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# The global financial crisis: an institutional theory analysis

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**Abstract**

**Purpose** – This paper seeks to provide insights into the current global financial crisis from an institutional theory perspective.

**Design/methodology/approach** – The paper presents the development of key concepts using institutional theory, grounded in a discussion of the context of the current global financial crisis.

**Findings** – The interplay of financial industry organizations and formal and informal institutions is key to understanding the creation of the crisis.

**Research limitations/implications** – The treatment is brief but serves to provoke further research on the global financial crisis through applying and extending new institutional theory.

**Practical implications** – Fundamental aspects of the crisis need to be understood with respect to the organizational-institutional interplay involving the financial industry. This would help to reveal the general pattern of such crises and also point towards what needs to be taken into account for potential solutions.

**Originality/value** – The paper has value for researchers as it opens up a discussion of the current crisis from an institutional theory perspective. Fresh concepts introduced here could be extended further and inform institutional theory in general. The paper has value for policy makers and practitioners in helping them understand the fundamentals of the organizational-institutional interplay underlying the current crisis.

**Keywords** Recession, Financial institutions, Organizational structure

**Paper type** Viewpoint

## 1. Introduction

The current economic crisis, rapidly gaining ground across the world everyday, has been appropriately labeled as a "global financial crisis". News stories focus on the collapse of banks and financial services organizations that until recently were deemed to be very successful and highly legitimate businesses. How could such successful businesses suddenly collapse and lose all legitimacy? How could the entire industry of investment banking lose legitimacy to the point where popular financial media report on the embarrassment of investment bankers at dinner parties?

While the current crisis has several aspects that can be understood using various disciplines and theoretical lenses, new institutional theory (DiMaggio and Powell, 1983; Meyer and Rowan, 1977) can provide a unique perspective for understanding key aspects of the organizational-institutional interplay in the unfolding of the present crisis. In some ways, this situation is not new, and similar elements have been witnessed in prior crises and bubble bursts. There is an opportunity here to understand

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these crises in a broader manner with theoretical insights that draw out the general pattern. Theoretical insights grounded in a discussion of the current global financial crisis can therefore provide a unique opportunity in understanding the fundamentals of such crises in general, rather than simply documenting the facts as they unfold.

I suggest that the current crisis calls for examination as an institutional crisis, resulting from the interplay of the financial industry organizations and broader formal and informal institutions. Such an examination requires understanding the mechanisms of organizational-institutional interplay that follow from basic tenets of new institutional theory. In this position paper, I draw upon the formal theoretical apparatus of new institutional theory and extend its core ideas to help explain the unfolding of the present crisis.

## 2. Institutional theory and the crisis: a view of the iron cage, inside-out

In this section, I present theoretical arguments to throw light on the interplay of financial industry organizations with formal and informal underlying institutions, including the international dimensions of the crisis through the build up of a "contagion of legitimacy".

For analytical purposes, I consider the investment banks and financial services organizations comprising the finance industry as organizations that exist within the wider framework of formal and informal institutions. I focus specifically on the US context, though the ideas extend to several affected regions of the world. The formal regulative institutions (Scott, 2001) include the central bank – The Federal Reserve, The Treasury and The Securities and Exchange Commission (SEC) – while the informal normative and cultural-cognitive institutions (Scott, 2001) include the cultural acceptance of debt, high mortgages, disregard for savings, and an aggressive investment-oriented culture that involves even pension funds and 401K accounts as active investors in high-risk equity and debt securities.

The new institutionalism has, as one of its core defining symbols, the "iron cage" of homogenization put forward by DiMaggio and Powell (1983), building on Weber's idea of the iron cage of bureaucratization. In this perspective, organizations are viewed as "imprisoned" by institutions through the powerful processes of institutional isomorphism. While this visual is apt in describing the influence that the institutional environment has on organizations in general, this is only half the picture. The flip side to this is a view of the iron cage inside-out, that reveals the prominent role organizations have in influencing institutions. While the functioning of institutions and their influence on organizations has been much explored, the processes of creation, maintenance, demise and death of institutions have only recently received some attention. This theoretical problem has been described as a concern with the silences of institutional theory, rather than a rejection of its core tenets (Brint and Karabel, 1991). Half of a full sociology of institutions is thus a work in progress, and is key to understanding situations such as the current financial crisis. The need for work in this area has been highlighted by prominent proponents of institutional theory (DiMaggio and Powell, 1991), and recently, several attempts have been made to cover this gap (e.g. Battilana, 2006; Greenwood and Suddaby, 2006; Garud *et al.*, 2002; Galaskiewicz, 1991; Brint and Karabel, 1991; DiMaggio, 1991; Fligstein, 1991).

These emerging ideas on institutional formation, institutional development, deinstitutionalization and reinstitutionalization (Jepperson, 1991) have much to inform our understanding of the complexities of organizational-institutional interplay in contexts such as the present crisis. However, several of these ideas have been alluded to in empirical works but have not been brought together through theoretical development that would help us understand the issues in an integrated manner. Here I draw upon and extend these ideas to help us understand the unfolding of the current financial crisis. In the sections below, I present key concepts, such as "reverse-legitimacy", "illegitimate structures" and "institutional crisis", that extend and integrate some of this emerging work and are particularly useful for understanding the current crisis from a theoretical perspective.

That organizations themselves can be the means, and organization-institution interactions be the processes through which power and interests are made to bear upon institutions (e.g. Greenwood and Suddaby, 2006; Garud *et al.*, 2002) is a particularly useful view for understanding the creation and maintenance of the institutional framework underlying the current crisis. Organizations represent powerful interests (which could be considered their own or those of their agents) that have a bearing on the survival of the institutional framework in the domain of the organization's operation and influence. I contend that many institutions, in fact, cannot survive today without the active support and sanction of organizations. This is particularly valid for the formal and informal institutional framework underlying the financial industry organizations.

I thus argue that the "engine" of institution-organization influence identified by DiMaggio and Powell (1983) works both ways in its effects. Things have indeed changed since the times of Weber, but one important change is in the power and influence wielded by organizations, particularly business and financial industry organizations, all over the world today. Assuming that multinational organizations with budgets far exceeding those of several countries put together are necessarily *passive* players submissively seeking legitimacy in their interaction with institutions is an anachronistic thought. Business and financial organizations today are powerful beyond imagination, and have a role in influencing, shaping and manipulating anything that happens to be in the way of their survival and success. And what else could be more "in their way" than institutions? While 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. In today's world, the power equation between organizations and institutions is such that one's answer to "Who is caged?" with respect to the organizational-institutional interplay might well depend on the perspective one chooses, i.e. from which side of the iron mesh one views the world.

### *2.1 Reverse-legitimacy*

DiMaggio and Powell (1983) concede the active role of organizations when they state that organizations *try to change constantly*, yet the *aggregate* effect of such change is homogenization. I argue that this homogeneity could also serve to legitimate the institutions whose forces underlie the institutional isomorphic processes. This mutual legitimation could give rise to a “contagion of legitimacy” amongst the organizations and institutions involved.

Institutions have power over organizations to the extent that they can grant legitimacy to organizations, or can make an organization that does not conform to institutional pressures “illegitimate”. I contend that with the emergence of powerful business and financial organizations, this “legitimacy” flows both ways. Not only does the appearance of conformance to institutional pressures have a role in organizational success, but organizational success in turn confers a “reverse-legitimacy” upon certain institutions that are deemed to have had a role in the success of organizations associated with these institutions.

If organizations within the organizational field are successful in the aggregate, the institutions from which the organizations have sought legitimacy (through conforming to the isomorphic pressures generated by these institutions) are sanctioned as having been responsible for giving rise to such successful organizations. In reality, the success of organizations could be dependent on several other factors internal or external to themselves, yet their association with certain institutions provides these institutions with the “halo” of success. One sees such situations when certain public policy decisions are made to replicate institutions that are deemed to have contributed to, or even given rise to, successful organizations (Jepperson and Meyer, 1991).

This is most dramatically discernible in the clear attempt by less developed countries to imitate institutions from countries where powerful business and financial organizations have succeeded, and to then invite these powerful organizations to the host countries and hope for similar success of these and similar organizations. The proliferation of “free trade zones”, “special economic zones”, “commercial regions”, etc., in parts of the world that generally do not have institutions similar to the developed world is partly an attempt to provide powerful organizations with institutional structures of their liking, in which they have succeeded elsewhere.

Thus, organizations can “reverse-legitimate” institutions in the same way that institutions “legitimate” organizations. The institutional environment has been thought of as consisting of institutions nesting with one another (Jepperson, 1991), and of interrelated networks of mutually supportive or antagonistic parts, giving rise to “contagions of legitimacy” (Zucker, 1977). The concept of “contagions of legitimacy” is a useful one, with my additional insight being that business and financial organizations are a core part of such contagions, due to the ability of powerful business and financial organizations today to “reverse-legitimate” institutions through their own success. Groups of institutions and organizations form “contagions of legitimacy” and the survival or failure of institutions or organizations in such contagions is intricately connected. The concept of “reverse-legitimacy”, related to the idea of “contagions of legitimacy” is much needed to allow for further theoretical development of ideas that have been presented in empirical works in this domain (e.g. Greenwood and Suddaby, 2006; Garud *et al.*, 2002).

The above concepts and arguments serve to highlight key aspects of the current crisis. The success of business organizations in the finance industry, in the aggregate, conferred a “halo” effect on the underlying formal and informal institutional structures, which were reverse-legitimated and put beyond question. For example, mortgage-backed securities proliferated since the chain of organizations involved in their creation, securitization, insurance and rating, comprised of successful organizations in the aggregate, which helped sanction the formal regulatory institutions (particularly the Securities and Exchange Commission, but also the Federal Reserve and its credit expansion and inflationary policies) and also informal cultural-cognitive and normative institutions (for example, the cultural acceptance of high debt and excessive home mortgages).

This "reverse-legitimation" of institutions underlying the financial industry success also had international ramifications as theoretically delineated above. The institutional transformations associated with the financial industry in emerging markets (e.g. China and India) and transition countries (e.g. Eastern Europe), both in terms of the formal regulatory institutions and also in terms of the cultural-cognitive and normative institutions suggest attempts at replication of features of American and Western European "successful" institutions. For example, countries where cultural-cognitive and normative institutions had historically pushed people to save saw a cultural shift and a move towards acceptance of debt, while the regulatory institutions eased up to allow financial organizations to set up businesses similar to ones they had succeeded in elsewhere. A "contagion of legitimacy" was therefore created that primarily included the financial organizations in the USA and Western Europe along with the formal and informal institutions underlying this industry's success in this part of the world. Over time, this contagion spread across several parts of the globe where these and similar financial organizations set up businesses and features of the underlying formal and informal institutions were replicated.

In summary, I propose the following: while conforming to institutional pressures, powerful organizations, through their success, can "reverse-legitimate" the institutions that underlie these pressures, and this reverse-legitimation has a positive effect on the survival and continuation of the concerned institutions. Further, "reverse-legitimation" can lead to institutional formation through attempts at replication of the "successful" institutions where such institutions do not currently exist. In the context of the current crisis, financial organizations in the USA, through their success in the aggregate, were able to reverse-legitimate formal and informal institutions in the USA, and this reverse-legitimation led to replication of these institutions in other parts of the world, particularly in emerging economies that tried to replicate elements of this success.

*2.2 Illegitimate structures and institutional crisis*

While organizational success in the aggregate reverse-legitimates institutions, this is no guarantee of organizational conformance to all pressures from the underlying institutional framework. Though organizations derive legitimacy through the "contagion of legitimacy", they can further manipulate the legitimacy-granting process through strategies that help avoid institutional pressures not in line with parts of their structure (Kraatz and Zajac, 1996; Suchman, 1995). Under certain conditions, the "contagion of legitimacy" could then head for a crisis. These theoretical arguments are delineated here and relevant to understanding how the current crisis developed and where such crises could lead.

Organizations use a strategy of decoupling when faced with institutional pressures not in line with their existing structures (Meyer and Rowan, 1977). This involves symbolic conformance to the institutional pressures through the organization's institutional layer, and substantive non-conformance in technical aspects (Ashforth and Gibbs, 1990). Oliver describes similar strategic responses as "conceal" and "buffer" mechanisms, i.e. when an organization disguises non-conformity behind a façade of acquiescence or loosens institutional attachments, respectively (Oliver, 1991; Oliver, 1996). I extend these ideas to see the major implications such organizational strategies eventually have on the fortunes of the institutions involved.

I argue that a strategy of decoupling or concealment by powerful and successful organizations, prolonged over a period of time, has a negative effect on the survival of such institutions. Initially, while organizations attempt to comply in substantive terms, a few might discover ways to conceal compliance or comply only in symbolic terms while leaving their substantive aspects free from institutional pressures. The ability to carry out such a decoupling or concealment confers an advantage to these few organizations over others, since they are able to derive legitimacy from the institutions in question, and at the same time keep their technical or substantive aspects free to perform as necessary for efficiency reasons. Once such a strategy is discovered and implemented as a successful way of dealing with "undesirable" pressures from institutions, other organizations in the organizational field then mimic this strategy, particularly if it is followed by some of the more powerful and successful organizations.

The situation is made worse by the ability of powerful organizations to manipulate (Oliver, 1991) the concerned institutions as well. Manipulation could be undertaken so that the organization does not have to conceal altogether, or, often more easily and conveniently, it could be undertaken to make such concealment and decoupling strategies easier to execute. The latter strategy relates to weakening the ability of institutions to detect concealment and decoupling (non-conformity of organizations in substantive terms), and is important for our analysis.

As more organizations discover and implement decoupling and concealment strategies, and as implementation of such strategies becomes easier due to manipulation of the institutions by the more powerful organizations, the organizational field heads towards a legitimacy crisis. While the pursuance of symbolic conformance creates a heightened perception of organizational legitimacy to those outside the organizational field, internally, the organizations are replete with "illegitimate" substantive structures. Thus, a sustained strategy of decoupling, concealment and manipulation by organizations leads to heightened perception of legitimacy (for organizations comprising the organizational field) to those outside the organizational field, while increasing "illegitimate" structures within the field.

The homogenization of the field is thus achieved, in part, through organizational strategies that make "illegitimate" structures widely prevalent. The scenario is akin to that of a bubble, or a house of cards. At some stage, if the "illegitimacy" of a few organizations, particularly the more successful ones, within the organizational field becomes well-known outside the field, a domino effect occurs whereby the legitimacy of all organizations that have until now been considered as complying in all their aspects becomes suspect. Most importantly for our purpose, this has a dramatic effect on the institutions involved as well, since their legitimacy-granting powers become suspect: they are seen as having bestowed "legitimacy" to organizations with "illegitimate" structures within the organizational field. The case of investment banks in the USA is particularly relevant here.

Investment banks needed to avoid institutional pressures that were in conflict with substantive aspects of the banks' operations related to subprime mortgage risks, yet the nature of their businesses is such that they need to be seen as legitimate. To overcome this problem, banks resorted to a strategy of decoupling or concealment. They remained exposed to the high risk of subprime mortgages in substantive terms, while maintaining legitimacy in symbolic aspects. Pursuing a strategy of decoupling or concealment, along with manipulation where possible, helped banks carry on these substantive operations while maintaining the symbolic legitimacy, for a while. Such situations are, however, too good to last. Once the discovery of "illegitimate" structures within powerful and successful investment banks became public knowledge outside their field, the legitimacy of all investment banks along the relevant dimensions became suspect.

We therefore see how the domino effect spread through the largest Wall Street investment banks and other financial industry organizations, shaking up the entire financial industry and organizations beyond that were deeply connected to this industry. Three of Wall Street's five large banks ceased to be legitimate independent businesses within six months. Bear Sterns was bought by JPMorgan, Lehman Brothers filed for bankruptcy, and Merrill Lynch faced bankruptcy and was bought by Bank of America. A key aspect here is the change in organizational form to escape the legitimacy crisis due to the deinstitutionalization of their erstwhile organizational forms (Davis *et al.*, 1994) that were part of the earlier "contagion of legitimacy". For example, Goldman Sachs and Morgan Stanley changed organizational form to cease being specialized investment banks and became deposit holding banks. Bear Sterns and Merrill Lynch, earlier highly legitimate specialized investment banks, in effect changed organizational form through being acquired by universal banks JPMorgan and Bank of America, respectively. As the crisis spread across the erstwhile "contagion of legitimacy", other organizations in the field faced a sudden loss of legitimacy: mortgage giants Fannie Mae and Freddie Mac had to be saved through nationalization and insurance behemoth American Insurance Group asked to be saved by a government loan.

Ultimately, formal institutions also bear the brunt of this collapse of the "contagion of legitimacy", as they could lose their legitimacy granting powers and be themselves considered illegitimate. In the present scenario, skepticism is currently on the rise regarding the legitimacy granting powers of the Federal Reserve through its credit expansion and inflationary policies, the Treasury, the SEC, and governmental efforts based on these institutions to stabilize and provide legitimacy to the financial industry organizations. Similarly, informal institutions, such as the cultural-cognitive and normative acceptance of aggressive high-risk investments, high debt, excessive mortgages, disregard for savings, etc., are in question, and taken for granted assumptions about these are challenged. In other words, these informal institutions lose their legitimacy granting powers that bestowed legitimacy on financial industry organizations. This questioning and challenge of the formal and informal institutions is what manifests itself as widespread behavior that results in the flight of funds from equities, banks and other financial organizations, and even from money markets and bonds. In other words, the legitimacy of all players that were part of the erstwhile "contagion of legitimacy" comes into question and an institutional crisis ensues.

### 3. Discussion

In this paper, I support the use of the emerging literature in new institutional theory on the interplay of organizations and institutions to understand the current financial crisis. I provide fresh concepts and theoretical arguments on how organizations, particularly powerful and successful ones, could have an impact on the fortunes of institutions in their operating domains. My view is that a two-way influence in the institution-organization interplay has to be expected, particularly considering the existence of highly powerful and successful organizations today, that actively pursue their own interests (or those of their controlling agents). In other words, I argue for looking at the iron cage of DiMaggio and Powell (1983), *inside-out*, to use the same imagery, in order to understand the current global financial crisis.

The ideas presented here are useful to explain the present financial crisis by focusing on the major players in the financial industry and major formal and informal institutions relevant to these players. However, the organizations and institutions considered here could also be extended to include a broader set of players in the global arena. Further, the interplay between organizations and institutions could be explored further at a finer level of granularity. For example, the recent International Monetary Fund involvement in the present crisis in countries such as Ukraine, and the European Central Bank providing credit to Hungary, could constitute cases for more detailed analysis using the concepts discussed here. In particular, cross-border organizational-institutional interplay, such as that arising from the banking industry disputes between Iceland and the UK, could comprise interesting topics of research using new institutional theory. New theoretical insights could be developed through grounding future research in such contexts and extending the conceptual ideas presented in this paper.

The analysis in this paper suggests that those working for resolutions should attempt to understand the complex interplay of financial industry organizations and broader institutions, particularly with an emphasis on how this interplay provides perceptions of legitimacy to both parties. Simplistic notions of institutions pressurizing organizations in the organizational field to conform in order to seek legitimacy do not always apply, and could prove futile yet again in the future. The reality is more complex and notions of "reverse-legitimacy" and "contagions of legitimacy" are more useful. Fundamental questions about the nature of these institutions and their legitimacy-granting powers need to be raised, along with a focus on the powers that business and financial organizations, individually and collectively wield to "reverse-legitimate" these institutions. Further, wide use of decoupling strategies by business and financial organizations, such as the case of investment banks and high-risk mortgage-backed securities, could eventually trigger institutional crises that call into question legitimacy-granting powers of existing formal and informal institutions.

The current crisis thus calls for examination as an institutional crisis resulting from the interplay of the involved financial industry organizations and broader formal and informal institutions. This paper provided theoretical insights to enable our understanding of this interplay and potentially shape future policy relevant to this crisis and to similar potential crises in the future. Through grounding theoretical arguments in the context of the present crisis, this paper also introduced new concepts that would further theoretical and empirical work within emerging streams of new institutional theory.

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