Bank of America, Citigroup, Goldman Sachs, Morgan Stanley, J.P. Morgan and Merrill Lynch with social and banking institutions Partnership for New York City, Business Roundtable, Harvard Business School and the Federal Reserve Bank. Relationships are represented by the connecting lines in blue; nodes of banks and social institutions are colored green; CEOs are in red; the other colored dots represent members of executive teams. Insert shows exploded detail of the relationships between the Business Roundtable (green dot on the top of the insert); with Jamie Diamond, CEO of JP Morgan Chase (red dot on the right); with the Federal Reserve Bank of New York (green dot in the middle); and with Tim Geithner and Paul Volcker (pink dots on the bottom).

3.3 The industry-wide search for yield and mandate to grow

The first three years of the new millennium brought the dot.com bubble crash, the 9-11-2001 terrorist attack, and the War in Iraq. But for Wall Street, the long-term economic forecast looked promising. Despite these shocks to the system, the U.S. economy proved amazingly resilient. At last, it seemed, the market efficiency of the global economy, and the lessons learned from past, were paying off: the boom and bust extremes of the traditional

business cycle, along with double-digit inflation and interest rates, were now things of the past. The business cycle had been tamed, and the "New Economy" of the dot.com craze had returned to solid fundamentals.

Figure 3: Inter-industry social network map of Wall Street executives.



Source: "Graphing Wall Street with LittleSis.org" by Erich, 3/1/2009. How We Know Us.
http://www.howweknowus.com/2009/03/01/graphing-wall-street-with-littlesisorg

The Federal Reserve Bank, under the free market ideology and leadership of Alan Greenspan, appeared to have inflation and interest rates under control, and seemed posed to step in and fine-tune monetary policy if and when the laws of supply and demand got out of equilibrium. On the global stage, the spread of free-market capitalism appeared unstoppable.

For financial institutions competing in this new low-interest rate environment, expansion of credit and creation of innovative, financially-engineered products to enhance yields for institutional investors were key strategies to achieve competitive advantage. Institutional investors wanted higher yielding products to fund pension liabilities and boost their investment portfolio performances. In search for greater returns, many asset managers, particularly those serving educational endowment funds at the most prestigious universities, began increasing their allocations to alternative investments and private equity funds. In the fixed income market, hedge funds gained prominence by locking in small differentials in market pricing, rating, maturity or currency, and using vast amounts of relatively inexpensive leverage to boost returns. In the equity markets, hedge funds launched many long-short funds, which also often used leverage to enhance performance.

Wall Street's focus turned to financial engineering and automated trading. Innovative, off-balance-sheet accounting treatments using special purpose vehicles helped corporations enhance their earnings without impairing the perceived quality of their balance sheets. The growing sophistication of modeling software and increasing capacity and power of high-speed data distribution networks ushered in the age of high frequency trading. Traders used these advanced computational infrastructures to identify and exploit small and temporary

(sometimes only a fraction of a second) pricing anomalies within and across different asset classes (equities, fixed income, futures, options, currencies) – based on algorithms that mathematically described these pricing relationships and predicted their outcomes based on time-tested historical patterns.

New financial instruments, such as structured products that often used complex contracts called derivatives, were designed around the specific needs of clients. Just as it had improved upon the consumer savings bank account with the higher yielding money market fund, the employee defined benefit plan with the generally superior performing defined contribution plan, commercial bank lines of credit for short-term borrowing with generally cheaper and more flexible commercial paper financing, the financial services industry seemed once again to be introducing a new generation of products and services to better serve the needs of its clients.

In Washington, there appeared an emerging pride and political awareness that the financial services sector was becoming an increasingly important component of America's service-based economy, a critical source of job growth for "knowledge workers," and a strategic component of national competitive advantage. In support of the mandate for credit expansion to accommodate economic growth, Fannie Mae and Freddie Mac started buying large numbers of subprime loans from banks, as well as packages of mortgages known as mortgage-backed securities, helping fuel the originate-to-distribute asset securitization model in the mortgage banking industry.

As the initial success of innovations such as credit mortgage obligations were legitimatized by regulators and accepted as industry norms, the six major banks experienced mimetic growth of mortgage and loan volume, net of loss reserves, of six major banks, from 1999 to 2007. From first quarter of 1999 to year end 2009, Goldman Sachs grew its mortgage and loan portfolio, net of loss reserves by 519%, Wells Fargo by 256%, Citigroup by 236%, JP Morgan Chase by 166%, Bank of America by 141% and Morgan Stanley by 132%. Table 1 shows statistically significant correlation at the 0.01 level in a two-tailed test[1] in quarterly loan growth for all six institutions.

Table 1: Pearson product movement correlations of quarterly growth of mortgage and loan volume, net of loss reserves, of six major banks, Q1 1999 to Q4 2007.

Correlations

		Citigroup	Wells Fargo	JPMorgan Chase	Goldman Sachs	Morgan Stanley	Bank of America
Citigroup	Pearson Correlation	1	.975**	.889**	.907**	.867**	.894**
	Sig. (2-tailed)		.000	.000	.000	.000	.000
	N	36	36	36	36	36	36
Wells Fargo	Pearson Correlation	.975**	1	.901**	.858**	.841**	.871**
	Sig. (2-tailed)	.000		.000	.000	.000	.000
	N	36	36	36	36	36	36
JPMorgan Chase	Pearson Correlation	.889**	.901**	1	.862**	.824**	.918**
	Sig. (2-tailed)	.000	.000		.000	.000	.000
	N	36	36	36	36	36	36
Goldman Sachs	Pearson Correlation	.907**	.858**	.862**	1	.896**	.970**
	Sig. (2-tailed)	.000	.000	.000		.000	.000
	N	36	36	36	36	36	36
Morgan Stanley	Pearson Correlation	.867**	.841**	.824**	.896**	1	.891**
	Sig. (2-tailed)	.000	.000	.000	.000		.000
	N	36	36	36	36	36	36
Bank of America	Pearson Correlation	.894**	.871**	.918**	.970**	.891**	1
	Sig. (2-tailed)	.000	.000	.000	.000	.000	
	N	36	36	36	36	36	36

**. Correlation is significant at the 0.01 level (2-tailed).

[1] DISCLAIMER: Correlation supports proposition that, all things being equal, reverse legitimacy is associated with mimetic lending practices. Analysis, based on small sample (n=36), is NOT presented as statistically valid evidence that reverse legitimacy is the exclusive predictor of, or cause for, conformity of behavior.

3.4 Diffusion of practices and conformity to industry norms

This growth period (1999 to 2007) was also associated with the broad adoption of industry-wide innovations and advances. Credit underwriting of fixed income securities had been revolutionized. The industry had moved from maintaining in-house underwriting staff to perform time-consuming and manually intensive credit analysis, to outsourcing this service to external parties, specifically credit rating agencies with well-known and trusted brands such as Standard and Poor's, Moody's, and Fitch. To meet growing demand, these agencies expanded their rating services from traditional bonds to more sophisticated exotic credit structures such as CDOs (Collateralized Debt Obligations), CLOs (Collateralized Loan Obligations) and CMOs (Collateralized Mortgage Obligations).

The mortgage banking industry's adoption of a common platform called Mortgage Electronic Registration System (MERS), helped the mortgage originators keep pace with the super-heated residential real estate market by automating and simplifying the process by which mortgage ownership and servicing rights were originated, sold and tracked, which greatly improved throughput of this traditionally manually-intensive and paper-based process. At this same time, financial engineers were creating new products, such as credit default, interest rate and total return swaps that offered innovative and creative ways to tailor risk-reward scenarios, and Wall Street "quants" were creating major advances in risk modeling and credit risk pricing. Perhaps the single major advance was the credit default swap contract, a derivative that revolutionized credit risk transfer pricing by enabling real-time, market-based mechanism to price the risk that a given counterparty would default on a loan. With the risk of default accurately priced and effectively transferred, and the waterfall structuring of tranches of a credit structure to ensure priority claims of the cash flows of the underlying securities, most of the senior tranches, even with a great amount of leverage, could be rated AAA. To boost the credit rating of structures, issuers could buy "credit enhancement" via financial guaranty insurance providers such as MBIA and AMBAC.

3.5 Persistence of the institutionally enacted reality

Starting in 2006, however, the environment changed dramatically. As the prime rate inched past 7 percent in December of 2005, heavily indebted homeowners with adjustable-rate mortgages, some of which featured initial, short-term, below-market teaser rates, were unable to pay the new higher payments. As mortgage delinquencies soared, housing prices collapsed.

As the general economy started its decline in late 2007, market prices of investment structures based on mortgage securities plummeted as realization spread that the massive expansion of credit through the "shadow banking system" had distorted and underpriced credit risk. As investors rushed in to sell their positions, traders witnessed something not seen in their lifetimes. All but the highest quality credit markets simply stopped working. Price discovery disappeared; they were no willing buyers on the other end of the torrent of sell orders that flooded markets.

3.6 Selected excerpts from 2007 letter to shareholders: Conformity of view

In their respective 2007 letters to shareholders, the chief executives of the six major banks continued to report that risk management efforts were effectively reducing their exposure to the economic downturn. In nearly all of these disclosures, the systemic under-pricing of credit risk was portrayed as something that had other market participants – not their organization – had committed.

Bank of America: Bank of America's 2007 letter to shareholders began with, "2007 was disappointing year for our company." While acknowledging the "…unprecedented turbulence in the financial markets," CEO Ken Lewis stated that "Despite the short-term fallout from the so-called credit crunch, I remain confident and optimistic about our competitive position and our ability to generate attractive financial results in the future". In reassuring stakeholders that no major changes were needed or planned, Lewis reported that "Our long-term growth strategy is working and has not changed…Our earnings power from our core business activities and strong and growing." In the following year, the company reported a net loss of $1.2 billion.

Goldman Sachs: In Goldman's 2007 letter to shareholders, the leadership triad of Lloyd Blankfein, John Winkelried and Gary Cohn observed that "…the broad availability of credit has implications on the pricing of risk. As capital flows increased around the world, the search for excess drove yields down to unprecedented levels….the run-up in housing prices in the U.S. and much of Europe simply were not sustainable." But the Goldman executives foresaw no major impact to their firm, in part because of its core competency in risk management: "We believe that

rigorous mark-to-market accounting for financial instruments is fundamental to prudent management because it facilitates a clear view of risk. It allows us to manage market risk limits, monitor exposure to credit risk and manage our liquidity requirements. Effective risk management is demanding and often difficult, but lies at the heart of the management of a financial institution, and, we believe it is a core competence that helps define Goldman Sachs."

JP Morgan Chase: In his expansive, 15-page letter to shareholders in 2007 JP Morgan Chase annual report, CEO Jamie Diamond both cautioned and assured investors that "We generally avoided many - but not all - of the issues associated with the storm of 2007". After admitting that the firm tightened its underwriting standards six times, Diamond stated that "…we still believe that subprime mortgages are a good product," and suggested that the worst was over. "During the latter part of 2007, we set out to increase our home lending market share and have, so far, succeeded. By the end of the fourth quarter of 2007, our share had grown to 11% from 6% a year earlier. As a result of our liquidity and capital strength, we were able to underwrite these loans when others could not. Although we may pay for probably starting this expansion a little too early, we remain committed to the goal".

Morgan Stanley: John Mack, the CEO of Morgan Stanley, described the source of the impact of the global financial crisis to his firm as an isolated lapse in control, which had quickly and effectively already been corrected. In his 2007 letter to shareholders, he ascribed the source of the company's mortgage-related losses as "…the result of an error in judgment made by a small team in one area of fixed income and a failure to manage that risk appropriately"[2]. As did Diamond of JP Morgan, Mack described the situation as under control and the problem solved. "We moved aggressively to address these issues and to make the necessary changes…"

Wells Fargo: Chairman Richard Kovacevich and CEO John Stumpf began their joint letter to shareholders in the 2007 Wells Fargo annual report with a dispassionate description of the underlying causes of the financial crisis, which included "…careless, undisciplined lending, borrowing, investing and overall risk management across many segments of the economy." The bank executives noted, "This foolishness could not go on forever." But, as with the other banking executives, they saw the problem as an issue for other banks and financial institutions, not Wells Fargo: "Our Company maintained its credit risk discipline reasonably well during the years of excessive risk taking in our industry".

Citigroup: In attributing losses to the "…sudden and severe deterioration in the U.S. sub-prime market," CEO Vikram Pandit announced a new strategy for the company in Citigroup's 2007 letter to shareholders. In light of the spectacular market melt-down in the second quarter of 2007: "This strategy began in the third quarter; since then we have reduced our positions in mortgage-backed securities in the U.S. lending business…"

The change in the housing market can be seen in the Housing Price Index, a weighted average of price changes in repeat sales or re-financings of single-family properties whose mortgages have been purchased or securitized by Fannie Mae or Freddie Mac. In the first quarter of 1999, the index stood at 128.31, indicating that new homes were selling at an average of 28% more than they were when the index was first established as a baseline in the first quarter of 1990. The index reached a high of 226.02 in the second quarter, but soon began to decline, as shown in Figure 4.

By 2008, the six global financial institutions failed and were bailed out by a massive stimulus bill by the U.S. government. Together, they received $160 billion of Troubled Asset Relief Program funds, and borrowed as much as $460 billion from the Federal Reserve Bank (11/24/2011, Bloomberg).

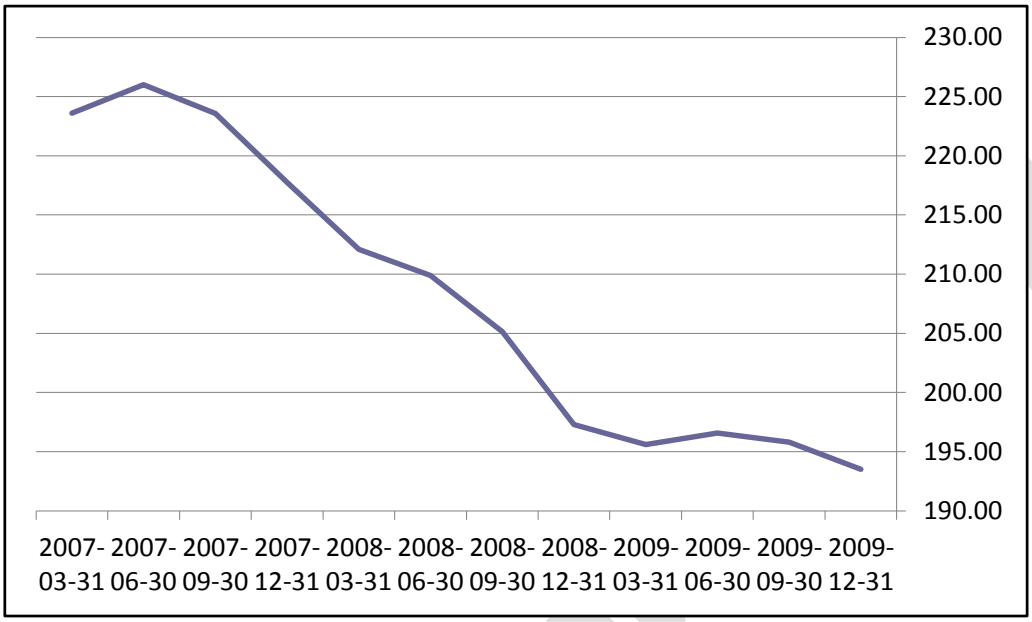
4. Conclusion

The purpose of this paper was to provide a partial but real-world case study on the effects of "reverse legitimacy" to show how permissive acceptance of industry practices by regulatory and governmental institutions leads to organizational conformity and cognitive impairment in the short run, and ultimately disaster in the long run. The study suggests that, in America's increasingly polarized economy, the "iron cage" of institutionalism may indeed

[2] Upon further reflection, in his January 13, 2010 Congressional testimony before the Financial Crisis Inquiry Commission, Mack admitted the problem was broader: "We did eat our own cooking, and we choked on it".

have been turned inside out, in which institutional actors, in their desire for upward mobility and acceptance by the national elite, take their cues from powerful industry players, who define the ground rules for economic life.

Figure 4: FHFA quarterly housing price index (2007 to 2009).



Source: The Federal Housing Finance Agency. http://www.fhfa.gov/Default.aspx?Page=14

This study raises issues about the current state of institutionalism, especially regarding the influence of financial industry organizations upon financial regulatory bodies. Riaz [1], drawing from the institutional concept of decoupling [27] – by which organizations depart from institutional pressures that are not compatible with their structures but continue to display symbolic adherence – proposes that the conversion of investment banks to commercial banks and forced mergers were evidence of such decoupling and concealment. Riaz [1] argues that such decoupling and concealment, which while providing a temporal competitive advancement, eventually leads to the downfall of organizations, triggering a "domino effect" (p. 31) of illegitimacy, which hits both organizations and institutions. In this view, investment banks that were widely viewed as legitimate and successful were suddenly not viewed as such by 2008, following their conversion to commercial bank status and consolidations.

To the contrary, this case study results suggest that the actual insolvency of these financial institutions was the trigger for illegitimacy (conversion of investment bank to commercial bank status was merely a regulatory prerequisite to receiving TARP funds), not the banks' de-coupling from institutional pressures. Instead, this case study propounds that is was the unquestioned legitimacy of the enacted environment that caused executive management to fail to adjust to the reality of the crisis unfolding around them, thus supporting the third proposition that institutional pressures of conformity impaired organizational learning.

Likewise, this study disagrees with Lang and Jagtiani [31], who cite principal-agency problems as the key reason why banks had accumulated massive concentrations of mortgage-related, in violation of widely-accepted risk management practices, which in turn triggered the financial crisis. This study instead suggests the main issue was not that risk management and controls were not in place and not working; instead, the problem was that many of these controls were woefully inadequate, as they were calibrated on the prevailing conventional wisdom or industry-wide system of beliefs in the infallibility of quantitative models and management's own assessment in their ability to manage such complexity, thus supporting the first proposition that reverse legitimacy of practices drive isomorphic conformity of thinking and behaviors.

Evidence of this enacted reality can be seen in the 2007 letters to shareholders from the chief executives of the six major banks, who continued to report that their risk management efforts were effectively reducing their exposure to the economic downturn, consistent with the concept of enactment, or "…Managers construct,

rearrange, single out, and demolish many 'objective' features of their surroundings…" [29] p. 243, and retrospective sense-making, by which individuals retrospectively examine their behaviors to decide and select situational or motivating explanations, selective interpreting or applying sense to new developments based on their past experiences. This small group of influential executives was able to set the tone of and rules for the institutional "mindset" or cognitive environment for their regulators, as per the second proposition, increased concentration of members of the national elite within a given regulated industry is positively associated with increased "reverse legitimacy."

4.1 Limitations and implications for future research

The study has considerable limitations, perhaps most predominantly, endogeneity, or the feedback relationship between the independent and dependent variables. As a qualitative paper, this case study presents only anecdotes as emerging evidence for the empirical basis for its arguments, based on a tiny sample (n=6) of major banks. Wider studies, with robust variables to show the directional causal relationship between institutional reverse legitimacy and organizational behaviors across a large sample of organizations are needed.

One might argue that reverse legitimization is nothing new: changes to regulatory or public policies typically lag industry trends, as democratic governmental institutions usually change only in reaction to a public groundswell of support or broad-based political pressure for action. Yet, the particular governance mandate for financial regulatory institutions – especially those entrusted with the safety and soundness of the banking system – would appear to demand a more preventive and proactive role in the identification and prevention of systemically harmful practices. In light of the role that speculation in complex derivatives played in the financial crisis, Posner and Weyl [32] have proposed a new financial regulatory agency, comparable to the Food and Drug Administration which reviews and approves new drugs, to prevent the sale of financial innovations that were designed purely for speculation, based on the doctrine of insurable interest. While it is intuitive that Wall Street's political power has grown along side its economic and social influence in the U.S economy, and that, in an "advanced oligarchy" [21] p. 4, regulatory institutions are beholden to the interests of the ruling class, the body of empirical research studies on the casual effects of reverse legitimization on modern institutional and organizational dynamics are in their infancy.

Many academics, as well as other observers of the recent global financial crisis – perhaps most notably, many who represent the "Occupy Wall Street" movement – call for an end to plutocratic capitalism [4] p. 66. But given the institutional environment, these pleas appear disingenuous. Despite broad-based calls from both Democrats and Republicans to break up the "too-big-to-fail" banks, address the issue of moral hazard, and end "crony capitalism," the six big banks presented in this case study are today bigger than ever (Bloomberg, 4/16/2012). The main provisions of the Dodd-Frank Act – the single greatest attempt at financial reform by Congress in reaction to the 2007-2008 global financial melt-down – are now being successfully challenged, weakened and otherwise compromised by powerful Wall Street and other business interests. If left unchecked, the continuation of "reverse legitimacy" by financial regulatory institutions could mean the cycle of initial success, herding behavior, and impaired cognition reorientation will continue, paving the path for the next global financial catastrophe.

Competing Interests

None declared.

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