Keeping Bad Company

Building societies: a case study

Purpose

- compare two organisational forms, the management controlled organisation (MCO) with the shareholder value organisation (SVO).
- to assess their relative strengths and to provide some explanation as to why converted building societies as SVOs were more susceptible to, and constituent of, the current financial crisis than their mutual counterparts, MCOs.
- institutional economics, organisational sociology, political economics and the law.

Overview

- Small terminating mutual societies gave way to large MCOs.
- MCO theory – supportive and critical.
- Neo-liberal theory crystallised with MCO-based criticism which led to reform of societies as SVOs.
- Problem with shareholder value and SVOs.
- Compare MCO building societies and SVO converted societies.

From collectives…

- 18th century, industrialised cities.
- Member-based saving groups, terminating.
- 1836 Benefit Building Societies Act.
- Established regulator – the Registrar of Friendly Societies 1849, FSA 2001.
- Rapid growth (Reform Act 1832 and freeholdland societies – Chartist Co-operative land Society).
- Permanent societies to accommodate larger societies.
- Building Societies Act 1874.

To MCOs...

- Berle and Means(1932) separation thesis.
- Complexity of permanents required trained management.
- Growth and mergers – 1890: 2,286 societies, 600,000 members. 1950: 819 societies, and 1.5 million members
- Retained One-member-one-vote.
- 1869 Building Societies Protection society, later Building Society Association (BSA) co-ordinated movement – 1939 recommended interest rates policy.

Normative implications: positive

- Institutional economics: Corporation no longer comprehensible according to classical economics, profit low priority, replaced by managerial goals, stability growth, product development.
- Later Berle (1967) corporation socialised and dependent on state intervention – public not private. Profit goals replaced by good labour standards and stability.
- Galbraith (1967) risk averse management, sales growth, prestige, product development.

MCOs and efficiency

- Alfred Chandler's '*Visible Hand*' (1977) entrepreneur replaced by manager – capitalism more efficiently responded to crises through management structures.
- Professionalisation of managers.
- Vertical and horizontal mergers, reducing inefficient market transacting.
- MCO not primarily from share dilution.
- Oligarchy, stable and rational.
- Conformed to Weber's rational bureaucracies (1905).
- Marxists Sweezy and Baran (1976) – elite management with group coherence, stable and crisis-resistant.

Theoretical origins of efficiency
Ronald Coase (1937)

- Markets most efficient way to transact if costs are nil.
- In reality costs are high (information, enforcement).
- Firms will emerge where cost of transacting each arrangement in the market is more costly than if co-ordinated ‘in house’.
- ‘market transactions are eliminated’ and replaced by ‘the entrepreneurial co-ordinator, who directs production’
- Like institutional economists, efficiency not just profit but product growth.
- But unlike them, Coase retained market forces.

Normative implication of MCOs: negative

- Marxist: Baran and Sweezy (1976) – management not benign or neutral but represents a class.
- Later Weber – malignant bureaucracies determined by their own irrational rules and structures.
- Braverman (1974) – MCO facilitated social division of labour and empowered and security of management by conscious disempowering of others.
- Burnham (1940) – expropriated knowledge and skills to de-skill workers and disempower investors.
- Management goals – security and self perpetuation.

- Perrow (2002) – socialise, negative cultural influence, wage dependency, centralisation of wealth.
- “bureaucratic organisations are the most effective means of unobtrusive control human society has produced, and once large bureaucracies are loosed upon the world, much of what we think of causal in shaping our society – class, politics, religion, socialisation and self-conceptions, technology, entrepreneurship – become to some degree shaped by organisations”.

MCO criticism dovetailed with neo-liberalism: 1970s-present

- Rejected normative values of MCOs' institutional and non-competitive practices and promoted the free market of contracting private property owners.
- Coase's firm substituted by firm as *internalised market* by law and economics theorists.
- Alchian and Demsetz (1972) substituted Coase's hierarchy with a team of contractors.
- Manager exists to meter 'shirking'.

Firm as nexus of contracts

- Jenson and Meckling (1977) – legal fiction with agency costs. Bonding and monitoring to ensure pursuit of shareholder value.
- Easterbrook and Fischel (1993) – most efficient model for business – state interference reduced efficiency.
- Hansmann and Kraakman (2000) – 'End of History for Corporate law'.

Neo-liberal formula for MCOs

- Hierarchies have a negative effect on profitability/ shareholder value because they reduce the positive aspects of market forces ie information so....
- 1. reduce state interference, allow individual negotiation and invisible hand;
- 2. agency problem in contracts?
  - a. share options
  - b. market for corporate control
  - c. thus making them fully shareholder value organisations (SVOs).

Building societies reform from MCO to SVO

- Wilson Report (1980).
- Self protecting oligarchy.
- BSA ‘recommended interest rates’ anti-competitive, self protecting.
- Irrational bureaucracy: prudential policies resulted in indirect discrimination.
- Management goals: empire building not profit/efficiency ie Branches – from 1970-78 rose from 2,016 to 4,595, high operational costs.

The Green Paper 'Building Societies a New Framework' 1984

- Reduce building societies' quasi-social status:
  a. extend purpose of Building societies
  b. facilitate challenges to BSAs new 'advised' rates by removing exemption from the Restrictive Practices Act 1976
  c. allow conversion directly becoming SVOs

- Building Societies Act 1986

Superior forms of organisation?
The Problem with SVOs 1: managers

- Enslaves manager to the share market
  1. Encourages distorted relationship to risk
  2. Jenson (2005): Target base corporate budgeting systems and their manipulation
  3. Exacerbated by institutional shareholders..
     1. Poor monitors. Roach (2006)
     2. Interest limited to company as a profit maximizer
     3. Use of professional fund managers. Froud (2006)

The Problem with SVOs 2: Share Market

- SVOs encourage expectation of high returns which is reflected in share price.
- Neo-liberal – accurate as market efficient at reflecting information, calculating risk, returns and interest rates.
- Cannot buck the market – Louis Bachelivier (1900).
- But: Disparity between expectation (price) and profitability (translated as dividend in SVO governance).
- Froud (2006) – S&P, 20% returns but 70.1% share price. Dividends 4-5% (interest rate).
- Blair and Schary (1993) – critique of Jenson’s free cash flow theory of LBOs.

Why?

- Henwood (1998) – Untrained, incontinent, irrational.
- Froud – shareholder exuberance, low interest rates and institutional investment.
- Market not efficient as reflects ideologically provoked high investor expectations.
- Rational expectation that managers will take action to enhance shareholder value.
- Problem: objective limits to profitability.

SVO

- Ideological v economic limitations
- Individualised, competitive
- Profit/shareholder value
- Contractual model
- Agency costs and high remuneration (manager to blame?)
- Responsive to shareholder demands
- Private: no justification for state interference

MCO

- Stability: more descriptive
- Collective, oligarchic
- Growth, balance, prudence
- Hierarchical
- Managerial but modest managerial pay
- Member's power diluted
- Partly public in character and therefore justifiably regulated by the state

Building societies. SVO v MCO

SVO (converted society)

- Funding from wholesale market. Northern Rock 75% ‘reckless business model which was excessively reliant on wholesale funding’ (Treasury select committee)
- Bradford & Bingley. Buy-to-let – June 2008 60%.
- B&B sold to Santander
- Northern Rock nationalised

MCO (mutual society)

- Limited by law (50%) and BSA (30%)
- Pro-emptive mergers – Brittania and Co-operative Financial Services
- Collective response – 1978 Grays, rescue fund
- Sept 2008 Barnsley and Yorkshire, Nov Nationwide, Cheshire , Derbyshire, December Catholic and Chelsea, March 2009, Scarborough and Skipton
- No member vote: s.94(5)
- No windfall payment

Conclusion

- Either SVO or MCO?
- MCO theories cited public participation, stability, state involvement as reason to abandon notion of MCO as private and the abandonment of shareholder value.
- Current response: state involvement, public money but no correlating understanding of organisations as public.
- Next – the social-value organisation?