

**‘Strategic Failure’ and the case of the UK’s former Building
Societies: lessons for the reform of governance in the UK
Banking sector**

J. Robert Branston, Philip R Tomlinson,
James R. Wilson

University of Bath
School of Management, Working Paper Series
2009.09

This working paper is produced for discussion purposes only. The papers are expected to be published in due course, in revised form and should not be quoted without the author’s permission.

**University of Bath School of Management
Working Paper Series**

School of Management
Claverton Down
Bath
BA2 7AY
United Kingdom
Tel: +44 1225 826742
Fax: +44 1225 826473
<http://www.bath.ac.uk/management/research/papers.htm>

2009		
2009.01	Androniki Apostolakou & Gregory Jackson	Corporate Social Responsibility in Western Europe: An Institutional Mirror or Substitute?
2009.02	Meryem Duygun-Fethi & Fotios Pasiouras	Assessing Bank Performance with Operational Research and Artificial Intelligence Techniques: A Survey
2009.03	Klaus E. Meyer	Corporate Strategies under Pressures of Globalization: Globalfocusing
2009.04	Christos Ioannidis, Fotios Pasiouras & Constantin Zopounidis	Assessing bank soundness with classification techniques
2009.05	Klaus E. Meyer	Corporate Strategies under Pressures of Globalization: Initiating a Forward-looking Debate
2009.06	Philip Cooper, Eleanor Dart	Change in the Management Accountant's Role: Drivers and Diversity
2009.07	Gregory Jackson	Actors and Institutions
2009.08	Richard Fairchild	Incentive problems and Reciprocal Behaviour in Venture Capital/entrepreneur Dyads: The effect of Inequity-aversion, Trust and Social Norms
2009.09	J. Robert Branston, Philip R Tomlinson, James R Wilson	'Strategic Failure' and the case of the UK's former Building Societies: Lessons for the reform of governance in the UK Banking Sector

‘Strategic Failure’ and the case of the UK’s former Building Societies: Lessons for the reform of governance in the UK Banking Sector

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

Abstract

We present a broad view of the crisis affecting the global financial sector by drawing upon the strategic choice approach to the theory of firm (Cowling and Sugden, 1998, 1999). We emphasise the process of engaging interested ‘publics’ in corporate decision-making. This is important given the concentration of strategic decision-making in the banking sector, where the pursuit of short-term corporate interests have been demonstrably inconsistent with wider public interests. We analyse three UK cases which required major public interventions - Northern Rock, Bradford and Bingley, and HBOS banks. Their history reveals significant changes in ownership, governance and corporate strategy, which we link to their current plight. The current period of reform represents an opportunity to address serious concerns over governance and we offer some suggestions.

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

JEL Codes: G21, G38, L21 and L52

Address for Correspondence

Dr J Robert Branston
School of Management
University of Bath
Bath
BA2 7AY
U.K.
J.R.Branston@bath.ac.uk
Tel: +44 (0)1225 383179
Fax: +44 (0)1225 386473

1. Introduction

Until recently the idea of a Western bank or financial group failing was beyond the realm of most people's imagination (except perhaps in very extreme cases, such as Enron or BCCI, where corporate fraud or criminal activity by managers had become a problem). Depositing savings or making an investment with a bank was seen to be reasonably safe, a virtually risk free action, which was part of the normal functioning of the economy and society. Events in 2007 and 2008 have illustrated how wrong this commonly held perception was, as the global financial system suffered from a 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, emergency financial injections and bankruptcies, with some banks even being taken into public ownership. In the UK, for instance, there have been high profile cases, most notably involving Northern Rock, Bradford and Bingley, HBOS and Royal Bank of Scotland.

Much has been written about the sub-prime crisis, how this has 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 of these contributions have tended to point towards inadequate regulation, poor monitoring and excessive risk-taking within the financial markets as the major contributory factor to the current turmoil (see for example, OECD, 2008, Krugman, 2008, Brunnermeier, 2009 or HM Treasury, 2009) and as such, have in general adopted some form of 'regulatory' or 'market failure' type of analysis. While these analyses have undoubtedly provided useful insights, they have also skirted around what we would argue are the fundamental issues of the financial crisis, in particular issues of ownership and governance of the banking system.

It is our intention in this paper to explore such issues and thus contribute to debate on the financial crisis. In doing so, 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 governance of key decisions as being particularly important for achieving the public interest, and views a given sector in terms of its impacts throughout the economy. It allows us to identify some of the deeper causes behind recent events, while also providing unique insights into appropriate government policy for the future governance of the financial sector. This is especially timely given the magnitude of recent government interventions in the sector worldwide¹.

In conducting our analysis, we focus primarily upon three of the aforementioned UK cases, which required major interventions by the UK Government - Northern Rock, Bradford and Bingley, and HBOS banks. These are not only interesting cases in themselves where significant financial institutions have required substantial government assistance and led to (part) public ownership, but all were former building societies that were mutually owned until a change in government policy in the mid 1980s allowed their conversion into publically owned banks.² An analysis of these cases using the strategic choice approach therefore links their plight in the present financial crisis with the previous decisions concerning their ownership and governance structures, and in doing so requires a re-examination of the issue of mutual ownership and its potential to be an alternative to the shareholder or public ownership models that currently dominate. In exploring these cases we seek to learn lessons for potential wider application, both for other institutions within the financial sector, and for institutions in other sectors.

In order to pursue these arguments, the paper is organised as follows. Section (2) provides an overview of the crisis as it afflicted the UK banking sector, focusing specifically upon our chosen cases. Section (3) considers conventional analyses, namely regulatory and market failure type arguments. In Section (4) we introduce the strategic choice approach and suggest that changes in the ownership and governance structures of the former building societies provides crucial insights into

the root of the current problems afflicting the banking sector. Section (5) then muses over possibilities for alternative governance structures for our three cases, and UK banking more generally. Finally, Section (6) concludes.

2. The Crisis afflicting Northern Rock, Bradford and Bingley, and HBOS: An Overview

Unlike in traditional banking models, where funding for mortgage advances was predominantly from bank deposits, modern banks now largely finance their lending activities through (a combination of) inter-bank borrowing on the global wholesale markets and securitisation. In this respect the inter-bank market provides banks with access to global funds, allowing them to borrow short-term (the amount dependent upon their own credit-rating) from which they can finance their long term lending activities (i.e. mortgages). In benign conditions, banks can renew their maturing borrowings quite easily to meet their daily obligations and perhaps take advantage of interest rate spreads. Short-term liquidity however, can become a severe problem if market confidence is adversely affected (as in the credit crunch). Securitisation involves banks repackaging their assets (their mortgage book) and selling them on as securities to investors. This allows banks to circumvent Basel minimum capital requirements by reducing the amount of risky assets on their balance sheets, and raise (short term) liquidity from which to fund new mortgage borrowing. One obvious problem here – from a public interest perspective – is that, in the aggregate, securitisation lessens the banking sector’s interest in and ability to monitor loans and evaluate their risk (Chick, 2008). A lack of prudence in lending decisions and poor monitoring can create and exacerbate a bad debt crisis and destroy market confidence.

Since the mid-1990s, these new modes of finance have become more prominent and have allowed banks to pursue an aggressive strategy in a lucrative mortgage market, often offering a range of low-cost mortgage products to customers, including those who might be deemed to be ‘sub-prime’

(see Langley, 2008).³ In the UK, for instance, the ratio of total outstanding mortgage debt to GDP has risen from 45% in 1995 to 82% in 2006 (OECD, 2009). The former building societies have been at the forefront of this extraordinary growth in the mortgage market. Following demutualisation, Northern Rock began to pursue a core strategy of focusing almost exclusively upon the mortgage market, gradually withdrawing from the provision of what might be described as ‘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 (BBC News, 15/09/07) with this lending largely being funded from the global wholesale markets.⁴ 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 which has a higher 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 sub-prime mortgages. By the end of 2008, it was anticipated that around one-third of HBOS’s mortgage book had loan-to-values of over 90%. 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).

It is now widely acknowledged that aggressive mortgage lending, in particular to ‘riskier’ clients, has led to the recent problems of heavy over-indebtedness. These practices have been fuelled by banks’ greater access to global funds on the inter-bank markets and securitisation practices. The subsequent problems of high levels of default, initially in the US (and now in the UK) sub-prime housing markets, have reduced these avenues for bank liquidity and led to the so-called credit crunch. In the latter respect, while banks’ assets have covered liabilities, their inability to raise sufficient short-term liquidity to meet their daily operations has exposed the weaknesses of their business models.

In the UK, Northern Rock was the first major casualty in September 2007. Its weaknesses were exposed leading to a 'run' on the bank, the first in the UK since 1866 (Shin, 2009). This ultimately led to the bank seeking emergency funding of around £3 billion from the Bank of England (BBC News, 15/09/07). Within a week of the crisis, Northern Rock's share price fell by 60% on the London Stock Exchange (BBC News, *ibid*). This in turn reduced Northern Rock's credit rating further and its ability to raise funds in the wholesale and retail markets to meet its' short run liabilities. 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 2008.⁵

Almost a year later, a similar fate afflicted Bradford and Bingley (B&B) and the much larger HBOS. In the case of B&B, rising concerns about its exposure to the 'buy-to-let' market led to a downgrading of its' credit rating and thus its ability to access wholesale markets for short-term funding. This had been exacerbated by a 93% fall in its share price in the year to September 2008 (Channel 4 News, 28/9/08). A rights issue of £400 million in June 2008 failed to provide sufficient new capital, and by the late summer of 2008 the bank's ability to continue its daily operations had been severely compromised. In September 2008 B&B was nationalised, while its savings operations were sold to the Spanish financial group Banco Santander for £612 million. The UK government took control of B&B's mortgage book, personal loan book, wholesale liabilities and treasury assets.

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 bank Lloyds TSB to secure its capital base and create a new ‘superbank’ was waived through and allowed to bypass UK competition law (See Section 4.1). 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.⁶

3. Regulatory and Market Failure arguments

In analysing the banking crisis, financial analysts and commentators have tended to point towards an inadequate level regulation and poor monitoring within global financial markets as the main contributory factors. At the global level, much of the financial regulation since the late 1980s has emanated from the so-called Basel committee for international banking supervision. The first Basel Accord in 1988 set international minimum capital requirements requiring banks to hold capital equal to 8% of their risk weighted assets. The aim was to reduce systemic risk in the international banking system, while also minimising the impact of national bank capital regulations on free market competition. Basel I has subsequently been superseded by Basel II (2004), which is currently being implemented. The new Accord is more flexible in that it allows banks to hold capital reserves appropriate to the type of risks to which they are exposed, while providing a framework for managing and monitoring risks⁷. While Basel II aims to provide greater transparency with regard to banks’ risk portfolios, concerns have been raised as to the mechanisms by which risk is measured. In early discussions relating to Basel II, a number of leading academics voiced their concerns about the statistical modelling of risk and the particular difficulties in modelling risk due to lack of appropriate data. Incorrect inferences in this respect could lead to under-estimation of financial risk, create uncertainty and destabilise the financial system. They also expressed concerns at the heavy reliance upon credit-rating agencies, who are unregulated and whose quality of risk estimates is largely unobservable (see Danielsson *et al.*, 2001). These concerns have, of course,

been subsequently realised, with the credit worthiness of banks being significantly (and dramatically) adjusted downwards to correct for previous miss-judgements. This in turn has reduced their ability to access global wholesale markets⁸.

In the UK, responsibility for the supervision of the financial system and the implementation of Basel has, since 1997, been held by the Financial Services Authority (FSA). The FSA has responsibilities for maintaining market confidence, promoting public awareness of the financial system, consumer protection and reducing financial crime, with a remit to ensure that financial firms meet the requirements of current regulations, while also facilitating competition between firms. Following the Financial Services and Markets Act 2000, the FSA acquired additional responsibilities for building and friendly societies, investment management and the securities and futures markets, while in 2004 it also became responsible for mortgage regulation. The FSA's creation was part of a new government macro-micro financial framework, where the (independent) operation of monetary policy was assigned to the Bank of England, which, in turn, acquiesced its' own responsibilities for financial supervision to the new body (the FSA) so as to avoid any 'conflict of interest' (see Di Noia and Di Giorgio, 1999).⁹

Some commentators have recently suggested that, in hindsight, responsibilities for financial supervision ought to have remained with the Bank of England on the basis that through its daily operations in the money markets it would have had better access to information about the liquidity of the banking system, and would have been able to have acted quickly and accordingly in response to the recent crisis. Indeed, the ability of the FSA to monitor minimum capital requirements and risk has been particularly criticised in the light of recent events. In the Northern Rock case, for instance, it has been claimed that the FSA ignored warning signs from the bank and continued to allow it to operate without a risk mitigation programme in the months preceding its eventual collapse. It had

also been warned by the Bank of England and other authorities of the risks in Northern Rock's wholesale funding model as early as October 2006 (The Times, 29/04/08).

The Bank of England has also not been immune to criticism. In the midst of the Northern Rock crisis, it appeared overly concerned with the consequences of offering a blanket guarantee to safeguard all deposits held at the bank for fear that 'rescuing' a retail bank in such a way might encourage 'moral hazard'. The argument goes that if banks were not allowed to 'fail' and could fall back upon government support in times of crises then they would be encouraged to engage in 'risky behaviour' in the pursuit of higher returns. The subsequent delay/inactivity by the Bank of England in dealing with the immediate crisis was seen to raise levels of uncertainty and exacerbate the unfolding situation.

The above regulatory and monitoring issues have been widely debated, along with the banks heavy reliance upon securitisation and the wholesale markets to finance aggressive mortgage lending (see for example OECD, 2009). While these contributions sometimes differ, one thing they have in common is their focus on some aspect of competition, management or regulation; in other words they adopt a standard 'market failure' type of analysis and argument. For instance, they tend to focus upon issues such as whether the relevant authorities handled the crisis in an optimal way or whether tighter financial regulations and better monitoring could have prevented problems from developing, or at a micro level, whether shareholders lost control over managers in their company.

One such contribution is Krugman (2008), which not only shows the parallels of the present financial crisis to several other historical crises (including the great depression), but also professes to diagnose the cause of the current crises: the main focus is placed upon inadequate regulation. This isn't however, deficient regulation of the banks, but rather the emergence of a 'shadow banking system'¹⁰ (p.158) which serves the same basic function as the banks, but does so outside

the banking regulation system. By operating outside banking regulation, strict controls were avoided which initially facilitated increased profits, but also absent was the stability and safety net that banking control regulations are designed to provide. This shadow banking system was therefore vulnerable when the US housing market started to collapse, and quickly created a contagion which spread throughout the financial sector given the inherent web of interconnections that exist. Krugman (2008) is essentially blaming the advent of unregulated financial products such as auction-rate securities, Collateral Debt Obligations (CDO) and other similar modern ‘financial instruments’ and innovations for the financial crisis. In line with these conclusions, Brunnermeier (2009) presents a more detailed account as to how (some of) these new financial products played a key part in the crisis as part of his wider overview of events.

While there is much value in exploring such perspectives, they have been addressed elsewhere and seem to be the focus of current public policy reforms (see for example, the proposals for the UK as outlined in HM Treasury, 2009). Moreover, the focus on a pure ‘market failure type’ analysis can mask more fundamental issues at the root of the present crisis. Their analysis is essential if policy-makers wish to fully rectify current systemic deficiencies and thus avert future problems. In our view, the roots of the present crisis are linked to the governance of the institutions that comprise the banking system and indeed contemporary capitalist economies more generally. By governance we refer specifically to the ways in which different interests in the behaviour of these institutions are articulated in the process of making key decisions.

This emphasis is something quite different to the focus placed on regulation by most authors and policy makers. As identified by Branston *et al.* (2006a) a focus on regulation is essentially ‘an arms-length response to failures in arms-length relationships’ (p.203); a rigid framework is employed to try to enforce behaviour of a type that is deduced to be in the public interest. Whilst regulatory systems undoubtedly deliver benefits, it is often the case that regulation will struggle to keep pace

with the evolution of the sector (as has been suggested of recent developments in the financial sector). More importantly, the ‘public’ is itself usually divorced from the process; thus there is every chance that collectively ‘the public’ might desire alternatives to either the regulated outcome or the regulation mechanism. Gauging the public interest through conjecture and attempting to achieve this through regulation is a poor substitute for their direct involvement in identifying and implementing optimal outcomes as an integral part of the decision-making process. Indeed, Long (1990, p. 171) defines the public interest as such: “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”.¹¹ 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.¹²

As a simple and acknowledgedly limited analogy, consider the actions of parents looking after a young baby who is unhappy. When the baby can’t communicate the parents have to guess at what is making the baby unhappy and it often takes time to identify the needs/desires of the child or to simply pacify it when its needs/desires can’t be directly identified. This is akin to a regulated solution in that the benign authority (the parents) are doing what they *think* is in the general interest of the child (which we might think of as representing the general public). In contrast, when the baby is able to communicate the parents can often find out *exactly* what the baby is unhappy about, and thus address it directly, no doubt sometimes after negotiations where the opinions of baby and parent differ. This is almost certainly a more efficient solution in that is quicker, because the parents don’t have to go through several guesses before hitting upon the correct 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. Thus with regulation of

the banking and finance sector and indeed more generally: a system based upon the articulation of what Hirschman (1970) has identified as 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 wider public interest (see Section 4).¹³

In contrast to a focus on (failures of) regulation, an alternative for an analysis of the current banking and financial difficulties is to examine the implications of governance: in particular the issue of corporate control. By examining issues such as which groups are in a decision-making position and whose interests are being pursued with the execution of these decisions, we generate a focus that is quite different from a pre-occupation with the regulation of market failures. Indeed, as we will show, this alternative focus is critical if an analysis is to truly consider what is in the public interest, which should surely be the ultimate goal of any policy maker. It is to this analysis that we now turn in the next section through the strategic choice approach.

4. An Alternative Analysis based on the Strategic Choice Framework

4.1. The Strategic Choice Approach

There is a growing body of literature that analyses the development of industries and economies from a ‘strategic choice’ perspective (Bailey *et al.*, 2006 and references therein). This work has its 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 (Cowling and Sugden, 1998, p.64-67). They suggest that the concentration of strategic decision-making in modern corporations is likely to result in ‘strategic failure’: a situation

arising when the strategic decisions of corporate hierarchies fail to meet the wider public interest(s). This occurrence is more likely in imperfect markets, where a 'few' corporate executives are often able to pursue their own interests despite potential resistance from the 'many' wider stakeholders in society who may be impacted on by the former's higher-level decisions. Hence socially inefficient outcomes are likely as those able to exert control are free to ignore the wishes of society at large which give rise to the public interest.

A simple application of this theoretical framework might be to re-consider the takeover of HBOS by its rival Lloyds TSB (see Section 2). During the financial troubles of the global banking sector Lloyds TSB Plc was a British bank which was relatively well placed given that it had avoided much of the contagion in the marketplace. When in autumn 2008, its rival HBOS found itself in considerable financial difficulties, Lloyds TSB sought to purchase it in 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. Not surprisingly, the takeover has been controversial particularly among those with an interest, largely on the grounds that the full implications of the takeover for the wider public interest will take several years to emerge (see *The Economist Opinion* 6/11/08; Whittam-Smith, 10/11/08). Those in opposition to the deal favoured other possible solutions to the problems that existed at HBOS, which if chosen may have different impacts upon the banking sector and the wider public interest (see also *The Daily Telegraph*, 18/5/09). The key point is that while the deal was opposed by many of those with an interest (shareholders, employees, governments, consumer organisations, and indeed rival banks), the executives in control of strategic decision-making in the two banks were able to execute the deal with expediency despite this resistance. While too early to make a judgement of strategic failure, the process carries a high risk of generating a socially inefficient outcome 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 as 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, and suggests a requirement of 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 the various organisations and institutions in society are governed. While the governance of economic activity co-ordinated by governments and by other non-governmental organisations is likely to be important, the most natural departure point from Cowling and Sugden’s original analysis is to focus upon the governance of economic activity co-ordinated by firms. Indeed, there is a strong tradition in the literature seeking to analyse the so-called ‘public interest’ with regards firm-based economic activity (a detailed discussion of which can be found in Branston *et al*, 2006) and in analysing the governance of specific industrial sectors (see Bailey, 2006).

At this point we should note that our use of the strategic choice approach suggests a focus that is markedly different from traditional analyses of ownership, competition and regulation. Our notion of governance differs from a narrow focus on shareholders controlling managers or a regulatory authority controlling a particular industrial sector. Rather it implies a deeper and broader 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 among the ‘publics’ affected by corporate decisions. This governance focus does not necessarily imply one or another form of ownership; ownership *per se* is not the key issue. Indeed, ever since Berle and Means (1932) first identified the separation of ownership and control, we know that the two are not perfectly correlated and are in some sense quite separate. Senior

managers and the Board of Directors of the modern corporation 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. The importance of ownership is only in so far as it impacts upon governance; more specifically, different ownership settings may render effective governance in the public interest more or less likely in different contexts.

4.2. Mutuality, Demutualisation and ‘Strategic Failure’

In applying the strategic choice approach to our cases, it is appropriate to consider the concept of mutuality and the subsequent impact of demutualisation upon the governance structures and strategic decision making processes within the former building societies. According to Marshall *et al.* (2003, p. 735), mutuality ‘stresses mutual interdependence as the means of promoting collective well-being’. In mutual societies, customers (often referred to as members) are both users and own a share of the business. There are no external shareholders and surpluses are typically distributed to members in the form of low cost mortgages and low risk savings accounts with preferential rates of interest (Kay, 1991). 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). In theory, mutuality confers a democratic and inclusive environment where all members have one vote - irrespective of the size of their deposit holdings – through which they can exercise their ‘voice’ at annual general meetings, where the society’s executives appear for re-election (the exit option is also available by moving deposits elsewhere).

Notions of democracy and altruism within the UK building society movement are, however, not completely realistic. Indeed as early as 1984, Barnes (1984), for instance, was concerned about the

monopolistic activities of the larger building societies: in particular the building society cartels that persisted in the 1960s and 1970s which restricted competition at the expense of members' welfare. He was also concerned about the low participation rates of members in societies' decision making processes – such as at annual meetings – and the (lack of) accountability of directors to members, particularly in relation to the lack of transparency over the use of building society reserves and the appropriability of surpluses between members.¹⁴ 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, 1998), thus distancing themselves from the original ideals of mutuality.

Indeed, demutualisation followed a long period in which financial market de-regulation had led to building societies facing increased competition from banks and other financial institutions. By the late 1980s and early 1990s, mutuality was increasingly regarded as being an 'outdated' form of ownership. The ability of building societies to compete on a level playing field was compromised by the size of their capital and legislation. In the first instance, building societies had long been restricted in their ability to expand by the size of their capital reserves - which are built up from accumulated profits – and the more 'competitive' markets of the 1980s and 1990s had led to lower profit margins, thus constraining their ability to grow even further. Secondly, while legislation in the 1980s – such as the 1986 Building Society Act – had provided building societies with more commercial freedoms, they still faced several legal restrictions on their activities, particularly in relation to raising external funds on wholesale money markets (see also Boxall and Gallagher, 1997).¹⁵

The inability to compete equally with banks led to a 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 – an option under the 1986 Act - was thus seen as an opportunity to break free from legal restrictions and allow building societies greater freedom in the market. For senior executives, there were other attractions. Demutualisation offered legal protection from hostile takeover for 5 years following conversion, thus protecting incumbent positions of office (this was diluted in the 1997 Building Society Act, whereby the protection was removed if the successor company acquired another financial institution or 75% of shareholders voted to waive the protection). 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). Supported by members' growing expectation of demutualisation windfalls, a number of leading building societies converted to public limited companies in the late 1990s.

As we are now aware, these incentives and the ability of the new banks to raise large sums on the wholesale markets to fund aggressive mortgage lending to increase their market shares (and executive commissions) has contributed to the present crisis and led to the 'strategic failure' afflicting the whole financial system and society more widely. Yet, would mutuality have provided for a more stable financial environment? A crucial argument in this respect relates to the degree of risk undertaken within the overall market. Interestingly, 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 to deliver quick returns. This is particularly so given that mistakes are likely to be extremely costly for mutuals since they inevitably lead to (painful) balance sheet adjustments and thus restrict their future growth. In contrast, commercial banks are able to replenish their capital through the wholesale markets, and thus pursue more risky projects. In

considering earlier crises afflicting the British banking sector during the 1970s and 1980s, where retail banks were seen to ‘over react’ in pursuing short-term (risky) profitable ventures, Llewellyn and Holmes muse whether the greater instability that subsequently occurred (within the system as a whole) would have happened if there was a greater balance in both mutual and PLC firms in the market (p.344). The point seems particularly pertinent given recent events.

Our analysis would interpret the present crisis afflicting the former building societies as ‘strategic failure’. Driven by the deregulation and liberalisation of financial markets in the 1980s and 1990s, the corporate hierarchies of the former building societies have consistently pursued their own strategic interests, such as pushing the de-mutualisation process forward and pursuing aggressive mortgage lending. As we discussed earlier, the strategic interests of this group often ignore the protests of others: see, for example, Perk’s (1991) in-depth account of the measures taken by corporate executives in the case of Abbey National to nullify opposition to that society’s demutualisation process in the late 1980s. Moreover, as we have seen in the ensuing crisis, the pursuit of these corporate interests has been inconsistent with the wider public interest in the long term, with the recent bailouts by the UK government (the amount of which are unprecedented) being testimony to this ‘strategic failure’. In line with this analysis we can similarly attribute the recent difficulties that a number of current building societies have also found themselves in, to a lack of accountability in their governance structures, and associated behaviour outside their traditional domains in attempts to compete with the wider banking sector. The Dunfermline Building Society, for example, has also found itself in financial difficulties and had to be rescued by the government and its rival the 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.¹⁶ We can therefore see that governance reform, both for banks and existing building societies, is critical if we are to have a sector that

operates free from strategic failure and thus in the public interest. The question is what structure might this reform take, and it is to a discussion of possible ideas that we now turn.

5. Future Options for Bank Governance Structures

The current period where Northern Rock and Bradford and Bingley are both wholly in public ownership, and where the government has significant stakes in two of the largest high-street banks (Lloyds Banking Group and also RBS), provides a once-in-a-lifetime opportunity for significant reform. This might be focussed on these particular institutions directly, and if implemented successfully could light the way in addressing concerns over the future governance of UK banking institutions more generally. For these reforms to be meaningful they need to move beyond current proposals for the sector which seem to centre on tighter regulation and restraint of large bonuses, and instead directly address issues of governance. Indeed most concerning are reports that the UK government want a quick return to the private sector of the stakes they own in these financial institutions. This policy would completely miss the opportunity for serious reform of these institutions and is no doubt influenced by short-term political objectives with the government being eager to relinquish the state's involvement and presumably highlight its 'success' in 'turning around' the ailing banks to court public opinion ahead of a general election in May 2010. Such short-term politically driven thinking must be resisted if structures are to be put in place which can lead to the attainment of the public interest in the longer term and avoid a repeat of current difficulties though failure to address the underlying causes.

5.1 Mutuality

One possibility might be to consider a return of the former building societies back to some form of reformed mutual status. Such a move would remove the bank from the state's books and thus ease the pressure on the public finances. It should also provide the opportunity for members to begin to feel some form of 'ownership' of the society. In this latter respect, membership rights might be

conferred for a small (nominal) deposit (e.g. £1), as in the remaining building societies. They would be open to all.

However, as noted in Section (4), mutual status by itself does not necessarily provide for an inclusive and democratic environment (see Barnes, 1984). There is the danger of ‘elite capture’, with agendas and strategies being pursued in the interests of the few. To guard against this and such practices, measures will need to be put in place, perhaps in the Articles of Association, to safeguard the democratic rights of all members and encourage wider participation. In particular, it might be necessary to prevent against any possibility of a second de-mutualisation. 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 can not co-exist with more commercial organisations as they have done for over 150 years previously, and be able to pursue a wider set of interests than that of commercial profit.

The main obstacle to this route for reform is that the mere transfer of the state’s ownership stakes to the (new) society’s members will not raise any monies to recompense the tax-payer for their involvement in the sector. Given the current and unprecedented level of UK government borrowing, this is likely to be a significant barrier to reforms of this nature. However, with some creative thinking and a long-term view, mutuality might still be feasible. Two possibilities immediately present themselves. The first is that the government creates mutual ownership organisations for the former building societies it wholly owns, and funds this through the profitable commercial sale of its partial stakes in other banks. This is clearly a second best solution in that it only partially addresses institutions in the sector and so would need to be seen as part of a longer, on-going project. The second possibility is that the government again creates mutual ownership structures, but does so through the loan of the required capital to these new mutual organisations. This money

is then repaid to the government through any profits the organisations earn in the future until the state's financial commitments have been fully repaid. This second possibility would not raise monies in the short-term (which might be problem), but it does have the advantage of being applicable to all of the financial stakes in banks that the government owns at present.

5.2 Alternative Management Structures

Alternative structural solutions for the reform of the banking sector and that are seen to have had some success at a national level (and which could address our concerns with 'strategic failure'), might draw upon the experiences of other public organisations operating in commercial environments, most notably the British Broadcasting Corporation (BBC) and Network Rail. The BBC, for instance, is a large and successful media organisation with an interesting and arguably unique governance structure (see Branston and Wilson, 2006). Neither privately nor publically controlled in the conventional (government) sense, the BBC has no shareholders and is explicitly 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 task 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 thus less prone to 'strategic failure'.

Similarly, Network Rail, the British railway infrastructure company, has no shareholders and a mission 'to deliver a safe, efficient, sustainable and reliable rail service' (Network Rail, 2007/08, p.1), rather than profits. Network Rail owns and operates the railway infrastructure in Great

Britain, providing the facilities (such as track and stations) for the train operating companies to use when providing services to the public or to industry.¹⁷ Legally it is a company limited by guarantee, which means that it is a private limited company. However rather than shareholders, it has 108 members (Network Rail, 2008, p.20) who provide the corporate governance and hold the management team to account. The company is professionally run by a board of directors and senior management team with the aim of making profits, as with a traditional shareholder owned firm. However, rather than paying dividends to shareholders, profits are re-invested in the industry.

Such a model is potentially more likely to avoid problems of ‘strategic failure’ because the organisation is explicitly designed to make decisions informed by the ‘many’ with an interest in the railways, rather than the ‘few’ with an interest in their own private return. Our arguments would suggest nevertheless that its success in doing so will depend on the governance mechanisms in place to articulate these interests. In the case of Network Rail, mechanisms are focused on the role of its ‘members’, who include representatives from all stakeholders in the industry. Members are appointed following an open application process and appointment panel, and there are two main categories: Industry Members and Public Members. Industry Members are drawn from all of those firms which operate within the railway industry; from firms that operate trains, to companies that provide engineering services to Network Rail. Public Members are drawn from all other individuals or organisations which have an interest in how the railway functions; from individual members of the public with an uncommon interest in the sector, to worker representatives, to regional transport organisations. Thus there is an open opportunity for everyone with an interest in the company to engage with its decision-making process, either directly through becoming a member and holding management to account, or indirectly through representations to those selected to be members.

Whilst different in their nature, both of these examples illustrate institutional possibilities that offer significant potential for the development of governance solutions that can reduce the dangers of

strategic failure in key economic sectors, of which banking is undoubtedly one. We suggest that exploring, testing and advancing these possibilities in the context of the banking industry is an important challenge for public policy.

5.3 A hybrid solution?

In light of the possibilities outlined above, we would advocate a hybrid solution that combines elements from each, whilst also recognising the constraints that exist, most notably the current level of government debt. First of all, some form of mutually owned organisation would seem to be an appropriate starting point given that it automatically gives the right of participation to those with a significant interest, and does so in a way that isn't dependent upon a significant financial contribution. One difference to existing practice would need to be the inclusion of employees as clearly they are a group with a very significant interest in the organisation but are currently excluded. Furthermore, there would need to be safeguards to ensure that the society was run in the interests of all of its members and avoid the re-occurrence of 'elite capture' by senior executives (see Section 4.2).

One way of achieving this might be for the creation of a BBC Trust style panel or a wider Network Rail member grouping to more forcefully represent the views of the members in some form of supervisory capacity. One of the problems 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 some form of members' body that sits between management and all members, this problem would be directly addressed. Clearly there would have to be careful planning if a 'super-member panel' were to be created to ensure that it did represent member views, but with some trial and adjustments something beneficial is possible. Perhaps seats could be reserved for borrower members, saver members, and employees so that no one set of interests is unduly dominant, and this member panel could be established with

a specific statutory duty of consulting all members as to what is appropriate policy, and report back to them on key decisions taken. It could be said that a BBC Trust style body is perhaps a little too small and so something more of the size of the Network Rail membership of 100 might be more appropriate. The exact size will no doubt be determined by the exact constitution of the body, and the balancing between different sorts of members that needs to take place. That said, we might expect it to be somewhere between the two, balancing the need for defuse decision-making with the need for limits on the number to enable a practical operational design.

If such a member centric organisation could be created from the government holdings in say Northern Rock and Bradford and Bingley, there is no reason that this model, once established, could not be extended to other building societies that currently exist. The government could provide backing for this scheme in terms of processes and since these are already mutually owned financial institutions, such changes should not draw heavily upon resources. Indeed, by kick-starting such a reform of the wider building societies sector we might envisage a further level of reform where each society might specialise in a certain area. This might be a geographic area, providing financial services of the type required by particular locations or regions, or could be specialising in the needs of specific industries, or indeed, a combination of the two where appropriate. It might also be the case that they specialise in other ways, providing ethical banking for example, or services acceptable to various religious faiths.

One of the main obstacles to this vision is the financial constraints that currently exist in the UK public finances. As mentioned in Section (5.1), this might be addressed with some imagination, perhaps through some long-term payback to the state for the initial endowment in the two newly established mutually owned building societies, and/or through the profitable commercial sale of the government's stakes in the high-street banks. This would obviously place a 'profit-satisficing' condition on future operations at least until the government investment had been repaid. Such an

approach might also find favour with the European Union, whose market and state aid rules and regulations are also likely to need to be given consideration when undertaking such reforms.

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 undoubtedly important, there is a danger that such approaches may be too narrow and neglect deeper issues that are at the root of the crisis. In contrast, the strategic choice approach calls for a broader view of the situation, with a particular emphasis upon addressing the issues of ownership and governance within the banking sector for the attainment of the public interest. 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, as the strategy chosen by ‘the few’ in control of these institutions was excessively dominated by a desire for short-term returns which necessitated disproportionate risks. This was particularly the case in the UK former building societies and our analysis here linked their current plight with previous strategic decisions concerning their ownership and governance structures and the subsequent and excessive focus upon sub-prime lending, and a heavy reliance upon securitisation and wholesale funding. This has invariably contributed to ‘strategic failure’ both in the financial sector and in the economy and society more widely.

Our focus on ownership and governance has pointed towards a re-examination of the issue of mutual ownership and its potential to be an alternative to the shareholder or national ownership models that currently dominate. Furthermore, we have suggested that the concept of mutual ownership needs to be reformulated so that included as members are all of those with a significant interest, and also to ensure that members rather than managers have the real power in the

governance process. To that end we advocated exploring the possibility of creating membership panels to sit between the body of members and those running such institutions so as to ensure the wider public interest is achieved.

In advocating such policies we are in essence calling for 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 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 Northern Rock, and Bradford and Bingley is therefore just a first, but we would argue, necessary step if the banking sector is to be transformed so that it is run in the public interest.

7. References

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 (22/06/09a) 'Timeline: US Government bail-outs',
<http://news.bbc.co.uk/1/hi/business/7748874.stm>.

BBC News (22/06/09b) 'US unveils new \$1.5 trillion plan',
<http://news.bbc.co.uk/1/hi/business/7880969.stm>.

BBC News (31/07/09) '\$10 trillion credit crunch cost',
<http://news.bbc.co.uk/1/hi/business/8177814.stm>.

Boxall, A & Gallagher, N (1997) 'Mutuality at the cross-roads', *Financial Stability Review*, Autumn, pp.105-117

Bailey, D., De Propris, L., Sugden, R and Wilson, J.R. (2006) Public Policy for European Economic Competitiveness: An Analytical Framework and a Research Agenda. *International Review of Applied Economics*, 20 (5): 555-572.

Barnes, P (1984) *Building Societies: The Myth of Mutuality*, London, Pluto Press

Barnes, P and Ward, M (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, 209-244

Berle, A.J. and Means, G.C. (1932) *The Modern Corporation and Private Property*, New York: MacMillan.

Branston, J. R., Cowling, K.G. and Sugden, R. (2006) Corporate Governance and the Public Interest. *International Review of Applied Economics*, 20 (2): 189-212.

Branston, J. R. and Wilson, J.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.

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

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

Cowling, K.G. and Sugden, R. (1987) *Transnational Monopoly Capitalism*. Sussex: Wheatsheaf Books.

Cowling, K.G. and Sugden, R. (1994) *Beyond Capitalism: Towards a New World Economic Order*, London: Pinter Publishers.

- Cowling, K.G. and Sugden, R. (1998) The Essence of the Modern Corporation: Markets, Strategic Decision-Making and the Theory of the Firm. *The Manchester School*, 66 (1): 59-86.
- Cowling, K.G. and Sugden, R. (1999) The Wealth of Localities, Regions and Nations: Developing Multinational Economies. *New Political Economy*, 4 (3): 361-378.
- Danielsson, J, Embrechts, P, Goodhart, C, Keating, C, Muennich, F, Renault, O & Song, Shin, H, (2001) 'An Academic response to Basel II', *Special Paper No 130*, LSE Financial Markets Group.
- 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, J. (1927) *The Public and its Problems*, in: Boydston, J. A. (1988) *John Dewey. The Later Works Volume 2: 1925-1927*, Southern Illinois University Press: Carbondale and Edwardsville.
- Di Noia, C & Di Giorgio, G (1999). 'Should Banking Supervision and Monetary Policy Tasks be Given to Different Agencies?', *International Finance*, 2:3, 361-378
- Drake, L (1998) 'The economics of mutuality', LUBC-BSA Project Paper 3, The Building Societies Association, 3 Savile Row, London, W1S 3PB.
- Drake, L & Llewellyn, D (1998). Mutuels in the financial system, *Financial Stability Review*, pp.33-45
- Ediz, T, Michael, I & Perraudin, W (1998) 'The Impact of Capital Requirements on UK Bank Behaviour', *Economic Policy Review*, October 1998, 15-22
- Goodhart, C & Schoenmaker, D (1995) 'Should the functions of monetary policy and banking supervision be separated?', *Oxford Economic Papers*, 47, 539-560
- Hirschman, A.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)
- Kay, J (1991) 'The economics of mutuality', *Annals of Public and Co-operative Economics*, 309-318
- Krugman, P (2008) *The Return of Depression Economics and the Crisis of 2008*, London: Penguin Books.
- Langley, P. (2008) 'Sub-prime mortgage lending: a cultural economy', *Economy and Society*, Volume 37, No. 4, November, 469-494
- Llewellyn, D T & Holmes, M J (1991) 'In Defence of Mutuality: A Redress to an emerging conventional Wisdom', *Annals of Public and Co-operative Economics*, 319-354

- Long, N. E. (1990) Conceptual notes on the public interest for public administration and policy analysts, *Administration Society*, Volume 22, 170-181.
- Marshall, J N, Richardson, R, Raybould, S & Coombes, M (1997) 'The transformation of the British Building Society Movement: Managerial Divisions and Corporate Reorganisation, 1986-1997', *Geoforum*, No 3-4, pp.271-288.
- Marshall J N, Willis R, Richardson R, (2003) "Demutualisation, strategic choice, and social responsibility" *Environment and Planning C: Government and Policy* **21**(5) 735 – 760
- Network Rail (2007/2008) *Corporate Responsibility Report 2007/08*, downloaded from <http://www.networkrail.co.uk/> on 23rd September 2008.
- Network Rail (2008) *Network Rail Ltd Annual Report and Accounts 2008*, downloaded from <http://www.networkrail.co.uk/> on 23rd September 2008.
- OECD (2008) "The Current Financial Crisis: Causes and Policy Issues" in *Financial Market Trends*, Number 96, Volume 2008/2.
- 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*, 393-429
- Pitelis, C. N., and Sugden, R. (1986) The Separation of Ownership and Control in the Theory of the Firm. *International Journal of Industrial Organization*, 4 (1): 69-86.
- Sacchetti, S., and Sugden, R. (2007) Creativity in Economic Development: Space in an Inferno, University of Birmingham Institute for Economic Development Policy Discussion Paper 2007-02.
- Shin, H. S. (2009) Reflections on Northern Rock: The Bank Run that Heralded the Global Financial Crisis, *The Journal of Economics Perspectives*, 23(1), pp.101-119.
- Staff of the Securities and Exchange Commission (08/07/2008) 'Summary Report of the Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies', *United States Securities and Exchange Commission*: Washington, DC.
- Stephens, M (2001) 'Building Society Demutualisation in the UK', *Housing Studies*, Vol 16, No. 3, 335-352.
- Sugden, R., and Wilson, J.R. (2002) Development in the Shadow of the Consensus: A Strategic Decision-Making Approach. *Contributions to Political Economy*, 21: 111-134.
- Sugden, R., and Wilson, J.R. (2005) Economic Globalisation: Dialectics, Conceptualisation and Choice. *Contributions to Political Economy*, 24: 1-20.
- The Daily Telegraph (18/05/09) 'Lloyds merger with HBOS under fire as Sir Victor Blank departs', *Telegraph Newspapers*, London
- The Daily Telegraph (01/08/09) 'Banking bail-outs hit total of £1,227bn', *Telegraph Newspapers*, London
- The Times (29/04/08) 'FSA allowed Northern Rock to keep breaking rules', *News International*, London.

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

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

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

Tuya, J & Zamalloa, L (1994) ‘ Issues on Placing Banking Supervision in the Central Bank’, in T.Balino and C.Cottarelli, eds, *Frameworks for Monetary Stability*, Washington, DC: IMF

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

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

¹ For example, the British Government made £500 billion available to rescue the banking sector (HM Treasury, 2009), and the IMF estimates that the total support given to the British financial sector at more than £1.2 Trillion (The Daily Telegraph, 01/08/09). In the US, the Federal government created the \$700 billion Troubled Asset Relief Program (TARP), the majority of which was used to support the financial sector (BBC News, 22/06/09a), and has supplemented this with another bailout plan which uses public and private funds worth at least \$1.5 Trillion (BBC News, 22/06/09b). On a global level, the IMF estimates that more than \$10 trillion of government support has been given to the financial sector (BBC News, 31/07/09).

² A ‘building society’ is a mutually owned bank which specialises in mortgages and saving products. These institutions are very similar to ‘building and loan associations’ of the USA.

³ The term ‘sub-prime’ originates from the US mortgage market and relates to customers who have poor credit histories and are thus a higher risk to lenders. Such customers usually pay a premium rate on loans to compensate the bank for bearing the higher risk.

⁴ It is estimated by the middle of the current decade, three quarters of Northern Rock's funding came from the global wholesale markets (BBC News, *ibid*).

⁵ See Shin (2009) for a more in-depth overview and analysis of the collapse of Northern Rock.

⁶ Other banks were also affected, most notably the Royal Bank of Scotland Group.

⁷ Basel II is regarded as being more 'risk sensitive' in that it takes account of the different types of risk that banks face, such as operational risk arising from a bank's normal operations (e.g. fraud and legal risks, physical and environmental risk), market risk (where asset values decline due to market factors), and credit risk (the risk of default). In short, the new rules imply that the greater risk to which a bank is exposed, the higher the bank's capital requirement to safeguard its solvency.

⁸ A damning recent criticism of the role of credit-rating agencies in the crisis has been made by the US Securities and Exchange Commission (08/07/08). They noted in particular the lack of documentation and transparency in the credit-rating process, with staff often failing to follow correct procedures and model guidelines in assigning credit ratings for residential mortgage backed securities, which tended to be more optimistic and did not reflect their true loss risk. Langley (2008) has also noted problems with credit-rating agencies and their role in fuelling sub-prime lending.

⁹ At the time, the transfer of the supervisory role from the Bank of England to the new authority attracted minor controversy and debate, though the 'conflicts of interest argument' held (see Di Noia and Di Giorgio, 1999, for a summary). The main argument was that micro regulation tends to be pro-cyclical, while macro (monetary) policy tends to be counter cyclical, so in periods of high inflation, monetary policy may favour higher interest rates, which for regulatory authorities may cause concern if they adversely affect the profitability and solvency of the banking system. A further complication could arise when central banks employ monetary instruments (such as access to open market operations) as an instrument to enforce supervisory recommendations (see Tuya and Zamalloa, 1994).

¹⁰ Also sometimes said to be known as a 'parallel banking system'

¹¹ 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).

¹² This involvement would need to take the form of more than just sample based public consultations by the regulatory body. This would only be a partial solution, the reasoning for which will be explained further in the next section which focuses on the strategic choice framework.

¹³ 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, in the same way that parents sometimes know better what is in the interest of their child. It isn't always appropriate for the 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.

¹⁴This might be contrasted with PLC status, where there is much less ambiguity over entitlement to the share of profits – it belongs to the shareholders (Kay, 1991).

¹⁵Under the 1986 Building Society Act, building societies were limited to borrowing up to 20% of their total funds from wholesale money markets. This limit was later raised to 40% (Marshall, et.al 1997).

¹⁶ See BBC News (20/05/09).

¹⁷ Network rail doesn't operate passenger or freight trains, nor own the rolling stock used to provide these services.

These are provided by train operating companies, freight operating companies and rolling stock companies respectively.