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ADVANCED CORPORATE MANAGEMENT

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DEMUTUALISE OR BUST?

A comparative study of the evolution of cooperatives in two industries.

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Abstract

This paper compares the evolution of cooperative organisations in the financial sector with those in the agricultural sector in New Zealand. Cooks'(1995) five stage model of the development and evolution of cooperatives is applied to the financial sector in the wake of demutualisations that occurred in the 1990's. This is compared to the different options taken by many agricultural cooperatives. Regulatory influences and producer-cooperative relationships are found to have played a key role in creating these differences.

Introduction

In the wake of firms throughout the western world changing their governance structure or adjusting their form through the 1990's, many reports have been written to try and explain this phenomenon and what it may mean for the organisation of the future.

This paper will look firstly at the cooperative organization as a structure and then examine the features of demutualization in the financial sector. Cook's (1995) 5 stage of cooperative development and evolution will be applied to the building society industry specifically in an attempt to draw some comparisons with what has occurred in the NZ agricultural industry.

SECTION 1

1.1 Cooperatives – Common Features

Cooperative businesses have been in existence for as long as people have been willing and able to pool resources to achieve a joint goal.

They exist in almost every sphere of business and have in the past been the dominant form of organizational structure in industries such as agriculture, fisheries, insurance, and credit unions. The key features of a cooperative firm are that it is owned by the user-members, controlled by those users and its primary goal is to benefit those members.

Any returns that the firm distributes to members is typically done on the basis of patronage with the firm rather than by investments as in the case of investor owned firms. Many Cooperatives do not distribute any returns to members directly, instead operating more like non-profit organizations where any surplus is retained within the organization so members may benefit in other ways such as offering cheaper loans or higher interest rates on savings.

A further feature of many cooperatives is that they operate in perpetuity such that the benefit of the retained surpluses is kept so that not only the current members can enjoy the benefits being offered but also future generations. This being one of the 'shared goals' of the organization. Many 'public good services' cooperatives are clearly set up where there is a shared understanding among current members that the benefits accrued will stay within the firm to provide services for successive generations.

They are established for various reasons including; risk spreading, mitigating against the likelihood of being taken advantage of by other firms ('hold up'), to achieve economies of scale and or scope, to increase market power or to address an information asymmetry. It is noted that they typically develop in economically depressed times and when there is little competition and many studies point to criteria including; low competition and homogeneity of interests as being important factors that contribute to the long term survival of the cooperative structure (Hart & Moore, 1998).

Cooperatives have typically had distinct differences from their investor owned counterparts. A traditional cooperative structure is set up as a one member/owner- one vote system, retains the profits made, and has the strategy of improving benefits of member welfare as its core purpose (as opposed to the IOF which has profit making as its primary goal). The table below summarises these differences.

Table 1: Comparison of traditional cooperative structure versus IOF

Component	Cooperative/Mutual Firm	Investor Owned Firm
Owned by	Members (producers, consumers, employees)	Shareholders
Ownership votes	One member-one vote	One share-one vote
Control	Originally owner controlled – latterly Management team controlled – owners represented on BoD	Management team –owners represented on BoD
Associated Agency Costs	Manager-owner conflicts	Owner- customer conflicts
Residual Returns	Depending on policy – may be a payout (sometimes in proportion to patronage) but majority of funds reinvested in firm	Dividends paid out to shareholders
Ownership rights	Non tradeable	Tradeable

The seven principles that underpin a cooperative according to the International Co-operative Alliance (ICA) which represents cooperatives internationally are:

1. voluntary and open membership
2. democratic member control
3. member economic participation
4. autonomy and independence
5. education, training and information
6. cooperation among co-operatives
7. concern for community (<http://www.ica.coop/coop/principles.html>)

At least initially, cooperatives are usually small in scale and relatively simple in structure and are restricted in scale of operation (either by regulation or by member direction) and therefore have limited risk to the members.

1.2 Are Cooperatives as Efficient as Investor Owned Firms (IOFs)?

Hansmann (1996) suggests that ownership structures will evolve in an effort to minimise transaction costs (efficiency hypothesis) including contracting costs and ownership costs. He developed this theory by observing the situations in which the cooperative form exists and then applying a theory to explain this pattern. As Kalmi (2003) points out, this strategy has the problem of assuming that what exists is in fact efficient. One of the difficulties of this logic is that in most industries, there exists competing firms in both cooperative and investor owned forms. One would have assumed that a firm that was inefficient would not survive in a competitive situation for long. Much has been made of the efficiency debate over the ownership models, however, studies have failed to consistently demonstrate one model is more cost efficient or profitable than the other (O' Sullivan, 1998, Delfino, 2003).

Perhaps the most conclusive study to try and explain the co-existence of these organisational structures within an industry, was that by Cummins, Weiss & Zongmin (1999) who found, using a cross-frontier analysis, on firms in the insurance industry, that investor owned firms and mutuals operated on separate production and cost frontiers and as such represented different technologies. That is, they demonstrated that each form of the firm was operating efficiently in the areas in which they had advantages; IOFs were more efficient in lines of insurance where high levels of managerial discretion are required (consistent with their ability to have greater control over managers), whereas mutuals performed better in lines of insurance that had longer payout periods (eg:liability insurances) where the owner-policy holder duality acts to prevent the exploitation of the policyholder.

It could be suggested then that the continued existence of both these forms of organization is due to them operating successfully in different activities for different market segments based on risk preferences.

1.3 Types of Cooperatives

There are various types of cooperatives based on their ownership profiles (see below):

Producer -owned	Customer-owned
Professional partnerships (accountant firms, lawyer firms)	Mutuals including building societies, retail cooperatives, mutual insurance firms, credit unions.
Employee owned co-operatives	
Farmer owned co-operatives	

Hansmann (1996;12) suggests that an investor owned form is merely a “special type of producer cooperative” in which the investor is the producer-supplier of capital required by the firm.

Employee-owned firms are becoming increasingly prevalent in countries that have recently disbanded communist regimes. (Villalonga, 2000, Park, Li & Tse 2005, Bezemer 2004, Yakovlev 2004). The most successful of these firms is perhaps the Mondragon Group of over 200 companies across several different industries and a workforce of over 70,000 (Surroca, Garcia-Cestona & Santa-Maria, 2006). While they do employ professional management teams, the employees are represented on the companies various boards. However, the major decision rights of the cooperatives has been delegated most recently to a centralized board, the MCC executive commission whose role it is to develop a common strategic plan for the entire group. This has assisted with co-ordination issues and has strengthened internal regulations that help resolve the conflicts of interests that might emerge between companies within the group in fulfilling the strategic plan. Their success may be in part due to their commitment to continue to operate as small business units (of approximately 500 employees) where the homogeneity of each cluster is maintained. The most successful cooperative firms like employee

owned companies are increasing in number throughout these developing countries while in the Western world they have been in decline, in their traditional form, for the past two decades. This does give weight to the argument that cooperatives do develop in transitory or more depressed economic environments.

This paper will specifically examine the experience of financial mutuals and compare this to the experience of farmer owned cooperatives in New Zealand.

1.4 Agency Costs

The agency problems that may be associated with a cooperative structure are manager-owner conflicts. Due to the fact that owners are more dispersed and the one member – one vote policy results in members having little voice and little incentive to take part in decision making – they are less likely to monitor managers. Managers are able to potentially take advantage of this situation by acting opportunistically for their own gain, in conflict with the members' interests and quid pro quo in conflict with the goals of the organisation. Baker & Thompson (2000) argue that industry regulations that limit managerial discretion together with the low exit barriers for members through their withdrawal of funds results in a proxy for monitoring managerial behaviour.

The agency cost issues relating to this manager-owner conflict will be explored in the next section with specific reference to the building society sector.

1.5 Cooperatives in New Zealand Today

Although the Western World has seen a decline in the number of cooperatives operating in their traditional form, modern cooperatives continue to play a significant part in the landscape of NZ enterprises. In New Zealand today, 40% of the adult population are members of co-operatives and mutuals. It is estimated that approximately 22% of the gross domestic product (GDP) is generated by co-operative enterprise. Co-operatives are responsible for 95% of the dairy market and 95% of the export dairy market. They hold 70% of the meat market, 50% of the farm supply market, 70% of the fertiliser market,

75% of the wholesale pharmaceuticals, and 62% of the grocery market. (New Zealand Co-operative Association, 2007, as cited on www.coop.org)

1.6 Demutualisation of Cooperatives– general features

Over the past two decades, following the deregulation of many industries, and facing increased global competition and the need to generate larger amounts of capital, a large percentage of mutual and cooperative companies decided to demutualise – some in order to merge with existing investor owned firms and others to convert to IOFs themselves. More recently, particularly in the agricultural industry, co-operatives have changed their structures in such a way as to take advantage of the benefits of being an IOF while retaining their mutual/cooperative status. These are commonly referred to as the New Generation Cooperatives. The New Zealand agricultural industry perhaps offers a unique spread of the range of these forms of cooperatives for analysis.

The four reasons often given for demutualisations were; “an attempt to maintain full organizational independence, an attempt to maintain operational independence, a growth by acquisition strategy and members revolt” (Stephens 2001;335).

A further reason proposed for demutualisation has been the difficulty of the co-operative structure to operate on a large scale. As co-operatives start off as small entities serving a relatively small group of people with shared interests, the question is whether there is a critical mass of ‘owners’ at which point the co-operative structure no longer operates efficiently. Is there a point at which the managers of co-operative firms become complacent due to the lack of co-ordination and interest of the owner-members to monitor poor performance? Birchall & Simmons (2004) examined this issue of optimum cooperative size and concluded that member participation could be positively affected by introducing incentives and face to face meetings regardless of the size of the organization.

One issue of contention that has been raised about the number of demutualisations occurring is that of managers and directors acting opportunistically to achieve greater

personal wealth by accessing a share of the reserves as well as shares in the newly formed company. Cook et al (2001) gives several examples of senior managers of financial mutuals making large short term financial gains as a result of a demutualisation including payouts, increased salaries in the new enterprise and a disproportionate number of shares that had been set aside for the managers and directors from those issued to the members.

Stephens (2001) challenges the ethics of the wave of demutualisations based on the premise that current members really have no right to the distributed surpluses of what was gained by contributions made by past members in the belief that their contribution would continue to serve generations to come. He cites several examples where demutualisations have created huge wealth for directors and limited benefit for the members (especially those members who at the time of the demutualisation were unable to afford their entitlement of shares and effectively received nothing).

There is a conflict of interest inherent in demutualisations for directors and managers. They stand to gain significantly from undertaking this process via higher salary packages, increased opportunities for more senior positions and obviously having share options in the newly demutualised enterprise.

By virtue of their ownership structure, mutuals do not have to pay out dividends to any shareholders. In addition, they typically have large reserves of capital which previous members have contributed to, thus can provide services at lower cost than investor owned companies. Thus, it is argued that those that become members of these co-operatives (particularly financial cooperatives) do so because they are seeking lower prices and lower risk for the services they require.

Co-operative members both past and present have arguably contributed to the pool of funds to receive the benefits of what was offered, for example; cheaper insurance or housing loans and continue to contribute to those funds in order that future generations will have that same opportunity.

Further to this argument one must surely ask why the member-owners of mutuals who arguably took little or no risk with their investments should be entitled to any payouts of reserves or share offers in a newly formed enterprise as these would normally be given out relative to the level of risk involved. In recognizing these conflicts, some cooperatives, including a number of community banks that did demutualise took the option instead to retain their surplus for community trusts which can continue to benefit the local community for the future.

SECTION 2

2.1 Five Stage Cooperative Evolution Model

In an attempt to understand this demutualization phenomenon more fully, the 5 stage model of the evolution of cooperatives as postulated by Cook (1995) has been applied to the financial sector, and in particular building societies. Cook (1995) outlined this model in respect to the agricultural sector in the US and it was later applied to the Australian Grain Industry (Bielik 2004). Cooperative firms in the financial industry are commonly referred to as mutuals and as such the terms are used interchangeably throughout this paper.

2.2 Stage 1 – Development of Cooperative

Cook (1995) suggests that in this first stage there are two economic justifications for forming a cooperative. Firstly to bring economic balance under the control of the parties requiring it (eg: producers/suppliers) and secondly to provide an institutional mechanism to protect those parties against opportunism and holdup situations.

In the case of the financial sector, the early development of cooperative banks and building societies in the mid 1800s was in direct response to the lack of available capital for peasants moving into urban areas or to farmers who could not afford the high interest rates and short terms of the loans, as banks were restricted in offering loans within a five

year maturity. As peasants moved to the towns they were unable to access capital by conventional banks who no doubt classified them as high risk so they were forced to create their own institutions by pooling resources and offering favourable terms. As Cook (1995) points out, the development of these organisations as cooperatives was defensive in nature and as other writers have commented on, came at a time when markets were depressed and there was little competition (Hart & Moore 1998).

The first cooperative banks were very low cost to run as they operated out of a farmers home with volunteer staff and operated primarily to draw outside funds into a community (usually rural) to provide loans to member-farmers. (McKillop & Wilson 2005). By 1913 there were almost 17,000 rural credit cooperatives in Europe and today, the largest of those remaining, the Volksbanken-Raiffeisen Banken, still has 16% market share in Germany (ibid).

Both Building Societies (UK) and their U.S equivalents the Savings and Loans Associations originated when people started to move to urban areas. In order to afford housing, they collectively formed local groups from which they could borrow money for mortgages. These organizations were run by a committee of members and they were regulated to prohibit them from engaging in activities other than providing mortgages for members. The original societies were able to overcome the problems of asymmetric information particularly about credit risk as everyone involved knew each other. They also served to eliminate the impact of the ‘hold up’ they experienced from existing institutions in obtaining access to capital. Perhaps more as a consequence of their structure rather than as a motivating factor, they were able to control interest rates and keep them low. The original societies also disbanded after each of the members had purchased a property and any residual surplus was distributed equally among the members.

Stock exchanges, originally started as trading houses or ‘coffee houses’ to facilitate the trading of stocks and were established as mutual enterprises. This cooperative structure which had a closed membership (where members paid fees to enter) served the purpose

of controlling the credit risk of participants and limiting access to the public. The monopoly power that such an organisation could potentially exert on its customers in the role of buying and selling shares could be mitigated by the customers owning the firm. (Grote 2007)

2.3 Stage II - Competition

Cook (1995) outlines the next stage where the cooperative survives the “infant stage” (p 1156) because it can offer more favourable prices than their investor-owned competitors.

The original form of building societies had insufficient funds to keep up with the demand for all the members to construct housing within a reasonable timeframe. As such, they encouraged an additional type of member to make investments into the society and the first ‘permanent’ society was founded in 1845. For decades, the needs of both parties (investors and borrowers) were met. Investors could enjoy almost risk free saving and mortgage lenders were able to build houses when they wished (Cook, 2001). These permanent societies implemented a system of different classes of shares to encourage such investments, not unlike what is seen today in the ‘new generation cooperatives’.

At the point at which the building societies attracted investors, they started to grow in size and professional managers were employed to take control of the day to day operations with members having representation on the board of directors. Depositors and borrowers were called ‘members’ and arguably became more removed from their role as ‘owners’. These mutual banks and building societies were still able to offer a low risk investment and keep interest rates low as they built up considerable reserves of capital. They were clearly meeting a market ‘gap’ not filled by the incumbent investor owned banks.

When the first life assurance mutual entered the market in 1848, it offered much lower prices for whole life policies and investor owned companies could not compete. Mutuals

dominated in this area until the late 1800s when insurance regulation was implemented (Simpson 2001).

Financial mutuals and cooperative institutions also experienced regulatory benefits in respect to tax relief for several years in both the UK and the US which also made them able to compete well with favourable interest rates (Hansmann 1996).

At this stage, most mutuals really did look more like non-profit firms where the managers became fiduciaries for the members. (Cook, Deakin & Hughes, 2001).

2.4 Stage III – Agency Problems

During this stage, competitors modify their offerings to compete more for the market identified by the cooperative. This in turn, results in members of the cooperative evaluating more closely the transaction costs that result from the increasingly complex structure. The conflicting property rights between depositors and borrowers can become problematic as well as increasing difficulties with control problems with management, horizon problems and portfolio problems.

As mentioned above, the typical conflict expected between the different agendas of the types of member-owners was mitigated and off set by the ability of the cooperative building society to meet both needs adequately for many years. This was greatly assisted by the nature of the regulations that inhibited any investment by a building society beyond property, thus the risk profile remained very low.

Interestingly, by the 1970s building societies abandoned the patronage refund (dividend) and by doing so severed any economic relationship between members and their cooperative (Birchall & Simmons 2004). One might expect, even using the term ‘member’ as opposed to ‘owner’ would lean itself to people not being that aware of their ownership rights and responsibilities as it becomes so far removed. When there is not a tangible transaction based on ones ownership of an entity (such as the distribution of surpluses) then one is not likely to recognize the dual owner-member roles that they in fact have. It

could be further suggested that the lack of this recognition on the part of the members also contributes to the managers themselves becoming less aware of whom they are accountable to.

The potential agency problem originally identified by Jensen & Meckling (1976) which outlined that directors or managers were in fact able to operate without many controls and the only recourse members had was to withdraw their funds is particular to cooperatives. Barnes & Ward (1999) suggest that for both Savings & Loans and Building Societies there is considerable evidence that fraudulent behaviour on the part of managers was prevalent throughout their history dating as far back as 1892.

Horizon problems occur in life assurance or retirement schemes for example due to the length of time that elapses between purchasing the service and delivery. This time lag creates an increased risk of managers acting opportunistically.

The UK Building Societies were deregulated in 1986 as a response to a need for increased competition in the financial services sector. Their US equivalent, the Savings and Loans Associations were deregulated earlier in 1980 after a fall in interest rates left them unable to attract funds. (Barnes & Ward, 1999). At the time of deregulation, most mutuals had grown significantly in the number of members each had. Monitoring of managers by members was predictably low. Birchall & Simmons (2004) studied the incentives of members and their participation in decision making in the multi-national Co-operative Group which includes the Co-operative Bank and Co-operative Insurance Company and has a membership of 1.2 million individuals and 120 other co-operative companies. It was found that members did take the opportunity to participate in decisions when encouraged to do so particularly if it involved face-to face meetings rather than by 'flyers' even in very large cooperatives. However, Birchall & Simmons (2004) also note that members were more likely to be interested in 'local' issues that directly affected them rather than larger, more global scale concerns.

As O'sullivan (1998; 146) stresses, the fusion of the role in cooperatives of the customer and owner creates "a greater degree of ownership diffusion which makes effective control of senior management extremely difficult". Cooperatives also lack the control mechanisms of takeovers and large block shareholders that are used effectively in IOFs.

A key outcome of deregulation of the industry was to allow mutuals to merge with other entities and then the opportunity to increase their risk through the removal of portfolio restrictions. These heightened the conflict managers faced in achieving personal gain at the expense of the members. This was particularly noticeable in the building societies after 1986. Many mutuals, on commercial grounds rather than in the interests of their members, relaxed their lending rules and granted mortgages at full valuation. The cost of these moves were not insignificant including the subsequent repossession of over 130,000 homes by building societies between 1991-1994 (Barnes & Ward 1999;219)

An interesting example of incentives and the unintended consequences of policy during this deregulation process was the requirement for voting to effect a change of structure. 50% of investors were required to vote and 75% of those investors were required to support the motion to change. Borrowers, on the other hand had no voter turnout requirements and only a majority vote was required to pass the resolution to convert. This was designed to redress the difference in numbers of each of the parties concerned, and protect the interests of the borrowers, however, the voting for conversions "consistently demonstrated much greater support for conversion among investors than among borrowers" (Cook et al, 2001:24). This difference could be explained by the fact that the policy may have acted as an incentive for investors to get out and vote while borrower members assumed because there were so many of them that each did not need to vote.

2.5 Stage IV – Awareness of benefits of exit strategy

Further to the problems arising in stage III, the cooperative becomes increasingly complex to manage effectively. The structure no longer provides the benefits it originally

was set up to provide and balancing the conflicting and vague property rights limits the response of the organisation to three options: exit, continue or transition.

As the level of competition increased so did the need to get larger and the incentives to grow via mergers and acquisitions was prevalent throughout this sector.

Mergers had occurred between mutuals prior but large scale mergers were a result of deregulation throughout this industry as institutions sought ways to rationalize their use of capital, cut costs and increase revenue by achieving economies of scale. The obvious problem that this trend of consolidation creates is that of decreasing competition in the market. Harper (2000) points out a further possible outcome of the mergers; that of creating banks too large to fail. He suggests that governments would not allow such large entities to fail as the political fall-out resulting from the loss of so many depositors funds would be unpalatable. If bank directors are aware of this, they may engage in more risky lending policies. One way to manage this moral hazard would be to limit the amount by which an entity can reduce its capital base (ibid).

Deregulation within the various sectors have been pointed to as primary drivers of demutualization. (Grote 2007). The deregulation of the financial sector occurred for the primary purpose of removing the barriers for institutions to compete in various markets in order to stimulate competition.

2.6 Stage V – Choice of Strategy

The choices at this stage are to exit, transition or continue. Perhaps this is the stage at which, unlike the agricultural industry which was able to make use of the other options, the vast majority of financial institutions that were mutuals opted to convert to investor owned enterprises. This was likely to be heavily influenced by the regulations of the day which stated that for mergers to occur with IOFs, they also had to be an IOF.

An exit strategy can take two forms; liquidating or converting to an investor owned firm. Most mutuals and cooperative financial institutions that had continued to this point were high performing organisations so were in a healthy position to convert rather than liquidate and as such, managers had to sell their conversion to an IOF status to their members.

This conversion was the process of demutualization the key feature of which was the separation of membership and ownership.

Over the 1990s the vast majority of mutuals in the Western World, in the financial sector (stock exchanges, insurance mutuals, building societies) sought to convert to IOFs.

Mayers & Smith (2002) offer three possible motives for a mutual to convert:

- access to capital in order to grow the business
- a desire to enter markets that are not suitable for the mutual form
- wealth transfer of accumulated surpluses

Various studies as reviewed by Davis (2005) have sought to examine these hypotheses with mixed results although most conclude that most demutualisations are not motivated by access to capital as there were usually several other options available. In fact, the evidence shows that mutuals with strong cash reserves were more likely to convert presumably because it provided greater incentive to transfer those assets (Cook et al 2001).

As mentioned previously, there is debate about the motivation to transfer wealth as a key driver of demutualisation. It does link with agency theory and it is a fact that senior managers and directors gained significantly from the process both in the short and long term whereas, many studies indicate that only very brief short term gains were experienced by borrowers (Cook et al 2001). The exception for this were the “carpet baggers” who, as ‘free riders’ became members of mutuals once deregulation occurred with the express purpose to vote for demutualization and stood to gain a windfall

disproportionate from their investment because of the one member-one vote system. This happened during the first wave of demutualisation's and thereafter additional regulations were imposed to limit the payout to members who had joined up to two years prior, the others having to nominate a charity to receive their payouts.

The outcome for many building societies and more so in the savings and loans of the US, were company failures as managers, not having the imposed limits of previous regulations and seeking to grow the newly established IOFs sought ventures that were too risky and which quickly saw their demise. Barnes & Ward (1999) indicate that most of the losses incurred in the collapse of the savings and loans in the US were associated with speculative properties or very high risk investments that directors gambled on. The outcome of these decisions was the "most costly financial failure in US history" costing an estimated \$500bn USD (ibid;215). The fact that many deposits were insured to a higher value than previously perhaps contributed to the lack of diligence shown by many managers.

The relationship between the competition between banks and the stock exchanges is also noticeable. Traditionally, banks, operating as financial intermediaries, relied on information asymmetry surrounding the financial markets to fulfill this role. As improved technology has resulted in low cost and easily obtainable access to information about financial markets and its activity, on a real time basis, the banks and other institutions have found themselves in competition with the markets themselves. Thus, as Harper (2000) points out, banks are left with two choices, to incorporate financial market activity within their operations or face failure.

Bradley (2002) points out, stock exchanges are changing their structures from mutual organizations to corporations in response to these changes in technology which has resulted in the conditions of competition increasing the scope of competitors to both domestic and international markets. In order to compete successfully, joint ventures and mergers across geographical boundaries are increasingly common. Grote (2007) also suggests that an exchange that has a corporate structure can react faster to changes

because they can make decisions faster (without having to consult with large groups of owner-members as in a cooperative situation), and that capital is easier to raise via IPOs. The issue around raising capital has been argued as a reason for demutualization and has been used by managers to promote the idea of demutualization but it is argued by many that there are several ways in which a cooperative can raise any necessary capital.

For example; material given to the members of the Toronto Stock Exchange promoting demutualisation stated that:

“The board believes that members will reap many rewards for their support. Today, TSE seats have a static value that is unrelated to the TSE’s asset base. Members have no right to any surplus, while the risk of liability is of increasing concern in the new environment. Fundamentally, members have outgrown the need for seats” (as cited in Bradley, 2002).

The New Zealand Stock Exchange demutualised under a special Act of Parliament in 2002 to become NZ Stock Exchange Limited. It is listed on its own market and was able to raise capital. It was seen as a move primarily to increase investor confidence and raise capital. The NZ Stock Exchange and the Securities Commission work as co-regulators to monitor the trading activity (Diplock, 2003). In response to the conflict between regulatory functions and the pressure to make profits, most exchanges that have demutualised have had other bodies imposed in supervisory roles (for example; Australian Stock Exchange has the ASIC, London Stock Exchange has the FSA, NZSX has the Securities Commission). One issue that has directly resulted from demutualization and remains today is the threat of exchanges becoming targets of takeovers.

In Australia, all of the major Insurance mutuals have demutualised as they were required to under regulations in order to merge with other entities. In a review of studies that evaluated performance of demutualised insurance companies in the UK, (O’Sullivan, 1998) found that there was strong evidence that demutualisation was more consistent with the efficiency hypothesis as opposed to the expropriation hypothesis. This was

because as predicted under the efficiency hypothesis, after demutualisation there was generally little change in premium income and no change in lapse rates but a significant increase in capital and surplus.

One of the concerns about the focus on demutualisation is that firms will adopt short term policies which will be valued immediately by the market as opposed to taking a longer term approach which may be better for shareholders in the longer term. The pressure to maintain your market position is high as otherwise the entity is potentially a take over target.

2.7 Summary

Application of Cook's 5 stage model of cooperative evolution to the financial industry has highlighted a number of key features that help to explain why this sector has experienced the wave of demutualisations that it has over the past two decades.

The importance of regulations and sound policy in managing agency conflicts is highlighted, as when the regulations were removed, those conflicts were key issues that led to the devolution of so many cooperative structures. Managers who arguably saw an opportunity to gain substantially by taking a certain direction and managers who had difficulty in balancing the increased risk of portfolios contributed greatly to the decimation of an organisational form within this industry that had worked successfully for over a hundred years.

It is of note that no new mutuals have been established in this industry since these demutualisations occurred and yet it is likely that the market for affordable housing through low risk borrowing remains.

One reflection that has not appeared in commentaries is the issue of trust. One of the reasons as mentioned in section 1 that cooperatives are started is to address an information asymmetry, that is, to have some trust in the people you are dealing with. It could be

suggested that an increase in heterogeneity removed the ability to use ‘homogeneity and trust’ as a proxy for monitoring fellow members and thus another instrument is required for effective monitoring. Did monitoring become ineffective with the increase in heterogeneity of members under the old structure? Taking a macro view, the wave of demutualisations occurred at a time in Western history when individualism was at its peak of ‘revolution’ and as such was shaking up many institutional ways of thinking. If one sees the firm as a collection of individuals and therefore a microcosm for society, it would seem likely that this change in social structure was reflected in the move away from collective goals and towards individual gain. Demutualisation may have been one tool for changing the culture of these firms.

SECTION 3

3.1 New Zealand Agricultural Industry

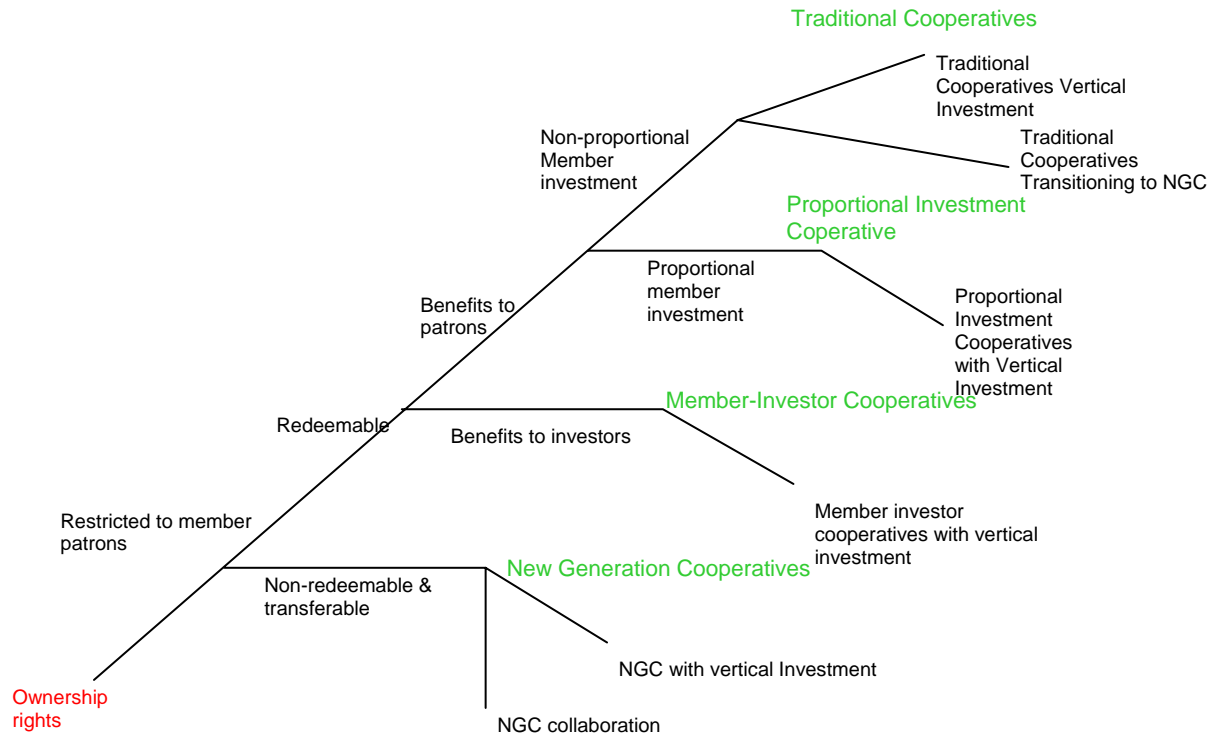
In comparison to the financial industry, agricultural cooperatives have taken a variety of options in structural development to meet the challenge of increasing competition.

Similar to the financial industry, the agricultural industry has faced several changes in its structure in the past couple of decades including, increased globalisation, the deregulation of the industry and withdrawal of government funded support organizations. This seems to have forced many co-operative organizations to look at how they can move beyond their limitations to meet these changing demands. At the heart of the matter, agriculture is a volatile, cyclical, commodity market for which most elements have a very small end product range which are subject to the changing demands of the end consumer. With the exception of the dairy industry which is able to utilize milk products in various other industries such as cosmetics, various forms of food products, pharmaceuticals, the other main agricultural forms in NZ such as meat and fruit have limited opportunities for divergence into other markets.

Evans (2004) points out that the 1984 reforms in NZ agriculture, where government subsidies were withdrawn, has resulted in farmers adopting a portfolio approach to increase the number of activities they are involved, and better resource allocation that more closely matches consumer demand rather than that which was previously supported by government subsidy. Evans (2004) states that between 1933 and 2001 the number of dairy cooperatives fell from 499 to just 4 as a result of mergers and acquisitions.

Further to the 5 stage model of cooperative evolution, Cook & Chaddad (2004) outlined in more detail, additional options for cooperatives that in stage IV would move to a transition strategy rather than an exit strategy. These options are outlined below on a continuum from traditional cooperative structures to New Generation Cooperatives. These strategies are also seen as an attempt to overcome difficulties experienced with traditional cooperative structures in a highly competitive environment where access to significant capital may be required or where member-owners cannot capture the benefit of any profit. The Cooperatives Act (2006) in NZ has supported the development of cooperatives in various forms.

Figure 1: Emerging Forms of Cooperatives form an ownership rights approach
(adapted from Cook & Chaddad 2004; 1250)



There does seem to be some confusion about identifying which structures fit these categories and many writers appear to refer to new generation cooperatives as any firms that have moved away from the traditional model.

3.2 Traditional Cooperatives

Traditional Co-operative structures have been seen “as vehicles through which growers can collectively further their economic interests in the supply chain” (Bielik; 2004, 5). PPCS and Alliance, competitors in the NZ Meat industry, would be considered as operating as traditional cooperatives. They have retained an open membership, one member-one vote and most of the assets are retained. They do have a proportional

shareholding and disbursement distribution based on patronage as per the contract for supply.

The meat industry is at an interesting crossroads in respect to cooperative development as many farmer-owners of these two cooperatives are suggesting a merger of these organisations. Both cooperatives have existed for several decades in competition. Many farmers are members and suppliers of both enterprises. The motivation to merge is to achieve economies of scale in reducing administration and transaction costs, increasing the ability to compete in a global market and to stop a competitive situation which results in the cannibalizing of ones own market. Their situation does raise significant questions if the meat industry is to develop further. Firstly, growth in this industry is likely to require some investment particularly in down stream processes like marketing. Much is already spent in research and development. If the existing cooperatives such as PPCS and Alliance wish to develop their structures to take advantage of these opportunities they have the options of engaging in joint ventures with existing companies or perhaps encouraging a member-investor option. The difficulty with this option, is that it would require farmers to invest additional capital into the organization at a time when they may not be able to afford it because of market prices for their goods being low and equally they may be perceive it as too high a risk while the market is depressed.

The other key question that is raised by the current situation in this industry is the challenge of balancing the shifting boundaries of competition (from regional/national to global) with the need to have entry and exit options for farmer-owners. Arguably the competition for most agriculture sectors needs to be viewed in a global environment but doing so in a small economy such as New Zealand has the potential side effect of consolidating the market so that monopoly firms evolve. If this occurs, the above analysis would suggest that retaining a cooperative structure in which farmers retain control of down stream activities would be advantageous unless regulations that mitigate and monitor the agency issues described are implemented.

Proportional Member Investment Cooperatives are those that in most respects are like traditional cooperatives but which require member patrons to invest in the cooperative in proportion to their patronage.

3.3 Member-Investor Cooperatives

An example of a cooperative that has adopted a Member-Investor approach includes Fonterra Cooperative Group in the dairy industry. In the NZ Dairy industry, the two largest co-operatives merged in 2001 to become Fonterra with the aim of achieving economies of scale. This followed the Dairy Industry Restructuring Act (2001) which outlines the obligations of the co-operative and gives open entry and exit to any supplier. They have aligned ownership rights with member investment via a system of fair value shares where the share value is aligned to a tradeable share. These strategies employed by Fonterra are an example of alternative or proxy measures that can be used to simulate a competitive situation.

3.4 Hybrid – New Generation Cooperatives

Similarly to the Australian Agricultural industry, many of the NZ agricultural cooperatives have adopted ‘hybrid’ structures that allow two classes of shares in the firm. The obvious question this hybrid ownership structure raises is whether farmer interests will continue to be paramount.

Examples of firms in the agricultural industry in NZ that have converted from cooperatives to this hybrid structure include Satara and Eastpack both in the horticultural sector. NZ legislation limits non-member investors to control up to 40% of the votes although they can have more than 40% of the capital. Both Satara and Eastpack are kiwifruit “post harvest companies” and have two levels of membership; transactor shares and investor shares. Transactor shares in Eastpack can be purchased by members in installments and this year had first call on the profits via a rebate of 30c per tray. The investor shares receive the balance of the profit after the rebate via a dividend. The investor shares are tradeable and available to growers with transactor shares to the maximum of two shares per tray (www.eastpack.co.nz). Eastpack has grown from

packing 60,000 trays for 23 member shareholders to 12.2 million trays for 389 suppliers. Satara is closest to the 'New Generation Cooperative' model as described by Cook as it has its investor shares on the open market and initially those shares were purchased by those closely associated with the industry. Woodford (2003) suggests that the motivation behind the move to this hybrid structure was the impending retirement of existing shareholders in the cooperative who were interested in obtaining access to the considerable assets that had been retained. This does raise the question of demographics in the agricultural industry and how it has influenced these changes. As Farmers and growers have got older (one estimate suggests that 50% of professionals in agriculture are over 50 years of age), one could expect that their strategic intents may alter and a different type of horizon problem could occur in which they are more focused on short term gains.

With shares on the open market though, increases the potential for a conflict of interest between members and non-members much as what occurred in the building societies once the regulations limiting the areas of investment were lifted. The challenge for managers when there are two classes of shares will be to balance two differing goals; the benefit of the grower-members and the profit making agenda of the investors.

While it has been argued that conversion to IOFs is imminent on the grounds that increased technology takes away the ability for farmers/growers to control the value added attributes from their products and therefore they have no control over the variation in the end products. On the other hand, Lang (1995;1163) argues that in fact there is greater potential for farmer/growers to add value in response to consumer demand via for example research in genetics, introducing new varieties, reducing fat.

SECTION 4

4.1 Comparison between the two industries

In comparing the two sectors, it would seem that there may be subtle differences in meeting needs as producer owned versus consumer owned cooperatives. However,

applying Cook & Chaddad (1995) 5 stage model of the life span of cooperatives suggests that there similarities in the evolution of cooperatives in general.

This analysis has shown distinct differences between the two types of industries in this evolution that may explain the persistence of the cooperative form, even with its adaptations, in the agricultural sector and in contrast the demise of it in the financial sector.

- The level of interdependence between a producer and the downstream activities such as packers and processors and even marketers is much different than the independence of investors and borrowers of financial institutions. This level of interrelation of activities means that farmers will be interested in achieving scale and keeping costs down in these areas and as such will take a keener interest in the running of these organisations. This contrasts to the dispersed and much more disinterested member-owner of a building society who arguably was not even aware of their dual role. The monitoring of the organisation will therefore be higher in an agricultural cooperative and reduce the risk of agency conflict.
- Further to this, the exit costs for farmer-growers are much greater than those of members of financial institutions. One of the control mechanisms in financial cooperatives was the ability for members was the low barriers to exit. Arguably, as the market consolidates, farmers do not have a great choice of alternative processors within their locality and a large amount of capital is required to establish a new plant. There would be considerable capital already invested by the farmer in any existing plant which is not accessible.
- One key difference is that in agricultural cooperatives the assets are more in the form of plant and equipment and are not as easily converted to cash as in the financial sector. This is likely to inhibit the wealth-transfer motivation that was observed in the demutualizations of financial cooperatives.

- With the introduction of fair-value shares (eg: Fonterra) there is a proxy, transparent market-value attributed to the firm. This results in managers salaries and packages being more closely aligned to the current market value also, and this eliminates the need for a firm to convert to IOF status in order for managers to receive higher, market driven salaries as occurred in the financial sector.
- The role and importance of regulation and effective monitoring tools has been highlighted in both sectors to mitigate opportunism and conflicting agendas. Regulations that limited risk for both investors and members resulted in their respective involvement in Building Societies being more homogenous than one might expect. Thus, the needs of two different types of shareholders were successfully met for several years. The lesson for the agricultural industry as more cooperatives move away from traditional structures to hybrid structures and look at open membership for investors is to ensure that effective policy or regulation is in place that maintains the integrity of the organization and decide whose interests will take priority.
- In both sectors, increased competition has played a crucial role in motivating change. Acknowledging the changing boundaries of competition to a global scope will bring challenges for regulators to balance the need to compete effectively in global markets with increased consolidation and creating monopoly enterprises.
- Observing other social changes occurring in the environment that are influencing the economic concepts of the day are also helpful to gain a wider perspective. As societal attitudes has shifted towards individualism in the Western world so these philosophies been reflected in the corporate landscape. Perhaps this is most obvious when examining the changes experienced with the organizational shift away from cooperatives whose goal was the collective welfare enhancement for members. Demographic changes in an aging population will also continue to influence organisational policy and structure. As indicated, as people get older,

their focus is likely to start to look toward the short term rather than longer term benefit of the organization.

4.2 Policy Issues

Further policy issues that may be considered for the continued improvement of cooperatives could include:

- Specific management development programmes such as those proposed by Davis, (2001) and the development of a code of ethics specific to cooperative managers.
- It is noted that the success of the employee owned cooperative group, the Modragon Group, has a well established infrastructure that supports its core businesses. These include education and training, technical support and consulting services. Although New Zealand does have the Co-operative association that is affiliated with the ICA, it is unclear as to what level the resource and support given to cooperatives are. This could be one area for future development if cooperative structures are to be encouraged.
- As Woodward (2003) suggests income bundling becomes an issue for policy. There is potential for economic distortions to occur when “value adding is based on addition of capital but the additional returns are distributed according to patronage”. The price signals could be misinterpreted by members to increase their production when in fact what is required is increased investment in activities further downstream.
- The question may be postulated - when is a co-operative no longer a co-operative?

SECTION 5

5.1 Conclusion

It would seem that as earlier writers have predicted, the closer to a perfect competition the market is, the less likely a traditional cooperative structure is able to respond efficiently. As such, most industries in which cooperative structures have been prevalent and even dominated in the past, have changed significantly in direct response to market changes including deregulation and the emphasis on increased competition.

In some industries such as financial institutions (banks, building societies and sharemarkets) cooperatives operated for several years under regulatory regimes where their parameters of operating limited their risk profiles and as such were able to successfully serve two types of owners (investors and lenders) before they moved to mass demutualisation to unlock their assets. In other industries such as agriculture, the interrelationship that producers have with their downstream assets has resulted in a different pattern of cooperative evolution in an equally competitive and changing market. The question remains however, as to how successful, traditional cooperatives will continue to be in this fast moving competitive environment.

It is noted through the application of Cooks (1995) 5 stage cooperative life span model to the financial sector that although most opted to demutualise by stage five, they had already had decades of successfully managing two different types of shareholders and it is predicted that although the new generation cooperative options have been selected in varying degrees by the agricultural sector, the problems in managing these conflicts mitigated in the financial sector by regulations limiting the scope of investments are not likely to be imposed and as such are open to managerial opportunism.

The cooperative purists are likely to point out that it is difficult to see how hybrid cooperatives can remain as genuine farmer-owned and controlled businesses, as farmer owners become more and more removed and their interests are in conflict not only with managers but also with non-member investors. The shared interest philosophy that underpins the formation of the cooperative structure is arguably no longer present and the

goal although 'fuzzy' to begin with (to improve the members' welfare) is even more clouded now and would probably, in a competitive market tends towards the profit making agenda at the expense of the farmers other interests. Thus it could be fairly predicted, that after some time has elapsed and as non-member investors gain more control of cooperative firms, the risk profile will change and investments that are more risky than previously are likely to be made which could potentially put the firm at risk as occurred in the financial sector. In this situation the ownership role of the producer is arguably nominal so it would be perhaps the perception of ownership rather than the reality that is being maintained.

There are certainly many options open to the existing cooperative to expand and meet market demands without going through the process of demutualisation including further vertical integration via entering joint ventures or investing in IOF subsidiaries, but one would have to ask if none of the features that prompted the formation of the cooperative structure actually exist – what is the benefit in continuing to maintain that structure other than the cost of change and peoples inherent difficulty in managing large scale change?

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