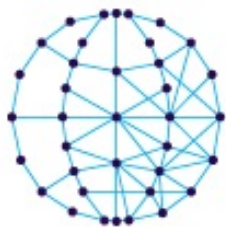


*Cooperatives' Power of Innovation*

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## INNOVATION IN THE GOVERNANCE OF LARGE COOPERATIVE BUSINESSES: THE ALARMING CASE OF UK CO-OPERATIVE GROUP

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## Abstract

The Co-operative Group is one of the world's largest consumer cooperatives. Because of recent catastrophic losses, the Group has lost control of its subsidiary, the UK Co-operative Bank, and is now itself on the verge of bankruptcy. Its governance is being completely restructured, with the current board being replaced by an expert "plc"-type board and a member representative council. This paper explains how the Group's current governance structure has come about. Then it provides a summary of what has happened since its current troubles began in 2009, asking what has gone wrong and why. It asks who is to blame: Is it a failure of management or of governance? Governance has to take a large part of the blame; recent innovations have led to the current peculiar and unsatisfactory governance structure. The paper explains the work of this author and his colleagues at Co-operatives UK in providing critical input to the governance redesign process. It draws on an analytical framework outlined in Birchall's study of the world's largest cooperatives (2014) to provide a method for evaluating alternative governance structures.

## Résumé

Le *Co-operative Group* est une des plus grandes coopératives de consommateurs au monde. Dû à de récentes pertes catastrophiques, le Groupe a perdu le contrôle de sa filiale, la *UK Co-operative Bank*, et est désormais lui-même au seuil de la faillite. Sa gouvernance se voit complètement restructurée, le conseil actuel étant remplacé par un conseil d'experts de type société publique et un conseil de représentants constitué de membres. Cet article explique comment la structure de gouvernance actuelle du Groupe en est arrivée là. Il fournit ensuite un résumé de ce qui s'est produit depuis que les problèmes ont commencé à surgir en 2009, se demandant quelles erreurs se sont produites et pourquoi. Il demande aussi qui est à blâmer : est-ce un échec de gestion ou de gouvernance? La gouvernance doit assumer une grande partie du blâme : des innovations récentes ont mené à la structure de gouvernance particulière et peu satisfaisante actuelle. L'article explique le travail de cet auteur et ses collègues à *Co-operatives UK*, qui vise à fournir un apport critique au processus de refonte de la gouvernance. Il fait appel à un cadre analytique décrit dans l'étude des plus grandes coopératives du monde de Birchall (2014) afin de fournir une méthode d'évaluation des structures de gouvernance alternatives.

## Resumen

El *Co-operative Group* es una de las mayores cooperativas de consumidores del mundo. Debido a recientes pérdidas catastróficas, el Grupo perdió el control de su filial, *UK Co-operative Bank*, y en este momento está al borde de la quiebra. Su administración está siendo completamente reestructurada, la junta actual ha sido reemplazada por una junta de expertos de tipo sociedad pública y un consejo constituido por representantes de los socios. Este artículo explica cómo fue creada la actual estructura de gobernanza del Grupo. Presenta luego un resumen de lo acontecido desde el surgimiento de los problemas en 2009, preguntándose qué errores se cometieron y por qué, y a quién se debe culpar: ¿ha sido un fracaso de gestión o de gobernanza? La gobernanza debe asumir gran parte de la culpa: recientes innovaciones han conducido a la peculiar y poco satisfactoria estructura de gobernanza actual. El artículo explica la contribución fundamental de los trabajos de este autor y sus colegas en *Co-operatives UK* al proceso de replanteamiento de la gobernanza. Recurre a un marco analítico descrito por Birchall (2014) en el estudio de las mayores cooperativas del mundo con el fin de proporcionar un método de evaluación de las estructuras alternativas de gobernanza.

## Introduction

The Co-operative Group is one of the world's largest cooperatives. It is a "family of businesses" that, as well as its supermarket chain, includes a bank and insurance, funeral, travel and farming business that together turn over £13 billion. It has a mixed ownership, with nearly eight million individual members and 127 corporate members (the most important of these being 12 independent regional consumer cooperatives). It is the UK's fifth largest food retailer, operating across the country with 4 500 retail outlets and nearly 90 000 employees (Co-operative Group, 2014). Amongst its other wholly owned businesses are the UK's largest funeral services provider and third largest pharmacy chain. One interesting feature of this cooperative is that, in 1997, a decision was made to get out of the superstore business and focus on smaller supermarkets and convenience store trading, in which it is now pre-eminent.

The Group used to boast that it was the largest cooperative in the world, but according to the World Co-operative Monitor it is in fact third after the Swiss consumer cooperatives Co-op Swiss and Migros (Euricse, 2013). It also used to boast that it owned the world's most ethical bank, and the Bank did indeed win many prizes for its ethical investment stance (Birchall, 2005). However, because of recent catastrophic losses, the Group has lost control of the Bank and is now (in June 2014) itself on the verge of bankruptcy. In 2012, the Bank posted a loss of £648 million, and then in June 2013, a capital shortfall of £1.5 billion was discovered, followed by a further £400 million in March 2014. The Group now owns only around 20% of the Bank; hedge funds have taken control and soon the Bank is to be floated on the stock exchange. In March 2014, the Group itself posted a loss for 2013 of £2.6 billion. The life insurance business has already been sold, and some of the other businesses in the Group – the pharmacy chain, the farms, and probably the funeral services – will also have to be sold.

A report by Sir Christopher Kelly has just been published (May 2014) detailing what went wrong and who is to blame. A report by Lord Myners, published almost simultaneously, has condemned the Group's governance structure as being completely unfit for the purpose, and proposed a new structure based on a public limited company (plc) type board, a larger member representative council and direct elections by members (which would mean that the current regional and main boards would cease to exist). The Group is currently planning for the imposition of this new governance structure, which will involve the dissolution of the regional and main boards and direct elections to a new board of directors and a member representative council. If the new governance structure is not agreed to and enacted in the next few months, it is likely that the banks that are owed £1.4 billion by the Group will force it into "administration."

This paper begins by providing a short history of the Group and the Bank, showing how its current governance structure has come about, followed by a summary of what has happened since its troubles began in 2009, and asking what has gone wrong and why. Then it asks who is to blame: is it a failure of management or of governance? It finds that governance has to take a large part of the blame, and so examines the recent innovations that have led to the current peculiar and unsatisfactory governance structure. It then looks forward to the redesign of governance that has been called for by Lord Myners, and explains the work of this author and his colleagues at Co-operatives UK in helping with this process. It provides a method for evaluating alternative governance structures using an analytical framework first proposed in Birchall's study of the world's largest cooperatives (Birchall, 2014).

## A Short History of the Co-operative Group and of its Governance

In 1863, a group of small retail cooperative societies set up the North of England Wholesale Society, in 1872 renamed the Co-operative Wholesale Society (known as CWS). With hundreds of local retail coops in membership, it had a guaranteed market that enabled it to grow steadily until it became one of the largest manufacturing and wholesaling businesses in the world (Birchall, 1994; Wilson, Webster, & Vorberg-Rugh, 2013). The sector began to decline rapidly from the 1960s onwards due to increasing competition from supermarket chains. At first, the movement's "ambulance society," Co-operative Retail Services, took the strain by taking over many ailing societies that otherwise would have gone bankrupt. Then it also began to be at risk, being unable to absorb any more losses, and from the 1970s onwards the CWS itself began to absorb some retail societies, taking in 41 by 1990. Then the first merger from strength occurred when the regional North Eastern Society volunteered to amalgamate, and from then on some of the largest regional groupings such as United Society and CRS also merged with CWS. In 2001, after the merger with CRS, it changed its name to the Co-operative Group and set up a new governance structure that is still largely in place today.

The Group is thus a hybrid society, 22% owned by independent societies (127 of them, but with 12 regional consumer cooperatives dominating) and 78% owned by the eight million individual members. This is unique among consumer coops, as the other three largest are either primary (Co-op Swiss, Migros) or secondary (S Group). In the 60 largest cooperatives worldwide there are only four more hybrids; the three largest US farmer coops (CHS, Land O'Lakes, and Dairy Farmers of America) and the French bank, Credit Agricole (see Birchall, 2014). Before the merger with CRS that prompted a governance review in 2001, CWS had been unpopular with the board members of retail societies because it had been seen as biased towards its corporate members, and this had delayed mergers with regional societies (Wilson, Webster, & Vorberg-Rugh, 2013).

After 2001, the Group had a complicated three-tier structure of 45 area committees, eight regional boards and a main board, with the area committee members taking the place of members in general as the voting body making up the AGM. It was a compromise structure that ensured that activists from the old CWS and CRS would continue to be influential, but it had some dire unintended consequences. It stopped members in general from having voting rights except to the area committees, because members of the area committees provided the voting constituency for the regional and main boards. It meant that in order to be on the main board, directors had to serve on the areas first, then the regions, and had to stay elected to both these tiers in order to stay on the main board. It was — and is — a precarious existence that gives rise to factionalism and prevents many people who cannot afford the huge amount of time involved from standing for a board.

Because members have to serve for two years at each tier before becoming eligible for the next, it also restricts the pool of candidates eligible to be on the main board. Also, the size of the main board is still comparatively large at 20 people (five from the corporate members, 15 from the regional boards; until 2009 it was even larger, at 33). Finally, though the main board has the right to appoint up to three independent experts to the board, it has not chosen to do so, and its members do not have the skills or experience to govern such a large and complex set of businesses (Myners, 2014).

The UK Co-operative Bank began as the Banking Department of CWS in 1872, set up to meet the needs of the hundreds of retail cooperatives in membership. It used to be said that it was neither a bank nor a cooperative! It was only in 1971 that an act of Parliament enabled it to become a wholly

owned subsidiary, and in 1974 that it became a clearing bank. Even then, it was never a cooperative in its own right, unlike the European cooperative banks that, following a completely different evolutionary path, had their own customer–members and a group structure with independent local societies and powerful central banks. In the late 1980s, Terry Thomas was appointed as chief executive. He saw the potential of the Bank in an ethical and environmental niche market, and in 1992, he launched its now famous ethical policy. A liquidity crisis in 1994 led the Board briefly to consider selling the Bank, but from then onwards it became more and more profitable for the Group (Birchall, 2005). When in 1997 the Lanica Group launched a hostile takeover of CWS, it was the Bank that they most coveted.

In 2006, the Group launched a genuine dividend card for members, and changed the rules so that customers could become members through the Bank as well as through the retail stores. It thus came closer to being a real cooperative, though it is notable that when the Bank merged with the Britannia Building Society in 2009, Britannia's members had to vote on it, while the Bank's members (really the Group's members) were not asked. Until the recent loss of control, the Bank was one of three subsidiary boards (the others being Food and Specialist Businesses). Until 2011, it was a large board of 20 members but, under strong advice from the regulator, this was reduced to 14. Unlike the main board, it has appointed independent experts to its board; since the loss of control in 2013, these have become the majority.

## What went Wrong?

In August 2009, the Co-operative Bank merged with the Britannia Building Society. It was the second largest society in the UK, with 254 branches, 2.8 million customers and assets of £35 billion that made it six times larger than the Bank, by assets. It had the traditional low-risk member business, but also a high-risk specialist arm of commercial lending, which it carried out through intermediaries with reliance on the wholesale money market; this made it unusual for a building society. Because of the profits made from the commercial lending and the sub-prime market, it had been able to pay an annual bonus to members, but this came with greatly increased risk: the commercial side was half the loan book but over 90% of risk-weighted assets, and the Society had a higher exposure to sub-prime lending than any other building society (Kelly, 2014). It was, as the Kelly Report comments, a surprising time for the Bank to be contemplating a merger a year after the global banking crisis, especially with a society that had such a different risk appetite. However, the Bank needed to reduce its costs by scaling up, so it looked like an attractive proposition.

Even before the merger, Britannia began to post losses on its commercial arm. The Bank's due diligence was cursory; phase one was done by KPMG but the auditors had no access to Britannia's loan book, and phase two was done in-house with no records kept to determine how well it was carried out. The business case for the merger deteriorated, but nobody noticed and the Board was kept in the dark about it. After the merger, the losses piled up, but by continually pushing the bad news into the future, the Bank's managers were able to survive until, late in 2013, they had to admit to a capital shortfall of £1.5 billion. Four other problems added to the losses. Instead of modifying its IT platform as most other banks have done, the Bank decided to invest in a completely new platform. It did not have the capacity to achieve this, and eventually it had to abandon the scheme at a loss of £300 million. Between 2010 and 2012, a managerial initiative called Project Unity led to managers being swapped around between the Group and the Bank, causing more disruption. Despite the Bank's claim to be driven by ethical values, it was as dependent as other banks on the profits from payment protection



insurance (which amounted to between 6% and 8% of the Bank's income). With claims now being made that stretch back to the 1980s, the final bill for this shameful ethical lapse is still unknown.

Finally, the Bank had an ambitious plan to buy a part of the Lloyds Banking Group that was a legacy of the old Trustee Savings Bank. With 632 branches, five million customers, and assets of £53 billion, it would have enabled the Bank to become a "challenger bank" to the big four investor-owned banks. When in April 2013 it finally withdrew from negotiations, a bill for £73 million in transaction costs was added to the losses. More seriously, the Verde deal, as it was known, had been a massive distraction. Kelly comments that, "without the distraction caused by Verde, the emerging capital issue might have been better recognised and more effectively addressed at an earlier stage" (2014, p. 81).

The Bank's ex-chairman blamed the Government for applying pressure to pursue the deal, but the Kelly Report finds that there is no compelling evidence of pressure from government ministers or anyone else. It comments that the Bank's managers and board were capable of making their own mistakes without any help!

At first, the Group's board thought they could save it by a partial flotation in which the bondholders would become shareholders, absorbing most of the losses. In return, the Group was to inject new capital. Co-operatives UK commissioned a report on the governance of minority-investor-owned cooperatives that predicted how such a hybrid of a cooperative with a minority of shareholders would be governed (Birchall, 2013). However, events overtook the Group's offer (and gave Birchall's report a shelf-life of just four days!), when US hedge funds took an ownership stake and insisted on a much tougher deal that led to the Group's ownership stake dwindling to just 30%.

In April 2014, the Group announced losses of £2.6 billion. It has already lost control of the Bank, and its 30% ownership stake has declined further, to around 20%, as demands are made of the shareholders to plug a new £400 million hole in its finances caused by continuing losses from the Britannia loan portfolio, and fines for mis-selling of insurance and for administrative errors made in bank statements. The Group has its own problems. In 2009, it bought 750 stores from a retailer called Somerfield, at one stroke leaping from a market share of 4.5% to 7.2% of the retail food market, and into fifth place behind the big four supermarket chains. Yet seven years on, it has lost most of the gains from this, partly because of the fierce competition within the food retail market, and partly because of poor management and governance failure (documented in graphic detail by the Myners Report, 2014).

It may be that by the time this paper is published, the Group will have been put into administration. If it does survive, it will be by selling off its farming, pharmacy, insurance, and funeral businesses. Whether it survives depends largely on the acceptance of a new governance structure that satisfies its creditor banks that it will be well governed in the future. In this unfolding drama, governance takes centre stage.

## Who is to Blame?

The loss of the Bank and the current capital shortfall in the Group are partly attributable to the failure of management, and in the Kelly Report, the CEOs of both the Group and the Board come in for criticism. However, ultimately the managers have to be accountable to, and controlled by, their boards. There has been a massive failure of governance. The Bank and Group boards failed to see the extent of the Bank's – and then the Group's – deteriorating capital position, and seemed content with whatever information and explanation was provided to them. They failed to discuss the most important issues, such as the growing losses from the Britannia commercial loan portfolio and the poor

performance of the Group's retail stores. They were easily distracted from the hard grind of meeting the competition and ensuring customer satisfaction. When the managers pursued particular projects such as the Verde deal or the IT platform, they failed to notice that things were going wrong, and did not offer any challenge. They did not ensure that due diligence was done and had a superficial and amateurish approach to risk management.

All of these failures and more are detailed in the Kelly Report and Myners Review. In a chapter on governance, the Kelly Report says of the Group Board, *One of the most surprising features of this whole episode is that the Board seemed unaware of its limitations* (2014, p. 115).

Even the five members of the Board who were themselves chief executives of retail cooperatives were inexperienced by industry standards. The training of board members was far from rigorous. The chair who led the Board after 2007 had no experience prior to being appointed. After the 2007 review of governance, they had the power to appoint up to three independent professional directors, but did not do so. The executive of the Group also did not understand the financial services industry, and the relationship between the CEO and board deteriorated.

*The Co-operative Group thus found itself in a situation in which it had a strong-willed chief executive and a board too weak and inexperienced to hold him adequately to account.* (Kelly, 2014, p. 116)

The Bank's difficulties took many of the members of the Group Board by surprise. The Group Board and Co-operative Bank Board both failed in their oversight. The chair of the Bank (who, at the height of the Bank's troubles in November 2013, was arrested for trying to buy class A drugs) was "a wholly unsuitable person to chair the Co-operative Bank Group board" (Kelly, 2014, p. 120). The independent directors on the Bank board, and the regulator, became increasingly frustrated but were unable to make an impact.

The Myners Review is even more scathing. Myners was invited to become an independent director on the Group Board in December 2013, so that he might devise a new, more fit for purpose governance structure. He refused to accept payment, except for the £1 cost of becoming a member of the Group, and assembled a team of top business school academics to help him. In February 2014, a two-year deal with the Chief Executive, Euan Sutherland, that gave him a salary of £6.6 million over two years, and other deals with top managers, were leaked to the *Observer* newspaper. Sutherland resigned, declaring the Group "ungovernable." Myners then hit back at the Group board members with an interim report that declared the loss of the CEO to be a "catastrophe," and outlined a completely new governance structure. By April, he had himself resigned from the Board, citing as his reason the fact that, despite more than half the Group's assets being wiped out in the last five years, the directors were stubbornly refusing to admit their part in the failure.

## The Proposed Governance Structure

The Myners Review, published in May 2014, has as its aim "to develop a set of practical reforms that will protect the Group from the deplorable governance failures that have been exposed over the last year." (2014, p. 7) It sets out three principles:

1. A new board that has the skills and experience needed;
2. A powerful representative forum of elected members;
3. Extension of full membership rights to all individual members.

What this means in practice is that there will be a new, independent chair of the Board who has had no previous relationship with the Co-operative. The entire board will be replaced by a new “plc”-type board elected directly by the individual members of the Group, and qualified entirely by their skills and experience in the business. The regional boards will be disbanded, and a new member representative council (MRC) of about 50 members will be voted in, again directly by the full membership. This council will look after the social goals of the cooperative. Crucially, a nominations committee will be set up, with one or two members of the MRC on it, but controlled by the board so it can ensure its own succession and make sure it retains the right skills and experience needed for effective governance.

In his view, Myners is like a medical doctor diagnosing the problem and writing a prescription. There can be no deviation from this even if the Board members are unwilling to vote for it. He wants to make clear that his proposals are fully compatible with the core values and principles of cooperative ownership. However, a team from the trade association, Co-operatives UK decided to propose some key amendments that might also be considered (Barber, Birchall, & Mayo, 2014). Calling their report “Myners plus,” they argued that the chair of the Board and the MRC should be the same person rather than the two people Myners wanted, because otherwise there would be discord and the costs of governing would be too high. They proposed that the nominations committee be a sub-committee of the MRC rather than the Board, and that the member representatives be in a majority. This is so that the board does not become self-perpetuating. They insisted that the splitting of the social from the economic goals of a co-operative, with the member council monitoring the social aspect and the Board the economic, was a retrograde step because the social and economic should be seen as all part of the same strategy to achieve a “cooperative advantage.” At a special general meeting, the Group accepted the principles behind the Myners proposals, while allowing for a certain amount of discussion about the details. It may be that the *Myners plus* approach will also be taken into account in the deliberations, but only time will tell.

## An Evaluation Tool for Assessing Governance Structures

The *Myners plus* report takes as its starting point a simple analytical framework for governance proposed by Birchall in his study of the governance of large cooperatives, commissioned by Co-operatives UK and published just before the Myners Review (Birchall, 2014). This study uses the World Co-operative Monitor to identify the top 10 cooperatives in each of six industry sectors, making 60 cooperatives in total. It then provides a useful summary of the governance structure of each, attempting to sum up their wide variety of structures that mostly — Co-operative Group excepted — seem to work quite well.

The variety in governance structures shows that there never has been a single blueprint for good governance, and that cooperatives have adopted structures that they first borrowed from others and then adapted over time. They have evolved, adapting to changing circumstances, mutating (perhaps with mistakes that have proved useful, as in biological evolution) and occasionally being redesigned. In some cases, one suspects, inertia has set in. There are no neat divisions into two or three governance systems, such as the European two-tier model, or the US unitary board. Instead, the Report asks us to imagine that we have to cut up a long chocolate cake into four pieces. The first piece is member voice, the base level of engagement with members that can be quite informal but is necessary in order to involve at least some members in governance. The second piece is representation, the channeling of the energy that comes from member involvement into a smaller set of elected representatives who can carry the members’ voice into the governance structure. The third is expertise, which is needed



to ensure that the business does not take unacceptable risks and works effectively on behalf of members, and the fourth is management, that puts all of this into practice. The problem is that the cake can be cut unevenly into the four pieces so that some are small and some larger; sometimes after three pieces there is no cake left — this is sometimes what happens to the member voice, that gets left out altogether.

Member voice is orchestrated by some of these cooperatives in innovative ways that are not too costly and work well — informal meetings that encourage exchange of views and information, and that motivate members to vote for their representatives. Without it, boards tend to be self-selecting and to engage in circular routines with nomination committees and complex, rule-governed behaviour that ensures nothing but oligarchy. Representation is not difficult to organize, provided the members are divided into natural constituencies by geographical area or interest group. It tends to result in large, unwieldy boards and is better funneled into an even larger representative assembly where, provided they have real powers, representatives can keep an eye on the board of directors.

Expertise is achieved by having a small, mixed board of representatives and appointed experts. Around half of the 60 boards have independently appointed experts on them, and we can expect more to follow. Most boards achieve some balance between representativeness and expertise by controlling the appointment of new board members through nomination committees. This can become undemocratic, particularly when they neglect member voice and make sure only their recommended candidates get elected. It is better to open up elections of representatives to competition while ensuring expertise through appointing extra independent board members.

What should be the place of management? Most cooperatives have an executive board or committee of top managers that relates to a separate board of directors, but among the 60 cooperatives there are some interesting permutations. Having a large assembly of representatives enables some cooperatives to have a smaller, mixed board of directors and managers that seems to work well. It is all about the effective distribution of different types of authority.

## Conclusion

Using this simple framework, the *Myners plus* report summarizes the situation in relation to the Co-operative Group. The existing structure has a large element of representation, but not much member voice and hardly any expertise. The Myners proposal would amplify the expertise and the direct voice of members, but arguably at the expense of representation. In the view of this author, the *Myners plus* suggestions would enable the Group to better balance the three elements and so produce a new governance structure that will help it to recover from its current malaise.

## Note

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## **Directors of the call for papers of the 2014 International Summit of Cooperatives**

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