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ABSTRACT

The last financial crisis could have been caused by rational and irrational exuberance. (That is, overreaction by agents to both good and poor signals in the financial markets). The problem is further exacerbated by institutional rationality. Rule following is one mode of behavior in dual-mode institutional rationality (Redmond 2004; Verstegen 2006). Rule-following behaviors hamper agents' abilities to adapt to new circumstances. It is shown that management structures where both upper-level and field managers exhibit purpose-seeking behaviors is necessary for corporations to overcome any type of economic and financial volatility.

I. INTRODUCTION

Irrational and rational exuberance are terms used in the behavioral financial literature to describe investors' beliefs and response to market conditions. Rational investors are assumed to have rational expectations based on the information available to them, including probability distributions of economy's random variables (Lagunoff and Schreft 1999). Rational investors are assumed to have near perfect foresight about the true state of the economy, and the ability to forecast correctly the behaviors of other traders.

Irrational investors act and reallocate their portfolios without justifiable market conditions. LeRoy (2003) describes irrational traders as noise traders who behave for reasons outside a model. Irrational investors misestimate the behaviors of other investors and market fundamentals. In the behavioral finance literature, irrationality leads to a bubble, which is assets prices exceeding their present values. Such market phenomenon, if largely complemented with unrestrained optimism and enthusiasm by investors, is referred to as irrational exuberance.

Irrational exuberance was first used to describe the financial market by the former Federal Reserve Chairman, Alan Greenspan, in a speech on December 6, 1996.

It was also cited as a cause of the last financial crisis. According to Lagunoff and Schreft's abstraction (1999), rational and irrational exuberance could lead to a financial market collapse. While the behavioral finance literature distinguishes between rational and irrational agents, mainstream economics based on neo-classical rational choice theory makes no room for irrationality (LeRoy 2003).

II. DUAL RATIONALITY

As opposed to rational choice theory, this paper looks beyond orthodox economic analysis and behavioral finance, which regards the firm as a unitary rational decision maker in forming expectations. It looks at the firm as a micro-institution harboring teams with different motivations. Using a dual-mode institutional rationality, this paper demonstrates why management in many financial institutions were oblivious to indicators leading to the financial crisis. Hodgson (2006) describes firms as institutions operating in a broader institution (industry). Industries as institutions define the way the game is played. Nonetheless, the objective of a financial firm (as institution) is to establish a set of rules for teams within the firm to win the game.

Two modes of valuations and decision-making processes are described in the institutional economics literature. They are "ceremonial" and "instrumental" modes (Bush 1987). "Logics behind ceremonial warranted valuations are sufficient reasons; myths not subject to critical scrutiny and not tested for refutability. Whereas, the logics behind instrumental behaviors are value systems that pursue efficient cause" (Bush 1987). Instrumental warranted behaviors are problem solving and can also be validated. Bush's work is a continuation of classical work on institutional economics by Veblen (1909) and Dewey (1922).

Redmond (2004), along the same line as Weber (1921), further streamlined institutional rationality into dual mode "pre-scripted" rationality and "planning" rationality. Pre-scripted rationality is a mode of valuation that exhibits rule-following behavior. Planning rationality is purpose seeking, calculative, and deliberative. Economic agents should be able to distinguish between actions that are consequences of rule following and actions resulting from deliberations (Redmond 2004). Perhaps, irrationality in behavioral finance literature is equivalent to rule-following behavior. Bush (1987) and Redmond (2004) assume that decision makers either show rule following or purpose-seeking behaviors and either ceremonial or instrumental behaviors. Verstegen's (2006), however, presents a two-phase, rule following and purpose-seeking decision-making process, where the latter is bounded by the former or vice versa.

TABLE 1
ASSUMPTIONS AND IMPLICATIONS OF THE RATIONAL CHOICE FIRM

Assumptions	Implications
1. Sole player making unitary decision	1. This ignores organizational structure.
2. All agents are purpose seeking	2. Decisions are not bounded by previously set goals.
3. System works on a free-wheel	3. Assumes flexible decision-making.
4. Save resources spent on deliberation	4. Different layers of managers do not have different motivations.
5. All decisions are rational	5. It is rational to over-react (rational exuberance).

Table 1 shows the assumptions of the neo-classical firm as a rational agent and the implications as compared with dual-mode institutional rationality model discussed above.

III. MANAGEMENT AND INSTITUTIONAL RATIONALITY

While dual-mode rationality could influence the decision-making process, leadership style or organizational structures (Williamson 2000) could further complicate the decision-making process. The extent to which embedded rules within an organization, including goal of the firm, chains of command, and rules of communication, act as a coordinating mechanism is determined by management style.

There are authoritative (autocratic), consultative, and participative (democratic) styles of leadership. Kennish (1994) describes autocratic management as one in which the superior is domineering and controls all information, people, and money matters. Here, workers do as they are told and are forced to meet goals irrespective of circumstances. This type of institutional arrangement could hinder the flow of sincere information within an entity and in turn affect operations.

Kennish (1994) describes participatory management as a positive style whereby managers reward employees by decentralizing authority. Junior managers and employees are involved in planning and problem solving. Senior managers welcome ideas and suggestions, as well as solicit for a true picture of operations from junior managers.

In this dual-mode institutional model, decision making, and responsibilities are allocated between lower-level and upper-level management. Where upper management may display purpose-seeking type of behaviors, lower management is institutionally required to think of routine, rule-following behavior or vice versa.

Assuming that there are slight differences in managerial paradigms between upper and lower management within an organization; thus, there are differences in institutional rationality. Management can be categorized into lower and upper levels in this dual-mode rationality model. We can consider different scenarios where lower management is rule-following and upper-level managers, such as chief executive officers, are purpose seeking or vice versa. According to Verstegen (2006), in dualmode rationality the first mode, rule-following mode, formulates the problem and the second mode, purpose seeking solves the problem, but the latter is rationally bounded by the former. On the other hand, lower-level managers could be purpose seeking and the upper level would be characterized with rule-following behaviors in implementing decisions.

Management can adopt different spectra of administrative structures. But for simplicity, let's assume that an organization is implementing a participative or authoritative management style. In authoritative management, as in budgeting, upperlevel managers set the goals and give commands. This type of management style produces faster decision making, but top management is divorced from the day-to-day activities of the business.

In participative management, as described above, lower-level or field managers participate in decision making. There is a bottom-up flow of information and this allows lower-level managers to pass on non-distorted pictures of field activities. On the whole, the distribution of authority and responsibilities between higher-level managers and lower-level managers, as well as the frequency of communication between them, define the differences between authoritative and participative management.

Note that rule following in institutional rationality denotes habits, conventions, norms, and routine activities, while purpose seeking is calculative, deliberative, and instrumental (Redmond 2004; Hodgson 2003; Verstegen 2006). It is not incomprehensible for different levels of managers to exhibit different rationality taking into account differences in motivations.

Table 2 shows different scenarios in the dual-mode institutional rationality and management paradigm.

TABLE 2
THE DUAL-MODE RATIONALITY AND MANAGEMNT PARADIGM

Field Managers\CEOs	Purpose Seeking	Rule-Following
Participative	A	B
Authoritative	C	D

Purpose Seeking =Anticipative, calculative and deliberative, thus instrumental
Rule-Following = Routine activities, industrial norms and conventions, thus ceremonial

Lower-level Managers = Field Managers
Upper-level Managers = CEOs

Cell A is the best of all the cells whereby lower-level management fully participates in decision making and supplies useful field activities to goal-setting upper management. Every decision here is calculative and deliberative. Even if upper managers are rule following, they are rationally bounded by the decisions of purpose seeking field managers. Therefore, the final decisions and activities in the organization are not of the repetitive routine nature. An organization can strive even in volatile times. All agents in rational choice theory are assumed to be in cell A.

Alternatively, lower-level management is rule-following and participative in decision making, that is cell B in Table 2. Thus, upper management would be totally aware of field activities. Because, according to Verstegen (2006), the decision maker is bounded by the decision of the rule-following first mode. The final decision in this cell would be sub-optimal, regardless of the decision mode of upper management. In the language of Bush (1987), upper-level management is "ceremonially encapsulated" by lower-level management because rule-following mode of thinking is a ceremonial behavior. However, the organization is worse off if upper management is also rule following. Here the organization can never deviate from industrial norms and conventions irrespective of the economic environment.

If an organization practices authoritative management, where lower management and workers in general do not participate in setting goals and decision making (cell C), there would be a vacuum. In authoritative organizational structures, lower managers are forced to meet goals irrespective of circumstances. Upper management is also bounded by the decisions of purpose-seeking lower management. This cell is also close to cell A, and a superior level of operations than (cell B), except that upper managers may not be fully aware of the true picture of activities on ground. This is even more so in a segment responsibility reporting (Verstegen 2006) where lower managers' performance is measured by goals met.

Cell D is the worst-case scenario. Field managers are rule following. The management environment is authoritative. If upper-level management is rule following as well, then the firm is lost in the norms and conventions of a particular industry. This would spell disaster for the firm, especially in a fast-changing economic environment. Assuming upper-level management is purpose seeking in making decisions, they would be constrained, however, by first mode, rule-following field managers.

Can an authoritative upper-level manager have enough field information to be purpose seeking? A suspecting lower-level management (first mode, rule-followers) in financial or any organization may be fully aware that a good proportion of these mortgage loans are overpriced, but due to institutional factors, such as a company's targeted quarterly revenue, income, and stock price, it would be improper to convince higher management to do otherwise. By default, authoritative management creates rule-following lower managers, who inherently abide by industrial norms and conventions (cell D). Moreover, knowing the cost of acquiring new information and the risks involved in losing market shares, many organizations may inadvertently be slanting towards rule-following behaviors.

Take a look at events in Bear Stearns, for example; the gigantic Wall Street investment bank that collapsed during the crisis. As of 2005, there were signs that earnings from mortgage backed securities (CDOs) had reached their peak and were declining. Yet, in 2006, a fund manager at Bear Stearns, Ralph Cioffi, created an "Enhanced Fund" which was associated with higher risks. Enhanced Fund and his first fund, High-Grade Structured Credit Fund, were two hedge funds in B.S.A.M (Bear Stearns Assets Management). Enhanced Fund borrowed as high as 100% of available cash for trading. Both funds eventually filed for bankruptcy. When asked about his role as a supervisor to Ralph Cioffi, co-president at Bear Stearns, Warren Spector said, "Well, I never knew his actual positions" (Cohan 2009).

The above events and upper-level manager's comments unveil the mode of rationality and organizational structure at Bear Stearns. Analysts believe that sub businesses or fund managers at Bear Stearns ran their funds as they saw fit, as long as they met income targets. There was not much communication between upper-level managers, middle managers and lower-level managers. Fund managers seemed to have more information that was not passed on to the presidents.

Furthermore, fund managers at Bear Stearns did not pay attention to the mortgage market before creating high leveraged CDO backed funds, even when the managers had less liquidity available to cover their debts. They also failed to forecast the impact of economic downturn on the sub-prime security market. These are rule following behaviors. In Table 2, one could conclude that Bear Stearns operated in cell D.

Rumors concerning liquidity problems circulated about Bear Stearns weeks prior to its demise. Investors reacted by pulling out several billion dollars of funds from the troubled investment banker. Such actions could be rule-following behaviors by investors if actually the firm had no liquidity problem, but the withdrawal itself created it.

In the same token, sub-prime lenders showed rule following behavior because they did not consider the consequences of their actions. They were, nonetheless, faced with two types of homebuyers: those who were willing to accept "jumbo" loans including a second mortgage, and those who minimized their loans and declined second mortgage outright. At the second phase of the decision mode, the first group of homebuyers finalized their transactions because both the lenders and borrowers had rule-following thoughts. The second category of homebuyers turned down the deal, as they were bounded by the first-mode purpose-seeking behavior.

IV. CONCLUSION

Irrational exuberance has been cited as the cause of the last financial crisis. However, a non-orthodox economic model is illustrated to explain the financial crisis. As opposed to single-mode global preferences in rational choice theory, institutional rationality has two modes: rule following and purpose seeking. In rule-following behaviors, agents stick to routine activities, norms, and conventions. This mode of thinking is ceremonial (Weber 1921; Bush 1987; Hodgson 2003, 2006; Redmond 2004; Verstegen 2006). A purpose seeking behavior, on the other hand, is calculative, deliberative and anticipative. This mode of behavior is instrumental and suitable for a fast-changing economic environment.

A dichotomized management paradigm, with participative and authoritative styles is considered. It is concluded that organizations with rule-following behaviors operating in an authoritative management environment are prone to crisis when an economy is experiencing changes. Firms inherently display rule-following behaviors in order to minimize costs associated with purpose seeking. Rule following is the dominant mode of behavior as teams are bounded by past commitments including targeted income. Solutions would include structural changes that require no misrepresentation of information within organizations.

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