The rise and fall of the 'ethical bank'

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| 15th January 2019

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Pervasive mismanagement contributed to the near collapse of The Co-operative Bank.

In ancient Greek mythology, the sin of hubris – excessive self-praise and over-weaning pride – was punished by Nemesis, the goddess of indignation. It is a metaphor sometimes used to describe how the giants of the banking industry were destroyed by market forces in the great recession that began in 2008.

Their inflated egos allowed banks to lose the run of themselves, investing in assets that were vastly over-valued and which the bankers often didn't even understand.

It would be nice to report that it was different at The Co-operative Bank, the so-called 'ethical bank'. Sadly, the story was just the same. It was managed by people who were not up to the job, overseen by a board that were sometimes kept in the dark and who were often too consumed by inflated ambitions to apply common sense.

Ethical business

It was not supposed to be like this. The Co-operative Bank was formed in 1872, as the banking arm of the Co-operative Wholesale Society – the body that supplied the co-operative retail stores across the UK.

Those shops emerged out of the Rochdale Pioneers' example, who set-up a store to sell nourishing, unadulterated food at affordable prices to low income families. That is about as ethical as a business can get.

But the co-operative retail societies declined and merged, until only a few survived. Most of their department stores closed, as shoppers moved towards Tesco and other hypermarket groceries, selling a massive variety of goods at often lower cost.

Co-ops failed to keep track with customers' demands – and in many cases forgot what these days is called 'the co-operative difference'.

A study by co-operative practitioner Peter Couchman and academic Murray Fulton examined the failure of large co-ops. It found five consistent features in these failures: seeing the co-operative structure as a weakness, not a strength; having the wrong people in charge; lack of board oversight; over-confidence; and a 'final roll of the dice', to achieve a big bang merger solution to a problem built-up, and left festering, over a long period. Those five factors were central to the problems and near collapse of The Co-operative Bank.

Merging institutions

Readers of national newspapers could be forgiven, by contrast, for believing that the Bank's problems were entirely the result of the strange behaviour of its chair, the Reverend Paul Flowers – Christened by the tabloid press as the crystal Methodist. His penchant for drugs and his liaisons with teenage male prostitutes certainly damaged the Bank's brand, but it was not the cause of its crisis.

In fact, the cause of the near sinking of the Bank dates from when it took over the Britannia Building Society in 2009. This was before Flowers became chair of the Bank. The board were not even informed of the merger discussions by management of the Bank and its owners, the Co-operative Group (the new name of the old Co-operative Wholesale Society).

When the negotiations were complete the board were told this was a great arrangement, which would take the merged organisation to new heights, with much greater economies of scale. The management seem to have believed their own hype.

Regulators, however, had a different perspective. They regarded the Britannia as a weak institution, which was being rescued by The Co-operative Bank. Yet they did not share their view with the boards of either the Bank or the Group.

Bizarrely, the chief executive of the failing institution was appointed chief executive of the merged body. And although the regulator had its reservations, it did not block the arrangement.

Financial crisis

While the regulator was aware of the weakness of Britannia, The Co-operative Bank should also have been aware. In any major business transaction, the buyer undertakes what is called 'due diligence'. This involves close scrutiny of the books and assets of the business to be acquired.

In the case of The Co-operative Bank's takeover of Britannia, there was only limited due diligence. Crucially the bits of Britannia that were later found to have been greatly over-valued and the cause of the Bank's near collapse were the parts that were not subject to proper due diligence.

This failure of process, some years later, led to the professional disgrace of one of the Bank's senior executives, who had to pay substantial penalties.

If the Britannia merger was an example of hubris, it was outdone by the later attempt to take over more than 600 branches of Lloyds Bank – the so-called Project Verde deal. It was only when this unravelled that the scale of financial crisis at the Co-op Bank was revealed.

But the Bank's financial crisis had more than one cause. The frantic attempt to build 'scale' was certainly a factor. It was also, though, related to a lack of strategic consistency. A massively expensive IT system was procured to implement one business model, only to become redundant when a different strategy was adopted in the chase for scale.

Customer base

Meanwhile the branding of 'the ethical bank' brought its own problems. In truth, the slogan owed more to accident than design.

This often badly run bank conducted research to determine why their customers remained loyal, despite often poor service. The research found it was the bank's ethical principles that customers valued.

Yet, until that point, it did not have established ethical principles – instead it had built up a customer base from being the only high street bank that did not have a direct relationship with apartheid-era South Africa.

Building on that foundation, 'the ethical bank' branding was born. Yet some of its practices sat uneasily with this. In particular, the bank later had to make substantial repayments over the mis-selling of Payment Protection Insurance.

Today The Co-operative Bank is no longer owned – either in whole or in part – by the Co-operative Group. It was rescued by international hedge funds, which continue to proclaim it as an ethical bank. Perhaps surprisingly, many customers continue with their loyalty.

Ultimately, what did it for The Co-operative Bank was incompetence on a massive scale. Ethics – and the lack of it – comes into the story. But essentially this is a story of how bad managers destroyed a bank and how bad directors allowed them to do it.

This Author

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