Society for Co-operative Studies

Journal of Co-operative Studies 87 September 1996 Vol 29 No 2

Contents

Editorial
Johnston Birchall 1

Short Articles

The Smart Card and the Concept of Mutuality
- Steve Worthington 3

The Impact of Information Technology on Retail Trade
- Noel Branton 7

Marketing the Co-operative Advantage
- Tom Webb 10

The Future of Mutuality
- Philip Ireland 16

Ted Stephenson - An Appreciation
- Lily Howe 24

Longer, Refereed Articles

Regulating Private Utilities: the Customer Corporation
- John Kay 28

Co-operative Legislation
- Hans-H Münkner 47

Some Reflections on the mutuality v Conversion Debate
- David T Llewellyn 57

Annual Report (1996)
The Society for Co-operative Studies
- John Butler 72

Editorial

One of the ironies of co-operative economic history is that the Co-op's competitors have always tried to steal its best ideas. In this issue we include two articles which identify recent examples of this. Steve Worthington notes the introduction by UK retailers of loyalty cards which look almost identical to the old co-op dividend, and their further development into 'smart cards' which enable retailers and their customers to have an on-going relationship. He argues that this could be the way in which mutuals can offer both the rewards from membership and democratic involvement. Noel Branton writes more generally about the impact of information technology and the smart card on the relationship between retailers and their customers. Tom Webb notes the attempt by American businesses to create a membership-like relationship with their customers, and he argues that co-ops can do in reality what shareholder companies can only pretend to do; they can 'market' a real relationship based on common interest and mutual trust.

The question of whether there is a future for mutuality is the subject of the 1996 annual conference of the UK Society for Co-operative Studies. Philip Ireland argues, from his perspective as a building society general manager, that there is a future, and a very bright one, providing those societies which have not converted into banks realise the tremendous competitive advantage that mutuality can give, and providing there is some strengthening of legal protection. Such protection, among other aspects of co-operative law, is the subject of an article by a leading international expert on the subject, Hans-H Münkner. We are pleased to be able to publish the findings of a UK Building Societies Association research project on the future of mutuality, written by the chief researcher, David Llewellyn. He confirms Ireland's positive view of that future and sets it within a wider vision of the future of the financial services sector as a whole. Finally, in a long and closely argued article, John Kay provides both a critique of the current regulatory system for UK privatised utilities and a bold design for a new 'customer corporation', which he suggests is close to the consumer co-op model. Now, to propose that the massive private water, gas and electricity utilities be turned into co-ops or mutuals is bound to be of intense

interest to our readers, both in the UK and abroad. Some of his proposals, particularly that private shareholders could continue to own the utilities, fall short of a fully co-operative model, and readers may wish to write to the editor and begin a debate.

All of these themes will be explored further in forthcoming issues. We are commissioning articles which compare the UK situation with mutuality in other countries. As well as analysing the defence of mutuality in those organisations which are currently mutuals, we will continue to speculate about how other investor-owned businesses could become more accountable to their customers by converting into mutuals: an article on the conversion of UK health trusts is promised. It is important that, in defending the existing 'third sector' of co-ops and mutuals we also go on the offensive, showing how investor-owned businesses are not necessarily the best way of delivering benefits to customers, workers or the wider community.

The Smart Card and the Concept of Mutuality

Steve Worthington

Reading my Co-operative News of April 23rd, I came-across two snippets of information that prompted me to pen this article. The first was the news that The Society for Co-operative Studies had the case for mutuality as the topic for its fringe meeting at the 1996 Co-operative Congress. The second was in the review of the annual report of the Chelmsford Star Co-operative Society where a 21% increase in membership was reported, a large proportion of which were holders of the Chelmsford Starcard. This is a plastic card onto which is embedded a computer chip which is capable of holding details about the cardholder (name, address etc) as well as a record of their spending at the Society's outlets and of holding a rebate value on the card, which is effectively their dividend, earned in direct proportion to the value of their spending with the Society.

The move towards using plastic cards as both a distribution channel for financial services and/or as a loyalty device to reward ongoing relationships with suppliers of goods and services, is well underway in the United Kingdom. During1995 there was a 15% increase in the value of spending on credit cards and an even more staggering 25% increase in the value of spending on debit cards. In the year to 31st October 1995, consumers used their plastic cards 1,400 million times in the 20,000+ Automatic Teller Machines (ATMs) in the United Kingdom, to take out £70,000 million pounds. The value of cashback at the Point of Service (POS) is in addition to this, and one in every five supermarket transactions now involves a cashback transaction, facilitated by a plastic payment card.

New technologies such as the computer chip have enabled the development of the so called 'smart card', which has memory and interactive capabilities, allowing it to exchange data at an electronic POS terminal. The electronic purse and loyalty applications are two examples of the value-added services which can be supported by a smart card. 1995 saw the launch of the Mondex electronic purse in a pilot test in the town of Swindon and this is a plastic card designed specifically to replace notes and coins in payment situations. Shell have launched their Shell

Smart Card loyalty system and it reportedly has over 2 million card holders, who accumulate points on their cards in direct proportion to their spending at Shell garages and who then redeem their points against a variety of reward options. The most successful loyalty card in the United Kingdom (by numbers issued) is the Tesco Clubcard which reportedly has 8.2 million card holders. Whilst this was launched as a traditional magnetic stripe card, there is no reason why it cannot or will not be upgraded to a smart card as that technology becomes more widespread. The Tesco Clubcard and the Safeway ABC card have effectively hi-jacked the concept of the dividend and used the plastic card to offer this principle in a contemporary format. As people become more used to plastic cards either in payment situations or as loyalty tokens, so their familiarity with plastic cards increases and they become more and more card centric. How then can the concept of mutuality be advanced through the plastic card and more particularly through the smart card?

Organisations whose roots are in mutuality and who intend to remain mutuals within the social economy are searching for ways in which they can justify their continued existence in this form. The most obvious points of differentiation for mutuals against other forms of organisations are their value systems of mutual creation and distribution of surplus and of equitable ownership and participation in the affairs of the mutual society. If these values can be operationalised and delivered to members in the contemporary form, then mutual societies can maintain their differential from their competitors and indeed begin to stress the advantages to members of this particular form of organisation.

The smart card offers mutuals the opportunity to achieve these goals and it fits squarely with the increasingly card centric nature of the United Kingdom. A smart card issued by a mutual organisation to its members could hold a record of their relationship with that mutual. The length of that relationship, the breadth of the relationship and the recency and frequency of contact between member and mutual, can all be recorded on the smart card. Retention of customers is increasingly important, and relationship building is one way to both receive information from your supporter and to communicate information to them. The smart card offers an opportunity to build and evaluate

relationships between members and their mutual organisations. Once a surplus has been created by the activities of the mutual, part of it can then be distributed to members of that mutual organisation, in direct proportion to the extent of their relationships with their mutual. Here again the smart card can provide both a means of calculating each member’s 'reward' for their relationship and of distributing it by loading that 'value' onto each Member's smart card. members could at any time during their relationship with their mutual see how much that relationship was worth to them, by using the smart card to call up a current balance of their 'rewards'. Whilst these may or may not be available to them instantaneously at least they would be able to recognise the 'value' held on their smart card and the value to them of their relationships with their mutual(s).

The second potential differential of mutuality lies in the ownership and control of mutual organisations. Here again the smart card has a role to play. Members holding a smart card issued by a mutual organisation can use that card both to authorise their ability to vote and verify that it is their vote that is being cast, in deciding the affairs of the mutual organisation. The smart card can help empower the members to take a more active role in the control of their mutual organisations. Whilst this may not always be good short-term news for the managers of mutual organisations, in the long-term it is only by accentuating and delivering the differentials between mutuals and other organisation types that mutuality and their jobs will survive. The private sector competitors can use plastic cards to try and secure customer loyalty, but they cannot use them to increase ownership and control of their organisations!

Individuals who choose to become members of mutual organisations do so for a wide mixture of reasons. There are economic reasons if that mutual is a cost-effective supplier of goods and services. There are philosophical reasons if the value system embodied by the mutual organisation reflects the value system of the individual. There are political reasons if the individual is interested in playing a full role as a member of a mutual organisation. Whatever the reason(s), the smart card also offers a visible manifestation of that individual's membership of the mutual organisation, one that they can carry with them and use frequently to either identify themselves as members or reap

the rewards of their ongoing relationship with their mutual organisation.

Thus, the smart card and the concept of mutuality have a number of connections. Such cards are rapidly entering everyday use, and they offer forward thinking mutuals a mechanism whereby they can both deliver and promote the benefits of mutuality. For too long the positive attributes of mutuality have been hidden away as if we were somehow ashamed of how different they made us from other species of organisations! Why not combine the revival of interest in the values of mutuality and the virtues of the social economy, by harnessing modern technology to both deliver the message and the rewards? Let's get smart and play the mutuality card!

Steve Worthington is Professor of Marketing and Financial Services at Staffordshire University, UK.

The Impact of Information Technology on Retail Trade

Noel Branton

In the retail distribution system, the traditional supply line was powered by manufacturer "push" - retailers stocked and sold what the manufacturers produced and advertised direct to the public. This, of course, was not the case in co-operative retailing which channelled its purchases to the wholesale societies who either produced them in their own factories or bought them from other co-operative sources. This was done partly to control the quality of their products and the prices at which they could be sold and partly because on account of resale price maintenance they could not always obtain goods which their customers wanted. Now the supermarkets have created a demand chain driven by consumer "pull" created by what consumers obtain from their shelves.

One of the virtues of the small retail shop under private enterprise, which was often a family business, was that the shopkeeper knew his or her customers by name; together with their tastes and preferences which he did his best to meet. The same was true in the co-operative store because of a shared philosophy. The development of self service (pioneered by the co-operatives) broke this link; customers travel the store, make their own selections, take them to the checkout, have them priced and the account printed out and paid. In the co-operative shops members will be identified, elsewhere they remain anonymous. In the supermarket under private enterprise there is an information gap. Under co-operation in theory there is information available, but is it being used effectively?

The means to use information is now being provided by developments in information technology. Cheaper and more sophisticated database technologies are making it possible for supermarket operators to obtain more detailed knowledge of their customers akin to that formerly possessed by the small shopkeeper. The checkouts collect vast amounts of information most of which has been wasted because its value has not been exploited since the technology was not available to deal with it.

Yet although information technology is a precondition for success it is not a panacea. Failure to appreciate this fact has led many businesses to make heavy investments with very disappointing results. Competitive advantage is created from what is done with the system rather than the system itself.

Information technology has given business the ability to manipulate large volumes of data quickly. This "database mining" confers the ability to sieve out information about customers and indicate new marketing options. The type of question which it is now possible to answer is more sophisticated than the traditional "how many people buy baked beans on Fridays?" Cash register data can be used to discover what items customers tend to buy at the same time. This information can then be used to devise improved floor and shelf layout. An often-quoted example is the discovery by Wal-Mart in the US that sales of diapers and beer rose on Friday evenings. Apparently this arose from the buying habits of men with young children. It may be difficult to explain the timing, but the store can exploit the fact by moving the products closer together on the shelves. A British example concerns a bulky product which was no more than marginally profitable and which the store was proposing to discontinue. Data mining revealed that the people who bought it were also consistently the outlet's biggest spenders on other products so that the proposed action might be wrong.

A further benefit which can be obtained from database mining is the speedy identification of niche markets. In the fast-moving retail market, it is important to identify a sales trend and take action on it quickly, since some of these opportunities while short lived can also be very profitable while they last. Again, account must be taken of the 80:20 per cent rule applied to retail business when 20 per cent of the customers provide 80 per cent of the turnover.

It is clearly important to identify the 20 per cent and discover what motivates them and what products they tend to buy during a single visit to the store.

Profits from customer relationships are the lifeblood of every business. They may be increased only in three ways. The first is to obtain more customers - to increase the number of people who wish to use the service provided by the business - but new customers cost money to acquire. The second is to increase the

profitability of existing customers - to induce them to buy more or to make purchases offering a higher margin of profit. The third is to extend the length of the relationship of customers with the business. The longer a customer stays with the company the more she is worth. Long term customers tend to buy more, take less of the time of the staff, are less sensitive to price and bring in new customers.

The relative stability of the level of prices has stimulated a search for alternatives to price cutting for securing customer loyalty - a role which was filled traditionally by the co-operative dividend. Tesco led the way when in February 1995 it became the first British food retailer to launch a loyalty card called Clubcard which now claims six million card holders. The holder is rewarded with £1 for every £100 spent but the minimum purchase required to score points is £10. Card holders receive their vouchers every three months. The retention of consumer loyalty may in the long run not be the major benefit of the scheme. The holder's name and address now form a database enabling the business to analyse the purchasing patterns of its cardholders and target them with promotions. Money spent on sales promotion can be directed where it is most likely to be effective.

Noel Branton is Emeritus Professor of Commerce at the University of Strathclyde.

Marketing the Co-operative Advantage

Tom Webb

In Atlantic Canada, where I live, there are retail co-ops, housing co-ops, fishing co-ops, and credit unions. The credit unions have assets of about $2.6 billion: that's significant. The retail co-operative system has retail sales of just over $1Bn dollars per year and in Atlantic Canada that too is significant. The 'Antigonish Movement' as it has come to be known, was a very successful effort in community-based economic development. Individual farming and fishing families came together to build what became Co-op Atlantic. We are now committed to renewing the vision that created this movement. I want to try and address three questions. Firstly, what is the context we are working in? Unless we stop for a moment and think about the world around us and what is happening in it, it is very difficult to come up with a course of action. Secondly, who are we? What are co-operatives and what are they all about? Thirdly, given the world around us and who we are, what are the implications of this and what are the opportunities, particularly for marketing?

The context we are working in

I am going to paint what might be seen as a dismal picture, not to be depressing or to dwell on the negative but simply to highlight some of the things we need to think about in the world around us. There are positives and negatives. We are entering into a global economy in a way the world has never had a global economy before. We are looking at the emergence of global corporations with enormous capacity to ship capital anywhere in the world almost instantaneously, and that has enormous implications for our communities and to the society around us and we need to think about that. We are moving toward global markets. Markets have been important, because markets are based on very simple principles; they are based on billions and billions of dollars, and each dollar is one vote. We are also in an era which is witnessing the retreat of civil society and government

as we have known it. Certainly, government in my country is in extended, prolonged, and rapid retreat - from education, health care, and all areas of service. Government is built on a different basis, of one person, one vote; we are retreating from that.

We are in the midst of a profound ecological crisis. In the area of the world that I come from, in 20 years we have turned the ocean from a pasture of plenty to a commercial desert. When John Cabot arrived here 500 years ago, he wrote about the ability to almost walk across the water on the backs of the fish, and today we have turned that into a desert; we cannot catch a cod fish now ... but remember, the earth has no dollars, so the earth has no vote. It does not have a vote in the market place.

We are living in the midst of an amazing information revolution. I can sit in my office and talk via E-mail to someone in the Japanese co-operative movement, and ten minutes later I can talk to someone in the Mondragon co-operative movement, and ten minutes after that I can talk to someone down the street - all with the same technology. I can tap into databases in the United States, Europe, and anywhere in the world. We are in the midst of a technological spiral, and I say spiral because it is getting faster and faster and faster. Technology is primarily produced by the military and by large corporations. We are in a technological race which has.no speed limit, yet we still do not fully understand the technologies we brought in 20 years ago. We are on this amazing technological spiral where the computer you buy today is out of date when it touches your desk.

We are also living in a world which Xabier Gorostiaga, Rector of the University of Central America in Managua has called 'the champagne-glass global society', a society where the top 20% owns 84.7% of the wealth of the world, and the bottom 20% owns only 1.4% and the other 60% are in the middle; that, too, has profound implications for the future. We are in a world that is in ethical retreat, and when I hear people talk about the economy I hear them talk about an angry god, to whom we must sacrifice women, children, the elderly. There is no end to the sacrificing, and yet the economy god doesn't get any happier - the rate of sacrifice just speeds up. Is everyone gloomed out? Don't be! We only really need to be depressed if we refuse to look these trends in the face and if we stop asking, "What kind of world do we want to build?"

Who are we?

Co-operatives are an alternate form of enterprise with a different basis than the standard form which dominates the economies of the west. They are, therefore, the basis for an alternative kind of economy - an economy that is not an angry god. The key value of co-ops comes from the fact that they are people- centred rather than capital-centred and that has profound implications for co-operatives as enterprises. It gives them, among other things, multiple bottom lines. Welch's, for example (a large and successful US farmers' processing co-op) would not go out and deliberately squeeze every last cent out of the farmers that own their national grape co-operative. Co-op Atlantic would not try to squeeze every last cent out of the consumers who own it; they wouldn't do it; it is not thinkable.

There is one part of the co-operative difference that is very important to what we are talking about - marketing. Co-operatives are based on the dignity of people. That belief in the dignity of people is where the commitment to education comes from, otherwise who would educate people if we did not think they had dignity? Why would we accord them any rights? Why would we believe in empowerment? Why would we believe in responsibility? How would responsibility be possible without education? Education is a fundamental part of what co-operatives are all about and it has always been a fundamental part. There is a difference between education and communication. Communication is just getting any idea across, while education has to engage people, it has to engage their dignity, it has to spark some growth. Much of that education is focused on the board members, the employees, management - people who are immediate stakeholders. Much of it is focused on external stakeholders - the general public and groups of people within the general public, it might be politicians. So let us remember that in co-operatives marketing is integral to education, it is not separate from education; all marketing is education.

We often used to say at Co-op Atlantic 'When the member walks in the store you are educating'. What they see when they go into that store tells them a lot about what you believe in, what your principles and values are. If they go into a co-op store and they see the same attempts to rip them off that they see in

any other store, you have taught them something that $10 million worth of pamphlets or 200 courses will not change; you have taught them not to trust you. So, marketing and education are not separable, some education is marketing, all education impacts on marketing, and all marketing impacts on education.

The implications for marketing

I want to set up a distinction between image marketing and what I call character marketing. **Image marketing** is based on getting others to believe what we want them to believe about us. So, we create an image and then begin communication - not education but communication - in order to create that belief in their minds. It begins with an image that we want to create and is often focused on the competition. We spend a lot of time with image marketing looking at where the competition is going. Who are they? What are they doing this week? Image marketing exaggerates trivial differences, because often these are the only kind of differences there are. It supports its claims about those differences with contrived evidence. We often hide statistics that are at odds with the image; we do not often see big corporations risk their image by airing any dirty laundry of any sort or admitting that they have any shortcomings (this is often true of co-operatives as well). Image marketing relies almost totally on company-generated communication; the way they will get their message across is to generate the message themselves because they cannot trust anyone else to generate it.

Often, image-based corporations have conflicting brands. You might have a perfume company with one brand up here which says it is this, and another brand down there which says it is that. You say, 'Wait a minute. How do you get these two different brands? Which one do I believe in?' Traditional marketing says just keep them separate, no one will know that they are made by the same company; you are selling the brand, not the company. Image marketers often strain credibility and create cynicism, and they attempt to create feeble relationships. So, you have the amazing proliferation in the last 10 years of clubs: frequent flyer programs, frequent hotel guests: you stay in a hotel 10 nights and get one night free. All of these are attempts to create a very feeble relationship, a thin bonding between the customer and the

company.

Now let us look at **character marketing;** this should be the natural choice for co-ops. It is about communicating what we really are, communicating what we are all about. Instead of going out and trying to create an image about your products, you try to create a product that reflects what you are, that reflects your values. Character marketing creates real differences, because once you define who you are you begin to impose that definition on what you do. It also means you can rely on other people to give your message, because you haven't built it on contrived differences. You can allow the news media to pass on your message, because you are not hiding anything. You can do as Ben & Jerry's (the ice-cream company) does - they have an independent social analyst. Every year he does a social audit of Ben & Jerry’s, and they print it in the annual report. It says, 'Look here at the fifteen areas where we fell down on who we say we are'. Does that hurt Ben & Jerry's? No, because they know who they are and what they believe in, and they know that in spite of the fact that they have shortcomings there is credibility in being honest and having integrity.

Character marketing creates the basis, for deeper relationships. For co-operatives, that is a unique advantage. It is not hard for co-operatives to build deep relationships; that is their uniqueness. Co-operatives **are** relationships. Relationship or character marketing for co-operatives is just a natural. In the context of the trends that are causing such enormous concerns in our world today, people are incredibly hungry for something they can trust. They do not trust big business, they do not trust big government, they **do** trust co-operatives. They want something they can believe in. The unique selling point for co-operatives is that they are positioned by their principles and values. Those values are a source of hope to more and more North Americans. The beauty of Co-op Atlantic's position in the marketplace is that the competition cannot copy it without becoming a co-operative, and they will not do that, so the Co-op is unreachable. The only thing that can destroy this advantage is when co-ops undermine their integrity, their own uniqueness.

Furthermore, the beauty of character marketing is that it has an enormous positive impact inside as well as outside the

company; when you look at United Airlines' marketing you get a sense of the power of that. If you tell people in your advertising who you are, and you are honest about who you are, then your employees also get a powerful message. If, on the other hand, you duck who you are and you say something like, 'Get them in the door with cheap prices and we will tell them about the co-op stuff later' - eventually you destroy yourself. You are telling your employees, 'We're ashamed of who we are. We have no pride in who we are, and we don't believe in who we are'. What character marketing allows you to do is to keep your integrity intact, and there is nothing more powerful in the world of business enterprise than an organisation that has integrity. There is real excellence in pursuing your co-operative values and marketing your co-operative values, and that excellence will enhance your market position.

The opportunity exists to renew our co-operatives, and for them to draw their business strength from their co-operative values and principles. Ten years ago, I do not think people believed that. They were not ready for character marketing by co-ops. Now they are starting to believe it, and so now co-ops can draw their business strength from co-operative values and principles. They can move from being tentative and shy about who they are - little co-operative islands in a sea of investor-owned businesses - to being confident and dynamic about who they are. This is because the values that underlie co-operatives are a source of hope in a world in which there is despair and increasing fear about the future.

Tom Webb is the Director of the Extension Department, St Francis Xavier University, Antigonish, Canada

This is an edited version of a talk given at the Marketing the Co-op Difference Forum, Boston USA, November 1995.

The Future of Mutuality

Philip Ireland

The current Building Societies Act came into force less than ten years ago. Although it included provisions to allow building societies to convert from mutual to company status, we believed that such conversion would be difficult to achieve and, therefore, very rare. The Act was welcomed as being progressive and enabling societies to take on new powers and, therefore, to become more competitive. That was ten years ago. By the end of next year, in asset size, 30% of the sector will remain. But for the recession this position would probably have been reached five years ago.

It may appear that the building society industry, with a little help, has set its course on a one-way journey to oblivion. It may appear that the only uncertainty is when this will occur. Realistically no new society can be formed, and the rate of conversion appears to be on the increase. You may draw the conclusion from this that building societies are weak and so should disappear. You may also draw the conclusion that we are not operating in the best interests of our customers, most of whom are our members. On the contrary, many remaining mutual societies are financially very strong and are demonstrating their commitment to mutuality and the benefits this can bring to their members.

Mutuality and its benefits

I propose to examine in more detail the reasons for conversion and the reasons why mutuality is a sustainable option. But first what is mutuality in the case of building societies? You may find that some of these criteria apply equally to the Consumer Co-operative Movement. Firstly, all of a building society's members are customers. These are made up of borrowers and investors. Secondly, each member has one vote, regardless of the size of investment or mortgage. Thirdly, the principal purpose of building societies continues to be limited primarily to the raising of retail funds for the purpose of making secured loans.

The final criterion is that the share capital of a building society is fluid, and shares are not generally transferable. The share capital in the case of a building society is the total value invested in shares at any time. Building societies are therefore effectively 'consumer co-operatives', mostly set up during the last century as self-help societies with open membership and a democratic voting system. Under the building societies legislation, societies must be run for the benefit of prospective as well as current members. All benefit from the built-up wealth and strength of their societies.

Virtually all of these examples of mutuality apply to co-operatives. I would identify four main differences between building societies and co-operatives. Firstly, there is the complex nature of ownership within the Co-operative Movement. To the outsider, there appears to be an interweaving ownership between primary, secondary, and tertiary organisations which certainly, as things now stand, appear to make conversion or take-over of the larger constituents of the movement difficult, if not impossible. Secondly, the range of businesses is far wider than, and not subject to the same restrictions as, building societies. Thirdly, the make-up of boards tends to be more representative of the members, who are encouraged actively to participate. Building societies, on the other hand, generally select external directors who are, certainly in the larger societies, City based or leaders in industry. Lastly, as a result of the different types of business, returns to members can take on many different forms. Building societies generally provide benefits through attractive rates of interest.

Having outlined what mutuality is, what are the arguments in its favour? Evidence, including Consumers' Association research, shows that customers of building societies get better returns and supports the view that, in general, customers prefer dealing with building societies to banks. For example, over the last ten years all the top ten cheapest mortgage lenders have been mutual building societies. Over that period the difference in cost for a £50,000 mortgage between the cheapest lender (a mutual building society) and the dearest (a plc) was £2,943 ('What Mortgage' magazine). Bank of England figures show that bank savers lost a massive £24bn between 1986 and 1995, compared to what they would have received if they had saved with mutual

building societies. The basic mortgage rate of 6.74% at the Yorkshire Building Society saves a £50,000 borrower £250 a year compared to what would be paid at the Halifax, Woolwich, Alliance and Leicester, Bristol and West, and Northern Rock all of which have announced their intention to convert. Today's best buy tables are dominated by savings products from mutuals. Societies do not have to pay dividends to shareholders and are not, therefore, subject to conflicts of interest between customers and shareholders. And finally, the disciplined and risk averse approach of building societies and their regulators provides a secure home for retail customers, none of whom has lost a penny through membership of a building society.

The disappearance of the building society sector would therefore have a number of major impacts. It would undoubtedly lead to the growth of widely diversified bancassurers whose primary motivation is one of profit for shareholders. The removal of competition from the building society sector would lead to widening of margins with higher mortgage rates and potentially more limited choice of retail investment products, with banks able to turn for all their funding to the wholesale markets. Therefore 'pay back time' would arrive for all those building society members who have sold out.

Reasons for conversion and the conversion process

You may ask, therefore, why building societies are converting and how they are managing to persuade their members. Supporters of conversion argue along the following lines. Firstly, the society has outgrown its roots and sees its future as a major bank not subject to the limitations of mutuality. Secondly, conversion provides potential for wider powers and attracting new capital. In answer to these points, members of societies should ask how they achieved such positions of strength if they were so limited as building societies, and exactly what wider powers or capital they need and how this will benefit the current members. Thirdly, critics argue that, in reality, members of building societies do not use their powers. But at least they do not have any conflict with external shareholders. Fourthly, they ask why members should not release the reserves to themselves. But this is a short-term view, and members are naive if they

think they are getting something for nothing. Conversion will undoubtedly affect their position as customers and those paying for conversion will ultimately look to get their money back many times over.

Fifthly, they will suggest that members who prefer mutuals can still move on; but for how much longer? Sixthly, they argue that building societies cannot take full advantage of funding from wholesale markets and must raise a proportion of their funds from individual investors, possibly at higher cost. But we have seen what happened to the centralised lenders who grew in the late 1980s and were not subject to the same controls. Seventhly, they say customers will continue to receive the same services. But not necessarily; margins will suffer in order to pay dividends, and there is no obligation, as with building societies, to lend the bulk of their funds on retail mortgages nor to raise fund through retail investments. Lastly, they may point out that there are benefits for senior management through share options - I cannot argue with this!

I return now to the Building Societies Act of 1986. In reality, those drafting the legislation, and indeed those running building societies, felt that the requirements to convert were difficult to achieve. No-one foresaw the levels of payouts which would be offered to members to sell out. The Act puts the whole conversion process in the hands of the society's own Board; all conversions (including, I would argue, the National and Provincial) have been instigated by the actions of Boards of societies. The Act required 20% of savers to vote on a conversion with 75% in favour, and with even more stringent rules for a takeover. It also required a borrowers vote and included the 'two-year rule' which it was believed meant that no payout could be made to members of under two years' standing. It has since been shown that this seemingly difficult process was in fact easily achievable. The Abbey National won a crucial court case which rendered the two-year rule useless and meant that new members could share in the distribution where this was in shares as opposed to cash. The previous 5% vote from annual general meetings increased to over 60%. The directors, therefore, saw the benefits and the opportunity to persuade members through a one-off payout. One of the lessons to be learnt is undoubtedly that, in introducing any new legislation or regulations, organisations need to be alert and fully aware of the wider

implications.

The British government has made clear its pleasure at the impact of money being released into the hands of members to increase the 'feel good factor' and the buying power of customers. In reviewing the new legislation, the government is making sounds in support of building societies but not showing this in any meaningful way. It is not prepared to reaffirm the two-year rule and so remove the potential for bribes and the key influence of the 'greed factor'. The government stance has been very much on the lines that societies and their members in choosing conversion are getting what they want. Therefore, what is the problem? Members have always voted in favour of conversion. They have, however, been bribed and persuaded by self- interested management. Payouts have been heavily skewed in favour of small investors as a result of the one member one vote principle. In the case of a £100 member, it is perhaps understandable that they should accept £500 or more in return for their vote. But even for such members this is not necessarily in their best interests. This generation is taking the wealth built up by previous generations and denying both itself and future generations the benefits of mutuality. We believe that a reduced margin producing lower interest rates for borrowers of at least 0.5% is sustainable by building societies. Currently the Yorkshire's standard rate is 6.74% against the Halifax rate of 7.25%. Taking an average mortgage of about £50,000 this produces an annual benefit of £250 set against a possible one-off payment to that borrower of £500 (and borrowers do not necessarily benefit at all on transfer).

So, what will happen to converting societies? Some are already being swallowed up within big banks. Others are planning to go it alone. I have no doubt that societies like the Halifax will succeed. The position of smaller societies is in considerably more doubt, and I would envisage many of these ultimately being taken over by banks, insurance companies or other large conglomerates. Indeed, I would envisage converting societies such as the Northern Rock and Woolwich being targeted by hostile predators ahead of the remaining mutuals.

The future for building societies

What about the future for those building societies that remain?

We see tremendous competitive advantages from mutuality for our members. I have referred to the ability to operate on narrower margins so that our customer-members take the full benefit from our products without having to reward external shareholders. We will continue to focus in two key markets for which there will always be a demand. Societies are stable and secure organisations who have built up their current position of strength over many years. Competitively, therefore, things could not be better for those societies remaining. Having said this, we are aware of the threat of hostile approaches and the influence of greed; ironically, both of these demonstrate the perceived strength of building societies. But how do we resist these forces?

Firstly, it is crucial to appreciate that mutuality will not in itself guarantee success. Mutuality is only sustainable if it delivers the products and services members want at the right price so that members can see clearly ongoing and tangible benefits. Secondly, societies must strive to create a 'virtuous circle' of mutuality with attractive products producing higher growth, resulting in lower management expense ratios, thereby enabling them to produce more attractive products, and so on. Cost efficiency takes on more emphasis than profitability and, in this respect, cost growth must be below asset growth. Thirdly, societies must have in place sturdy defence mechanisms. In this respect, the Yorkshire's first line of defence is its clear mutuality agenda with benefits for members and clear accountability to them. A full understanding of the fine detail of the conversion process and of the influences on decision-making is crucial. Societies should continually test out their defences and arguments internally and through external advisors.

We are currently reviewing legislation and probably the key aim of societies is to improve the protection measures. We are therefore lobbying for restrictions on the proportion which can be paid to individuals to remove the potential for bribes and encourage members to take a more balanced view of short- and long-term benefits. We are also looking to strengthen the two-year rule and to give statutory force to the view that Boards of Directors should consider the wider interests of all stakeholders, in other words, not just current members but prospective members, staff and communities served by societies. This would reduce pressure from some members (notably the speculators or

'carpet-baggers' as they are now popularly known) who suggest that Boards should only have regard for the interests of current members and that conversion and therefore payouts are, by definition, in their best interests. We are also lobbying for the removal of protective measures for the benefit of converting societies in the event that such societies themselves make hostile approaches.

It is important to remember, however, that the biggest threats are from within, in particular from other converting societies and internal Boards and management. In short, mutuality is only justifiable if it is beneficial and sustainable, but its benefits are irrelevant if its management does not want it. The intention behind some of these changes in legislation for which we are lobbying is therefore to reduce the ability of management to influence unreasonably the decisions of members. Are we postponing the inevitable? I believe that those societies that choose to remain will grow from strength to strength and that managements and members will benefit from the strong competitive position and from carefully managed mutual agendas. The objective is that members will, therefore, come to appreciate the longer-term benefits. Regrettably, unless there is a radical change in the law, there is no realistic chance of creating new societies. They will, therefore, inevitably diminish in number but we should reach a point (and may be close to it now) when the benefits start to be appreciated and the balance tips more in favour of societies.

Are there any warnings in this for the Co-operative Movement? Firstly, and most obviously, it depends on what those running it want. If you wish to remain as you are, it is important that the benefits from your form of mutual ownership are seen to be delivered. Whilst it is important to be aware of all potential threats, the current structure of the Movement would appear to make any significant level of conversion virtually impossible to achieve. Just like the building society industry ten years ago? As numbers reduce, for example, through transfers of terms of engagement or through concentration in a small number of societies, the risk could increase. It is therefore crucial to understand all the implications of development, the potential impact of new legislation and regulations, and the personal agendas of those involved in the Movement. This is a crucial

time for mutuality. I wonder what the originators of our movements at the beginning of the last century would make of these developments.

Philip Ireland is the General Manager of Yorkshire Building Society

This is an edited version of the talk given by Philip Ireland to the Society for Co-operative Studies fringe meeting of the 1996 UK Co-operative Congress.

Ted Stephenson - His Contribution

Lily Howe

Ted Stephenson's contribution to the consumer co-operative movement was outstanding for its quality, its depth, and its constancy over 40 years. It spanned his time at the University of Leeds where he was deputy head and senior lecturer in the Department of Management Studies, continuing throughout his retirement until he died early in June. In his writings, his consultancies, his conference addresses, his group meetings and in more private discussions he took us with him on the road to a searching self-examination before going on to probe future strategy and all that flowed from it.

"Survival", he recently wrote, "depends upon rethinking many long-held assumptions and upon a reappraisal of every aspect of co-operative retailing activity." He clearly believed, as Abraham Lincoln once said, "If we could first know where we are and whither we are tending we could better judge what to do and how to do it."

This continuing exercise was far more than the intellectual journey of an academic. Ted had the knowledge and experience not only to advocate apposite strategy but also to advise on operational plans to carry it through effectively with co-operative distinction. He *knew* the complex consumer movement - some societies intimately through his consultancy work - and was concerned for both its commercial success and its distinctive democratic values. At once an independent critic and a loyal advocate, he looked to the twin aims of economic efficiency and social responsibility between which he saw no conflict, recognising both as aspects of a common purpose. While he underlined the need for the right rate of net profit he warned against the economic emperor with no co-operative clothes.

Much of his counsel was timeless. With his wide-ranging mind, his wisdom, his judgement and his - all too uncommon - commonsense he consistently underlined the 'art of the possible' believing the gap between rhetoric and reality should be closed.

The grand strategy, as an apparent panacea, never beguiled him. This was significant, for he was consulting, writing and

speaking over the years spanning the UK Movement's Regional Plan, the Single National Federation debate, the Tripartite approach to a CWS/CRS merger and other major strategic initiatives. "National plans", he once wrote, "do not sit comfortably on the disparate organisations that make up the co-operative movement."

He called for innovative thinking within the broad framework of co-operative ideas. More than a decade ago he was writing of an alternative method of merger: the phased merger whose limited joint activities are entered into with agreed full merger as the final product. But he was quick to warn "Combining inefficient, ineffective societies will not produce efficient ones - only failure on a wider scale."

A realist, he was careful in analysis to place consumer co-operative results in the context of the wider retail trade recognising that co-operatives cannot - or should not - be examined in isolation either for market share or for profitability. One such analysis in a major piece currently circulating in the international movement concludes "The emerging message is that the movement has to seek, both individually and collectively, a distinctive role. Differentiation is essential in a crowded market with a static or weak demand."

In an age of rapid change, he maintained that whatever the technology, whatever the structures "nothing can replace human judgement". And he would return to the theme that we may travel too far along some wrong or over-narrow road before we discover costly errors entered into through not taking the broad or long-term view. "The problem with short term thinking is that it concentrates attention on means, such as structure, at the expense of ends", he averred.

Ted was as much concerned with member involvement, lay leadership and directoral control as with executive management. Themes to which he frequently returned were the critical nature of the relationship between the board and the chief executive, the accountability of management, the supply of information to members and employees and an active membership base as a prerequisite for healthy governance. This broad canvas led to a rich profusion of writings and other involvements.

Co-operative education and training much concerned him. To the Institute of Co-operative Directors, he gave unstinting support

and practical help, recognising on its formation a decade ago the value of the innovation which came, with hindsight, surprisingly late. He developed a section for the Institute's manual dealing with "Functions, authority and roles of the board of directors" and became a regular contributor to the Institute's 'Director Briefing'. In earlier years when he was at the University of Leeds his discussion groups for society officials formed the basis on which much of their management style and thinking is still based.

He was, among others, a faithful president of the society for Co-operative Studies and it followed that the 'Journal' Editor frequently called upon him to contribute. The 'Co-operative News', 'Co-operative Marketing and Management', the Plunkett Foundation 'World of Co-operative Enterprise' and other publications regularly benefited from his thought stimulating articles. "Stirring dull roots with spring rain" was ever his art.

In all this and his related work Ted needed his quiet, wry sense of humour, never waspish, never unkind, always understanding, though sometimes - eyebrows up, eyes widening - almost incredulous. But the steel was there and so was the courage. Whatever the controversy, he stood fast to his fundamental beliefs. He recognised that compromise is an integral part of management, but he never compromised on co-operative values and saw no reason to do so. Combining top quality management with effective directoral control he saw as the route to both commercial success and the co-operative difference.

Ted was to me, as to so many others, more than a professional colleague, for he quickly became a staunch and valued friend. From time to time, we would meet in Manchester when I was at the Co-operative Press. We wandered the movement, lingering along the way to pinpoint and analyse current issues, problems, and opportunities, then going on to discuss future commissioned contributions. Invariably, I returned to my desk refreshed, enlivened and not a little comforted to have again been reassured through our exchanges that we had many common thoughts on the movement.

To an Editor, Ted Stephenson was the 'compleat' commissioned contributor: clear, concise, orderly and with an elegant turn of phrase. His theme was always relevant to the current co-operative environment and tailored to each individual publication. A bonus

- so crucial for an Editor - he never missed a deadline.

Publishers outside the co-operative movement recognised his quality. In 1963 Heinemann published his 'Management of Co-operative Societies' and in 1985 Macmillan his 'Management: a Political Activity'. The movement was fortunate to have a friend of such high standing in the broad management field.

Ted went too soon for all of us, but quickly as he would have wished. Happily, he embraced life to the last - writing and, with Margery who had been his wife and close companion for so long, walking the lovely Northumbrian countryside around Wooler where he savoured his busy retirement.

We shall miss him; do miss him. But as we approach the 21st century the challenges to co-operative enterprise he explored with informed perception are waiting to be grasped. To take hold of those challenges - the problems and the opportunities - to ensure a significant role for co-operatives in the future is the finest tribute we can now pay to him and to his contribution to co-operative development.

Lily Howe was Editor of the 'Co-operative News' and 'Co-operative Marketing and Management' from 1972 to 1984. Over many years she has been associated with the UK Society for Co-operative Studies and the Plunkett Foundation.

Regulating Private Utilities: the Customer Corporation

John Kay

The regulation of privatised utilities in Britain is widely criticised today. The criticism comes from many quarters. Customers resent their money being handed out in excessive salaries and dividends. Academics are now widely critical of the price fixing formula (RPI-x) which was once a proud British innovation. A curious alliance of politicians and senior industry executives is concerned to suggest that the regulatory process is insufficiently accountable. Much of this criticism of regulators is misconceived. On balance, regulators have done a better job than could reasonably have been expected. The problems of utility regulation are mostly not the fault of the regulators. They arise directly from the failure to address a range of fundamental structural issues about the management of utilities at the time of privatisation. If people are trying to push water up hill, the correct response is not to berate them for incompetence or to look for ingenious devices to help; it is to point the finger at those who gave them the job to do in the first place. We should address our criticisms to the politicians who devised the framework rather than at the regulators who struggle to operate within it.

The deficiencies of that framework are of three main kinds, and they have been cumulative in their effect. All have a common fundamental cause, which is that the principal concern in all privatisations (with the partial exception of electricity and buses) was to achieve a successful flotation. That was largely perceived as an end in itself. To the extent that the architects of the programme thought beyond that, it was simply assumed that the change in ownership would bring about the desired results. The first weakness is that the terms on which utilities were privatised were much too favourable to firms and their shareholders and gave insufficient attention to the interests of customers. The second is that no explicit mechanism was put in place for securing a substantial share of the expected efficiency gains for customers. Even if - as can be argued - such a mechanism was implicit, the

absence of a clear relationship was bound to leave customers dissatisfied. The third, and deepest, of the problems is that the privatised utilities lack what political theorists term legitimacy - a popularly acceptable basis for the power they exercise. Much concern has recently been expressed over the accountability of the regulators; the man in the street is not concerned with this but with the accountability of the companies themselves, and he is right. It is this absence of legitimacy which explains why privatisation remains unpopular with the public even as it has started to deliver benefits to them in the form of lower prices. It is also why attempts to extend privatisation further - in post and railways, in health and education - have ground to a halt.

This paper develops these propositions and argues that attempts to add bells and whistles, or more accurately balls and chains, to the current regulatory system are certain to fail. They will increase rather than reduce dissatisfaction with the current structure. The right answer is a partial retreat from privatisation. It is an acceptance that the governance structure of the plc is not suitable for the governance of monopoly utilities even if it is appropriate for firms which operate in competitive markets (it is not clear it is appropriate for them either, but that is a matter for another article).

The basic reform proposal developed here is a very simple one, though far-reaching. At present, the conventional view is that the primary duty of corporate boards is to the shareholders of the company, and its obligations to customers arise incidentally to the fulfilment of that obligation. In a competitive market, the interests of shareholders can only be achieved by meeting the expectations of customers. But this is not true for a firm which does not face a competitive market, such as a monopoly utility. For such a company, the legal position should be the other way around. The purpose of a privatised utility should be to serve its customers, and its obligations to shareholders exist only to the extent necessary to ensure that the company can meet that primary purpose. This change would have implications for the appointment and conduct of Boards, for the financing of companies, and for the role of the regulator.

From my knowledge of the managers of privatised utilities, I believe that this change would reflect the ways in which the vast

majority wish to behave and the ways in which they, in the main, do behave. To remove the tension between their aspirations and the expectations of the capital market would be to the long run benefit of everyone. Some utility executives will see this as a major erosion of the management freedom which privatisation has given to them. The intention, and the effect, would be precisely the reverse. The only hope of maintaining that freedom, and the efficiency gains which have been derived from it, is to find a structure which legitimises it more effectively. Decisions as to what level of renewal investment is necessary, which new activities will benefit customers, how improvements in service quality should be balanced against price increases, are all best taken not by politicians, or regulators, or referenda among customers, but by utility managers themselves. What we need is a framework that both encourages and allows them to make these decisions in an environment which focuses unambiguously on the interests of customers. The alternative, which is already in progress, will be a continued erosion of management autonomy through expansion of the scale and scope of regulation and from increasing direct political intervention.

The Achievements of Privatisation

Before turning to the supposed failures of regulation, it is well to begin with the successes of privatisation. There have been substantial improvements in efficiency in all those firms which were publicly owned when the privatisation experiment began in the early 1980s. Most of this improvement, possibly all of it, has come from reductions in manning levels. The most remarkable achievements have been from those formerly state- owned firms operating in a competitive environment: steel, airways, the two electricity generating companies. Telecom and gas were slower to slim their workforce but have begun to do so as competition has become more effective. The pace of change has been less marked in water and electricity distribution, and in these industries there are probably large improvements yet to come.

In broad terms, these changes have been achieved without loss of output or service levels. To a much greater extent than had been realised, nationalised industries had become employers

of large amounts of unnecessary unskilled labour. The Central Electricity Generating Board (CEGB), widely regarded as one of the most efficient of nationalised industries, can now be seen to have been grossly over-manned. Other countries have had similar experiences in the restructuring of their public sectors. It is, however, important to recognise that competition, rather than ownership as such, seems to have been the key element. Not only have changes happened more quickly in competitive environments than in others, but substantial productivity gains have also been made in the same period in other industries, such as the Post Office, which remained in state ownership.

These efficiency gains have revealed clearly the negative effects of traditional 'accountability' which takes the form of detailed supervision of management actions and of firms' investment plans and operating activities. Such accountability had, in practice, undermined the responsibility of the managers of the businesses concerned for the consequences of their actions without effectively transferring it to the supervisory civil servants or politicians. The recent fracas over prison management is an unambiguous reminder of the weaknesses of this structure as a means of organising industrial activities or, for that matter, anything else. Greater freedom to manage has everywhere led to improvements in morale and performance.

Almost all utilities have become more customer focused, in terms of attention to service quality and relationships with customers. British Telecom's redesignation of 'subscribers' as 'customers' is in a sense only symbolic but represents a real change; customers may now have a choice, and even those utilities which remain monopolies are more inclined to treat customers as if they did have a choice. The influence of employees on British nationalised industries was substantial, but implicit rather than explicit, and hence essentially negative. It operated to prevent change in the structure of organisations, in working practices, and in the range and nature of services provided. There was also an excessive emphasis on technical issues relative to those of marketing and finance, reflecting political love of the grandiose and the wide influence of equipment suppliers. Electricity generation illustrates the nature of change here. The CEGB focused on large, state of the art generating sets, few of which were ever built to time or budget. Since privatisation, all

new capacity (apart from Sizewell B, an overhang from the old days) has taken the form of small, combined cycle gas turbines, which can be built rapidly on well-established principles.

Privatisation has given utilities more investment freedom. The results of this have been more mixed. Most have taken the opportunity to diversify, either internationally, or outside the core business. Since utilities see limited prospects for growth within the core business, internal and external pressures to do this have been substantial. Very few of these diversifications have been in any way successful. Companies have also been able to invest far more in their core businesses, and this has been particularly true in telecommunications and in water. Arguably, a systematic bias towards under-investment has been replaced by a systematic bias towards over-investment. And the problem of monitoring investment and securing effective discipline without depriving consumers of necessary capital expenditure, has been changed in form but not in substance. In water, in particular, the appraisal of investment programmes by the regulator, at once detailed and arbitrary, comes more and more to resemble the methods of Treasury scrutiny and control which were applied in public ownership. No better answers have been found in gas and electricity.

There is a substantial positive balance to be recorded. It is possible that many of the gains which have occurred in the last decade could have been made without privatisation. It is, however, a matter of historical record that they were not made without privatisation, and that they now have been realised. It is also possible that the effect of reducing manpower levels, which is by far the most important consequence of the programme, has been to replace disguised unemployment by actual unemployment. Nevertheless, there is no going back, nor should there be.

Has Regulation Failed?

Criticism of the current regulatory structure comes both from those who applaud the developments described above and from those who remain hostile to privatisation. One line of attack that unites both is the alleged lack of accountability of the regulators. The various Acts prescribing their duties do so only in rather

general terms. The details vary from industry to industry, but the model has substantial common elements. Each utility operates under a licence awarded to it at privatisation. This licence imposes detailed requirements in respect of behaviour and the supply of information to the regulator. Amendment to the licence, or modification or renewal of the price cap which limits prices, may be made by agreement with the firm concerned. In the absence of such agreement the Monopolies and Mergers Commission (MMC) adjudicates.

While the role of the MMC is confined to major issues involving licence changes, judicial review offers a second mechanism for challenging regulatory decisions. This latter procedure is a common law remedy which has grown explosively since the mid-1970s. One unfortunate effect of judicial review on the regulatory process has been that it has increased the reluctance of regulators to provide detailed rationale for their decisions. It is easier to mount legal challenges to the steps of an argument than to the simple exercise of a general discretion which statute undoubtedly confers on the regulator. That discretion is itself the subject of criticism. It is easy to sympathise with the argument that what is needed is clarity and transparency of regulatory procedures and formulae, and that management should then be free to operate within the framework so prescribed. But the sought for clarity and transparency is largely illusory.

Consider some of the issues which are central to utility regulation. What is the cost of capital in electricity distribution? When is price discrimination pro-competitive and when is it anti-competitive in effect? What level of efficiency savings can a water company be expected to achieve? Decisions on each of these can only be made by the exercise of informed judgement. It is certainly possible to construct mathematical formulae, but their operation would be arbitrary and unfair. My preference is for giving discretion and autonomy to informed individuals capable of balancing conflicting duties and interests, rather than for the prescription of detailed rules. This applies both to regulators and to the managers of regulated companies.

(RPI-x).

The (RPI-x) formula is the distinctive British contribution to the

regulatory debate. The concept behind price cap regulation is that it provides reasonable prices to customers while preserving efficiency incentives for regulated firms. It is essential that prices should be based not on what costs are but on what they ought to be. The best source for this would be knowledge of what has been achieved by other firms, in the UK or overseas. In practice, almost no use has been made of international comparisons in British regulation, and there is little sign of any sustained attempt to develop them. Another source is the cost levels achieved by other companies. The opportunity for yardstick or comparative competition of this kind provided a specific rationale for the maintenance of ten separate water and sewerage companies and twelve regional electricity companies. But the failure to make comparative competition effective has been one of the major disappointments of the UK regulatory regime. The agencies have not been successful in developing robust measures of relative performance and have not been able to get beyond broad qualitative groupings of those above and below average.

In practice, price caps are based on forecast costs adjusted by reference to an efficiency target. The incentives established by this regime are not particularly attractive, and in some respects perverse. The regulator cannot, after the event, distinguish between cost savings which arise because cost forecasts were unduly pessimistic and those which arise because the firm has done better than could reasonably have been expected. The regulated firm has therefore very strong incentives to pad out its forecasts of operating costs and investment needs. Since the regulator knows less than the company about what is necessary, he or she is inevitably forced to make arbitrary reductions in the levels of cost and capital spending planned by firms, and such reductions will, on average, be justified. But these will affect all firms, not just those which most exaggerated their expected costs; and that means that all firms must play the game of proffering inflated estimates of operating costs and investment needs, even if they would rather be frank and open with the regulator.

The game which results is one which the regulator must inevitably lose, because the regulator can never know as well as the company what costs and capital programmes are really required. At the same time, it undermines any rational process of investment evaluation, and it diminishes incentives to control

operating costs. The rational response of companies is to maintain a reserve of inefficiency, some of which can be eliminated in the aftermath of each regulatory review, hence ensuring that each target can be met or outperformed without either eroding too much the capacity to meet future efficiency targets or encouraging these targets to be set at even more optimistic levels. These are not theoretical or hypothetical concerns. Elements of this behaviour are apparent from the recent regulatory reviews in water and electricity. The fundamental problem is that regulator and company management have different objectives, and the regulator never has enough information.

There is a further problem which was not widely recognised at privatisation, and which has become evident as the system has operated in practice. It is that 'success' for a company means doing better than the regulator had anticipated when he set the price cap. It inescapably follows that such 'success' appears as a failure of regulation. Customer dissatisfaction is simply inherent in the structure, and paradoxically, the better companies perform in managing it, the greater such dissatisfaction is likely to be. Such dissatisfaction had been building up steadily since privatisation. When the golden shares in electricity and water expired in 1995, the emergence of hostile bids forced companies to be explicit about their success in beating the regulatory system. At that point, dissatisfaction boiled over.

The Problem of Legitimacy

Privatisation is, and has remained, an unpopular policy. A recent opinion poll showed that the proportion of the electorate which disapproved of water privatisation had risen from 71% at flotation to 75% now. In its early stages, the main popular attraction of privatisation was the quick and generally substantial gains which small investors made on the shares and there were few, if any, customer benefits. In electricity and water, the process of preparing the industry for privatisation led to higher prices than would otherwise have been imposed. With longer experience of privatisation, the combination of efficiency gains by the industries and a tighter regulatory regime has led to significant price reductions. Increases in the x factors in telecoms and gas have led to lower consumer prices in nominal terms in the

second five-year phase of price regulation. Competition in electricity generation led rapidly to falling prices, and substantial reductions in distribution charges are now in progress. Although water costs will continue to increase in real terms in the second five-year period the rise will be much less than in the first quinquennium.

Although these things might have been expected to win more support for the framework of privatisation and regulation, criticism has grown rather than diminished. Coincident developments have not helped. The share options which were awarded at flotation have produced unacceptably large gains for senior executives of privatised utilities. Although the salaries of these executives are not high by the - admittedly generous - standards of private industry generally, many people still remember that the same jobs were done only a short time ago, often by the same people, for relatively modest remuneration. The fundamental problem which privatised utilities face is that which political scientists recognise as the issue of legitimacy: 'What gives them the right to do that?'. Legitimacy can stem from many sources: traditional authority, direct election, proper and accepted delegation from those whose authority is itself legitimate. Unsatisfactory though the performance of nationalised industries was in many respects, their legitimacy was not in doubt. But this is not true of their successors. Legitimacy is rarely a problem for institutions which are seen to be doing a good job. But, as Fukuyama puts it, 'The strength of legitimate government is that it enjoys a reserve of goodwill which protects it when things go badly'. The weakness of privatised industries is that they enjoy no such goodwill.

The drought of summer 1995 illustrated precisely that. No reasonable person could blame either privatisation or the managers of water companies for the absence of rain. Yet the result of water shortages was to unleash a further wave of hostility against the privatised industry. That hostility was not confined to newspapers, or politicians, but widely felt and expressed. In earlier droughts, such as that of 1976, there was a general perception of common cause between water suppliers and their customers. Under the current structure, that perception no longer exists although the actual behaviour of the suppliers is virtually unchanged.

An instructive demonstration of these issues of legitimacy was provided at the recent annual general meeting of British Gas. An ill-timed announcement of a substantial pay rise for the company's chief executive provoked controversy. The AGM provoked a barrage of hostile criticism of the company and its management. In the end, the chairman used institutional proxies, overwhelmingly supportive of the management, to defeat all critical resolutions by large majorities. In a real sense, the institution of the AGM- a meeting of the company's shareholders - was being abused. The representatives of the shareholders included, for example, Ken Livingstone, a left-wing Labour MP purportedly representing an American institutional shareholder. Livingstone was not, in fact, there to express concern for the interests of shareholders, and nor were most of those present at the AGM. He was there to make a political speech on what he considered a matter of public interest.

But it is difficult to argue that Livingstone's interest was not a proper one. It is not a good answer to the criticism levied at the company, and at its relative treatment of its own managers, employees, and customers, to say that these things are a private matter between the company and its shareholders - they are not. It is a better answer to say that the regulator is the vehicle through which the public interest in these questions is expressed. But the regulator, correctly, argued that few of the matters in dispute lay within her jurisdiction.

And the vote which vindicated British Gas management turns out, under scrutiny, to be an unsatisfactory affair. The billions of votes which supported the board were in fact cast by a small group - well under one hundred - of city investment managers, who had been assiduously cultivated by the British Gas chairman in the weeks preceding the AGM. These individuals were not themselves beneficial owners of claims against British Gas, and insofar as they had proper authority to act on behalf of those who were, it is not at all clear that such authority extended to matters such as these. It is very likely that the views of the beneficial owners - pensioners and holders of life policies - were closer to those which were expressed at the meeting than to the votes that were cast on their behalf. But even if it were practical to canvass the opinions of those who directly or indirectly owned the shares, no one can seriously believe that seeking these opinions would

be a good way to run the company. The whole procedure might be from Alice in Wonderland: nothing is what it seems, no-one is what they say they are.

In the early years of privatisation, it could be argued that the unpopularity of privatised industries was a transitional issue, and that once the structure was properly understood it would be more widely accepted. The moral of the British Gas fiasco is that it is wrong to think that the problem is one of education and explanation. On the contrary, the more closely the structure is studied, the less defensible it becomes.

Incentives for Whom?

One of the advantages generally claimed for price cap regulation is the incentive which it offers for greater efficiency in the firms concerned. This argument deserves more careful attention than it has received. The incentives provided under the system are incentives to shareholders. To the extent that firms do better than the efficiency targets set with the price cap regime, earnings will be higher than anticipated. The importance of incentivising shareholders assumes, however, that shareholders are in a position to bring about improvements in the efficiency of the companies concerned or, alternatively, that unless so incentivised they would wish to obstruct such improvements. There seems to be no reason to believe either proposition. The annual general meetings at which small shareholders are represented are a farce, and almost wholly irrelevant to the operational management of the businesses. If large institutional shareholders have played an active role in demanding efficiency improvements in some of the worse run utilities, this role has been a very low key one.

The simple, obvious point is that the substantial efficiency improvements described have not been brought about by shareholders, but by managers. If it is necessary and desirable to provide incentives to improve the efficiency of utilities, and it is, then the important people to incentivise are managers, not shareholders. Now the interests of managers and shareholders are to some degree aligned. There are two main elements in this: share options and the threat of take-over. It is paradoxical that management share options, which are the most criticised single element of privatisation and its consequences, are also the main

mechanism for improving the efficiency of privatised companies. They are not, however, a very good mechanism. If we accept for a moment the widely publicised estimate that the managers of privatised utilities have received £25 million in profits on the exercise of share options, we might observe that this amounts to less than 0.1% of the capital gains made by shareholders since flotation. Put another way, each £1 that is used to incentivise managers costs the company's customers £1,000 to provide. That figure might be easier to defend if there was a clear connection between the incentive and the efficiency improvements. But there is not. There is no correlation whatever between the size of the gains which managers have made from stock options and their assiduity in promoting efficiency. If the executives of some English electricity companies have done particularly well, and the Scottish electricity companies and British Gas relatively badly, it is because of the way the cards fell rather than as a result of the effectiveness with which these managers fulfilled their functions.

Several of the privatised companies - such as BT or British Gas - are in practice immune from take-over. Most of the water and electricity companies were subject to a five-year moratorium on bids which has now lapsed. So far, the record of take-over threat as a spur to efficiency inspires little confidence. In only one of the bids so far made or threatened - that of Scottish Power for Manweb - has the suggestion that an alternative management team could do a better job been a central issue. In others, such as Trafalgar House's offer for Northern Electricity, the bidder has no relevant skills or experience and does not profess them. In most, the bidder has promised - whether credibly or not - that he will not change the operations of the firm he is buying in any material way. If the objective is to give the managers of utilities incentives to provide better service at lower cost, then the best, simplest and cheapest way to do it is to give them incentives to provide better service at lower cost. If bonuses given to executives were based on performance relative to demanding efficiency targets or, better still, directly tied to reductions in charges to customers and improvements in the quality of services offered, then the. indignation which has been provoked by the exercise of share options would largely disappear. The reason there is much less hostility to option schemes in other companies is that profits

earned in competitive markets are, at least in broad terms, related to the effectiveness of the company. By contrast, the public thinks that profits are easy to earn in monopoly industries and that profits have often increased for reasons which are unrelated to improvements in efficiency or service. And again, the public is right.

Profit Sharing

It is essential that the link between firm performance and customer benefit be clearly established. At present, the utility retains all benefits up to the time of the next periodic review, at which time an indeterminate fraction of efficiency gains is passed on to customers. It is essential that the lag be shortened, and the connection made explicit. The most obvious method of achieving this is a mechanism for sharing profits between shareholders and customers. The attraction of a system of profit sharing is that it represents a relatively modest reform which appears to answer some of the central criticisms of the current regime. On closer examination, however, the scope of the reform is wider than it appears at first sight, and its effectiveness in defusing customer criticism of the current arrangements more doubtful. The measures adopted by several water companies, and the industry-wide agreement on a programme of leakage control, are examples of voluntary profit-sharing arrangements, and both represent constructive responses to recent customer criticism. But the limitations of voluntary arrangements are obvious. Unless very modest in scale, they create tensions between companies which choose to behave in this way and those which do not, and they put the managers of companies faced with hostile take-over.in an untenable position. Unless very limited in amount, profit-sharing is only possible within the framework of broadly agreed industry parameters. That leads directly to the need to design a profit-sharing formula. There are two main alternatives. The simplest method is that a fraction of all profits in excess of today's level be allocated, not to dividends, but to lower customer charges; the great advantage of such a scheme is its simplicity. Another approach involves sharing of profits in excess of the levels provided for in price-setting. This would demand that the regulator be more explicit about the basis of his calculations

than has generally been the case in past reviews.

However, the attractions of a general profit-sharing mechanism diminish on closer examination. Such a scheme is likely to aggravate the problem of gaming between regulator and regulatee, and to lead to a significant increase in the intrusiveness of regulation. It is also likely to provide disputes which may take us further from the fundamental objective of strengthening customer involvement in the present system. The issue is therefore whether the basic objectives - of preserving and enhancing management autonomy while clarifying and increasing commitment to customers -can be achieved by a different path of reform.

The Customer Corporation

An alternative mechanism of profit sharing is one which creates a link between dividends paid to shareholders and charges to customers. The merit of this proposal is that it creates an automatic alignment of the interests of customers, investors, and the regulator. The adversarial system described above, in which the regulator's concern for customers is pitched against the company's concern for shareholders, neither generates the quality of information needed for regulation nor provides adequate incentives to efficiency or protection to customers. But a share whose dividend entitlement depends on charges to customers, rather than on the earnings of the company, is fundamentally different in character from a conventional equity.

The conventional view is that a company exists to maximise profits for its shareholders. Of course, a company which considered exclusively the interests of its shareholders would not survive for long. For a firm which operates in a competitive market, the only way in which it can serve the interests of its shareholders is by identifying and meeting the interests of its customers. But a monopoly utility is different. A firm with a monopoly of electricity distribution can do well for its shareholders whether it satisfies its customers or not, and that is why the profits earned by utilities are inevitably a matter of controversy. We therefore suggest that the ordering be reversed. The customer corporation is one whose primary objective is to produce services of the quality demanded by its customers at

the lowest possible prices. But since it will operate in a competitive capital market, it will be obliged to consider the interests of investors in doing so. It is important to understand that putting customers first is the natural instinct of the vast majority of managers of privatised utilities. Few of them leap out of bed looking forward to the prospect of another day enhancing shareholder value; but the motivation to do a good job for customers is generally extremely strong. Many such managers will volunteer that the opportunity to give priority to customer interests, with greater freedom from union influence and political restriction, has been the principal benefit of privatisation.

It is an extraordinary feature of current arrangements that, far from encouraging this emphasis on the consumer, the structure invites managers of utilities to fight against it. It encourages, even requires, that they pursue shareholder value, with the regulator as customer advocate, in the essentially adversarial relationship between companies and regulator described above. It presupposes a priority of shareholder interests which would not necessarily be defended even by the shareholders of these companies themselves. If we truly believed that a water company put the interests of its shareholders ahead of its customers, we would prefer not to have to drink their water. The companies often do not behave as the model would have them behave, but why do we encourage this futile tension in the first place? The customer corporation leaves managers free to do what they mostly want to do and what we want them to do. It removes an apparent divergence of interest between companies and the public which is quite unnecessary, and which has created much of the discontent with the performance of privatisation and regulation.

In advocating customer corporations, I emphatically do not propose either that management should be elected by customers or that customers should 'own' the business. It is essential that these firms are run by teams with common interests, values, and identity. Although Yorkshire Water's response was heavy-handed and inept, the election to the Board of Diana Scott (the vocal chair of the company's Customer Service Committee who subsequently sought election to the Board) would not have served the best long-term interests of that company's customers. If the

board of a company is not united in purpose and objective, it rarely functions effectively, and the practical consequence is that substantive decisions are made outside it. The customer interest is likely to be better served by professional managers committed to that interest, and accountable for it, than by representatives of consumers (who are, in the main, rendered unrepresentative by their very willingness to undertake the task). We should learn from the competitive failure of the co-operative movement. Much of the problem was that customers were not, in fact, interested in exercising control, which reverted to employees and politicians. The present method of Board selection and election of public companies generally is considerably less than ideal, but it functions tolerably well in practice, and there is no urgent need to change it. The Board of a customer corporation should, however, be encouraged to be widely representative of the community in which it operates (such a requirement should be part of the customer corporation statute). The following activities are some of those which would be appropriate for customer corporations:

- Water and sewerage services
- Electricity distribution
- The National Grid
- British Gas Transco
- Airport non-trading functions
- Railtrack
- The Post Office
- British Telecom Network Services
- The BBC

There is no reason why a customer corporation could not be owned by a plc. And given the current starting point we visualise that most customer corporations would; Eastern electricity Customer Corporation might be wholly 'owned' by Hanson plc or by Eastern Group plc. 'Ownership' would, however, only relate to the securities of the customer corporation concerned. The plc would not 'own' the assets or revenue streams of the customer corporation and would not be able to use these as security for its own borrowings. The customer corporation would not be permitted to undertake any activities other than those

prescribed in its licence. This would imply ring fencing the monopoly utility activities of the customer corporation, and any transactions between the customer corporation and its plc parent would be the subject of specific regulatory approval. Arrangements of this kind already exist in the water industry but would need to be introduced into other utilities.

The Financial Structure of a Customer Corporation

I expect to be told that no one would invest in a customer corporation, and certainly at first sight it would seem that a move to order interests of customers ahead of shareholders would make it more difficult to raise money from shareholders. This view is superficial. Customer corporations would certainly attract investment, and because of their low-risk character it is likely that they would do so more cheaply than do privatised utilities under the current system of regulation. Uncertainty about the earnings streams of activities such as water and electricity distribution arises from two main sources. One is the possibility of divergence between the regulator's efficiency target and the actual outcome. The other is uncertainty about the evolution of the regulatory regime itself. If these sources of uncertainty were removed or reduced- as would be true for a customer corporation - than the cost of capital would be reduced correspondingly.

What does this mean in practice for the capital structure? A customer corporation could be expected to carry considerably more debt in its balance sheet than do the existing utility plcs. The debt of these companies might be provided by the parent plc or raised directly by the customer corporation. The equity of customer corporations might take two forms: indexed preferred stock (IPS), and ordinary shares. IPS would carry a dividend coupon linked to the Retail Price Index and would have priority over the payment of any ordinary dividend and the holders would acquire voting rights over the company if dividends were not paid on the due date. The ordinary securities might be directly held by individuals and institutions, or wholly owned by a plc whose shares were in turn owned by individuals and institutions. In either case, the ordinary shareholders would enjoy the usual voting rights attached to such shares and would be entitled to

a stream of dividends.

How would dividends be determined? One possibility is that the ordinary shares might themselves have indexed dividends. The attraction of this is that it is simple and minimises the need for regulatory oversight. The weakness is that ordinary shareholders have little incentive to take an interest in the company's efficiency. An alternative is that the directors might set dividends by reference to what they consider prudent; this is exactly how dividend policies of plcs are determined today. The interests of customers would be protected by the statutory obligations of the company and the ultimate ability of the regulator or of the customers themselves to seek legal enforcement of them. The interests of shareholders would be protected by the company's need to secure continued access to the capital markets.

Regulating the Customer Corporation

The essence of these proposals is that many of the duties of the regulator are taken over by the board of the customer corporation itself. The intention is to replace a regime based on a battle between managers representing shareholders and a regulator representing customers with one in which a customer-oriented management makes the trade-offs for itself. There are overwhelming advantages from a shift from a relationship between regulator and regulatee which is fundamentally adversarial to one in which both parties are pursuing broadly similar objectives. The result would be a much more light-handed system of regulation than we currently have. The regulator would publish information on the comparative performance of firms, police the ring fence between the customer corporation and the owners of its securities and provide an important buffer between political influence and operational management of utilities.

Conclusions

On balance, the credit ledger of privatisation far exceeds the debits. The task for the next decade is to find a structure which preserves these gains while meeting the criticisms which are fairly levelled at the existing arrangements. I have argued that

the key to this is to move to a structure which entrenches clear priority for consumer interests in monopoly utilities while maintaining and in general enhancing the freedom of operational management which has been the most valuable product of the last decade of privatisation and regulation. The customer corporation is a vehicle for achieving that. It recognises fully the consumer interest, while minimising the need for politicians and regulator to second guess what are best taken as managerial decisions. It is less novel than it sounds. It is, in reality, a modernisation of the statutory water company framework, which was by no means unsuccessful in Britain for over a century; the companies were, on average, more efficient than their public sector counterparts but suffered none of the problems of legitimacy which have dogged their privatised successors. There are other historical and institutional parallels. Indeed, one of the attractions of the customer corporation framework is its relevance to schools, hospitals, and other state activities for which full privatisation is inconceivable but a dilution of unproductive structures of political and bureaucratic control essential.

Professor John Kay is Chairman of London Economics

This paper is an edited version of the Institute of Economic Affairs lecture on regulation delivered at the RSA in London, October 1995.

Co-operative Legislation

Hans-H Münkner

Introduction

When discussing co-operative legislation, this means in many countries discussion of Co-operative Societies Acts specially designed for co-operatives as a legal pattern of its own. In other countries, where co-operatives are not seen as a legal pattern, but rather as a special way of doing business, co-operative law means general corporation law applied to co-operatives. In this case, any standard form of incorporation, such as company or society, can be modified by its founder members in the by-laws (articles of incorporation or rules) in such a way that it suits the needs of a co-operative society in terms of a people centred, member/ user-driven self-help organisation, following co-operative principles.

Member/user-driven organisations are different from ordinary commercial business organisations which are usually investor-driven arid in which all rules of operation are geared to attracting and protecting investors' capital and to safeguarding investor control. Rights and obligations of members are linked to their membership as persons and not to the amount of their capital contribution.

Member /user-driven organisations pursue different objectives and function in a different manner. In such organisations all rules are geared to user orientation of management, the object of member/ user-promotion and member/ user-control.

In this presentation some questions regarding the role of law in co-operative development will be discussed, e.g.:

- Are laws governing co-operatives known and understood by members and are they applied in practice?
- Are laws governing co-operatives useful for their development or have they become a burden of the past, a handicap as compared with the commercial competitors?
- Are there shortcomings in current co-operative legislation and if so, how can they be overcome?

Law Governing Co-operatives

Laws governing co-operatives cover much more than just a Co-operative Societies Act and Regulations made under such Act.

As a special form of private business organisation, co-operatives are subject to the provisions of the general law (e.g. regulating contracts, torts, offences, damages), if not expressly replaced by special provisions of the Co-operative Societies Act. The same applies to commercial law, tax law, labour law and competition law. Accordingly, for someone to understand co-operative law thoroughly, it is not sufficient to know the Co-operative Societies Act. Especially persons having the task to explain co-operative law to others must have at least a basic knowledge of the national legal system of which co-operative law is an integral part. On the other hand, lawyers in charge of drafting co-operative legislation must be familiar with co-operative theory and practice.

This integration of co-operative law into the national legal system sets certain limits for the way in which the Co-operative Societies Act of a country has to be drafted.

Although there are internationally recognised co-operative principles which the national co-operative law should respect, the national legal system reflects the existing political and legal system, which in turn will determine the interpretation given to the international co-operative principles in national co-operative law.

This is an area where open or hidden conflicts may arise.

For Whom is Co-operative Law made?

Unlike Company Law which is mainly made for the business community and in the developing countries also for the so-called "formal sector", i.e. for persons having either knowledge of and experience in legal matters or access to professional legal advice, the main target group of co-operative law are persons without such knowledge, experience, or access to advice.

Very often, workers, consumers, housewives or tenants join together to form co-operatives or operators of the "informal sector" formalise part of their economic activities by establishing or joining registered co-operative societies.

When drafting co-operative legislation, this difference

regarding the target group of the legal provisions should be kept in mind. However, it should not be overlooked that co-operative societies are not only formed and operated by persons of limited means, but also by owners of small and medium sized enterprises and, for instance, by the liberal professions (medical doctors, pharmacists, tax consultants, etc) and that co-operatives may develop from small and simple socio-economic units with voluntary leadership into large, professionally managed enterprises.

Accordingly, co-operative law must cover the full range of economic group activities and has to contain provisions meeting the requirements of the small and simple as well as the large and complex co-operative societies. This is why in some countries several co-operative laws exist for different branches of activity or for co-operative societies at different stages of maturity and size.

To be accessible to persons with a relatively low level of education and persons of limited means, the co-operative law must as far as possible be written in clear and simple language. The legal draftsmen will have to realise that when making co-operative legislation, the aim should not be to draft a law for lawyers but rather a law for the ordinary citizens.

This is important because the co-operative law aims at introducing a set of new rules to form and operate a successful, member/ user driven group enterprise, which are different from what the citizens usually know and do.

The target population has to know and to understand these new rules and to accept them as reasonable and useful, otherwise they are not likely to apply them in future in their day-to-day work.

Certainly, a law cannot be written like a textbook for beginners. However, there is a vast difference between a law conceived as a purely technical document on a high level of abstraction, full of cross-references and written in "legalese" (i.e. the technical language of lawyers) on the one hand, and a law deliberately drafted to be within reach of the ordinary citizen on the other.

What should be in the Co-operative Law?

A Co-operative Societies Act has to offer the legal framework

within which co-operatives can be formed and developed. This means that first of all the organisational pattern of a co-operative society has to be set out in the law: What are its special features, distinguishing it from other forms of organisation. How it is established, registered, run, financed, governed, and controlled and what role the members have to play in such an organisation.

At the same time, the Co-operative Societies Act has to reflect the co-operative principles which on the one hand are the operating rules of member/user-driven organisations and on the other hand the expression of a distinct co-operative value system.

The organisational structure of co-operative societies to be laid down in the co-operative law is the typical pattern of an organised membership group, financing, managing using and controlling a jointly owned enterprise (referred to as the dual nature of co-operatives and the principle of identity of owners, decision-makers, and users) but it has also to respect the general principles governing business organisations under the national legal system.

Usually, only general minimum standards are set out in the law. The standard pattern prescribed by co-operative law for all co-operatives has to be adjusted to the specific requirements of the individual society. For this purpose, members need autonomy in drafting the by-laws of their society. Limits to such adjustments are either set expressly in the co-operative law or by the co-operative principles.

A good co-operative law should encourage good practices (allow what is in accordance with the requirements of member/user-driven organisations and with co-operative principles) and discourage or prohibit bad or risky practices (e.g. simple imitation of rules made for investor-driven business organisations as well as aberrations from or violation of co-operative principles).

Furthermore, it should make it possible to distinguish co-operative societies clearly from other forms of organisation (such as companies or public enterprises) by giving co-operatives their own distinct identity.

In the developing countries the trend to turn co-operatives practically into extensions of a government service by giving a government agency in charge of co-operative development stringent powers of supervision, direct interference, and control

(dating back from colonial times and maintained after independence) is well known and has been identified as detrimental rather than helpful for the development of a viable Co-operative Movement. The new statement on the co-operative identity approved by the ICA Centennial Congress in Manchester in September 1995 includes a new principle on "autonomy and independence":

"Co-operatives are autonomous, self-help organisations controlled by their members. If they enter into agreements with other organisations, including governments, or raise capital from external resources, they do so on terms that ensure democratic control by their members and maintain their co-operative autonomy".

This new co-operative principle is a clear directive to governments, to cut back their influence over co-operatives, if they want to encourage self-propelled co-operative development.

During the past decades, another dangerous trend of adjusting co-operative legislation to present-day requirements in terms of strengthening the economic position of co-operatives can be observed. New provisions are introduced into co-operative legislation in Western European countries which are meant to increase the economic efficiency of co-operative enterprises and their capacity to compete with commercial firms, e.g.:

- to give management a wide range of powers and to increase the independence of management from member control;
- to open new possibilities for fund raising by enabling co-operative societies to admit investor-members and to issue non-voting, transferable preference shares to members and non-members, which may even be sold on the Stock Exchange;
- to offer ways and means for investment of large sums of money accumulated from undistributed surplus, which are solely controlled by the management and out of members' reach; and
- to encourage concentration and mergers in order to enable co-operatives to establish larger units and to improve their capacity to compete with their commercial competitors, while increasing the distance from their members.

All these new provisions weaken member/ user control and

are to a greater or lesser degree in conflict with the co-operative principles. They have the effect of giving more power to management, reducing the roles of members in co-operative societies and bringing co-operative societies closer to the company model. This increases the danger of detaching the co-operative enterprises from their membership base, turning the members into mere customers without real powers of active participation and holding only symbolic amounts of share capital. In this way the co-operative societies lose their specific profile as member/ user-based, member/ user-financed, and member/ user-controlled organisations as well as their identity as self-help organisations. Such provisions should not be included in a good co-operative law.

The Relationship Between the State and Co-operatives

The Co-operative Law and other enactments applicable to co-operatives (e.g. tax law) have to define the relationship between the state and co-operatives. In many developing countries (but not only there) this relationship has been one of master and servant, with co-operatives being the servants, called upon to implement government's development policy, while being offered technical assistance and "guidance" by a government department as well as financial assistance, tax exemption and other privileges in return.

The role of government in promoting, supervising, and controlling co-operative societies has been given a prominent place in co-operative legislation for many years and is perceived by some as indispensable. Very often the powers of government to control co-operatives are applied to all co-operatives, irrespective of whether they need such supervision or not, or whether they work with public loans and grants or with their members' own capital.

This paternalistic approach to co-operative development has created undue desires for privileges and concessions among co-operators while over-regulation, heavy government control and the use of co operatives for non-co-operative tasks have tarnished the image of co-operatives in the eyes of their members and of the public.

For decades, to call for withdrawal of the state from controlling co-operatives has been considered as a kind of taboo, even by

the ICA - the guardian of the co-operative principles.

Only in recent years the negative effects of over-regulation and excessive government control over co-operatives have been openly discussed. Financial constraints have forced governments to cut down expenditure and to trim down overstaffed and largely ineffective government departments. While in some countries of Africa, the Co-operative Departments were dissolved or reduced to simple registration services and most of their functions transferred to co-operative apex organisations (e.g. Senegal and Cameroon), in other countries the interventionist powers of government officials were deleted from the Co-operative Societies Acts (e.g. the requirement of prior approval by government officers for decisions of co-operatives concerning the use of their own funds).

Today, it is generally accepted that government assistance and government control often have more negative than positive effects on co-operative development, have prevented co-operatives from becoming self-reliant, autonomous self-help organisations serving their members and are in contradiction with co-operative principles.

After many decades of state-controlled co-operative development in the developing countries, policy makers and legislators finally agree that co-operators and their elected representatives have to be treated as adults who can decide for themselves how to run their affairs and who are responsible for their acts with the right to succeed or to fail. It is increasingly accepted that co-operative societies can only become self-reliant and mature if they are allowed to learn by making their own mistakes.

The Relationship Between Co-operatives and Their Members

With regard to the relationship between co-operative enterprises and their members, there is equally need for clarification of concepts. After a long period of approximating co-operative societies in their legal framework and in their management style to the rules governing investor-driven business organisations:

- giving economic growth, competitiveness, and the attraction of investors' capital priority over member/user promotion and participation and

- turning members more and more into simple customers with little to win and nothing to lose in "their" co-operative society.

Many successful co-operatives in the industrialised countries have come to a crossroad, where they have to decide whether to carry on with their approximation strategy towards the investor-driven company model or whether they want· to reinvent the co-operative as a member/user driven organisation:

- by providing visible and tangible economic and non-economic advantages to their members, thereby making membership worthwhile and meaningful,
- by turning members/users from minimal shareholders into true stakeholders and
- by placing emphasis on effective member/user control.

How to improve existing Co-operative Laws

In the developing countries having experienced colonial rule, the current co-operative laws are often "imported" laws i.e. they are laws introduced from abroad and more or less adapted to local requirements as seen by the politicians and legislators, who usually do not have in-depth knowledge of the co-operative way of working and living, of the co-operative principles and their translation into legal norms.

In day-to-day life, many of the provisions of the co-operative laws remain largely theoretical, they remain "law on the books", rather than to become "law in action". The co-operators often do not know and understand the justification of the provisions and, therefore, look for loopholes or for ways and means of going around the law rather than applying it, only comply with certain provisions for fear of committing offences. Instead of applying the law, they regulate their affairs as they feel just (e.g. holding meetings without a quorum, without keeping proper minutes or without observing the agenda, working for years without keeping proper books and. without audit).

If co-operative law is to serve its real purpose, namely, to guide co-operators in their efforts to establish and operate successful co-operative societies and to discourage practices known to be risky and detrimental, members must see the

provisions of the co-operative law as reasonable norms governing their own organisation for their own good.

They must know and understand the rationale behind the provisions of the law and accept them because they agree with the underlying principles and values as being sound and useful.

In order to adjust the co-operative law to practical needs and to achieve a better understanding of its provisions, co-operators must be given the chance to play an active role in determining the contents of co-operative legislation. This can be achieved in a process of participative law-making, e.g. by organising series of workshops and public discussions among all parties concerned on the shortcomings of the existing law and by collecting recommendations for its improvement. Such discussions were for instance held during the preparation of the new Co-operative Code of the Philippines in 1990. The results of more than 10 provincial meetings were compiled in a paper presented to the legislators under the title: "What the Filipino Co-operators would like to see in their co-operative law".

Some of the recommendations contained in this paper were in fact adopted by the Filipino law-makers, e.g. concerning the procedure of making Regulations under the law, which now has to follow much stricter standards than practised before.

In many industrialised countries the process of approximation of co-operative laws and co-operative business practices to the rules of investor-driven organisations and in particular to the company model has proceeded over the years to an extent that only a deliberate and vigorous effort on the part of the national and regional federations can break this trend. Only if the co-operative leaders at national level agree to reconsider their policies and to turn from approximation strategies to differentiation strategies in terms of emphasising the specific character of co-operatives as member/user-driven organisations with strong member orientation and member/user control will it be possible to maintain the co-operative form of organisation as a special legal pattern or as a special form of doing business.

Conclusion

A well-conceived co-operative legislation, written in clear and simple terms (and, in case of developing countries, available in national languages), can contribute greatly to sound co-operative

development. Well-conceived in this context means that the provisions of the Co-operative Societies Act and relevant sections of the commercial law, the competition law and the tax laws have to respect the special character of co-operatives being member /user-driven self-help organisations based on tested co-operative principles and carrying on business according to their own philosophy "not for profit, not for charity, but for service to their members".

Where co-operative law pursues different objectives and turns co-operative societies either into semi-public institutions, into development tools in the hands of government, into organisations working in the interest of the general public or into management-dominated business organisations, co-operatives are deprived of that specific profile, lose their identity as member-based and member-oriented organisations and will be unable to mobilise members' own resources for co-operative development. Such legislation made to implement a wrongly conceived "co-operative" programme does not encourage but rather obstructs sound co-operative development.

Where co-operatives lose their characteristic profile as member/ user-driven organisations, where they turn more and more into investor-driven enterprises:

- pursuing the objectives of growth, increase of market shares and of accumulation of unallocated reserves,
- being controlled by employed professionals rather than by elected member representatives,
- raising capital from investors rather than from members/users,
- paying dividend on invested capital rather than patronage refund in proportion to business done with the co-operative enterprise,

the justification of having a special legislation or of offering special treatment of co-operatives under tax law, labour law and competition law does no longer exist. In this case, co-operative enterprises are rightly treated like any other commercial, investor-driven business organisation and could very well work under ordinary commercial law.

Professor Münkner is Director of the Institut fur Kooperation in Entwicklungslandern (Institute for Co-operation in DevelopingCountries),Philipps University, Marburg, Germany.

Some Reflections on the Mutuality v Conversion Debate

David T. Llewellyn

Mutuals are but one form of economic organisation amongst many. The mutual form is not an aberration from the PLC norm but is justified in its own right. There is no intrinsic superiority in the PLC form. Each form has its own advantages and disadvantages, strengths, and weaknesses, which is why different organisational forms are able to exist side by side and sometimes in direct competition with each other. If one form was obviously superior the other would not have survived. Thus, the debate is not, or should not be, about the inherent superiority of one form over the other. There is a powerful case for diversity in organisational forms in the financial system.

However, regulation may impede a particular organisational form by, for instance, limiting its activities or inhibiting its ability to adjust to changing circumstances. It is questionable whether an Act of Parliament is an appropriate mechanism for defining powers of financial institutions in a situation where market and competitive conditions are subject to radical change, and most especially when issues of competitive neutrality in regulation are considered. In particular, regulation should have been changed some time ago (as some argued at the time) to allow for mutual banks.

It follows that there is no single correct form of economic organisation, and neither is there any presumption that the PLC form should predominate in finance. This is shown in many countries where mutuals, co-operatives, PLCs exist together. In fact, there is considerable merit in having a financial system with a mixed form of corporate structure. It is, therefore, a distortion in the public debate for some sections of the press, and one journal in particular, to refer to the "die hards" of mutuality as if it was an historic form that was only a relic of the past rather than one of many viable forms of economic organisation.

Mutuality is not a flawed concept: in some senses it is a natural form in some areas of finance most especially where long-term

relationships are involved. It is not, as sometimes alleged, a flawed concept for large organisations: size is largely irrelevant.

The mutual is one of several forms of economic firm. Firms of any kind exist as a means of organising economic activity and adding value in the economic system. As such, they have a command over economic resources (inputs) and in various ways transform these inputs into goods and services valued by the consumer. A firm, in say the manufacturing sector, needs an initial input of capital before it can proceed: initially this capital must be supplied externally. This is because the firm's suppliers and customers are not its owners. The firm needs financial resources to buy the inputs that are needed in the manufacturing process. However, there are two fundamental differences between firms in, say the manufacturing sector of the economy and those providing financial intermediation services - financial intermediaries:

(i) one of the major inputs of the financial intermediary is money which is the same commodity that companies require as capital;

(ii) in the case of the financial intermediary, its customers provide money and stand at both ends of the value process: customers provide the basic input (money) but also demand the service being supplied.

Put another way, the key difference is that in the mutual the customers are themselves the owners of the firm whereas there is a separation of the two in the case of the PLC.

For these basic reasons there is no *necessity* to have a specialist supplier of capital independently of the customers. It can be argued further that, if external suppliers of capital (shareholders in the case of PLCs) are not *necessary*, having them between the two sets of customers unnecessarily increases the number of stakeholders in the firm. It also adds to the complexity of agency relationships, creates potential (and unnecessary) conflicts between customers and shareholders, and raises the cost of financial intermediation. This is because there is a class of stakeholders which needs to be remunerated but which is not *necessary* for the basic function of the firm (financial intermediation) to take place.

Porter emphasises the *value chain* in the economic process of the firm. But if, in the case of a financial intermediary (and unlike a manufacturing firm), the customer is at both ends of the chain, a *value loop* is a more appropriate description. In which case the issue arises as to what precisely an external shareholder adds to the value created by the firm, and this can be justified only to the extent that the existence of the external shareholder enhances the value added by the firm, i.e. raises the efficiency of the process. To repeat: the issue arises because an external shareholder (supplier of capital) is not a *necessary* part of the financial intermediation process.

It is for these reasons that the mutual is a common organisation form for the financial intermediary firm, and why it exists in many countries. In fact, it could be regarded more as the natural organisational form and the PLC could be something of an aberration. The basic advantage of the mutual firm is that it offers a unique form of financial contract to its suppliers of funds which is a mix of debt and equity. This necessarily removes the potential conflict between shareholder and customer.

The fundamental issues, therefore, are which organisational form (mutual or PLC) has the greater potential to add value, who are the various stakeholders making a claim on the value added, and how payments are made to the stakeholders. The mix of stakeholders in the mutual and PLC are largely the same (customers, employees, suppliers etc) except that, in the case of the PLC, there is a separate group of shareholders who are not the customers of the firm in the same sense as the owners of the mutual who, by definition, are the customers. The over-riding issue is whether *external* capital and *external* ownership adds to the efficiency of the firm in any fundamental way. Care is needed when making the common assumption that the additional claim of an external shareholder *necessarily* reduces the benefit of the other stakeholders because, if the total value added is enhanced in the process, all stakeholders may gain because of the increased efficiency of the firm. This is the key issue: claims on the value added may not be additive within a given total.

There are two contrasting views: First, the existence of external shareholders adds nothing to the *value loop* but simply increases costs and adds an additional claimant on the value added by the firm; Second, the existence of external shareholders increases

the efficiency of the firm because they solve agency problems more effectively and efficiently. This is an empirical question that needs to be addressed.

Philosophical issues about the "true nature" of mutuality are a diversion and are largely irrelevant: the key issue is whether mutuals do or do not add value efficiently for consumers. A more pragmatic approach in the debate would be more fruitful.

Economics of the Mutual

The fundamental economics of the mutual firm (the "margin advantage" due partly to the absence of external capital that needs to be remunerated) are favourable to building societies (and life assurance offices). If there is a "margin advantage" building societies can adopt one of two broad strategies: (1) maintain a wider margin than is necessary and build up reserves through high profits, or (2) maintain a low (but sustainable) margin and increase their market share. In practice, building societies have often adopted the former strategy: had they not, their pricing would have been difficult for banks to follow. If building societies have had "margin advantage" the question arises as to how banks have been able to compete. Four factors have contributed:

(1) building societies allowed them to compete by maintaining margins in excess of what was needed to remain in business,
(2) banks have been able to cross-subsidise their business which was in direct competition with building societies,
(3) in the early years cross-subsidies by building societies (high interest rates on large mortgages) offered an entry route for the banks who targeted the subsidising part of the business, and
(4) at times, banks have had a wholesale funding advantage.

Nevertheless, for the future, the potential "margin advantage" means that building societies as mutuals have the potential to remain a powerful competitive force in the financial system providing the sector remains large enough. However, there is a dilemma in that the required interest margin of a building society

rises as its rate of growth rises.

If building societies have a "margin advantage" this can be used to benefit customers (members) in one of two ways: *ex ante* by a lower mortgage rate and/or higher deposit rate, or *ex post* by building up reserves .and enhancing the value of the ownership stake. If it is not done *ex ante* there will inevitably be pressure at some stage to release value to members *ex post.* It is ironic that, by adopting a policy of building up reserves by maintaining an excess margin, building societies simultaneously allowed banks to compete and may have undermined the long run viability of mutuality. A more cynical approach is that some societies may have adopted an excess-margin strategy simply to enhance their value for a conversion.

Mutual and PLC comparisons

Comparisons are often made between mutuals and PLC in terms of performance, accountability etc. However, such comparisons are often misguided as it is not always clear on what basis the comparison is being made. Four models can be compared: (i) the **ideal** PLC; (ii) the **ideal** mutual; (iii) the **actual** PLC, and (iv) the **actual** mutual. In other words, we need to distinguish between how institutions behave in some abstract, theoretical, or ideal state, and the way they operate in practice. The ideal PLC is probably the easiest to defend theoretically in that it produces clear-cut principles of objectives, accountability, and control. The ideal mutual suffers from being indeterminate: a "balancing of members' interests" is difficult to specify.

The behaviour of building societies is criticised from time to time. It is alleged that they do not always behave as mutuals should do; they have deviated from their true mutuality. Two immediate perspectives are relevant:

(1) It is not at all clear that there is (or indeed, need be) a clear objective standard to judge the true and ideal behaviour of a mutual. How should an ideal mutual in fact behave? Is there any objective standard? It is not clear that there is any absolute truth or unambiguous standard which defines "true" mutuality. This concept is something of a chimera, and perhaps not a particularly fruitful line of enquiry.

(2) If mutuals deviate from their alleged "ideal" form, the **actual** PLC model also deviates very substantially from its **ideal** in several respects:

   a) accountability to shareholders does not operate perfectly or according to the textbook: many institutional shareholders are on record in arguing that, in practice, their ability to bring inefficient management to task is very limited;
   b) the discipline of the capital market works very imperfectly as discussed below;
   c) companies, in practice, are not motivated exclusively by the maximisation of shareholder value: they often follow a wide variety of objectives and are conscious of a multitude of different stakeholders' interests which at times may conflict with the interests of shareholders. Thus, while the **ideal** PLC may be clear (maximise shareholder value) **actual** behaviour frequently deviates from this.

To compare the **actual** behaviour of a mutual with some mythical **ideal** form of PLC is clearly invalid.

Much of the public debate is in terms of comparing (iv) with (i) or (ii) with (iii) dependent on the stance being taken. In the real world, (iii) and (iv) prevail. In practice, both forms operate imperfectly and, in the world of the second-best, no safe conclusions can be drawn regarding the superiority of one form over the other. This applies particularly in the case of accountability.

In general, and when considering consumer interests, comparing the merits of the two organisational forms is probably of second-order importance in the context of: imperfect versions of each; when both operate in a competitive environment; and when the two forms compete in the same markets. Many of the arguments on both "sides" of the debate are spurious when in practice both forms operate away from their ideal characteristics.

Agency Problems, accountability, and market disciplines

In theory there is ample scope for a mutual building society to

be inefficient because of weak accountability and monitoring of its behaviour:

(1) it has a very diverse shareholding: a large number of small shareholders;
(2) there are only weak incentives for shareholders to exercise monitoring and control as the costs of doing so are prohibitive and out of all proportion to the value received by so doing (in effect, a "free rider" argument applies);
(3) there is an absence of large shareholders who have an incentive to monitor and control; this weakens practical accountability;
(4) dissatisfied members have the easier option of simply withdrawing funds from the Society;
(5) there is no market in ownership claims;
(6) because of this, there is no take-over threat;
(7) there is an absence of performance-related value of shareholdings by the management of the Society.

There are clear potential agency costs in the mutual form deriving from weak member control. However, this must be qualified as, in practice: there is no evidence that these agency costs are in fact significant, there is no evidence that they have adversely affected efficiency and performance, equally, there are agency costs in the PLC form which are similarly not perfectly addressed by its form of accountability.

Accountability of financial institutions (and all firms) is an issue that needs to be addressed: it is an important issue. However, it applies equally to the mutual and PLC forms. If accountability and corporate governance worked perfectly in the PLC there would not have been the Cadbury and Greenberry Reports or the RSA project on the company.

Capital market discipline

It is frequently alleged that a major weakness of the mutual form for building societies (and Life Offices) is that, as there is no market in ownership, there is no scope for capital market discipline to be exercised. In principle, the market for ownership of PLCs means that economic resources end up being managed

by those firms which can do it most efficiently. This is secured through the market in the ownership of companies. In addition, the threat of take-over is allegedly a powerful discipline on management. However, there are many and serious reservations to this simple proposition:

(1) the stock market frequently adopts a very short-term time horizon;
(2) the evidence indicates that only about half the company take-overs that occur actually succeed in adding value;
(3) there will always be substantial asymmetric information problems reducing the efficiency of the market: the acquired firm always has more information about itself than the bidder;
(4) asset stripping is not an unknown motive in take-overs: a successful company can be broken up simply to serve the· interests of the acquiring company;
(5) the management of companies often feels itself forced to adopt business strategies to satisfy the short-term time horizon of the market and measures to maintain the share price at all times;
(6) there is no obvious evidence that the discipline of the stock market has been a powerful force in beneficially disciplining the behaviour of banks;
(7) there is a lot of evidence that markets are not very good at equating market value of companies with fundamental value (i.e. rational expectations about future earnings) which means that a mis-allocation of resources can occur;
(8) take-over activity occurs in waves;
(9) there are many reasons why resources in the economy may not be allocated optimally: the "second best" argument indicates that, in such circumstances, improving (even supposing that that is the case) one part of the system does not necessarily result in a net overall improvement;
(10) in many cases sheer size offers a degree of protection against hostile bids.

Thus, heroic assumptions need to be made before we can be confident that the absence of a market in the ownership of mutuals creates a serious problem. In fact, it is only in the Anglo-Saxon world that this argument would be used at all: it is not

the norm in economic systems throughout the world most notably not in Germany and Japan. The position has been put well in a *Financial Times* leader (February 10th, 1996):

> "Since many take-overs fail to achieve adequate returns for shareholders and some fail disastrously, it would seem logical to expect the shares of an acquiring company to go to a bigger discount. The fact that they do not reflect not merely the triumph of hope over experience, nor the incantations of merchant bankers and financial PRs, but the stock market's bias for action ... In the case of mergers, shareholders of the acquiring company must satisfy themselves that there are real potential gains to be made from the combination, with a probability of success great enough to offset the generally unfavourable outcome of such transactions".

In the final analysis it is competition, and the low exit costs of members of mutuals, that is the major discipline on the mutual. If owners are dissatisfied they are able to withdraw their shareholding and, unlike with a PLC, this also reduces the capacity and overall size of the mutual. This is by far the most powerful discipline, most especially when the mutual and PLC forms are in direct competition with each other.

A positive case for mutuality

There is a positive case for mutuality in terms of:

(1) the superior performance of the mutual building societies compared with banks in terms of deposit and mortgage interest rates, rate of return on assets and capital, and overall efficiency;
(2) systemic interests;
(3) the possible positive merit of a capital constraint. It is often argued that a weakness of the mutual form is that, as capital is generated internally, it is not possible to raise large amounts of capital at one time. In fact, there may be some virtue in this as a capital constraint can act to limit risk as managers know that capital which is lost through

risky ventures cannot easily be replaced. There are many periods in history which indicate that banks with excess capital may be tempted into hazardous activities;

(4) the absence of costs associated with a potential conflict between customer and shareholder: one less class of stakeholder;

(5) the fact that many mutuals are regionally based and focused;

(6) the absence of "short-termist" pressure of the capital market;

(7) the spread of ownership rights.

There is a powerful *systemic* interest in sustaining a strong mutual sector and therefore it is a legitimate issue for public policy. It brings:

(1) the benefits of a mixed ownership structure in the financial system;

(2) in an uncertain environment diversity has advantages as it cannot be predicted which form is best suited to particular circumstances;

(3) it enhances competition through the potential for different behaviour, and

(4) it brings different forms of corporate governance.

There is a major public policy interest in sustaining a competitive market environment through different organisational forms because firms with the same form tend to behave in a similar manner. Choice and variety are ingredients of consumer welfare. There is no fundamental economic *need* or presumption for building societies to convert to PLC status though many may *choose* to do so. Thus, different societies will make different decisions, and both are viable. Many of the arguments put forward for the case for conversion are less than compelling: the need for more powers, the benefits of diversification beyond what is allowed as a mutual; alleged economies of scale requiring large size for institutions; questions related to capital; accountability; the superior disciplining power of the capital market, etc.

However, the constraints of Acts of Parliament can be binding

in some cases. This argues against having powers defined in Acts when the market and competitive environment are subject to change. The fact that a new Act is required fairly soon after the last, and that substantial adjustments were made within the context of the 1986 Act, testifies to this general proposition. In practice, the planned move towards a less prescriptive regime is to be welcomed though it is evidently too late for some societies. Press reports indicate that the Alliance and Leicester might have come to a different conclusion regarding plans to convert had the current draft Bill been enacted two years ago. To some extent, the regulatory regime has undermined the mutual status of building societies.

The major motives in practice for conversion are:

(1) to unlock embedded shareholder value which has arisen largely because building societies have adopted strategies which have built up excess capital;
(2) to secure an allegedly stronger position to participate in the on-going and accelerating pace of structural change in the financial system: a defensive motive. (It is the case that a PLC is more able to make large acquisitions as it is more able to raise additional capital and can issue more of its own shares);
(3) to acquire a minor addition to business powers.

However, given the "margin advantage" of mutuals, members may in practice be exchanging a short run gain (the one-off withdrawal of embedded value) at the cost of a higher cost of services in the long run. The evidence powerfully suggests that mutuals have fairly consistently offered better terms than PLCs and their overall performance has been superior. Such comparisons must, however, be made with caution given that, hitherto, comparisons have been made between banks and building societies which have different business structures. The comparison would be more valid when comparing remaining building societies with converted building societies as at the point of conversion the business structure remains the same. Nevertheless, the same superiority of performance also applies to life assurance where the comparison is more direct. In addition, the mutual has the "margin advantage" which a newly converted

building society does not have. Against this general argument must be set the benefit of dividend receipts if previous members remain as shareholders in the converted organisation. Thus, to some extent, for the member that remains a shareholder in the PLC the benefit is received *ex post* rather than *ex ante*.

A distinction is drawn between members and consumers in that there are intergeneration transfers to consider. On a conversion, the current generation of members (which may have been very recent) has a claim on the reserves effectively subscribed by past generations of members. But the withdrawal of mutuals denies future consumers of the benefits of the mutual form.

The long run dimension is important given that, in practice, conversions operate asymmetrically (only in one direction) and hence once mutuals have been converted the mutual sector is permanently smaller. The recent formation of Credit Unions offers a challenge to this general proposition.

Structural change in the financial system

The retail financial services industry will change radically over the next few years: a revolution. In this context, the key strategic issues faced by building societies (along with all financial institutions) are, in practice, more fundamental than ownership structure and organisational form. It may prove to be the case that the latter are of second-order importance in the total scheme of things. Business strategies need to be framed in the context of major structural change in the financial system generated by a combination of pressures: it is the *combination* of pressures that is powerful:

(1) there is increased competition;
(2) there are lower entry barriers into retail financial services;
(3) there is a new range of non-traditional suppliers of retail financial services;
(4) competition _is operating asymmetrically: non-financial companies are able to enter financial services more easily than financial firms can diversify away from finance: Marks & Spencer sells financial services, but the Alliance & Leicester does not sell men's and women's clothes;

British Petroleum has a banking licence while the Bradford & Bingley does not drill for oil!

(5) information and delivery technology is transforming the industry and the structure of the retail financial services firm;

(6) entry barriers are declining faster than exit barriers;

(7) there is excess capacity in retail financial services in four dimensions: capital, firms, infrastructure, and technology;

(8) *deconstruction* allows "cherry picking" by new competitors.

It is likely that a new structure of the financial system will emerge with much greater variety in the type of firms supplying financial services: financial conglomerates, retail financial services conglomerates, core-cluster institutions, specialist institutions, boutique suppliers, joint ventures, confederations of firms etc. *There is no single right structure for a financial services firm* and there is no presumption that the most successful will be either the largest or the most diversified. To assume the opposite is, in my view, to fundamentally misunderstand the nature of the pressures operating on the retail financial services industry.

Two major issues in bank and building society strategy relate to diversification (how far an institution should go in its diversification strategy) and size. In both areas some parts of the conventional wisdom need to be challenged.

It is a universal trend for financial institutions to diversify their range of financial services and products. In many cases, this is an entirely appropriate and viable strategy. However, equally in some cases it is not. The track record of diversification by financial institutions is not universally good: some spectacular mistakes have been made. A systematic survey of the empirical literature fails to find clear evidence that the alleged synergies which form the basis of diversification strategies are in practice powerful. There is also evidence indicating that specialised institutions are often more efficient than highly diversified institutions. The jury is still out on these issues. What is clear is that; diversification is not invariably a successful strategy; diversification is not a suitable strategy for all institutions; specialisation can be a viable and successful strategy. In the industrial world, although there are notable exceptions, the

fashion for conglomerates has passed and in some cases previous diversifications have been abandoned. Some conglomerates (eg ICI) have been broken up. This simply cautions against the implied assumption that diversification is invariably the best strategy.

The evidence about economies of scale in financial firms is also mixed. However, there are clear economies of scale in financial intermediation *processes*. The evidence powerfully suggests that efficiency has more to do with internal organisation within the firm rather than size *per se*. The fundamental economics of the financial firm are changing to an extent that may question the notion of a fully vertically integrated firm which conducts all the processes in its business. The strategy of deconstruction (where component processes of a business are separated, and some are outsourced) changes the economics of the firm. It is not necessary for the firm to conduct all of the processes internally. In effect, what the author has described elsewhere (*) as *Contract Banking* involves firms as managers of contracts with internal and external suppliers of processing services. This means that if there are economies of scale in processes, a small firm can secure the advantages by sub-contracting (out-sourcing) some processes. In effect, it buys into economies of scale. Thus, a firm can secure the benefits of economies of scale in four ways: (1) by itself being big, (2) by outsourcing some processes where the economies of sale are bigger than the firm itself, (3) through joint ventures, and (4) by forming a confederation of firms. It is along the lines of (2), (3) and (4) that small firms (building societies) will be able to maintain competitiveness.

The author has argued elsewhere (*):

> "What in practice is likely to emerge is a spectrum of different types of banks. At one end of the spectrum will be the traditional fully integrated bank which, because of the economies of scale in bank processes, will be very large. At the other end of the spectrum lies the virtual bank. In practice, the majority will lie within the boundaries of the two with some services being provided internally and others out- sourced. It is ultimately a question of the balance between internal and external contracts and many alternative structures are likely to emerge. The development of

outsourcing does, however, mean that there can be a role for the small bank in a market and technology environment where many banking operations require large scale to be economic. Thus, while there may be a trend towards more consolidation in the banking industry, there will still be a place for the smaller bank though it will not have the traditional structure."

The potential for new organisational structures within the financial system (e.g. the potential for *contract banking* and the *virtual bank*) may bring into question some of the strategies that lie behind conversion moves. As an example, if technology is increasing the economies of scale in bank processes this does not require financial institutions to be big as, through sub-contracting, economies of scale can be bought into externally.

This may also challenge the conventional wisdom that there is no future for small building societies. In my view there is a future and in different ways from those usually given in public debate. The change in the fundamental economics of the financial firm means that we need to re-assess our thinking about what constitutes a viable financial institution. It will doubtless be different in the future than in the past: we must not underestimate how radically the economics of the financial firm is changing.

(*) Llewellyn, D.T., "Banking in the 21st Century: The Transformation of an Industry" (available from the author on request).

David Llewellyn is Professor of Money and Banking, Loughborough University, UK.

This is an edited version of a paper presented at the Buildings Societies Annual Conference, May 1996.

The Society for Co-operative Studies 1996-97

Report by the Secretary

Professor Tom Carbery, Professor Tony Eccles, Dr Robert Marshall, John Morley, Lord Young of Dartington, and Dr Alex Wilson continued to serve as Presidents, while Graham Melmoth was elected as an additional President at last year's Annual General Meeting.

Sadly, during the year three Presidents have died - Lord Jacques, Keith Brading, and Ted Stephenson. We shall sadly miss these excellent Co-operators who have contributed so much to the development of our Society and the Co-operative ideal. The Chair has been occupied this year by Len Burch, with Peter Davis and Kathryn Smith as Vice-Chairs. John Butler has been Secretary, Frank Dent, Treasurer & Membership Secretary and Johnston Birchall, Journal Editor.

Peter Clarke serves on the Committee as immediate past chair, additional committee members are Garth Pratt, James Bell, Rita Rhodes, and Roland Dale.

During the year, the committee was also pleased to welcome three co-opted members - Jim Craigen, Alan Wilkins, and Roger Spear.

Committee Meetings

The Committee met in October, November, February, and June and will have a further meeting immediately before the AGM.

Membership

Paid up members for the year ended 31 March 1996 with 1995 figures in brackets are set out opposite -

Region	Individuals		Organisations		Academic		Totals	
Metro & South	64	(77)	13	(55)	18	(19)	95	(111)
Midland	25	(28)	6	(6)	7	(7)	38	(41) .
North West	32	(35)	9	(9)	6	(6)	47	(50)
Yorkshire & Humberside	7	(7)	4	(4)	9	(9)	20	(20)
Northern	3	(6)	3	(3)	2	(2)	8	(11)
South West	5	(5)	1	(1)	0	(0)	6	(6)
Scotland	15	(16)	4	(3)	6	(6)	25	(25)
Overseas	8	(6)	4	(4)	0	(0)	12	(10)
TOTAL	159	(180)	44	(45)	48	(49)	251	(274)

The total number of Journals distributed is 833 per issue.

The Committee have noted the small fall in membership, and it is hoped that a membership drive conducted in early July will lead to a reversal of this position.

Society Logo

The Committee during the year gave consideration to redesigning the Society Logo. Following a process of consultation a short list was established, and the Journal Editor was given the final and difficult task of selecting a logo that we hope will take the Society well into the next century. The new logo will now appear on all our publications, and we hope that members are satisfied with the final outcome.

Journal Editor

Our former Secretary reported last year upon the impending retirement of the Auld Firm, Drs Marshall and Carbery. Their contribution had been enormous. The election of Johnston Birchall at the 1995 AGM was an extremely important event. Johnston has set about his responsibilities with great enthusiasm and the Committee are confident that the Journal will continue to make a significant contribution to the Co-operative Movement.

The Journal

The Journal has been published three times during the year. The special features have been as follows -

No 85 (January 1996): 50 years at Stanford Hall: The Co-operative College 1946-96: Neither Public nor Private: The Co-operative Third Way: Report of the Society for Co-operative Studies Annual Conference 1995.

No. 86 (May 1996): The Future of Co-operative Education: Loughborough and Lady Byron: The California Mutual Housing Association: UK Consumer Co-operatives Trade 1995 - Reflections and Projections: Co-operative Principles and the UK Co-operative Law Reform: Employee Stock Ownership Firms, Producer Co-operatives, and the Forgotten Model of Mondragon: Towards a Value-based Management Culture for Membership Based Organisations

No. 87 (September 1996): The Smart Card and Mutuality: Marketing the Co-operative Advantage: The Future of Mutuality: Regulating Private Utilities - The Customer Corporation: Co-operative Legislation.

Financial Position

The 1995/96 Income and Expenditure Account and Balance Sheet prepared by Frank Dent are appended to this Report, together with Peter Roscoe's Auditor's Report.

The Society continues to enjoy financial health. Income has grown ahead of expenditure and the situation is further improved by the writing off of potential tax liabilities no longer required following our registration as a charity. However, this is offset to some extreme by the legal costs.

In the longer term the Committee intends to enhance the quality of the Journal and undertake more marketing. This will be financed from both the current excess of income over expenditure and an increase in membership subscription, if approved at the Annual General Meeting.

Fringe Meeting

As reported last year the Society's Fringe Meeting has become a regular and popular feature of Co-operative Congress. At the 1996 Harrogate Congress over 170 co-operators attended this year's meeting at which Philip Ireland, General Manager (Legal & Secretarial) of the Yorkshire Building Society spoke on "The

Future of Mutuality". It was the consensus view that this had been a highly successful meeting that had displayed strong support for the concept of mutuality. The thanks of the Society have been forwarded to CRS who provided generous financial support for the meeting. A copy of Philip Ireland's address has been distributed widely by the Society and a report of the Fringe Meeting appeared in the first edition of the Society Newsletter 'that accompanied Issue 86.

Internet Developments

We are indebted to Peter Clarke for all his hard work in developing the Society's entry. Peter is working closely with the CWS and ICA on this important project and it is anticipated that this project will be completed by the end of the current financial year.

Membership Subscriptions

In anticipation of additional expenditure which will be required to fund improvements to the Journal format and marketing anticipated Internet costs, research, and administrative costs the Committee agreed to recommend to members that the basic and sponsorship waged rates both be increased by £2 to £9 and £14 respectively and the unwaged and organisation rates remain unchanged.

Registration of New Constitution

The new constitution of the Society received the unanimous support of members at the 1995 Annual General Meeting. Subsequently the Society was registered as a Charity on 18 October 1995 and entered in the Central Register of Charities (Registered Charity Number 1049961). John Maddox of Crofton's Solicitors, Manchester has been of enormous assistance to the Committee in offering advice and assistance during the time-consuming process of becoming a charity and the Committee are pleased to record our sincere thanks.

Mutuality

The Committee has during the year given detailed consideration

to aspects relating to the theme of mutuality. It was the strong view of the Committee that the Society should indicate its support for the concept of 'mutuality' and develop clearly the arguments in favour of this concept The Committee has recognised the need to be prepared on occasions to articulate a collective viewpoint on key issues facing the Co-operative Movement. The Fringe Meeting at the 1996 Harrogate Congress highlighted the Committee's collective viewpoint at a very practical level and the Annual Conference will give members more opportunity to discuss an issue that is of enormous importance to all co-operators.

Developing Closer Links with the Co-operative College

An important task of the Committee during the current year has been to look closely at developing closer links with the Co-operative College. It is important that the society work closely with the College and to be actively involved in joint promotional and publicity initiatives. It was most encouraging when Alan Wilkins the Officer for Member Education at the College agreed to become a co-opted member of the Committee. A number of joint initiatives are already being actively considered and illustrate the need for a collaborate approach.

The Society's External Relations

The Committee have during the year recognised the need to look closely at the Society's external relations. Areas already identified where the Society should develop closer relationships include the Co-operative Research Unit of the Open University; the Research Forum of the International Co-operative Alliance; the United Kingdom Co-operative Council; Education Convention and Co-operative Congress; Societies for Co-operative Studies Abroad; ICA Committees. It is the strong view of the Committee that arrangements were required for the various bodies undertaking research to automatically liaise with the Society for Co°operative Studies.

A Year of Progress

1995/96 has been a year of steady progress for the Society. The

Committee have worked well as a team and the Society continues to pursue its objects which are "to advance the education of the general public concerning all aspects of the Co-operative Movement and Co-operative forms of structure, and in particular to assist commission and/or identify, and to publish research ... and to promote the exchange of information and experience on Co-operative studies and research".

The Society for Co-operative Studies 1995-96

Accounts

1. Income & Expenditure Account
for year to 31 March 1996

Income	Note	**1996**		1995	
Subscriptions	1	**4544**		4493	
Academic sponsorships		**589**		484	
Sale of journals		**1168**		316	
Annual conference	2	**399**		399	
Interest received	3	**1035**		885	
Grants and donations				50	
			7735		6627
Expenditure					
Journal	4	**4663**		4547	
Annual conference	2	-		-	
Congress fringe meeting		**413**		244	
Regional activity				98	
National officers' travel		**700**		395	
Secretarial					
Advertising				164	
ICA Congress reception		**119**			
Other		**10**			
			5905		5488
Excess of income over expenditure			**1830**		1179
Provision for possible tax					221
Add provision for tax written back			**2841**		
Deduct legal expenses for registering as a charity			**940**		
Excess after tax .to accumulated fund			**3731**		958

Provision for tax not now required.

2. Balance Sheet at 3i March 1996

	1996		1995		
FIXED ASSETS	£	£	£	£	£
Co-op Bank deposit account		**5 989**			5 953
Other investments		**15 000**			14 000
		20 989			19 953
CURRENT ASSETS					
Co-op Bank current account	**1178**			1 281	
Secretary's cash float	**30**			30	
Debtor				6	
TOTAL CURRENT ASSETS	**1208**			1 317	
CURRENT LIABILITIES					
Subscriptions received in advance	**706**		217		
Academic sponsorships			484		
Journal - printing	**900**		800		
Journal - distribution			180		
Journal - secretarial	**104**		0		
Other	**8**		0		
TOTAL CURRENT LIABILITIES	**1718**		1 681		
NET CURRENT LIABILITIES		**(510)**			(364)
Total assets less current liabilities		**20 479**			19 589
Less provision for possible tax					2 841
NET ASSETS		**20 479**			16 748
FINANCED BY:					
Accumulated fund		**16 748**			15 790
Addition to accumulated fund from 1994/5 revenue account		**3 731**			958
		20 479			16 748

3. **Auditor's Report**

I have audited the Financial Statements set out above and these are in accord with the books of account. In my opinion the income and expenditure account and the balance sheet give a true and fair view of the financial position as at 31 March 1996.

10 July 1996 Peter Roscoe

Notes to the Accounts

	1996		1995	
	£	£	£	£
Note 1 Members' subscriptions				
individual		1913		2314
organisation		2631		2179
		4544		4493
Note 2 Annual Conference				
income		**2226**		3503
less				
expenditure				
accommodation	1701		2905	
refunds	126		199	
		1827		3104
		399		399
Note 3 Interest received				
Co-op Bank deposit a/c		9		31
other investments		1026		1100
		1035		1131
Note 4 Journal				
printing		2881		3134
distribution		597		751
editorial & secretarial expenses		1185		662
		4663		4547