Citation for published version:

Branston, JR, Tomlinson, PR & Wilson, JR 2012, "Strategic failure" in the financial sector: a policy view', *International Journal of the Economics of Business*, vol. 19, no. 2, pp. 233-253.
<https://doi.org/10.1080/13571516.2012.684927>

DOI:

[10.1080/13571516.2012.684927](https://doi.org/10.1080/13571516.2012.684927)

Publication date:

2012

Document Version

Peer reviewed version

[Link to publication](#)

This is an electronic version of an article published in
"Strategic Failure" in the Financial Sector: A Policy View
J.Robert Branston, Philip R. Tomlinson, James R. Wilson
International Journal of the Economics of Business
Vol. 19, Iss. 2, 2012. International Journal of the Economics of Business is available online at
<http://dx.doi.org/10.1080/13571516.2012.684927>

University of Bath

Alternative formats

If you require this document in an alternative format, please contact:
openaccess@bath.ac.uk

General rights

Copyright and moral rights for the publications made accessible in the public portal are retained by the authors and/or other copyright owners and it is a condition of accessing publications that users recognise and abide by the legal requirements associated with these rights.

Take down policy

If you believe that this document breaches copyright please contact us providing details, and we will remove access to the work immediately and investigate your claim.

‘Strategic Failure’ in the Financial Sector: A Policy View

J. ROBERT BRANSTON

Centre for Governance and Regulation, School of Management, University of Bath, UK

PHILIP R. TOMLINSON

Centre for Governance and Regulation, School of Management, University of Bath, UK

JAMES R. WILSON

Orkestra-Basque Institute of Competitiveness, University of Deusto, Spain

November 2011

Abstract

Analysis of the recent financial crisis has tended to focus upon ‘market’ and corresponding ‘regulatory’ failures. While this provides important insights, it may neglect deeper issues at the root of recent problems. In this paper we take a broader perspective, drawing upon the strategic choice approach to the theory of firm (Cowling and Sugden, 1998, 1999). We present a governance-based analysis which emphasises the process of engaging interested ‘publics’ in corporate decision-making processes. We illustrate our arguments with respect to three UK cases – Northern Rock, Bradford and Bingley, and HBOS banks – which each required major interventions by the UK Government and whose recent history reveals significant changes in ownership, governance and corporate strategy. We argue that the current period of reform for these former building societies represents an ideal opportunity to address serious concerns over governance within the financial sector and we propose a revised mutual solution as one appropriate way forward.

Keywords: Regulation, governance, strategic decision making, strategic failure, ownership, mutuality, financial sector.

JEL Codes: G21, G38, L21 and L52

1. Introduction

The global financial crisis of 2007/2008 and the subsequent economic crisis have raised serious questions around the existing financial architecture. The banking sector plays a critical role in all economies, affecting the activities of every individual and firm. Yet as noted by Vives (2010) it is also a unique sector because banks display a particular mix of features that together imply enormous potential for systemic impacts. Indeed, this has been starkly demonstrated by the quickly-spreading contagion initiated by the so-called ‘subprime’ housing crisis in the USA. Banking groups around the globe have suffered from the collapse of deals, bank runs, crippling bad debts, emergency financial injections and bankruptcies, with some banks being taken into public ownership.

Much has been written about the subprime crisis in the USA, how this rapidly expanded into the worldwide financial and economic crisis that is evident today, and the various government responses to these challenges (for an extensive overview of events, see Brunnermeier, 2009). Most contributions have attributed blame to poor internal monitoring, excessive risk-taking within financial markets and, above all, inadequate regulation to counter the range of market failures intrinsic to the sector (see, for example, Blundell-Wignall *et al.*, 2008, Krugman, 2008, Brunnermeier, 2009, HM Treasury, 2009, Beck *et al.*, 2010, Vives, 2010, and Rajan, 2010). As such, analysis typically adopts a market failure perspective, with policy recommendations centred on finding appropriate regulatory responses. While these analyses have provided important insights, few have paid significant attention to underlying issues of governance of the banking system. Moreover, where they have emphasised governance issues (for example in the Walker Review, 2009), there has been a relatively narrow focus on specific failures in corporate governance.

The aim of this paper is to analyse the issues from an alternative theoretical starting point that emphasises the centrality of democratic governance in all socio-economic activity, and leads to a distinctive policy view on the banking sector. Specifically, we adopt a strategic choice approach to the theory of the firm. This is rooted in the work of Cowling and Sugden (1998, 1999), who build on seminal contributions from Coase (1937) and Zeitlin (1974). The strategic choice approach highlights the democratic governance of key decisions within firms (and other institutions) as critical for achieving the public interest, and views a given

sector in terms of its impacts throughout the economy. Examining the financial crisis from this perspective allows us to identify deeper causes behind recent events, providing insights into appropriate policy responses.

The analysis makes use of three cases which required major interventions by the UK Government: Northern Rock; Bradford and Bingley; and HBOS. These are all significant financial institutions that have required substantial government assistance, leading to (part) public ownership. Moreover they are all former building societies that were mutually owned until a change in government policy in the mid 1980s allowed their conversion into publically-owned banks.¹ An analysis of these cases using the strategic choice approach therefore links their plight in the present financial crisis with previous decisions concerning their ownership and governance. This leads to a re-examination of the issue of mutual ownership and its potential as an alternative to the shareholder or public ownership models that currently dominate, alongside a series of other suggestions relating to improving governance mechanisms.

The paper is organised as follows. Section (2) considers conventional market failure and regulatory perspectives on the financial crisis. In Section (3) we introduce the strategic choice approach as an alternative foundation for analysis. Section (4) uses our chosen cases to argue that changes in ownership and governance provide crucial insights into the roots of current problems. Section (5) then explores possibilities for reforming the governance of the sector by considering an updated mutual-based solution. Finally, Section (6) concludes.

2. Conventional Analyses of the Financial Crisis: Market and Regulatory Failure

Most analysis of the financial crisis has focused on market failures that characterise the financial sector and corresponding regulatory shortcomings that have failed to address or exacerbated these failures. The financial sector is characterised by what Vives (2010, p.1) describes as the “full array of classical market failures”. These include: externalities in the form of co-ordination problems and contagion, given the inter-connectedness of the system as a whole; asymmetric information among agents, leading to agency problems, moral hazard and adverse selection, and often manifested in excessive risk-taking behaviour; and the potential existence of market power. The complex co-existence of this set of issues has posed significant challenges for competition policy and regulation. Beck *et al.* (2010, p.1),

for example, describe a broad evolution from “the discontinuation of most standard competition policies in banking in order to foster financial stability” following the Great Depression, to “a swing of the pendulum towards deregulation, with more competition and innovation but also with many banking crises” from the 1970s. This latter period corresponds with fundamental changes in the functioning of banks, which forms the basis for much existing analysis of the causes of the most recent financial crisis.

In the ‘traditional’ banking model, funding for mortgage advances is predominantly from retail deposits. Banks make loans after undertaking risk assessment of clients and there is ongoing monitoring of borrowers, providing countenance against adverse selection and moral hazard. Loans are held as assets on balance sheets and banks cover themselves against unexpected risk by holding ‘appropriate’ levels of capital, while loan insurance is provided internally through the risk premia priced into the interest rate. In essence the performance of banks is determined by the quality of their own lending decisions, and responsibility lies therein (Michie and Llewellyn, 2010). Since the mid-to late 1990s, however, banks have begun to finance large parts of their lending through a combination of inter-bank borrowing on global wholesale markets and securitisation (re-packaging of assets to be sold on to investors as securities). This changed the landscape considerably. In benign conditions the inter-bank market allows banks to renew their maturing borrowings quite easily to meet daily obligations. Yet short-term liquidity can become a severe problem if market confidence is adversely affected. Moreover securitisation is a significant break from traditional banking, where the selling of loan assets was effectively precluded due to asymmetric information and the associated classic ‘lemons problem’ (Akerlof, 1970). Under securitisation the ‘lemons problem’ is supposedly nullified by the pooling of a diverse set of loan assets through Special Purpose Vehicles, thus making them attractive to investors. The debt products associated with these Special Purpose Vehicles were structured so that each could issue a variety of debt with different levels of agency rated risk attached, and these risks were seen to be minimal since insurance on default was being provided via the purchase of Credit Default Swaps. From a public interest perspective, however, potential problems arise since the securitisation process ultimately lessens the banking sector’s collective interest in and ability to monitor loans and appropriately evaluate their risk (Chick, 2008).

A common interpretation of events is that the adoption of these new modes of finance have allowed banks to pursue aggressive strategies in lucrative mortgage markets, offering a range of low-cost products, including to customers who might be deemed to be risky (Langley, 2008). A corresponding lack of prudence in lending decisions, poor monitoring of loans amidst the complexity of Special Purpose Vehicles (asymmetric information) and inappropriate risk identification have been widely acknowledged as the market failures at the root of the recent financial crisis. Further market failures of co-ordination and contagion (externalities) ultimately destroyed confidence in the system as a whole, and began a rapid process of spill-over into the real economy.

Given its *raison de être* as a response to these market failures, the effectiveness of regulation in balancing stability and competition is typically put under the spotlight in analysis of what went wrong and in making recommendations for what should change (see, for example, Blundell-Wignall *et al.*, 2008; Beck *et al.*, 2010; Vives, 2010). Contemporary global regulation emanates from the so-called Basel committee for international banking supervision, which among other things sets minimum capital requirements. However Krugman (2008) refers to the emergence of a ‘shadow banking system’ (p.158), which enabled the controls of the banking system to be avoided, initially facilitating increased profits, but without the stability and safety net that banking regulations are designed to provide. Thus blame is attributed to the advent of unregulated financial products such as auction-rate securities, Collateralised Debt Obligations and other similar modern financial instruments (see also Brunnermeier, 2009). Other criticism focuses on the mechanisms by which risk is measured within existing regulatory frameworks. There have been concerns raised about both the difficulty of statistically modelling risk due to lack of appropriate data, and the heavy reliance on unregulated credit-rating agencies (Danielsson *et al.*, 2001; Langley, 2008).

Such perspectives highlighting underlying market failures and corresponding regulatory shortcomings have been widely discussed and have influenced public policy reforms (see for example: proposals for the UK as outlined in HM Treasury, 2009; Independent Commission on Banking, 2011; and the establishment of a new Basel III Accord in 2010). They tend to focus on tightening existing financial regulations and improving monitoring to ensure more optimal handling of emerging problems. However, a relatively narrow ‘market failure’ frame

of analysis can mask more fundamental issues. In particular, what is often missed is the underlying processes of governance of the institutions that comprise the banking system and indeed contemporary capitalist economies more generally. In the next Section we therefore propose an alternative starting point for a complementary analysis.

3. An Alternative Perspective: Strategic Choice and Governance

The development of industries and economies can be analysed from a ‘strategic choice’ perspective (Bailey *et al.*, 2006 and references therein) with roots in Cowling and Sugden’s (1987, 1994, 1998, 1999) analysis of the modern corporation and their relationships with national and local economies. Cowling and Sugden build upon Coase’s (1937) distinction between in-firm planning and outside-firm market co-ordination and Zeitlin’s (1974) observations on corporate governance, to define the modern corporation as ‘the means of co-ordinating production from one centre of strategic decision-making’. Strategic decisions are defined as those which affect the strategic direction of the firm, such as the level of investment, employment or its location, and therefore its relationship with society (Cowling and Sugden, 1998, p.64-67). The concentration of strategic decision-making in large modern corporations, however, is likely to result in varying degrees of ‘strategic failure’: a situation where the outcomes of strategic decisions made by corporate hierarchies conflict, to a greater or lesser extent, with wider public interests. This is more likely in imperfect markets, where a ‘few’ corporate executives are often able to pursue private interests despite potential resistance from the ‘many’ stakeholders in society who may be affected by their decisions. Hence socially inefficient outcomes result, as those able to exert control can ignore wider public interests.

We can make a simple application of the strategic choice framework to re-consider the recent takeover of HBOS by Lloyds TSB. Lloyds TSB Plc was a British bank that had avoided much of the contagion in the marketplace and was relatively well placed during the financial crisis. When, in autumn 2008, HBOS found itself in difficulties, Lloyds TSB sought a controversial take-over to form the Lloyds Banking Group. The deal went through in January 2009, but required the UK government to bypass normal competition rules, given the size of both banks. The takeover has been controversial, largely because the full implications for the public interest will take several years to emerge (see The Economist

6/11/08; Whittam-Smith, 10/11/08; The Daily Telegraph, 18/5/09). However the executives in control of the two banks were able to execute the deal with expediency, despite resistance from many of those with an interest (shareholders, employees, governments, consumer organisations, and indeed rival banks). While too early to make a judgement of strategic failure in this case, such a scenario carries a high risk of generating socially inefficient outcomes because for the most part those in opposition to the deal were excluded from the decision-making process, and therefore had no real voice in determining strategy.

The main implication of the strategic choice approach is that through widening participation in strategic decision-making processes the power of ‘the few’ is diluted. They become part of ‘the many’ through the democratisation of governance, which in turn can nullify the risk of strategic failure and promote more socially optimal outcomes. In essence, this process gives Hirschmanian (1970) ‘voice’ (the articulation of interests to improve a situation) to those who are currently excluded, enabling a balance between the use of voice and the alternate mechanism of ‘exit’ (the withdrawal from an unsatisfactory situation). Overall, this implies greater focus upon how firms and other organisations are governed (see Branston *et al*, 2006, and Bailey *et al.*, 2006).

This perspective differs from the identification of specific market failures that lies behind much analysis of ownership, competition and regulation. In particular, the notion of governance is strongly process-oriented, dynamic and systemic. It implies a deep and broad understanding of corporate decision-making processes, starting from an analysis of whose interests are and should be articulated, and ultimately aiming to uncover ways of developing efficient and effective voice processes among the ‘publics’ affected by corporate decisions. Moreover, by recognising the separation of ownership and control as identified by Berle and Means (1932), the issue of ‘who’ owns the firm is not the main focus. In reality senior managers and the Boards of Directors of modern corporations exercise a good measure of control, yet often have no (or at least relatively small) direct ownership claims, whilst many (small) shareholders theoretically enjoy considerable ownership rights but have little real control. Ownership *per se* is not therefore the issue; it is important only in so far as different ownership settings in different contexts may render more or less likely the participation of those with an interest (‘publics’) in a firm’s decision-making processes. Indeed, this point seems to have been recognised by the recently established UK Commission on Ownership.²

A consequence of this perspective is a policy emphasis quite different to that typically placed on regulation. As identified by Branston *et al.* (2006a), regulation is essentially ‘an arms-length response to failures in arms-length relationships’ (p.203); a rigid framework is employed to enforce behaviour deduced to be in the public interest. As such regulation often struggles to keep pace with the evolution of the sector (as has been suggested of recent developments in the financial sector). More importantly, the ‘public’ itself is usually divorced from the process, and there is every chance that alternatives to either the regulated outcome or the regulation mechanism might be desired. Gauging public interest through conjecture and attempting to achieve it through rigid regulation is a poor substitute for direct involvement of stakeholders in identifying and implementing optimal outcomes as an integral part of the decision-making process. Indeed, Long (1990, p. 171) defines the public interest in just such a way: “consequences of private parties’ actions create a public as that public discovers its shared concern with their effects and the need for their control. The public’s shared concern with consequences is a public interest”.³ Preferences are undoubtedly shaped by the process of involvement, so in the absence of a collective voice process we have no way of knowing with any certainty the public’s evolving interest in key decisions.

As a simple analogy of the difference between a regulatory solution and the direct involvement of interested parties in decision-making, consider the actions of parents looking after a baby that is unhappy. When the baby can’t communicate, the parents have to guess at the cause of unhappiness, and it often takes time to identify the needs/desires of the child or to pacify it when these can’t be identified. This is akin to a regulated solution in that the benign ‘regulatory authority’ (the parents) are doing what they *think* is in the general interest of the child (the ‘public’). In contrast, when the baby is able to communicate the parents can find out *exactly* what the baby is unhappy about and address it directly, often after negotiations where the opinions of baby and parents may differ. This is almost certainly a more efficient solution in that it is quicker, because the parents don’t have to go through several guesses before hitting upon a resolution, and will most likely generate a Pareto improvement in that all involved are likely to be happier with both the outcome and mechanism of getting there. While this illustration considers mediating the interests of just one person rather than the many that form a public, the essential argument regarding

communication can be extended with appropriate collective mechanisms. With respect to regulation of the finance sector, a system based upon the articulation of the ‘voice’ of interested participants is likely to generate superior solutions to one which relies upon a fixed set of rules selected to achieve outcomes that are (often artificially) construed to be in the public interest.⁴ Indeed, this opens an interesting bridge with a resurgent stream of literature in political science that stresses the benefits of deliberative forms of democracy (and associated mechanisms) in the determination of societal objectives (Elster, 1998; Bohman, 1998; Dryzek, 2002).

In contrast to analysing ‘static’ financial regulation and its failures, therefore, an alternative is to make a more fundamental examination of the dynamics of banking governance and its implications. Governance issues have indeed been raised in the context of the recent crisis, but typically with a narrow focus upon failures in corporate governance, and particularly on the extent to which the banks’ corporate boards and senior managers were allowed to engage in excessive risk-taking strategies. The most notable contribution in this regard is the Walker Review (2009) into the corporate governance of UK banks and financial enterprises, which notes that *‘better financial regulation cannot alone satisfactorily assure performance of the major banks...these entities need to be better governed’* (ibid, p.9). The Review goes on to make a series of recommendations for improving governance structures. Proposals are primarily related to the composition of the boards of directors (and the role of chairpersons), and to encouraging greater activism on the part of non-executive directors and institutional shareholders in monitoring and engaging with corporate strategy. On the latter point arguments are made for adequate training to ensure effective participation.⁵

Many of the Walker review’s recommendations are sensible, important steps in creating a governance environment within banks that is more transparent, accountable and with internal checks and balances. Indeed, the need for better qualified (and trained) executives seems particularly important given the frequent charge that senior executives have struggled to understand the complexity of new financial products and were thus unable to monitor the activities of junior colleagues. However, it is debatable whether such recommendations alone would have been sufficient to nullify the risky strategies adopted by the banks amidst the rising property markets and neo-liberal beliefs in efficient markets and rational expectations that pre-dominated in the years leading up to the recent crisis. Indeed it is

notable that in such a climate, institutions such as rating agencies, central banks, governments and others failed to question the strategies and business operations of banks (Llewellyn, 2010). Moreover, even the governor of the Bank of England has questioned the efficacy of reformed international banking regulations, suggesting that “Basel III on its own will not prevent another crisis” (King, 2010, p.12).

The strategic choice approach invites a deeper consideration of the processes of decision-making that characterise the sector in seeking to understand the causes of the crisis. It urges analysis of *how* different (public and private) interests in the behaviour of banking institutions are articulated in the process of making key decisions. Focusing on issues such as which groups contribute to decision-making processes and whose interests are pursued in the execution of decisions, a process-oriented frame of analysis has potential to generate novel insights. In the next Section we illustrate our arguments with a discussion of three specific cases in the UK context, before turning in Section 5 to discuss possibilities for ways forward rooted in this perspective.

4. The UK Context and the Cases of Northern Rock, Bradford and Bingley and HBOS

Llewellyn (2009a, 2010) has argued that at the heart of the crisis in the UK was the move by bankers towards greater reliance upon wholesale funding, securitisation and the use of new financial instruments, shifting credit risk off the balance sheet. He (2010, p.8) concludes with the now universal phrase summarising the crisis: ‘*banks stopped behaving like banks*’. Traditional lending and monitoring practices were effectively relegated to a secondary role in the quest for greater market shares of (mortgage) lending. Retrospective analysis of these events has highlighted regulatory issues, focusing in particular on the split and execution of supervision responsibilities between the Financial Services Authority (FSA) and the Bank of England.⁶ However, a striking aspect often overlooked in discussions of the UK crisis concerns the characteristics of the banking institutions that played central roles in the development of the crisis.

Three of the main institutions affected had either converted from mutually-owned building societies or were the result of mergers including former building societies.⁷ Moreover they were at the forefront of the extraordinary growth in the mortgage market. Following

demutualisation, Northern Rock began to pursue a strategy of focusing almost exclusively upon the mortgage market, gradually withdrawing from the provision of ‘non-core financial services’ such as insurance products (Stephens, 2001, pp.338-341). By 2007, it had become one of the top 5 mortgage lenders in the UK, with this lending largely funded from global wholesale markets (BBC News, 15/09/07). Mortgage lending also became riskier and less prudent. Bradford and Bingley relied heavily upon wholesale funding to become a specialist in the growing ‘buy-to-let’ market, a market with greater exposure to default given the high number of ‘self certified’ mortgages (where borrowers are not required to provide proof of income). HBOS – a merger of the former building society Halifax and the Bank of Scotland in 2001 – was the UK’s largest mortgage lender and actively pursued lending in specialist higher risk activities, such as buy-to-let and subprime mortgages. HBOS was also the most reliant of all UK banks upon the wholesale markets, and its lending was estimated to be almost twice that of its deposits (The Times, 17/09/08).

Northern Rock was the first major UK casualty of the financial crisis in September 2007. Exposure of its weaknesses lead to a ‘run’ on the bank, the first in the UK since 1866 (Shin, 2009). The bank sought emergency funding of around £3 billion from the Bank of England, and within a week of the crisis its share price had fallen by 60% (BBC News, 15/09/07). By January 2008 loans from the Bank of England reached £26 billion, with further guarantees of approximately £30 billion. During the autumn of 2007 and the early part of 2008 the government invited bids for Northern Rock, although given the extent of the Bank of England’s involvement all bids were subject to government approval. Ultimately no bid was deemed acceptable and, given the interests of taxpayers, depositors and wider financial stability, Northern Rock was taken into public ownership in February 2008.⁸

Almost a year later a similar fate afflicted both Bradford and Bingley (B&B) and the much larger HBOS. In the case of B&B, rising concerns about exposure to the ‘buy-to-let’ market led to a downgrading of its’ credit rating and ability to access wholesale markets. A rights issue of £400 million in June 2008 failed to provide sufficient new capital, and in September 2008 B&B was nationalised, while its savings operations were sold to the Spanish financial group Banco Santander. HBOS’s tale is woefully similar. Falling housing prices meant that asset values on its book were unlikely to meet liabilities, again leading to a downgraded credit rating. The bank’s heavy reliance upon wholesale funding for daily operations was

compromised and the subsequent collapse in its share price in September 2008 exacerbated the situation. A proposed takeover by rival Lloyds TSB to secure its capital base was waived through and allowed to bypass UK competition law. In October 2008 the government took a 40% share in HBOS, becoming the largest single shareholder as part of the government's emergency £37 billion 'bailout' of the UK banking sector.⁹

These three cases raise important questions regarding the governance of key decisions. In particular, what drove these former building societies to pursue such risky strategies; strategies that they would not have been able to pursue had they remained mutual organisations, and which ultimately led to them being the most seriously affected UK banks in the crisis. Moreover, the behaviour of these institutions is particularly striking given that the UK mutual sector - with one or two exceptions - weathered the recent financial storm much better than commercial banks (Morgan and O'Hara Jakeway, 2009, p.34). Due to legal restrictions on accessibility to wholesale funding, reliance upon internal capital and a generally lower attitude to risk, the mutual sector was by and large far more prudent in its business decisions. As Llewellyn (2009b, 2010) notes, these firms did not move away significantly from the traditional banking model. As such they were generally in a better position to withstand the credit crisis, although they were clearly also affected by the contagion effects such as falling house prices and increasing personal bankruptcies.

The governance questions raised by this chain of events are coherent with the strategic choice perspective presented in Section 3. The juxtaposition of models with very different decision-making bases suggests a need to focus more analysis on how processes of decision-making are articulated within banks. The current period of reform for these former building societies, where government has been forced into taking significant ownership stakes, represents an ideal opportunity to do so. In this context the aim of the next Section is to explore possibilities that are rooted in fundamental concern with widening participation in decision-making.

5. Looking to the Future

Indications are that the UK government would like to seek a relatively quick privatisation of their stakes in the rescued financial institutions. Having previously split Northern Rock into

a ‘good’ and ‘bad’ bank in January 2010 (The Times, 26/04/2011), they announced in June 2011 the intention to auction off the good bank by the end of 2011 (BBC News, 15/06/2011; The Times, 17/06/2011), with a sale to Virgin Money announced in November 2011 (BBC News, 17/11/2011a). Furthermore, the government stakes are held by UK Financial Investments Ltd, which has a remit “to dispose of the Government’s shareholdings in RBS and Lloyds in an orderly and active way” (UKFI, 2011). Desire for speedy disposal is no doubt influenced by political objectives, with the government eager to generate capital receipts, reduce the state’s direct involvement in the financial sector and possibly highlight its ‘success’ in ‘turning around’ the ailing banks. There are, however, strong arguments against a rushed sale back to the private sector. In particular, public ownership of substantial interests in various financial institutions represents a unique opportunity for significant reform of governance within the sector that could address the strategic failures that underpin recent crises. The early sale of Northern Rock plc therefore represents a huge wasted opportunity for such reform, but the government has still got significant ownership stakes in other financial organisations for which it isn’t yet too late.

For governance reform to be meaningful it needs to move beyond current proposals by putting in place governance structures capable of achieving the dynamic integration of public interests. This requires more than the measures indicated in the Walker Review such as tightening regulation, ensuring competition, ring-fencing different banking functions, and more effective monitoring of risk taking. Specifically, reforms to the government-owned banks offer an opportunity to get to the root of strategic failure by creating more inclusive and democratic governance structures. While this will require a certain degree of experimentation with appropriate mechanisms to articulate different interests, failure to address the root cause of strategic failure risks a repetition of recent events and the prolongation of the status quo for a sector that is currently structured to serve the needs of the few but not the wider public.

5.1 A return to mutuality?

Given the policy prescriptions of the strategic choice approach and the history of both the UK financial sector in general and the three cases discussed in particular, an obvious starting point for reform discussions is to consider re-mutualisation. Indeed, mutuality is a form of ownership and governance that is presently topical in the UK. The Government has

launched, for example, a number of employee-led ‘pathfinder mutual’ pilot schemes aimed at furthering its ‘Big Society’ agenda of local mutually-provided public services (Cabinet Office, 2010). In line with this, mutual ownership is being considered in discussions around reform of the network of Post Offices (Co-operatives UK, 2011) and of Scottish Water (Scottish Futures Trust, 2010).¹⁰ Such a solution is also gaining interest with respect to the banking sector (Michie, 2010; Michie and Llewellyn, 2010; Oxford Centre for Mutual & Employee-owned Business, 2009), in which context Morgan and O’Hara Jakeway (2009, p. 34) have argued that the principles of mutualism ‘*could transform banks into the servants of their communities rather than masters of the universe*’. Furthermore, ideas for mutual ownership appear to enjoy some sympathy at the UK Commission on Ownership, and also benefit from a degree of political and public support. On the government’s announcement of the auction of Northern Rock plc, for example, the finance spokesman of the opposition condemned the move and called for a mutual approach instead (BBC News, 15/06/2011), and there were similar calls when the sale to Virgin Money was announced (BBC News, 17/11/2011b). A mutual solution was also supported by an opinion poll commissioned by the Coventry Building Society, one of two mutually owned societies reported to have been interested in the auction for Northern Rock plc (The Times, 26/04/2011).

From a strategic choice perspective, mutuality is intuitively attractive for the banking sector because the collective ownership (by their customers) of building societies provides potential advantages for facilitating more inclusive governance. Each member is given one vote irrespective of the size of their custom, and can use this vote to provide corporate governance in a similar way to shareholders in limited companies. For instance, members can exercise a certain degree of ‘voice’ at annual general meetings, where the society’s executives appear for re-election, and the ‘exit’ option is also available by moving deposits elsewhere. Thus in theory mutuality confers an environment that is conducive to a wider dispersion of strategic decision-making among customers, who constitute a key group of stakeholders with an interest in the activities of the organisation. Indeed, according to Marshall *et al.* (2003, p. 735), mutuality ‘stresses mutual interdependence as the means of promoting collective well-being’. As members are both users and owners of the business, the absence of external shareholders allows surpluses to be distributed to members in the form of low cost mortgages and low risk savings accounts with preferential rates of interest (Kay, 1991; Drake and Llewellyn, 2001). More widely, many building societies have

traditionally been involved in paternalistic activities in their own communities, often adopting ‘profit-satisficing’ behaviour such as maintaining (unprofitable) branch networks and extending basic financial services to financially excluded parties (see Marshall *et al.*, 2003: 743-746). While recognising that customers do not represent all potential interests in the activities of a given bank, it seems expedient to learn from experiences with such a model before also looking further afield to lessons from elsewhere.

5.2 Lessons from the past and the existing Building Societies

The fact that many financial organisations have moved away from a mutual model in recent years suggests that the traditional building society model has issues that need addressing. In this sense it is clear that it cannot be taken as a panacea for the problems of the sector. For instance, automatic notions of democracy and altruism within the UK building society movement are not realistic. Indeed, as early as in 1984 Barnes (1984) was concerned about the monopolistic activities of the larger building societies; in particular the cartels that persisted in the 1960s and 1970s which restricted competition at the expense of members’ welfare. He also raised concerns about the low participation rates of members in decision-making processes – such as at annual meetings – and the (lack of) accountability of directors to members. These issues became more acute as membership grew and senior executives became more remote. Moreover, in the more liberalised era of the 1980s and 1990s, building societies began to adopt a more commercial approach and often operated like banks (Drake, 1997), thus distancing themselves from the original ideals of mutuality.

The intense period of demutualisation during the 1990s followed a long period in which financial market de-regulation had led to increased competition from banks and other financial institutions that had left mutuality widely regarded as being an ‘outdated’ form of ownership. The ability of building societies to compete in this environment was compromised by the size of their capital and by legislation, and led to growing frustration among the hierarchies in a number of high profile building societies. These senior executives often had little sympathy for the principles of mutuality and generally favoured more aggressive commercial approaches. Moreover, they were increasingly influential, particularly in shaping the direction of corporate strategy within the sector (Marshall *et al.* 1997, 2003). Demutualisation was thus seen as an opportunity for greater freedom in the market and, supported by members’ growing expectation of demutualisation windfalls, a

number of leading building societies converted to public limited companies in the late 1990s.¹¹ For senior executives, there were also other attractions. Demutualisation offered legal protection from hostile takeover for 5 years following conversion, thus protecting incumbent positions of office. It also offered senior executives the possibility of higher personal financial incentives and rewards, something which was instrumental in driving the demutualisation process forward (see also, Barnes and Ward, 1999). These private interests were in some cases pursued despite resistance from others: see, for example, Perks's (1991) detailed account of the measures taken by Abbey National's corporate executives to nullify opposition to that society's demutualisation process in the late 1980s.

While strategic failure in the banking sector as a whole cannot be attributed to this process of demutualisation, the pursuit of narrow private interests that it illustrates is symptomatic of a more general diagnosis of the banking sector. Moreover, the recent difficulties of a number of current building societies can be attributed to a lack of accountability in their governance structures, and associated behaviour outside their traditional domains in attempts to compete in certain markets.¹² The Dunfermline Building Society, for example, had to be rescued by the government and its rival Nationwide Building Society in March 2009. In the four years prior to this, the society had been warned by the FSA that it was taking risks when it moved into commercial property lending and self-certified mortgages (BBC News, 20/05/09).

Yet would a greater degree of mutuality have provided a more stable financial environment? A crucial argument relates to the degree of risk undertaken within the overall market. In the earlier demutualisation debate, Llewellyn and Holmes (1991) argued that a wider variety of financial institutions provides greater stability to the overall market vis-à-vis a concentration of similar types of institutions. They suggested that since mutuals are not susceptible to the short-term demands of shareholders, they are less likely to undertake risky projects. A balance of ownership forms may thus play a role in limiting instability in the event of a banking crisis. Such arguments have seen resurgence in the light of the recent crisis. Various authors have suggested that a mixed governance structure for the overall financial sector, consisting of a variety of institutions with different capital structures and portfolios (i.e. 'bio-diversity'), is more likely to reduce systemic risk and provide for a more stable environment (Llewellyn, 2009a, 2009b, 2010; The Oxford Centre for Mutual & Employee-owned Business, 2009; Michie, 2010; Michie and Llewellyn, 2010; Ayadi *et al*, 2010).

Such diversity is in line with the theoretical arguments that support the strategic choice perspective. A balance of governance solutions potentially facilitates the participation of a wider range of interests in the key decision-making processes that shape the behaviour and performance of the sector as a whole. However, as is clear from the experiences discussed above, building societies in the UK also have governance issues and are subject to similar pressures to banks in many respects. Any moves to employ a mutual solution need to be updated so as to avoid the problems of the past. In particular they need to integrate new ways of dynamically articulating the full range of different interests in decision-making processes. As such, lessons can also be learned from experiences in other sectors.

5.3 Lessons from elsewhere

There are countless other organisations from which useful governance lessons can be learned. To start, we might consider the German two-tier board structure, where the management board is appointed by, and takes strategic decisions in conjunction with, a supervisory board which is more stakeholder orientated in that it contains shareholder and worker representatives (see German Government Commission, 2009). The enduring success of this system suggests a successful governance system need not be based solely on shareholders, and that a system with two boards, where each has its own clearly defined function, can be made to work. There are also many examples of UK organisations that are not shareholder based, but instead integrate the interests of a variety of stakeholders. The following are all ‘companies limited by guarantee’, meaning that they are limited liability companies which are owned and governed not by shareholders, but by a relatively small membership who are said to be representative of their wider stakeholders: Northern Ireland Mutual Energy, Glas Cymru (Welsh Water), Network Rail, Nominet UK, Oxfam, the Wellcome Trust, the England and Wales Cricket Board (ECB), and many other charities, social enterprises and housing associations.¹³ Similarly there are also many organisations which are ‘trustee companies’, where trustees ensure the organisation is run in the interests of the beneficiaries of the trust, which can be defined to include a range of stakeholder interests. Examples include the John Lewis Partnership, The National Trust, and the British Broadcasting Corporation (BBC).

Whilst these organisations operate in different fields and vary considerably in size and the detail of their governance arrangements, they have in common that they are successfully functioning organisations that are governed by members or trustees (henceforth members for simplicity) who represent not themselves, but other interested stakeholders. Generally speaking they are professionally run by an executive team who are experts in the sector. This team is held to account by a group of members, who represent wider interests within the scope of the rules in place for the organisation. The exact details of the size of membership and the process of being a member vary, so it is clear that there isn't a one-size-fits-all approach. By and large these member panels vary in size between 10 and 30, to balance practicality, cost and effective operation with the need to have sufficient voices to reflect the actual diversity of opinion. Most importantly, such organisations are explicitly designed to make decisions informed by the 'many' with an interest in their activities, rather than by the 'few' with an interest in their own private return. As such they represent an alternative to shareholder corporate governance models that is theoretically capable of representing a wider range of interests, potentially easing problems of strategic failure. Their effectiveness, however, will critically depend on the mechanisms in place to facilitate the articulation of these interests. There is no sense in creating such a membership model if members do not have effective and efficient ways of articulating their 'voice' that has real influence on strategic decisions.

To illustrate we might draw upon the experiences of the BBC, which is neither privately nor publically controlled in the conventional sense. It is mandated by Royal Charter to operate in the interests of the 'public' of license-fee payers that it is tasked to serve. To carry out this brief the Charter establishes a BBC Trust, which is required 'actively to seek the views of, and engage with, licence fee payers' (DCMS, 2006: Section 26). This operates alongside a series of mechanisms through which public 'voice' can be developed, including 'National Broadcasting Councils' for different parts of the UK, the geographical dispersion of production and 'drop-in' facilities, and considerable website space dedicated to informing on its activities and enabling comment and feedback (Branston and Wilson, 2006). Compared with the commercial rivals it competes against, the BBC is theoretically less prone to 'strategic failure' given the presence of channels for the development of voice and the use of these by a Trust that can hold management to account. Of course, how this operates in practice is another question, and the BBC has been heavily criticised for various aspects of

its operation. Nevertheless, that such mechanisms can work in enabling the interests of ‘publics’ to influence decisions can be seen in the decision to close the digital radio station BBC 6 Music, which was subsequently overturned by the BBC trust following the strong articulation of voice by certain publics (The Guardian, 05/08/2010).

Also of particular relevance to our discussion are the aforementioned reforms of the Post Office network and Scottish Water in officially commissioned reports. Both of these reviews recognise the inherent difficulties of balancing a workable system with the desire to include the many voices with an interest in the operations of such large companies. The simple mutual solution of ‘one member one vote’ is seen to be inoperable in both settings, and similar conclusions are reached as to an appropriate way forward if the current status quo of government ownership is to be rejected. Both commissions essentially identify a solution where management is held to account by a representative body of members representing public interests. This is in line with the experiences of the other organisations mentioned above and, we suggest, represents a route for consideration in the financial sector (see Scottish Futures Trust, 2010 and Co-operatives UK, 2010).

Indeed, each of the organisational examples considered herein illustrates institutional possibilities that offer potential for the development of governance solutions that can reduce the dangers of strategic failure. We suggest that exploring, testing and advancing these possibilities as part of the required governance reforms of the banking industry is an important challenge for public policy. The early sale of Northern Rock means we can only consider what might have been done with the governance structure of that organisation, but a change in the direction of current government policy could allow its ownership holdings elsewhere in the financial sector to be mechanisms for truly reforming policy.

5.4 An Outline Policy Suggestion

Based on our arguments above, one possibility for the banking sector is a return to some form of reformed mutual ownership status, but with a corresponding bolstering of governance mechanisms to ensure the development of voice. This would automatically give the right of participation to those with a significant interest, and would do so in a way that isn’t dependent upon a significant financial contribution. In this respect membership rights might be conferred for a small (nominal) deposit (e.g. £1), as in the remaining building

societies, so that they would be open to all. One difference to existing practice would need to be the inclusion of employees; a group with a very significant interest in the organisation, but excluded from the existing building society mutual model.

However mutual status by itself does not necessarily provide for an inclusive and democratic environment (Barnes, 1984). There is the danger of ‘elite capture’, with agendas and strategies being pursued in narrow interests. To guard against this, measures would need to be put in place, perhaps in the Articles of Association, to safeguard the democratic rights of all members and encourage wider participation. The real challenge would be to develop mechanisms and processes of engagement among members that are capable of balancing different interests in the process of strategic decision-making. In this regard lessons can be learned from the member controlled organisations cited in the previous section. Furthermore, articulating the advantages of voice processes will be critical to prevent against the possibility of a second de-mutualisation (an exit from mutuality). Of course, any new mutual society will continue to face competitive pressures to act commercially. Indeed, as we have noted, many remaining building societies now operate in similar ways to banks. However, if structures, regulations and Articles of Association are designed carefully then there is no reason why mutuals cannot co-exist with more commercial organisations as they have done for over 150 years previously, and be able to pursue interests that are wider than profit.¹⁴

One possibility for achieving these goals is the creation of a panel of members with a role to actively seek and represent the views of the whole body of members, acting in a supervisory capacity. A significant problem of a standard mutually-owned building society is that members are numerous and individually small, meaning that in reality there is little member power as it is hard to form a coalition for change (Barnes, 1984). By creating a members’ body that sits between management and all members, this problem would be directly addressed. Clearly careful planning would be needed to ensure that it did represent members’ views, but with some trial and adjustments real benefits are possible. For example, seats could be reserved for borrower members, saver members, and employees so that no one set of interests is unduly dominant, and the panel could be established with a specific statutory duty of consulting all members on appropriate policy, and reporting back to them on key decisions taken. The exact size and make-up of this panel would need to be appropriate for the organisation in question, balancing the interests of different types of members with the

size and nature of the firm, and also balancing the need for wide participation with limits on numbers to enable a practical operational design. Similarly the remit for this panel would need to be carefully defined so that they could hold the management team to account and appropriately be involved with strategic decision-making, but not in a way that requires too much specialised knowledge which would act to prohibit involvement. In this regard there might be a role for specialised members who are independent of the organisation but who have the appropriate level of knowledge to inform the work of the member's panel.

Whilst such ideas are a departure from the existing building society model, they are not so radical to be dismissed as unworkable; as we have seen, much of what we advocate exists in governance settings elsewhere. The likely main political obstacle is that the mere transfer of the state's ownership stakes to the (new) society's members will not raise monies to recompense the tax-payer. Given the current level of UK government borrowing, this is a considerable barrier. However, applying a re-mutualisation process to the nationalised banks would remove the banks from the state's books and thus (in time) ease the pressure on the public finances. Furthermore, with some creative thinking and a long term view, mutuality is a feasible and credible option. As noted above, there is much to be said for re-balancing the financial system between mutual and commercial banking institutions. Not only does such a move promote greater competition, but it also widens diversity in terms of capital structures and loan portfolios, thus reducing systemic risk within the system and lessening the possibility of future crises. A more stable and sustainable financial system is likely to provide real long term value to the taxpayer, and this might well outweigh the short-term benefits of immediate capital-receipts (Michie and Llewellyn, 2010).

Two specific possibilities present themselves. The first is for the government to create mutual ownership organisations from its stakes in former building societies, and fund this through the profitable commercial sale of its stakes in other banks. This is clearly a second best solution in that it only partially reforms the government-owned institutions. However, it could be seen as part of a longer, on-going project to establish new governance mechanisms in financial institutions, and test their benefits. The second possibility is that the government creates mutual ownership structures (and encourages associated development of new governance mechanisms) through the loan of the required capital to these new mutual organisations. This money is then repaid over time through a proportion of profits. This

would place a ‘profit-satisficing’ condition on future operations at least until the government investment had been repaid. This second possibility would not raise monies in the short term, but has the advantage of being applicable to all of the financial stakes that the government owns at present. A mixed alternative would ensure that some money is raised initially by the sale of some bank shares, whilst the former building society elements are re-mutualised with the investment capital being repaid slowly over time.

If such a member-centric organisation could be created using the government ownership holdings, there is no reason that this model, once established, could not be extended to other building societies. The government could provide backing for this scheme in terms of processes and governance models, and since these are already mutually-owned such changes should not draw heavily upon resources. Indeed, by kick-starting such a reform of the wider sector we might envisage a further level of reform where each institution specialises in a certain area. This might be a geographic area, providing financial services of the type required by particular locations or regions, or it could be specialising in the needs of specific industries. This has the advantage of focusing members’ interests and easing processes of participation and consensus-building in decision-making. Other possibilities for specialisation might include ethical banking or services acceptable to various religious faiths. Indeed, were such target institutions to be created, perhaps specialist ‘industry’ members might also be included in the governance mechanisms.¹⁵

6. Concluding Comments

The strategic choice approach provides unique insights into the recent financial crisis and a focus that is markedly different from typical mainstream approaches, which have tended to analyse regulatory and market failures. While these issues are important, there is a danger of too narrow a focus that neglects deeper issues at the root of the crisis. In contrast, the strategic choice approach calls for a particular emphasis upon processes of governance within the banking sector so as to facilitate the attainment of public interest objectives. The argument pursued in this paper is that the restricted strategic decision-making processes of the banks and other financial institutions prevented the identification of a strategy that was in the wider public interest; the chosen strategy corresponded to the interests of ‘the few’ in control of these institutions. This was dominated by a desire for short term returns,

necessitating disproportionate risks. The UK's former building societies are demonstrative of this scenario; our analysis has linked their current plight, and the associated 'strategic failure' in the financial sector, with previous strategic decisions concerning their ownership and governance structures.

Our focus on governance has pointed towards a re-examination of the issue of mutual ownership, given that different ownership settings provide different opportunities for governance processes. However we have suggested that this model needs to be reformulated so that all of those with a significant interest are included as members, and to ensure that these members have real power to articulate their interests in the governance process. To that end we have advocated exploring the possibility of creating membership panels with a clearly defined remit to sit between the body of members and management.

In advocating such policies we are in essence calling for measures that will facilitate the democratisation of the key decision-making processes of the various institutions that comprise the financial sector. The former building societies specifically discussed are just a starting point given the opportunity that the current government ownership of these institutions presents. In the longer term policies are required to ensure that the management of the whole financial sector is geared more towards the public interest than the attainment of short-run profits. Such policies need to nurture the public's articulation of 'voice' so that they no longer have to rely upon exit strategies when dealing in this market. The reform of state-owned financial organisations is therefore just a first, but important, step if the banking sector is to be transformed to better reflect the long-term public interest.

7. References

- Akerlof, George A. (1970) The Market for 'Lemons': Quality Uncertainty and the Market Mechanism, *Quarterly Journal of Economics*, 84 (3), pp.488–500.
- Ayadi, Rym, Llewellyn, David T., Schmidt, Reinhard H., Arbak, Emrah, De Groen, Willem Pieter (2010), *Investigating Diversity In The Banking Sector In Europe: Key Developments, Performance And Role of Cooperative Banks* (Brussels: Centre for European Policies Studies), downloaded on 9th November 2011 from:
<http://www.ceps.be/book/investigating-diversity-banking-sector-europe-key-developments-performance-and-role-cooperative>
- Bauer, Keldon J., Miles, Linda L., and Nishikawa, Takeshi (2009) The effect of mergers on credit union performance, *Journal of Banking & Finance*, 33 (12), pp.2267-2274.
- BBC News (15/09/07) 'Rush on Northern Rock continues',
<http://news.bbc.co.uk/1/hi/business/6996136.stm>.
- BBC News (20/05/09) 'Dunfirmline 'warned over risks'',
<http://news.bbc.co.uk/1/hi/scotland/8059994.stm>
- BBC News (15/06/2011) 'Osborne plans to sell Northern Rock to a single buyer'
<http://www.bbc.co.uk/news/business-13783724>
- BBC News (17/11/2011a) 'Northern Rock sold to Virgin Money'
<http://www.bbc.co.uk/news/business-15769886>
- BBC News (17/11/2011b) 'Northern Rock sale: Labour's Ed Balls questions timing'
<http://www.bbc.co.uk/news/uk-politics-15774826>
- BBC News (14/12/2011) 'Lloyds names Co-op preferred bidder of bank branches'
<http://www.bbc.co.uk/news/business-16174571>
- Bailey, David, De Propriis, Lisa, Sugden, Roger and Wilson, James R. (2006) Public Policy for European Economic Competitiveness: An Analytical Framework and a Research Agenda, *International Review of Applied Economics*, 20 (5), pp.555-572.
- Barnes, Paul (1984) *Building Societies: The Myth of Mutuality* (London, Pluto Press)
- Barnes, Paul and Ward, Martin (1999) The consequences of deregulation: a comparison of the experience of UK building societies with those of the US Savings and Loan Associations, *Crime, Law and Social Change*, 31 (3), pp.209-244
- Beck, Thorston, Coyle, Diane, Dewatripont, Mathias, Freixas, Xavier and Seabright, Paul (2010) *Bailing Out the Banks: Reconciling Stability and Competition. An analysis of state-supported schemes for financial institutions* (London: Centre for Economic Policy Research)
- Berle, Adolf A. and Means, Gardiner C. (1932) *The Modern Corporation and Private Property* (New York: MacMillan)

Blundell-Wignall, Adrian, Atkinson, Paul and Lee, Se Hoon (2008) The Current Financial Crisis: Causes and Policy Issues, *Financial Market Trends*, 96 (2008/2), pp.11-31.

Bohman, James (1998) Survey Article: The Coming Age of Deliberative Democracy, *The Journal of Political Philosophy*, 6 (4), pp.400-425.

Branston, J. Robert., Cowling, Keith and Sugden, Roger (2006) Corporate Governance and the Public Interest, *International Review of Applied Economics*, 20 (2), pp.189-212.

Branston, J. Robert and Wilson, James R. (2006) Transmitting Democracy: Broadcasting Policy and the BBC, *University of Bath School of Management Working Paper*, No. 2006.11.

Brunnermeier, Markus K. (2009) Deciphering the Liquidity and Credit Crunch 2007-2008 *The Journal of Economic Perspectives*, 23(1), pp.77-100.

Cabinet Office (2010) "Francis Maude launches Pathfinder Mutuals", press release downloaded on 22nd June 2011 from, <http://www.cabinetoffice.gov.uk/news/francis-maude-launches-pathfinder-mutuals>

Chambers, Clare and Ryder, Nicholas (2008) The funding of credit unions - where has all the money gone?, *Journal of Social Welfare & Family Law*, 30 (3), pp.243-252.

Chick, Victoria (2008) Could the crisis at Northern Rock have been predicted?: An evolutionary approach, *Contributions to Political Economy*, 27 (1), pp.115-124

Coase, R. H. (1937) The Nature of the Firm, *Economica*, 4 (16), pp.386-405.

Co-operatives UK (2011) *Mutual Options for Post Office Ltd* (Manchester: Co-operatives UK), downloaded on 10th May 2011 from <http://www.uk.coop/>

Cowling, Keith and Sugden, Roger (1987) *Transnational Monopoly Capitalism* (Sussex: Wheatsheaf Books)

Cowling, Keith and Sugden, Roger (1994) *Beyond Capitalism: Towards a New World Economic Order* (London: Pinter Publishers)

Cowling, Keith and Sugden, Roger (1998) The Essence of the Modern Corporation: Markets, Strategic Decision-Making and the Theory of the Firm, *The Manchester School*, 66 (1), pp.59-86.

Cowling, Keith and Sugden, Roger (1999) The Wealth of Localities, Regions and Nations: Developing Multinational Economies, *New Political Economy*, 4 (3), pp.361-378.

Danielsson, Jon, Embrechts, Paul, Goodhart, Charles, Keating, Con, Muennich, Felix, Renault, Olivier and Shin, Hyun Song, (2001) An Academic response to Basel II, *Special Paper No 130, LSE Financial Markets Group*. Downloaded on 10th November 2011 from <http://www.bis.org/bcbs/ca/fmg.pdf>

Davis, Kevin (2001) Credit union governance and survival of the cooperative form, *Journal of Financial Services Research*, 19 (2/3), pp.197-210.

DCMS (Department for Culture, Media and Sport) (2006). *A Public Service for All: The BBC in the Digital Age*, White Paper, March 2006, London.

Dewey, John (1927) *The Public and its Problems* (Denver, CO: Holt).

Di Noia, Carmine & Di Giorgio, Giorgio (1999) Should Banking Supervision and Monetary Policy Tasks be Given to Different Agencies?, *International Finance*, 2 (3), pp.361-378

Drake, Leigh (1997) *The Economics of Mutuality*, LUBC-BSA Project Paper 3, (London: The Building Societies Association)

Drake, Leigh & Llewellyn, David T. (2001) The economics of mutuality: a perspective on UK Building Societies, in: Johnston Birchall (ed) *The new mutualism in public policy*, pp.14-40 (London: Routledge).

Dryzek, John (2002) *Deliberative Democracy and Beyond: Liberals, Critics, Contestations*, (Oxford: Oxford University Press).

Elster, Jon. (1998) Introduction, in: Jon Elster (ed) *Deliberative Democracy*, pp.1-18. (Cambridge: Cambridge University Press).

German Government Commission (2009) German Corporate Governance Code, June 18th 2009, downloaded on 21st June 2011 from
http://www.ecgi.org/codes/documents/cg_code_germany_june2009_amendments_en.pdf

Hirschman, Albert O. (1970) *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations and States* (Cambridge, MA: Harvard University Press).

HM Treasury (2009) *Reforming Financial Markets*, CM7667, London: The Stationary Office. (downloaded on 30th July 2009 from
http://www.hm-treasury.gov.uk/reforming_financial_markets.htm)

Independent Commission on Banking (2011) *Interim Report: Consultation on Reform Options* (downloaded from <http://bankingcommission.independent.gov.uk/> on 10th May 2011)

Kay, John (1991) The economics of mutuality, *Annals of Public and Co-operative Economics*, 62 (3), pp.309-318.

King, Mervyn. (2010) 'Banking: From Bagehot to Basel, and Back Again', *The Second Bagehot Lecture*, Buttonwood Gathering, New York City USA, 25th October 2010, downloaded on 25th July 2011 from:
<http://www.bankofengland.co.uk/publications/speeches/2010/speech455.pdf>

Krugman, Paul (2008) *The Return of Depression Economics and the Crisis of 2008* (London: Penguin Books).

Langley, Paul (2008) Sub-prime mortgage lending: a cultural economy, *Economy and Society*, 37 (4), pp.469-494

Leggett, Keith J. and Strand Robert W. (2002) Membership growth, multiple membership groups and agency control ad credit unions, *Review of Financial Economics*, 11 (1), pp.37-46.

Llewellyn, David T. & Holmes, Mark J. (1991) In Defence of Mutuality: A Redress to an emerging conventional Wisdom, *Annals of Public and Co-operative Economics*, 62 (3) pp.319-354.

Llewellyn, David T. (2009a) The New Banking and Financial System, in: David Mayes, Robert.Pringle and Micheal Taylor (eds) *New Frontiers in Regulation and Oversight of the Financial System*, pp.49-58 (London: Central Banking Publications)

Llewellyn, David T. (2009b) Building Societies and the Crisis, *Butlers Building Society Guide*, (London: ICAP plc).

Llewellyn, David T. (2010) Banking after the crisis: Come back Captain Mainwaring – all is forgiven?, *mimeo*, (London: ICAP plc).

Long, Norton E. (1990) Conceptual notes on the public interest for public administration and policy analysts, *Administration Society*, 22 (2), pp.170-181.

Marshall, J N, Richardson, R, Raybould, S and Coombes, M (1997) The transformation of the British Building Society Movement: Managerial Divisions and Corporate Reorganisation, 1986-1997, *Geoforum*, 28 (3-4), pp.271-288.

Marshall J. Neil, Willis, Richard, Richardson Ranald (2003) Demutualisation, strategic choice, and social responsibility, *Environment and Planning C: Government and Policy*, 21 (5), pp.735 – 760.

McKillop, Donal G., Ward, Ann-Marie and Wilson, John O.S. (2007), The development of credit unions and their role in tackling financial exclusion, *Public Money and Management*, 27 (1), pp. 37-44.

Michie, Jonathan. (2010) ‘Promoting corporate diversity in the financial services sector’, research paper for the commission on ownership, downloaded on 22nd June 2011 from <http://ownershipcomm.org/research/>

Michie, Jonathan & Llewellyn, David T. (2010) Converting failed financial institutions into mutual organisations, *Journal of Social Entrepreneurship*, 1 (1), pp.46-170.

Morgan, Kevin and O’Hara Jakeway, Jenny (2009) Mutualism – an idea whose time has come (again), in: John Tomaney (ed) *The Future of Regional Policy*, pp.34-39 (London: The Smith Institute)

The Oxford Centre for Mutual & Employee-owned Business (2009) “Converting failed financial institutions into mutual organisations”, Kellogg College, University of Oxford.

<http://www.kellogg.ox.ac.uk/researchcentres/documents/Converting%20financial%20institutions%20into%20mutual%20organisations%20-%20final.pdf>

Perks, R.W. (1991) The fight to stay mutual: Abbey members against flotation versus Abbey National Building Society, *Annals of Public and Co-operative Economics*, 62 (3), pp.393-429.

Rajan, Raghuram G. (2010) *Fault Lines: How Hidden Fractures Still Threaten the World Economy* (Princeton: Princeton University Press)

Ryder, Nicholas and Baker, Andrew H. (2003) The enemy within? A critical analysis of the Credit Unions Act 1979 and the Common Bond, *Journal of co-operative studies*, 36(2), pp.117-140.

Sacchetti, Silvia, and Sugden, Roger (2007) Creativity in Economic Development: Space in an Inferno, University of Birmingham Institute for Economic Development Policy Discussion Paper 2007-02.

Scottish Futures Trust (2010) "Scottish Water: Future Funding Options", downloaded from <http://www.scottishfuturestrust.org.uk/publications.asp> on 20th June 2011.

Shin, Hyun. Song (2009) Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis, *The Journal of Economics Perspectives*, 23(1), pp.101-119.

Stephens, Mark (2001) Building Society Demutualisation in the UK, *Housing Studies*, 16 (3), pp.335-352.

The Daily Telegraph (18/05/09) 'Lloyds merger with HBOS under fire as Sir Victor Blank departs', *Telegraph Newspapers*, London

The Economist (06/11/08) 'Letting Lloyds TSB proceed with its takeover of HBOS is a mistake', *The Economist Newspaper Limited*, London

The Guardian (05/08/2010) "BBC 6 Music's audience rises again", *Guardian New and Media Ltd.*

The Times (17/09/08) 'HBOS shares slump puts the frighteners on 15 million savers', *News International*, London.

The Times (26/04/2011) 'Coventry aims to turn Rock back into a building society', *News International*, London.

The Times (17/06/2011) 'Virgin restates its interest in taking on bmi', *News International*, London.

The Walker Review (2009) *A review of corporate governance in UK banks and other financial industry entities: final recommendations* (London: The Walker Review Secretariat), downloaded on 26th November, 2009 from http://www.hm-treasury.gov.uk/walker_review_information.htm

Treasury Select Committee "[Fifth Report](#)"., House of Commons 24/1/2008.

UKFI (UK Financial Investments Ltd) (2011), company website, 'about us' section, 'investment strategies' sub-section', <http://www.ukfi.co.uk/>, accessed on 26th July 2011.

Vives, Xavier (2010) 'Competition and Stability in Banking', *CEPR Policy Insight No. 50*, www.cepr.org.

Ward, Ann-Marie and McKillop, DonalG. (2005) An investigation into the link between UK Credit Union Characteristics, Location and their Success, *Annals of Public and Cooperative Economics*, 76 (3), pp.461-489.

Whittam-Smith, Andreas (10/11/08) 'Lloyds and HBOS – a merger that should not go through', *The Independent*, London

Zeitlin, Maurice (1974) Corporate Ownership and Control: The Large Corporation and the Capitalist Class. *American Journal of Sociology*, 79 (5): 1073-1119.

¹ A 'building society' is a mutually owned bank which specialises in mortgages and saving products. These institutions are very similar to the 'savings and loan associations' of the USA.

² The Commission on Ownership was set-up in the UK following the financial crisis in order to establish "a new and clear understanding of the influence that ownership has on the governance of our country, on British businesses and in the public sector". See <http://ownershipcomm.org/> for more information.

³ Long draws in particular on the seminal work of Dewey (1927) in analysing the public interest: for a more detailed analysis, see Sacchetti and Sugden (2007).

⁴ The baby analogy is useful for a further point regarding regulation. Sometimes the public is 'wrong' and regulation is needed to limit what they would otherwise like to happen. It isn't always appropriate for a child to stay up late and eat chocolate. The key difference in this situation is that utilising regulation alone removes (or at the very least reduces) the possibility of the public themselves from identifying superior solutions or outcomes. The public in this setting has no possibility of using Hirschman's (1970) concept of voice.

⁵ The Walker Review was commissioned in February 2009 by the then UK Prime Minister, Gordon Brown, and was chaired by David Walker of the Audit Commission. The review made 38 recommendations in relation to reforming corporate governance within the UK banking and finance sector. Further details are available at http://www.hm-treasury.gov.uk/walker_review_information.htm.

⁶ The FSA's creation in 1997 was part of a new financial framework where the (independent) operation of monetary policy was assigned to the Bank of England, which in turn relinquished responsibilities for financial supervision to a new body (the FSA) to avoid any 'conflict of interest' (see Di Noia and Di Giorgio, 1999).

⁷ It is also noteworthy that in addition to these three cases not one of the other demutualised building societies has survived as an independent financial institution, the others being subsequently taken over by rival banking groups (Michie and Llewellyn, 2010).

⁸ See Shin (2009) for a more in-depth overview and analysis of the collapse of Northern Rock.

⁹ To comply with EU state aid rules, the enlarged Lloyds Banking group was required to divest a significant package of branches, brands and customer accounts. It was announced in December 2011 that the mutually owned Co-operative Banking Group was the preferred buyer of these assets which seems prescient given the arguments for mutuality contained later herein. See BBC News (14/12/2011) for more details on the sale.

¹⁰ In the latter case it is suggested that this option is unlikely to work given the large scale of the utility business. However another option being considered is a 'Public Benefit Corporation', which would own the organisation 'for the people' in a similar way to the 'company limited by guarantee membership' model that we mention in section 5.3 below.

¹¹ The demutualisation process was exacerbated by the entrance of 'carpet baggers', who became members in anticipation of participating in the expected 'windfalls'. In essence, demutualisation engineered an inter-generational redistribution of reserves, as current members appropriated value built up by previous generations of members (Llewellyn, 2009b).

¹² Building societies were not immune to the crisis. However, their problems largely emerged due to the subsequent downturn in the property market (which resulted from the crisis) rather than any over-reliance upon wholesale funding (Llewellyn, 2009b).

¹³ See overview in Scottish Futures Trust (2010).

¹⁴ In order to ensure stability and safeguard against further de-mutualisation (which current legislation would allow), some form of 'asset lock' preventing members from realising the mutual's underlying assets might be put in place. This could be achieved by legislation, but in the short term charitable assignment practices that have been a successful defence (against demutualisation) in existing building societies may suffice (Michie and Llewellyn, 2010).

¹⁵ Whilst our analysis has been applied to building societies, it should be noted that much of the content could also be applied to credit unions. Credit unions are relatively small, mutually-owned financial service institutions where membership is restricted to those with a 'common bond' (such as common geographic location or place of work). They account for a very small share of the UK financial market, but are seen to have a big role in combating social exclusion. For more on the functioning of credit unions in general, see Ryder and Baker (2003), Ward and McKillop (2005), McKillop *et al* (2007), and Chambers and Ryder (2008). For evidence of similar problems with their governance that we have highlighted for building societies herein, see Davis (2001), Leggett and Strand (2002), and Bauer, Miles and Nishikawa (2009).