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**Poverty of Agency Theory and Poverty of Managerial Practice: The Royal Bank of Scotland Fiasco**

**By**

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## Abstract

The divergence of ownership and management in modern capitalism gave rise to agency theory as a framework for analysing corporate governance. There is now an emerging body of literature questioning the wisdom of the focus on agency theory in business schools. We argue that the poverty of agency theory is compounded by the culture of deference to authority entailed in reliance on technocratic advice. By reference to the concept of hegemony, we conjecture that hegemonic pressures have produced a homogeneous managerial class with similar preference for maximizing short-term profit. The argument is illustrated empirically by the case example of the collapse of The Royal Bank of Scotland, where shareholder representatives followed management advice in pursuing a course of action that led to the demise of the bank.



**Keywords:** Agency theory, Bank collapse, Corporate governance, Hegemony, Management and ownership, Royal Bank of Scotland, Technocracy.

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## 1. Introduction

Commenting on the creation of corporate scandals like Enron a few years ago in a paper entitled 'Bad Management Theories Are Destroying Good Management Practices', Ghoshal (2005:75) argued that the theories and ideas of influential business school academics (like corporate governance courses grounded in agency theory) have been digested and put into practice by hundreds of thousands of business executives, and 'have done much to strengthen the management practices that we are all now so loudly condemning'.

Roberts, McNulty and Stiles (2005:57) argue that the assumptions of agency theory "have had an important influence on the process of governance reform as directed at boards and non-executive directors" but the theory fails to address questions of trust and accountability. Hendry (2005) also draws attention to complexities of organisational relationships that are not addressed in agency theory in explaining the role of non-executive directors. Filatotchev and Nakajima (2010) point out informal social understandings entailed in the governance of organisations. broadening  Picking up on some of these observations, and using the corporate scandal at Royal Bank of Scotland as our empirical unit of analysis, we argue in this paper that agency theory does not address the problem that it sets out to address, the problem of analysing the governance of modern corporations. The separation of ownership and management of large corporations in modern capitalist economies has drawn attention to the poverty of the pristine model of competitive capitalism delivering economic efficiency through the pursuit of profit (Berle and Means 1932, Galbraith 1967). Berle and Means argue that the power and responsibility associated with the ownership of capital has changed as capital is held as corporate equity that is controlled by a small group of managers who exert social and political power by virtue of the size of companies they control (Berle and Means 1932:46):

> "…a society in which production is governed by blind economic forces is being replaced by one in which production is carried on under the ultimate control of a handful of individuals. …The organisations which they control have passed beyond the realm of private enterprise…"

The pursuit of their managerial objective need not necessarily be aligned with the requirements of economic efficiency. According to Galbraith, a consequence of the separation of management and ownership of large corporations is the demise of the entrepreneurial motivation as the guiding force of capitalism (Galbraith 1967:71):

> "With the rise of the modern corporation, the emergence of the organization required by modern technology and planning and the divorce of the owner of the capital from control of the enterprise, the entrepreneur no longer exists as an individual person in the nature of industrial enterprise…. "

The entrepreneurial capitalist is still "to be found in smaller firms and in larger ones that have not yet reached full maturity", but the directing force in large corporations is not the entrepreneur but "an imperfectly defined entity" called management (Galbraith 1967:71). A logical conclusion of this line of argument is that the claim to the superior economic efficiency of capitalism derived through entrepreneurs seeking to make profits in innovative ways comes into question. The goal of management, a “technostructure” (Galbraith 1967: 111) exercising power, needs to be understood if decision-making in modern corporations is to be adequately analysed.

Bypassing the question of the hierarchy and control exercised in a technostructure, agency theory has tried to analyse the issue of corporate governance as a matter of devising incentives to align the interest of managers as they are with as they might be under entrepreneurial capitalism governed by economic forces guided by an invisible hand which was not under the control of the entrepreneur.

This research paper is especially topical because the Financial Services Authority (FSA) released its report in December 2011 about the near collapse of RBS in 2008. According to the FSA report, the three main reasons for the near collapse were: poor decisions by RBS' management and board; flaws in the FSA's own (light touch) approach to regulation; and lack of appropriate due diligence on the ABN Ambro deal. The FSA report also remarks that its own light approach to regulation was influenced by a repeated emphasis by politicians, including the then Chancellor Gordon Brown, on the perceived need for the FSA to be light touch in its operations. There was (and remains[1]), a strong public policy position on preserving the ‘competitiveness’ of financial services and the pre-eminence of the City, and an ideological belief that overly intrusive and restrictive regulation could damage that competitiveness. The FSA report proposals for future regulatory changes to the financial services sector encompass: calls for public debate about changing laws so that, in future, bank executives can face personal consequences in the case of a bank failure; new rules to make sure that bank executives and boards place greater weight on avoiding any bank failure; outlining methods to ensure that the risk/return balance at a bank is different from that of a non-banking firm; examining ways to ban executives of failed banks from future positions of responsibility, or changes to remuneration to ensure that a ‘very significant proportion’ of executives' pay is deferred and forfeited if a bank fails; and, finally, bank acquisitions should, in future, need more explicit regulatory approval (Guardian, 2011). However, neither agency theory, or the FSA Report, provide deep enough or sufficiently ‘grand narrative’ critical analysis illustrating how the structures and agency of power, mobilized often covertly in various hegemonic guises, have become concentrated in many large British corporations in the hands of an elite management technocracy – and the practical implications of this at corporations like RBS[2].

The paper is organised as follows. Section 2 below highlights the salient features of the literature on the separation of ownership and control and speculates on reasons how scepticism has developed about the relevance of agency-based remedies of the maladies identified by agency theory. Section 3 describes the shareholding pattern in RBS before and after the above merger with ABN Ambro to focus on the irrelevance of

[1] This is illustrated by the defence of the interests of the UK financial services sector and the City, and related opposition to mooted EU regulation of financial activities, by Prime Minister David Cameron when the UK was the only government to veto a proposed EU Treaty in Brussels in December 2011.

[2] The hegemony of the technocratic ideology can be found in the writings of economists arguing that large executive remunerations that have come into the focus of political discussion in recent years are not large enough (Jensen and Murphy 1990).

the view that shareholders are disenfranchised by management. Section 4 speculates about other explanations for the failure of shareholders to check management from choosing a course that brought the bank to its knees. Section 5 draws on the related concepts of hegemony and ideological power as a possible overarching explanation for why managerial shareholders accepted the course of events at RBS. Section 6 concludes.

**2. Shareholders and Management**

A particular line of analysis of modern corporations that gained currency some years ago was that corporate capitalism, characterised by the separation of management from ownership, was not a step change from entrepreneurial capitalism in outcome because managers were agents of shareholders in which the rights of capital vested. Proponents of this view argued that the technostructure behaved no differently from the entrepreneurial capitalist whose goal is to maximise profit, because management must behave as if they were entrepreneurial owners of firms. Otherwise they would not retain shareholder confidence (Peterson 1965). This view was further developed in the subsequent literature on the market for corporate control: "…the market for corporate control, often referred to as the takeover market, …[is] a market in which alternative managerial teams compete for the rights to manage corporate resources" (Jensen and Ruback 1983:6).

Whilst the failure of the market for corporate control to render corporate capitalism into a form that resembles entrepreneurial capitalism has been widely noted in the literature (Scherer 1988, Mueller 1989), the discussion about management behaviour in academic literature, especially in finance, remains focused on agency theory. This theory does not dwell on how social relations and controlling the agenda for discussion may enter into the decision-making process. The almost exclusive emphasis on agency theory in the management literature on corporate governance has recently been called into question (Ghoshal 2005, Moore and Rebe´rioux 2011).

Agency theory may have developed as a logical consequence of the view of the legal status of corporate entities as purely shareholder-centred bodies, as enshrined in the Henry Ford case below. Henry Ford, then chairman of Ford Motor Company, gave an interview reported in *Detroit News* on November 4 1917. He said that he wished to sell cars cheaply to enable more people to own vehicles. His reasoning was based not on shareholder wealth maximization but on corporate responsibility to society (quoted in Nevins and Hill 1957:97):

> "I hold this view because it enables a large number of people to buy and enjoy the use of a car and because it gives a larger number of men employment at good wages. Those are the two aims I have in life. But I would not be counted a success ... if I could not accomplish that and at the same time make a fair amount of profit for myself and the men associated with me in the business."

One of the shareholders objected to the management philosophy outlined in Mr Ford's newspaper interview. The matter went to court. A decision was handed down by Judge Ostrander on February 7, 1919. The management of the Ford Motor Company (ie Henry Ford), by taking social considerations into account, was found to have been in breach of their obligation to shareholders. Consider Judge Ostrander: (quoted in Nevins and Hill 1957:103)

> "We have no doubt that certain sentiments, philanthropic and altruistic, creditable to Mr Ford, had large influence in determining the policy to be pursued by the Ford Motor Company ... A business corporation is organized and carried out for the profit of the stockholders. The powers of the directors are employed for that end ... and do not extend to change in the end itself, to the reduction of profits or to the non-distribution of profits among stockholders in order to devote them to other purposes."

The view of the corporation underlying Judge Ostrander's edict is an organizational structure the aim of which is to maximize shareholder wealth, and this view is no longer held in legal circles.

Moore and Rebe´rioux (2011) maintain that the conceptual model of the legal identity of the firm as being owned by shareholders on whose behalf and on whose authority, conferred through shareholder meetings, management are obliged to act does not correctly describe the legal framework either in the US or the UK; notwithstanding attempts in, especially, the finance literature to channel discussion about governance within that framework. They cite legal precedents for holding that boards of directors have greater powers, and hence greater responsibility in the exercises of those powers, than those vested in mere agents of shareholders. The "board of directors of a corporation do not stand in the same relation to the corporate body which a private agent holds toward his principal." (a decision in a New York court of law quoted in Moore and Rebe´rioux 2011:86). Ghoshal goes further and argues that management curricula in business schools, by focusing exclusively on this disconnection between shareholders and managers, exacerbates the problem of bad management: "Our theories and ideas have done much to strengthen the management practices that we are all now so loudly condemning" (Ghoshal 2005:75).

An underlying theme in the emerging critique is that those who manage companies are made to think in a way that is a product not of the intrinsic nature of business, but is a consequence of "ideologically inspired" teaching promoting a particular type of management culture: "Even those who never attended a business school have learned to think in those ways because these theories [management are the agents of shareholders who are the principals] have been in the air, legitimising some actions and generally shaping the intellectual and normative order within which all day-to-day decisions are made." (Ghoshal 2005:75).

The 'intellectual and normative order' is characterized by a hankering for the ideal of a pristine form of entrepreneurial capitalism. The economy becomes deficient within its own terms if companies are so organized as to enable managers to deviate from this aim. The focus of the rules of corporate governance in a world where managers are not shareholders is to ensure that managers cannot get away with taking decisions that enhance their own agenda and downplay the interest of shareholders. This is the agency problem in corporate governance. Managers are agents of shareholders, the principals in the equation between managers and owners. The object of devising organizational structures and articulating a legal framework for companies is to ensure that the agents are not able to pursue their own agenda at a cost to the principals, the shareholders.

On a more pragmatic level, Posner (2009) provides an example about the need to understand the power relations in banks to explain the spectacular implosion of the banking system starting in the year 2008. He explains that the power to influence a bank's policy on risk became loaded in favour of traders and warnings from risk managers may have been unheeded contributing to the banking crisis in 2008. But these organisational nuances were ignored in the mainstream literature in economics (Posner 2009:80). The problems of "communication and control are endemic to organizations, especially large ones, and [these problems] played a role in the crisis" (Posner 2009:81). Organisations develop and adopt "strategies of coordination... in the face of complex reciprocal interdependence among operationally autonomous actors…'' (Jessop 2004:52)[3]. The social dimensions of the evolution of power relations through which communications are mediated within organisations are not captured in the methodology of agency theory.

We also highlight another aspect of the cultural milieu which may have to do with the sequential nature of the selection process to management posts discouraging independent questioning of specialist advice. The cultural milieu in which corporate decision makers, both as managers and shareholders, inhabit needs to be understood in the analysis of corporate governance. This is the issue addressed here in this paper by way of an example of the decision to take over the Dutch bank ABN Ambro by the giant UK bank, Royal Bank of Scotland, which then collapsed, resulting in the expenditure of massive amounts of public funds to ensure that the financial system did not implode.

Neglecting the fact that social relationships entail collective decision, agency theory attempts to explain managerial behaviour within the framework of profit maximising individuals that defines the textbook models of pristine capitalism. Based on the postulate that that the individual manager acts in his/her own interest which may not always be aligned to the interest of the shareholding capitalist, the focus shifts to incentive compatible managerial contracts to encourage managers to maximise shareholder wealth. Managers are supposed to further the interest of shareholders if the managers are doing their jobs properly (Williamson 1975, Jensen and Meckling 1976), and the thrust of management research is to investigate how to align the interests of these two groups through governance mechanisms impacting on the labour contract of management, and voting rules for shareholders.

The above approach focuses on how to reduce the chances of managers being able to get away with ignoring shareholder interest. Much is made of the fact that shareholders find it easier to sell up than to attempt to influence management decisions by exercising their right to franchise: "dispersion [of shares] is a pre-requisite for liquid stock markets, but it entails a collective action problem: individual investors have no incentive to engage in direct monitoring" (Becht 1999:. 1071). Shareholders have been urged to vote in corporate elections by modern reformers of corporate governance (Cadbury Report 1992; Hempel Report 1998), placing their faith in shareholder democracy to counter problems of agency.

What happened when the Royal Bank of Scotland took over ABN Ambro, and thus sowing the seeds for destruction of the merged entity, does not fit into the view that shareholders could have prevented the disaster by voting against management. The outcome of widespread participation of shareholder representatives at the

[3] Quoted in Whitley (2011:360)

Extraordinary General Meeting of the Royal Bank of Scotland on the 10th of October 2007 appears to have had the opposite outcome to the aim of shareholder wealth maximisation. The shareholders' representatives did vote, and voted with management, only to express regret later.

**3. The RBS ABN Merger**

The first point to note is that shareholders did not exit even when Sir Fred's "reputation as an exceptionally forceful businessman", to borrow a phrase from Mr Justice Tugendhat (Sabbagh et al 2011), should have warned them that offering almost £49 billion in October 2007 to take over ABN Ambro was a reckless act. Even before the start of a meltdown in the financial sector a year later, the combined valuation of the merged entity was in the range of £40-odd billion. The shareholders' representatives voted with RBS management. Then a year later, the value of RBS shares fell to £11bn on 13 October 2008 (Source: Thompson Reuters). It might have fallen to nil if government had not come to the rescue of RBS share prices by immediately purchasing 60 per cent of the equity.

The management of RBS which engineered that merger, although now criticised for compromising the interest of shareholders by that decision, had obtained overwhelming support at the Extra-Ordinary General Meeting of shareholders called for the purpose of approving the decision; which might have appeared strange because adequate due diligence had not been carried out according to management. Agency theory predicts that in a dispersed shareholding, shareholders that are sceptical of management policy would sell up and exit. If the shareholders had large enough blocks to influence directors, they would do so by, amongst other means, voting against reckless proposals of management. As we shall presently see, there was no discernible exit of shareholders. Instead, there was overwhelming endorsement for the reckless policy which brought the bank to its knees a year later.

Only around 1 per cent of the shares were voted against the management decision at the meeting on 10 October 2007. About 9 per cent of the shares were in the abstention camp. The point to note is that the shareholders were not individuals, but shareholder votes were exercised by managers of companies which held parcels of shares. Votes on behalf of shareholders were cast by shareholder representatives. Agency theory would put the blame on the then management under Sir Fred Goodwin railroading the above mergers decision[4], but the overwhelming shareholder endorsement of the policy is at odds with that theory.

We suggest that the complicity of the shareholder representatives at RBS in the decision to take over ABN Ambro, a decision which is now cited as the reason for the subsequent collapse, cannot be properly understood exclusively as an agency problem, even as an agency within an agency framework. The seemingly macho culture of the corporate world which gave rise to the race for merger, we conjecture, may be a culture of

[4] In a court case where his application for a court order banning the publication of details of his private life was denied, the judge maintained that Sir Fred's "reputation as an exceptionally forceful businessman" and "doing business on a global scale" made him a figure of public interest(Sabbagh et al 2011).

conformity and pusillanimity in the presence of technocrats[5]. To this end, drawing on the Gramscian concept of hegemony, we hypothesize that the pervasive discourse of short-term profit maximization and light touch regulation of financial services, and the related (re) production of a homogeneous managerial/shareholder class with shared preferences in this regard, can explain this conformity (Collin and Stafsudd 1999; Levy and Egan 2003). We utilize Lukes' (2005) third face of power, ideological power, to suggest that the discourse of profit maximization and light touch regulation has become so pervasive as to close-off alternative ideological frames of reference. Put simply, managers and shareholders may see no alternative to the dominant discourse.

Let us first look at the shareholding pattern of Royal Bank of Scotland immediately prior to and following the controversial merger with ABN Ambro that is alleged to have been largely responsible for subsequent difficulties leading to virtual nationalisation of the bank. There are very few blocks of more than 3 per cent of the outstanding equity and none above 8 per cent. Even if one gets down to blocks of no more than 1 per cent of outstanding shares, there are at most between 20-25 blocks. The total holding of these top 20-25 shareholders is a little less than 50 per cent of equity. The rest is distributed even smaller than 1 per cent parcels amongst roughly 1400 shareholders. This pattern remains throughout the period examined here, both before and after merger. Tables 1 to 4 indicate some turnover in shares, certainly amongst the large block holder's, further investigation reveals that it does not indicate any systematic exit by any group of large block holder to be replaced by another. The cumulative holding by the top five is around 25 per cent for the entire period. Furthermore, it is also noticeable (Table 5) that the top five shareholders, those holding 3 per cent or more of outstanding equity, remain the same between 31 December 2006 and 31 December 2007. If there was some turnover of shares, it did not suggest an exit strategy due to dis-satisfaction with management.

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Insert tables 1-5 about here

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Despite some adjustments in their portfolio over the year, the top five shareholders remained at the top and there was no exodus of the holders of small blocks of shares. There is another salient feature to note. The shareholders were themselves companies, sometimes large companies holding small parcels of shares in RBS, and the decision to vote with RBS management was itself a management decision by the managers of these shareholding companies.

There were newspaper reports from early 2007 that RBS management wished to compete with Barclays, which was then in negotiation with ABN for merger, to acquire ABN for a price which was to be greater than the market value of the entire outstanding equity in RBS. A financial website, *This Is Money*, reported on 25 March 2007 that RBS management were planning to outbid the offer from Barclays to the shareholders of ABN Ambro. The BBC news website was reporting exactly a month later that a bid for £49 bn, about £10 billion above the amount offered by Barclays, was being dangled by RBS in front of ABN shareholders. Exactly a year

[5] Whether the unquestioning culture is a result of fear or the product of more subtle conditioning may vary between organisations. Citing former bank employees who have left the banking profession to write books, Cohen argues the following: in discussing the allegations of widespread criminality in News International: "Keeping mum is not so dumb in the British workplace until you consider the consequences" (Cohen 2011:41).

later, RBS shares went into a freefall and the crisis at RBS was such that only a sudden purchase by government of 60 per cent of the shares prevented complete collapse.

Insert Table 6 about here

There was no flight of either small or large shareholders from RBS when media reports about the decision of RBS management to increase the price on offer for ABN Ambro started to emerge. Despite some turnover in shares, the top five shareholders, those holding 3 per cent or more of total equity, remained the same throughout the year 2007 (Table 5 above). Amongst shareholders with the smallest 100 blocks, over 40 per cent increase their holdings during the year. The total number of small shareholders went up sharply in September 2007 as new shares were issued, taking the outstanding number of shares outstanding from 6068133142 at the start of the year to 6380915216. Some of these new shareholders promptly exited, even though the total number of shares in the company rose marginally to 6471887178.

There was neither shareholder activism nor shareholder exit to keep RBS management in check. The RBS management enjoyed a free hand, without shareholder interference through activism or through exit, which might have triggered a battle for the control of RBS itself. At the meeting of RBS shareholders on 10 October 2007, that has been mentioned earlier, three proposals were put to vote: i) to approve the acquisition, ii) to increase share capital to do so, and iii) to approve specific authority for management to issue shares. The voting figures are reported in Table 7 below. Percentages are calculated by reference to the total outstanding security on 31 September 2007. It is clear that none of the five major shareholding blocks registered any dissent. The smaller blocks also recorded support for RBS management. The voters' representatives, themselves often managers of large companies, could surely not have been bamboozled by the directors of RBS, unless these companies are managed by people who are deferential to the hubris of authority.

[Insert Table 7]

## 4. Speculations about competence

The question is the following. Why did so many captains of industry and commerce representing the shareholding blocks in RBS fall for a policy recommendation from the management of the company to recklessly embark on a course of action which would see the demise in the value of the equity holding of the companies they managed?

Those who still have faith in the superiority of finance capitalism over other forms of organisations would seek organisational efficiency through contracts, incentives and market opportunities. A successful organizational form minimises this conflict of interest between different stakeholders. In the British-American system of corporate governance, the influential work by Michael Jensen and colleagues (e.g. Jensen and Meckling 1976, Jensen and Ruback 1983) suggest that any conflict of interest between shareholders and managers can be mitigated through a market for corporate control. Shareholders need not inform themselves about the merits of policy options to further their own interest. The beauty of the market for corporate control lies in the absence of the need for shareholders to exercise informed franchise rights. They need not gather information about the details of how their capital is managed. They can put their faith in specialist intermediaries, arbitrageurs, who have the competence and resources to put together teams of experts to dislodge non-performing managers through takeover of companies that are not managed to maximise shareholder wealth (Jenkins and Ruback 1983).[6] Critiques of the above policy, those that derive also from agency theory, exhort shareholders not to throw away their right to franchise (Cadbury 1992, Hempel 1998).

Standard arguments about why shareholders may fail to stop managers from taking decisions that reduce shareholder wealth do not apply here in this case. Most of these arguments are based on agency theory, and they are predicated on the assumption that the shareholders' votes in a company are cast by shareholding individuals and not by managers of other companies representing shareholder interest.

The shareholders of RBS we note are also companies. Managers of shareholding companies exercised shareholder franchise at that fateful meeting on 10 October 2007 approving the management proposal for merger. They may have placed too much faith in the specialist advice obtained by RBS management within a culture, we conjecture, of conformity of a pernicious kind in the corporate sector. Given the fact that the shareholder franchise in RBS was exercised by managers of shareholding companies, we wonder if there is a process of sequential selection operating in the corporate sector that creates a culture of unquestioning deference to specialist advice by those that are not competent to take an independent view.

There are two types of mistakes at each selection stage. Some of those promoted to the higher level are mistakenly promoted and some of those that are rejected at the lower stage are indeed competent for promotion but are overlooked. These two different types of mistakes in the selection process can, under certain circumstances, lead to a culture of incompetence amongst the corporate class: the **conditional probability** of a person holding a higher level position being competent to hold that position could be less than the conditional probability of a junior employee being competent in his job as a junior employee (Chakravarty 1993, Kraekel 1998). If there is also a reason for overlooking some of the more competent people at promotion because of their lack of respect for hubris, there is need to address the issue of corporate culture and agency theory fails to do that.

## 5. The hegemony of profit maximizing finance capitalism

Corporate governance in the UK, notably in financial services, is dominated by an ideological (and, we argue, increasingly hegemonic) discourse propelled by an apparent messianic belief that short-term share-holder/profit maximization is most efficiently achieved by atomistic agents acting in free markets with little regulatory constraint. There are of course exceptions to the rule, but generally speaking, this ideology is pervasive and is

[6] This approach absolved the agency theory of having to find solutions to the corporate governance problem when shareholders have little voting power. Leech (2002) provides a discussion of voting power of shareholders.

(re)produced by a homogeneous managerial/shareholder class that legitimates the authority and expert power of an elite technocracy operating in silos to make decisions on its behalf (Bowman et al., 2013; Locke, 2009; Tett 2010). Bowman et al., (2013) note the seemingly entrenched presence of sectorally-based power elites in the UK, especially in sectors like financial services, whose decisions have been very difficult to challenge. This includes decisions, like at RBS, which actually damage shareholder value, the company itself and, ultimately, the wider economy. In a similar context of short-term finance driven capitalism and light touch regulation, Lazonick and O'Sullivan (2000:33) argue that the experience of the United States suggests that the way corporate actors go about pursuing maximization of shareholder value may be "an appropriate strategy for running down a company – and an economy". Locke (2009:28) raises similar points about how the "triumph of a science-based "New Paradigm" in business school management education and in industry", with an assumption that managerialist elites hold "exclusive possession of the codified bodies of knowledge and know-how", is responsible for the "financial debacle" that caused much damage to American industry.

Explaining the failure of the mainstream academic profession to anticipate these problems, some of the leading lights of the profession confessed in a letter to the Queen that "…against those who warned, most were convinced that banks knew what they were doing" (BA 2009). The consequences of events like those at RBS have been nothing less than what Engelen et al, (2011) term an elite debacle: this was a period of unprecedented hubris by corporate, political, economic, and academic elites, and the resulting crisis was not an accident, but a debacle of elite rule. With elite connivance, the financial system became a fragile model of excess, disconnection, and structural contradictions, the result being a systemic collapse with devastating economic and societal consequences that are still being played out (Engelen et al 2011). Judge Richard Posner reflects on the unholy alliance amongst elites in industry and academia that may have stymied critical enquiry. "The entwinement of finance professors with the financial industry has a dark side" (Posner 2009:259).[7] Whether it is indeed conflict of interest or pure blind faith in technocracy, the academic has produced plenty of cheerleaders for rewarding corporate failure in the name of aligning the corporate bureaucracy with entrepreneurial capitalism. For example, Jensen and Murphy (1990) take issue with concerns expressed in the press and elsewhere in public discourse about vast increases in management salaries that are not correlated with rewards for shareholders. They argue that the shareholder interest would be better served by paying even higher salaries, on average, than the salary levels which have caused public concern so that poor performance could be punished by reduction in bonus. Even this is too much for those in academia who place their faith in technocracy being able to mimic the pristine world of entrepreneurial capitalism. Thus the above suggestion of downward flexibility is disputed on the ground that a symmetrical reward structure which punishes managers when the outcome for shareholders is poor would discourage risk taking behavior entailed in entrepreneurial success (Landsburg 1995: 27):

> "To the stockholder, the executive is just another employee, and like any employee he must be prodded to perform. One area where a little extra prodding might be called for is in the area of risk taking. Stockholders are

[7] As problems mounted for the global financial system, but before the implosion of 2008, one of the senior professors at Columbia Business School, an Ivy League institution, and an erstwhile member of the Federal Reserve Board, Professor F. S. Mishkin, was waxing lyrical about the benefits of financial liberalization in Iceland. A commissioned report by Tryggvi Herbertson and Frederic S. Mishkin entitled "Financial Stability in Iceland" issued by the Icelandic Chamber of Commerce at Reyjavik in 2006 has received critical attention for its naïve approach to financial liberalisation in Iceland which was to create havoc for the Icelandic economy in two years' time.

> generally favorable to risky projects with high potential rewards. The reason for this is that stockholders are usually well diversified. If the project fails, your stock could become worthless, but that is a risk you might be willing to take if that stock represents only a small fraction of your entire portfolio.
>
> Executives, by contrast, typically have large parts of their careers riding on the fortunes of a particular company and accordingly tread gingerly when risky projects come their way. From the stockholder's viewpoint, this is bad behavior and should be discouraged. The most direct form of discouragement is to monitor the executive's behavior and punish excessive caution. But if the stockholders were going to monitor every executive decision, they wouldn't need to hire an executive. In practice, stock holders don't have enough information to enforce their preferences directly".

Thus punishment for failure is not a sensible contractual option to encourage risk taking behavior by corporate management. This is the conclusion derived by Landsburg from an agency theory perspective.

Olivier Blanchard, later to become the director of the research department at the International Monetary Fund, was to write in the year 2000 that "progress in macroeconomics may well be the success story of twentieth century economics" (Blanchard 2000: 1375)[8]. He was writing when money was being created by the banking system using new methods, the properties of which were unknown. Consider again Judge Richard Posner (2009: 58): "…risk assessment had to be based on models rather than experience", and these complicated mathematical constructs were later to be found meaningless, as made clear in the above mentioned apology to the Queen from leading members of the economics profession writing under the auspices of the British Academy (BA 2009):

> "Risk calculations were most often confined to slices of financial activity, using some of the best mathematical minds in our country and abroad. But they frequently lost sight of the bigger picture…. People trusted the banks whose boards and senior executives were packed with globally recruited talent and their non-executive directors included those with proven track records in public life. Nobody wanted to believe that their judgement could be faulty or that they were unable competently to scrutinise the risks in the organisations that they managed. A generation of bankers and financiers deceived themselves and those who thought that they were the pace-making engineers of advanced economies."

With regard to the importance of the concept of hegemony for understanding these events, the most significant insight from Gramscian and neo-Gramscian theory is that the persistence of social and economic structures is not dependent on power exercised overtly by a dominant élite. Rather, hegemony rests on a broad base of consent channelled through ideologies that promote perceptions of a mutuality of interests (Levy and Egan 2003). For the purpose of this paper, the hegemony of short-term profit maximizing agency (together with light touch regulation) as an ideological preference shared by many managers is, we believe, shaped by the holistic configuration of a number of interrelated macro and micro-level factors which, together, create the conditions for more or less systemic hegemony (although we do not claim hegemony is total, uncontested, or uniform across all contexts).

[8] This issue is discussed in detail by Skott (2009).

At micro-level, the managerial selection process inside organizations may weed out managers who do not conform to the discourse of profit maximization/light touch regulation and appoint and promote those that do. Corporate cultures, and bureaucratic authority structures, processes and social relations, such as those at RBS, might be expected to further entrench the dominant discourse as managers rise through the ranks. Broader macro hegemonic forces also serve the dominant orthodoxy and cement the position of a corporate power elite, including the education system, media, political, economic, regulatory factors, and so forth (Mills 1957; Collin and Stafsudd 1999; Levy and Egan 2003; Tett 2010; Engelen et al 2011; Hutton 2011). As observed earlier, the fact that many members of the managerial class attend the same Business Schools and courses, in the process learning similar ideas about the supposed supremacy of shareholders and efficiency of a perfectly competitive free market, serves to cement the hegemonic grip of profit maximizing orthodoxy. Notwithstanding some nuances in corporate governance, the dominant model in the UK (and similarly in the US) remains servicing short-term shareholder primacy, rather than developing longer-term collaborative stakeholder approaches along the lines of other European countries like Germany (Armour et al, 2003; Hutton 2011; Lazonick and O'Sullivan, 2012). This is buttressed by structural and ideological preferences for light touch regulations in financial services (and in many other spheres, including labour markets) by politicians and corporate leaders. Therefore hegemonic power may operate through the complex ways in which economy and society are structured, through ideological forces, as well as through conscious action by the powerful.

Lukes' (2005) third face of power, ideological power, is relevant here, and his idea is that power can be utilized in covert less observable ways. Ideological power concerns the power to shape and manipulate peoples' interests, and even persuade people to act against their own real best interests. With regard to RBS, for example, company/management shareholders voted in favour of proposals even though they then turned out to be detrimental to their best interests. This conformity can be set against acceptance of the largely unquestioned ideological discourse that 'expert' management technocrats, such as those at RBS, are best placed to maximize shareholder value. This discourse buttresses the status quo, particularly in the absence of alternative counter-mobilizations against the dominant model.

## 6. Conclusions

The existence of corporations is problematic for the market model in economics in that the model of an efficient economy as a perfectly competitive economy fails to describe reality (Coase 1988, Milgrom and Roberts 1982). The basic assumption of the model of perfect competition, that the economy comprises self interest optimizing economic agents each operating on their own, is kept intact in the agency theory of corporate management. There is an emerging body of the literature questioning whether this narrow focus is able to shed light on complex forms of organizations such as large corporations. In our view, organizations develop their own methods of discourse and a culture of unquestioning belief in accounting numbers produced by specialists may be the culprit in many of the disasters we witness in the corporate sector. The belief "that the economic 'real' itself can be produced and authorized by financial professionals", to quote a phrase from Ailon (2011:150) describing the unfolding of the collapse of Enron Corporation, may provide a more fruitful route to the examination of corporate failure than explanations based exclusively on agency theory.

In a different context, when the Queen asked assembled eminent economists and academics why none of the bright minds had anticipated the financial crash, the aforementioned letter of apology acknowledged "the failure of the collective imagination of many bright people" (BA 2009). It is the "psychology of herding" encouraged by rewarding self-referential publications of seeming technical complexity but devoid of content for career advancement of economists that might be the culprit in this jigsaw puzzle. Fear of asking if the emperor had clothes was at the root of the problem. The fear was a defining characteristic of the academic culture, and the above letter apologises on behalf of the profession for blindly embracing that culture. We conjecture that the problem of conformity also applies to corporate culture and that problem is not addressed by agency theory of corporate governance.

Our argument is that the complicit corporate culture of conformity and managerial/shareholder preference similarity in organizations like RBS can be best viewed through the conceptual lens of hegemony and ideological power and discourse, which lie at the structural and agency root of such conformity. The agency theory literature detracts from critical examination of how power, mobilized often covertly in various hegemonic guises, has become concentrated in many British corporations in the hands of an elite management technocracy operating in silos.

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## TABLES

Table 1: Distribution of RBS Shares 31 December 2006

| Block size | No of blocks | % of equity | Cumulative % of equity |
|---|---|---|---|
| More than 7% | Nil | | |
| 6+ to 7% | 2 | 12.56 | 12.56 |
| 3+ to 6% | 3 | 12.56 | 25.12 |
| 2+ to 3% | 4 | 9.34 | 34.46 |
| 1+ to 2% | 10 | 13.40 | 47.86 |
| 1% or less | Approx 750 | 52.14 | 100 |

Source: Thompson Reuters

Table 2: Distribution of RBS Shares 31 March 2007

| Block size | No of blocks | % of equity | Cumulative % of equity |
|---|---|---|---|
| More than 7% | Nil | | |
| 6+ to 7% | 1 | 6.29 | 6.29 |
| 3+ to 6% | 4 | 17.39 | 23.68 |
| 2+ to 3% | 4 | 9.53 | 33.21 |
| 1+ to 2% | 9 | 12.32 | 45.53 |
| 1% or less | Approx 850 | 54.47 | 100 |

Source: Thompson Reuters

Table 3: Distribution of RBS Shares 30 September 2007

| Block size | No of blocks | % of equity | Cumulative % of equity |
|---|---|---|---|
| More than 7% | Nil | | |
| 6+ to 7% | Nil | | |
| 3+ to 6% | 5 | 22.64 | 22.64 |
| 2+ to 3% | 2 | 4.80 | 27.45 |
| 1+ to 2% | 14 | 19.94 | 47.39 |
| 1% or less | Approx 980 | 52.61 | 100 |

Source: Thompson Reuters

Table 4: Distribution of RBS Shares 31 December 2007

| Block size | No of blocks | % of equity | Cumulative % of equity |
|---|---|---|---|
| More than 7% | 1 | 7.80 | |
| 6+ to 7% | Nil | | |
| 3+ to 6% | 4 | 16.67 | 24.47 |
| 2+ to 3% | 1 | 2.46 | 26.2 |
| 1+ to 2% | 17 | 24.56 | 51.50 |
| 1% or less | Approx 820 | 48.50 | 100 |

Source: Thompson Reuters

Table 5: Top 5 Shareholders

| | Percent of outstanding equity held on | | | |
|---|---|---|---|---|
| Name | 31 Dec 06 | 31 Mar 07 | 30 Sep 07 | 31 Dec 07 |
| Legal & General Investment Management Ltd. (UK) | 6.29 | 6.29 | 5.98 | 7.80 |
| Barclays Global Investors (UK) Ltd. | 6.27 | 4.73 | 4.50 | 4.44 |
| Capital Research & Management Company | 4.73 | 4.73 | 4.49 | 4.43 |
| M & G Investment Management Ltd. | 4.20 | 4.23 | 3.75 | 3.57 |
| Standard Life Investments Ltd. | 3.64 | 3.71 | 3.92 | 4.23 |

Table 6: Stock market valuation of shares (£bn)

| Bank | 15 Oct 2007 | 10 Oct 2008 |
|---|---|---|
| Barclays | 41.0 | 17.0 |
| Royal Bank of Scotland (RBS) | 41.7 | 11.0 |

Source: Thompson Reuters as reported by BBC on 13 October 2007

Table 7: Votes on proposal by RBS management on 10 October 2007

| | Votes | % Of total equity outstanding on 31 September 2007 |
|---|---|---|
| FOR | 5741774485 | 89.98 |
| AGAINST | 67318357 | 1.05 |
| ABSTENTION | Rest of the shares | 8.97 |