Mutuality in Uncertain Times

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1. Introduction

There is an alleged old Chinese curse which runs: 'May you live in interesting times'. The present global financial crisis certainly qualifies as an example of interesting times, and many would say it is an example of a curse they would prefer had not been cast on them.

The global financial crisis shows the failure of three interconnected ideas which have underpinned economic matters in the last half century. Those ideas are:

Economic rationalism
Infallibility of markets
Accounting credibility

The global financial crisis is likely to be long-lasting and severe. It has already been acknowledged as being as serious as the Great Depression of 1929-37[1]. In my view it will have an impact close to that of the Long Depression of 1873-96.

In the US the banking system has been temporarily rescued by taxpayer bailouts but no structural changes have been made to eliminate the speculative excesses that have enriched executives and promoted a casino mentality.

In China, "the banking system is a house of cards, with billions of dollars of toxic loans made at the party's request to loss-making enterprises set against tiny amounts of core capital"[2].

The Observer also reported that

> China is saturated with ports, highways, steel mills, cement and petrochemical plants that operate at a fraction of capacity.
>
> The manufacturing heart in the Pearl River area near Hong Kong is being destroyed.
>
> Half the 2,200 factories in the shoe industry have shut, as have a third of the 3,600 toy factories.

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[1] 'Economy shrinks at 1930s rates. The recession is now on a par with the very worst year of the Great Depression.' *Telegraph* July 1, 2009.

[2] *The Observer*, October 26, 2008

Despite that, the global crisis does present a number of significant opportunities for mutuals and cooperatives. In order to understand what they are it may be helpful to look back at the circumstances in which cooperatives and mutuals first flourished.

2. The origins of mutuality

The Industrial Revolution 1760-1830 changed the face of the world and gave birth to modern society

> Now, for the first time, it was thought acceptable to allow people as individuals to take their chances within a volatile new market economy which could not guarantee survival. (Birchall, 1997:1)

Birchall continues:

> As Polyani puts it, whereas previously the market had been an adjunct to society, now society became an adjunct to the market.

The market economy tore society apart. One by one all the customary rights that working people had enjoyed were stripped away by the landowning class who had absolute political power in Parliament. The common lands were enclosed; the rights to gather firewood and hunt game were taken away as was the right to have wages set by a magistrate and the right to 'poor relief' if they were unemployed or laid off.

> The costs were also social. Relationships between those who had capital and those who had only their labour to sell became qualitatively different. Within one generation a gulf opened up between 'masters' and 'men' which became almost unbridgeable. … Factory owners worked children for twelve hours a day … Food could be adulterated at will by producers … Once the protective morality of the old society had been swept away **there seemed to be nothing that could not be done – as long as it made a profit.** (Birchall, 1997:3) (emphasis added).

It was against this background that people began combining – for the right to a better deal than the unbridled free markets were providing.

- Combining for the right to form unions which would negotiate for decent wages.
- Combining to market agricultural and other products.
- Combining to purchase unadulterated goods jointly at affordable prices.
- Combining to form credit cooperatives that would respond to the needs of small farmers, artisans and business people.
- Combining to provide affordable protection against the misfortunes of life.

Cooperation and mutuality flourished because it put the interests of members ahead of the interests of capital.

That is not to say that the founders of successful coops and mutuals were ignorant of prudent business practices or of the need for good communication.

Cooperatives and mutuals did collapse – usually because they made foolish business decisions. Their managers allowed members to buy on credit; the boards took it for granted that members would automatically support the venture.

3. Sound business practices

The principles adopted by the Rochdale Equitable Pioneers Society in 1844 were developed by "cautious, practical and experienced people" (Birchall, 1994:54). They included the following:

- Cash trading.
- Dealing only in pure and unadulterated goods.
- Quarterly general meetings at which members received audited financial reports.
- One vote per person (including women).
- 'Fixed and limited interest on capital'. 'Limited' meant that the rate should be only what was absolutely necessary in order to raise the capital.
- Distribution of the surplus, after allowing for some retention of profits, to the members in proportion to their transactions.
- Education of members.

These principles ensured that:

- the financial risks were minimised,
- only good quality products were sold,
- communications between members and directors were timely and credible,
- decision making was democratic,
- contributed capital was not seen as free,
- financial stability was more important than short term financial returns to members, and
- members' needs were recognised as extending beyond physical needs.

In 1845 the cooperative added another principle, the disposal of net assets without profit to members. This was a necessary protection against asset stripping where some would take windfall gains that had been generated by the prudence of past members.

I suggest that these still make a useful checklist for directors of mutuals in the twenty-first century.

4. The recent past

Earlier I claimed that three interconnected ideas have underpinned economic matters in the past half century. I shall now return to them – economic rationalism, the infallibility of markets and accounting neutrality.

Economic rationalism believes that all decisions can and should be made on the basis of financial factors alone. Yet, if people were economically rational they would never buy lottery tickets because they have a mathematically negative value according to basic statistical analysis. Nor would they have pets or children (who also have demonstrable negative economic value).

Economic rationalism underlies the monetarism of the 1980s and 1990s – it is predicated on the belief that markets operate best when free of controls or when regulation is necessary that self-regulation will work best to generate market efficiency. The evidence is clearly that this is not so.[3]

Occasionally this is admitted:

> "Those of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief," Alan Greenspan, former chairman of the US Federal Reserve, told the US Committee of Government Oversight. Oct 23 2008.

Economic rationalists ignore moral aspects of markets and even declare there are no moral concerns in business. George Soros is famous as a currency speculator and philanthropist. When asked about the havoc his currency speculation caused to Far Eastern economies in the crash of 1997, Soros replied "As a market participant, I don't need to be concerned with the consequences of my actions." (Clarke 2003:32).

Economic rationalists frequently quote Adam Smith and the 'invisible hand' of the free market as justification for an absence of controls over the market and its participants. They never quote Adam Smith's *Wealth of Nations*, Part 1, Ch xi, paras 8-10 where Smith cautions against the actions of those who lack a social conscience:

> 'The interests of [those who live by profit] … has not the connection with the general interest of society as that of…[labourers and landlords]. The proposal of any new law or regulation of commerce which comes from this order [those who live by profit], ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious, attention. It comes from an order of men whose interest is never exactly the same with that of the publick, who have generally an interest to deceive and even oppress the publick, and who accordingly have, upon many occasions, both deceived and oppressed it.'

The infallibility of markets is a part of the dogma of the New Zealand Business Roundtable and similar groups overseas. In a study of the writings of the Roundtable Barbara Vincent summarises their view of the market in the following religious terms (Robb, 2004):

- The market is powerful; it's almighty.
- The market provides; it's provident.

[3] See Frank Partnoy, *Infectious Greed – how deceit and risk corrupted the financial markets*. Times Books, 2003. Gillian Tett, *Fool's Gold – how unrestrained greed corrupted a dream, shattered global markets and unleashed a catastrophe*. Little, Brown, 2009.

- The market allocates fairly with an "invisible hand"; it's just.
- The market solves problems; it's beneficent.
- The market cannot fail; it's infallible.
- The market is without error; it's inerrant.

Many investors and observers today would question the validity of such a benign presentation of the market. They, like their ancestors in Victorian times, might agree with Galbraith (1990) who condemned the view that markets are "theologically sacrosanct" and rejected the view that they are a "neutral and accurate reflection of external influences". They have learned that fear and greed are powerful forces. The belief that markets will act fairly is demonstrably false.

A further victim of the global financial crisis has been the credibility of accounting. Many in the community have been wondering how companies can receive clean audit reports only to collapse within a very short time. How have innovative financial instruments such as CDOs, derivatives, enhanced leverage funds – all designed to make the financial markets more efficient – gone so wrong?

The answer is found in Galbraith (1990:19)

> The world of finance hails the invention of the wheel over and over again, often in a slightly more unstable version. All financial innovation involves, in one form or another, the creation of debt secured in greater or lesser adequacy by real assets.

The financial bubble which has burst involved an explosion of debt which was shamelessly marketed to the public. In my collection of financial emphemera I have a booklet issued by one of our major investor-owned banks entitled "Loving debt is easy".

Many have now learned that loving debt can be costly. On Jan 11 2008 it was reported in the NZ Herald that:

> The big Australian banks and their New Zealand subsidiaries have downplayed their direct exposure to the US sub-prime market as the debacle there unfolded.
>
> But it yesterday emerged that ASB Bank's owner Commonwealth Bank of Australia, BNZ parent National Australia Bank, the ANZ and Westpac had a combined A$850 million exposure to stricken US mortgage lender Countrywide Financial.

The downplaying of financial problems has been assisted by the flexibility of accounting rules which has allowed off balance sheet structures to be created, so hiding financial facts from shareholders and the public. In fact, compliance with our financial reporting standards actually creates off balance sheet entities in some situations. See National Business Review (2002:63).

The credibility of financial reporting (and auditing) has been severely dented as public company after public company has been found to have overstated its financial performance, frequently over several years.

"Accounting restatements", issuing retrospective financial reports showing that performance was overstated, are a phenomenon unknown when I became a chartered accountant 40 years ago. If you google the term "accounting restatements" you will be presented with over 2 million results (and that is up from 12,700 only 10 months ago!)

Past financial catastrophes have resulted in improved financial reporting.

The collapse of the Royal Mail Steam Packet Company in the 1932 led to a new Companies Act which required the publication of a profit and loss account as well as a balance sheet; it outlawed the use of secret reserves; it required the disclosure of group data instead of just the parent company figures. It required data to be presented that was understandable by non-accountants. In his decision, Lord Jowett said:

> 'If the documents convey to a reasonably intelligent person a false impression, all the technical rules of accountancy may be observed and at the same time the accountants' profession has failed to carry out its primary and obvious duty … to ensure that in the documents which are produced a true and accurate account of the affairs of the company is given." (Brooks, 1933: xiv)

The McKesson & Robbins fraud of 1938 resulted in a change of audit practice that in future required auditors to verify the existence and value of inventories and balances of debtors – an integral part of the process of establishing the credibility of balance sheets but one which had not been required until the credibility of accounting was challenged.

So now, in 2009, we have:

- communities facing some of the toughest economic conditions since 1930,
- the claimed reliability of "the market" and the superiority of investor-owned companies being seriously challenged,
- a justifiable loss of confidence in the smartness of the financial engineers and creative accountants, and
- the realisation that ethical values are important.

5 <u>Implications for mutuals</u>

Although the present global financial situation is serious, and will probably worsen, it paradoxically offers many opportunities for mutuals and cooperatives.

- They have **not** been involved in the financial engineering and creative accounting which has produced misleading financial reports.
- They have **not** been highly geared and they have **not** incurred the expensive overheads of the high-flying investor-owned companies.
- They **have** operated more efficiently as the Valuing our Mutuality reports have shown.
- They **have** the interests of members and the community as a priority, not the interests of financiers.

The environment today is not dissimilar from that of the days when mutuals and cooperatives arose.

- Investor-owned companies, it seems, have been doing anything as long as it makes a profit.
- Society seems to be an adjunct to the market.
- Inequality in remuneration has been increasing.
- Fear and greed have been drivers of activity in the share market.
- Conservatism and ethical behaviour have been absent from the headline grabbing activities and actors.

The challenge for mutuals is to show that they are different and that they have always had higher standards of behaviour towards their members, their staff and the community.

Businesses which gave their customers a fair deal during the Great Depression gained loyal customers for a generation thereafter. The same is possible today.

Two challenges (and opportunities) are to bring in new members and to keep close to all members.

6. Implications for Unimutual

The best means of bringing in new members is through satisfied present members. I am impressed by the Unimutual webpage which shows, through its case studies, how members get excellent protection. Be sure that these case studies are kept up to date.

Equally significant to members and potential members is your telephone policy.

> When members need to contact you do they deal with local people? Or do they end up talking to a call centre in an unknown location because labour costs are lower there?
>
> When potential members phone you, is their call answered promptly by a real person or do they have to listen to an automated system because it is cheaper?

Elsewhere I have raised the question of whether universities can be good corporate citizens (Nagy and Robb, 2008). I know from my experience on the University of Canterbury Council something of the resource limitations, political influences and other pressures which you as university managers and governors face today.

I am sure that you will face increasing pressures to make short term financial savings. Resist the siren calls of insurance brokers who will claim that they can make savings for you. You will not be good corporate citizens or good stewards if you withdraw from the protection of mutuality.

Mutual protection companies have an excellent track record. Studies by the International Cooperative & Mutual Insurance Federation (ICMIF) show clearly that mutuals outperform their PLC counterparts in almost every aspect – their expense ratios are lower, their distributions (claims-to-premium) ratio is better and their reserves are healthy.

Mutuals will not survive the challenges of the global financial crisis simply because they are mutuals. But **because** they are mutuals, and **if** their boards and managers are totally committed to mutuality and prudent operating policies **then** I believe they will survive and prosper.

Unimutual is celebrating 20 years operations. It is a tribute to those 'cautious, practical and experienced people 'who formed it and those who have directed it.

May Unimutual's next twenty years be interesting times – and that is not intended as a curse!

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