Emerging Trends in the Post-Regulatory Environment: The Importance of Instilling Trust

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Abstract The financial services industry is one of the most critical pillars of economic growth and sustainable development in any country. As such, the findings of the 2016 Edelman Trust Barometer, that measures trust in institutions with more than 33,000 respondents in 28 countries over the last 15 years, are highly alarming. Accordingly, the financial services industry is ranked among the lowest with a mere 51 % on a global basis. Despite this darkened outlook, areas exist that seem to be promising: Sustainability management, responsible innovation and the organized and systemic efforts to increase transparency, comparability, accountability and reliability. Although the recent crises in financial markets have led regulators to come to a general agreement that a mutual effort is needed to develop procedures for increased compliance standards, and increase the pace of harmonization in accounting and financial reporting standards, the industry is faced with an imminent challenge: The low levels of trust in financial services. In this chapter, the author discusses how to re-build trust and reputation of the industry.

1 Introduction

There are some industries in which trust, confidence, the feeling to be in "good hands", a gut instinct that the particular company is "the right one" for you, weigh relatively more heavily as a decision factor when considering to start or continue working with that specific institution. Financial services institutions are intermediaries with whom most people entrust their nest eggs and rely on these financial "trustees" to keep them safe and ready to be returned with an "interest" when asked to do so. Be it for investing or even speculating rather than saving purposes, risk-

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savvy investors, too, do exercise judgment over whether their financial institution is worthy the opportunity cost of not working with an alternative competitor.

The study of trust has been attracting diverse groups of researchers for long. Hence, various measures, definitions and drivers of trust depending on the discipline of the scholar, the types of stakeholders and the industry specifics (Huberman 2001; Tyler and Stanley 2007; Guiso et al. 2008), have thus far been determined.

The concept of trust in relation to financial services can be addressed in a systemic context (w.r.t. financial markets and their instruments), or on an institutional basis (ie. the confidence customers have in local banks, their stock brokers or insurance agents). Clearly, the financial system is comprised of markets, institutions, instruments and stakeholders, who all interact and create chain reactions, causing spillover effects and are even contagious on international levels. However, this chapter focuses on the institutional perspective and how financial institutions, in specific, can and do tackle customer trust, confidence and reputation-related issues.

Without the existence of risk or uncertainty about the outcomes of certain actions, trust would not be needed. Trust inherently is associated with vulnerability and individuals are potentially willing to accept such on basis of positive expectations about the intentions or behavior of another in a situation of interdependence and risk (Ennew and Sekhon 2007).

The financial services industry is, by far, one of the most versatile industries, which also determines its risk and return potential. In that sense it is uniquely fragile as it mostly relies on human sentiment. What makes it so unique, and, volatile at the same time, can easily be understood by examining the size and scope of financial innovations, some of which are shown in Fig. 1. As trade began to flourish, so did the financial system. In ancient Greece and during the Roman Empire, lenders based in temples made loans and deposits, and changed money. Archeology from this period in ancient China and India also shows evidence of money lending activity. Whereas the medieval and Renaissance Italy and particularly the affluent cities and wealthy merchants of Florence, Venice and Genoa are attributed the greatest role of the development of the modern banking system. Seventeenth century Amsterdam set the stage for many financial innovations such as the first joint stock company in history, the Dutch East India Company. It is often considered to have been the first multinational corporation in the world and the first company to issue stock. Undoubtedly, the invention of the automated teller machine (ATM) at the end of the 1960s, the advent of telephone banking by the mid 1980s, and the bloom of Internet banking in the 1990s laid the foundation of today's "modern" financial services industry with concurrent regulatory gaps either paving the way to misuse of innovation or constraints opening up the stage for disruptive competitors, such as new generation financial intermediaries, like crowdfunding platforms, or cryptocurrencies, like Bitcoin.

Marked by global macroeconomic instability and increased disruption, the financial services landscape clearly needs to restore trust and boost its clientele's confidence, which is comprised of retail banks, insurance companies, investment banks, accounting, audit and consumer finance companies, among others.

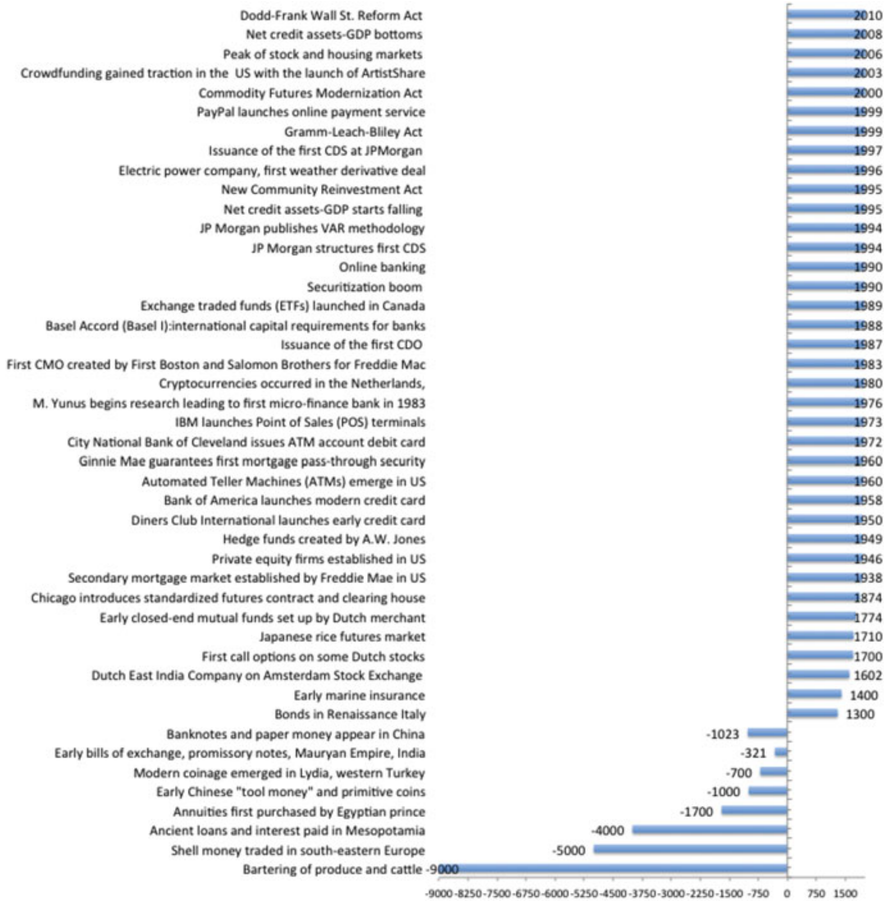

Fig. 1 A short account of financial services history. Source: Author's own elaboration, information is drawn from various sources (http://www3.weforum.org/docs/WEF_FS_RethinkingFinancialInnovation_Report_2012.pdf, https://bitcoinmagazine.com/articles/quick-history-cryptocurrencies-bbtc-bitcoin-1397682630, http://www.money-zine.com/investing/investing/collateralized-mortgage-obligations/, https://www.imf.org/external/pubs/ft/wp/2010/wp10164.pdf, http://w4.stern.nyu.edu/research/technological_change_and_fin_innovation_in_banking.pdf, http://www.freedman-chicago.com/ec4i/History-of-Crowdfunding.pdf)

The 2016 Edelman Trust Barometer[1] reveals that the financial services industry, although being on an upward trend since 2012 with an eight-point increase, ranked last in the 28-country survey of the general population with a trust rating of 51 %.

[1]Source: http://www.edelman.com. The 2016 Edelman Trust Barometer surveyed more than 33,000 respondents with an oversample of 1150 general population respondents ages 18 and over and 500 informed public respondents in the U.S. and China and 200 informed public respondents in all other countries representing 15 % of the total population across 28 countries.

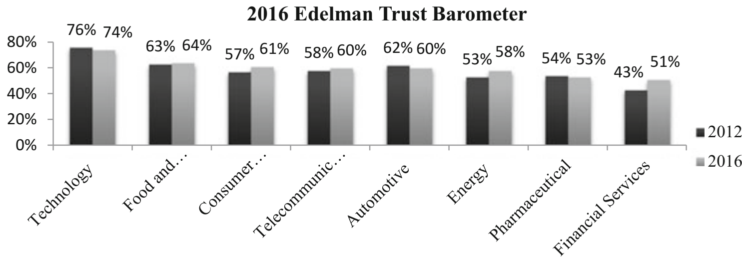

Fig. 2 2016 Edelman Trust Barometer. Source: http://www.edelman.com/insights/intellectual-property/2016-edelman-trust-barometer/

According to the results, the public is not only interested in adherence to profit-related goals but is also perceptive towards the societal contributions of firms. Integrity and engagement are among the potential drivers of lower trust levels. The previous, 2015 Edelman Trust Barometer, on the other hand, pointed out that only technology-related innovation in the financial services industry, that is electronic and mobile payments, garnered more trust than the industry itself.

According to a PwC report (PwC 2014),[2] the problem the industry faces, is bigger than trust. It is about the apathy and frustration of its clients who feel that all financial services institutions are the same. Anxieties have multiple drivers, (except for the investment banking sector that is most influenced by press coverage), personal experience is the most significant factor determining the trust level followed by press coverage, transparency of price and terms/conditions and word of mouth. According to the said report, among the factors that might improve consumer trust comes greater transparency on products and services (46 %), stricter codes of conduct for employees (41 %), changes to remuneration rules (40 %) and improved internal governance (37 %) (Fig. 2).

Reputation and trust are closely related. Jaffer et al. (2014), assert that strong trustworthiness, willingness and competence in keeping commitments, requires that the responsible institutions for delivering an obligation both, render an account of their performance, and be held accountable for such. To that end, informed and objective performance appraisal (what has been done and clearly communicated and enforceable standards of what ought to be done) and clear accessible communication of such is necessary.

Kindleberger and Aliber (2005) explain that the history of the financial services industry has been the stage for a multitude of bubbles, scandals, crashes, panics and fraudulent activity. Clearly, recent financial crises, such as the 2008 US Housing Bubble resulting in the sub-prime mortgage crisis (the financial crisis of 2008), the 2001 US Internet stock crash, the 1985–1989 bubble in real estate and stocks in

[2]The report is based on analysis of a survey of over 2000 people across the UK.

Finland, Norway and Sweden, and the bubble in real estate and stocks in Thailand, Malaysia, Indonesia and several other Asian countries have not contributed positively to customers' perceptions of financial services institutions. Kindleberger and Aliber differentiate between bubbles that are swindles and those that are not. According to the scholar, the Mississippi Bubble was not a swindle; the South Sea Bubble was. A bubble is said to generally start with an apparently legitimate or at least legal purpose. Accordingly, what became the Mississippi Bubble initially started as the Compagnie d'Occident, to which the Law system added the farming-out of national tax collections and the Banque. In the South Sea Bubble on the other hand, the monopoly of trade in the South Atlantic is said to be purely incidental (Kindleberger and Aliber 2005: 190).

Whether or not investors in financial markets can differentiate between purposeful and incidental financial tragedy though is a different concern.

2 Background

Be it retail or wholesale finance, the sources and drivers of trust (or distrust) are more or less the same across the globe.

Llewellyn (2014) discusses the importance of trust in financial services, with particular emphasis on the UK. According to the author, some of the several structural and behavioral elements as a result of which trust has been lost include: (1) Succession of high-profile scandals, the (complex) nature of financial products and services and the vulnerability of retail customers' trust is an important issue, (2) numerous episodes of mis-selling of some financial products, (3) a lack of diversity w.r.t. ownership structure of financial firms, corporate governance arrangements, capital structure and primarily business models, the latter reducing consumer choice and effective competition, (4) the fact that relationship banking has given way to transactional banking, which in turn has promoted a sales culture and potentially hazardous incentive structures within banking and other financial firms, (5) a serious erosion in the application of the principles of the "Treating Customers Fairly" regime, which was imposed on the retail financial services industry by the then regulator—the Financial Services Authority (FSA) (in the UK), (6) low priority given to ethical standards within financial firms, (7) the existence of perverse incentive structures inherent in the shareholder value maximization model and within financial firms in forms such as bonuses and salaries, (8) Opportunistic cross-subsidization by life assurance firms, who offer new customers better returns than existing ones, (9) unjustifiably high and complex charges in a complex intermediation setting and the lack of transparent pricing, (10) the lack of truly effective competition in some retail markets, (11) the lack of access to financial products and services for some consumers (financial inclusion issues), and (12) the fact that independent advisory market is weak due to the exit of several retail banks as a result of regulatory changes.

A survey (IPSOS 2013), conducted on 19 financial institutions measured across 25 countries, identifies key drivers of trust in financial services as: (1) experience/aspiration, (2) commitment to customers, (3) personal relationship, (4) the value of products and services, (5) transactional care, and (6) expertise/authority. According to this survey, payment-processing companies enjoy a much better reputation than do banks. Furthermore, the study determines that in nearly all emerging markets, domestic banks receive very high net trust scores—widely larger than do non-local banks on average.

Llewellyn (2014) furthermore argues for diversity in the financial system, in a way that promotes risk-diversification and states that there are clear economic, systemic and welfare benefits to be derived from a successful mutual or cooperative sector in the financial system. He further argues that a financial system populated by diversity of ownership and governance structures, and with contrasting business models, is likely to be more competitive and systemically less risky than one populated by a single dominant model, whatever that model might be. What follows from these arguments is that there is a public policy interest in fostering diversity in the financial system.

Herman (2015) reports that JPMorgan Chase launched The Financial Solutions Lab, in partnership with the Center for Financial Services Innovation (CFSI) to specifically address the issue of diversity. The motivation for this endeavor is the manifestation that low-income American families spend the same share of their yearly income on interest and fees as the average American household spends yearly on food. Moreover, low-income households are said to face financial literacy and infrastructure challenges at a much higher rate than the average American household. Consequently, it is implied that access to financial products and services is necessary to achieve full participation in the global economy. Thus, thus the accessibility of innovations can help increase savings, improve credit, and build assets.

Accenture consulting explains how technology can be used to rebuild consumer confidence, by not only being fast and flexible in their innovative banking application roll-outs, but also by being more responsive to customer needs with new products and services. This necessitates devising new ways of interaction with customers and investing more to learn about details of consumer attitudes to be able to separate hype from reality.[3] In that sense, big data analytics and, proper use of such, can provide key insights to trends and fads in consumer behavior. Academic literature, too, has already acknowledged the importance of big data analytics in understanding consumer confidence (Choi and Varian 2012) and investor sentiment (Son-Turan 2014).

In an effort to understand how consumer trust in financial services can be restored, the Social Market Foundation (2011) underscores that consumer trust and strong economies run in tandem and determines in its report that introducing 'simple products' may be one method of achieving this, but advises that the industry

[3]https://www.accenture.com/us-en/insight-financial-services-technology-rebuild-consumer-confidence.aspx

should also adopt a more sophisticated approach that explores how innovation and new technologies can simplify the consumer experience and enhance their interaction with financial services. According to the report, this would enable the delivery of faster, safer and more convenient ways for consumers to handle their finances, independent of government intervention. Furthermore, with regards to the proposition that financial crises have been the major cause of declining trust, the findings show that more long-term drivers, such as the distinctive nature of consumer finance products, are more instrumental in defining the concept of trust. Finally, the report proposes two interventions: First, the regulator should create a kite-mark for a wide range of privately provided 'trusted financial products', from current accounts to pensions, which would conform to mandated standards and act as market norms against which all other products could be compared. Second, having secured product quality through the 'trusted product' kite-mark, competition between providers should be strengthened.

However, whether regulation is a substitute for reputation is another issue and beyond the scope of this article.

A Global Consumer Banking Survey (EY 2014), which includes responses from over 32,000 retail banking consumers across 43 countries, explores the role of trust in creating customer advocates and how valuable trust is to the overall banking relationship. To that end, it established that the one most sought after benefit that needs improvement is the transparency of fees and simplicity of offers and communication. Secondly, while customers are satisfied with the convenience of traditional banking, their expectations are constantly rising as new technologies and consumer benefits develop. The findings of the report suggest that trust is mostly associated with the customers' experience of how they are being treated, followed by communication and problem solving.

3 Literature Review

The role of trust, confidence and reputation in financial services has been addressed frequently in academic literature. Tyler and Stanley (2007), in their qualitative research based on 147 in-depth interviews with corporate bankers and their clients, find that small companies are more trusting than large corporates. Furthermore the authors establish that, bankers use calculative and operational trust and were cynical about their counterparts' trustworthiness. Pi et al. (2012), propose a framework of intention to continuously adopt online financial services and suggest that (1) website trust influences on the intention to continuous adoption of online financial services, (2) cognitive trust of online customers influences on affective trust, (3) factors of transaction security, website and company awareness, prior Internet experience, and navigation functions directly influence on cognitive trust of online customers, and; (4) transaction security is the only factor that influences on affective trust of online customers. Bejou et al. (1998), examining the relationship between trust, ethics and relationship satisfaction establish that from the customer's perspective, the determinants of relationship satisfaction are thought

to include factors such as customer orientation, trust, length of relationship, expertise and ethics. Nguyen and LeBlanc (1998), using data collected from 1224 customers in the banking service industry satisfaction and service quality are positively related to value and that quality exerts a stronger influence on value than satisfaction. Howcroft et al. (2007), suggest that the financial services and products market consists of distinctive customer segments and that the majority of bank customers are still essentially "passive" and there appears to be an overwhelming customer need for more product information and more involvement with banks. Gill (2008) explores how consumer trust can be restored in financial services and provides financial services marketers some insight into the future of online advertising and explains the benefits of adopting a dual approach of both brand advertising and search marketing to restore consumer confidence. Prahalad and Ramaswamy (2004) pose the questions whether financial services firms should have a "consumer bill of rights"? and Ogrizek (2002) looks into the effect of corporate social responsibility on the branding of financial services.

On the other hand, the financial services loss-of-reputation literature seems to be more populated after 2008, coinciding with the global financial crisis. Brown and Whysall (2010) for instance, explore the perceived paradox whereby companies in Britain's financial services sector were externally promoted as "world class" yet on a major peer survey of company reputations performed relatively weakly. The authors mention of the possibility that recent events are seen as somewhat resolving the paradox in that low reputation has apparently been justified by crises in the sectors. Mintz (2016) discusses the disagreement on who was to blame for the sub-prime mortgage crisis and argues that ethical lapses in the financial services industry were an important cause. The author also draws attention to the fact that technology and better use of big data could also allow banks to use nontraditional standards for lending.

4 Conclusion

Compliance, especially starting with the Sarbanes Oxley Act, has been thought to be an effective tool, not only in hindering potential fraudulent activity, but also thereby instilling the trust lost in financial services. However, surveys like the Edelman Trust Barometer mentioned previously, imply that these measures have not been enough and the public, and especially the millennials, which form a huge percentage of the near future financial services customer base, cares about social responsibility rather than simple control and compliance, which are more or less de facto mechanisms nowadays.

The mind of a typical member of Generation Z ("Gen Z"[4]) is a crowded place (Holland 2013). Gen Z-ers are already the biggest generational group in the U.S.,

[4]Individuals born between 1995 and 2012, according to http://www.socialmarketing.org/newsletter/features/generation3.htm

having overtaken the millennials in what Sparks & Honey describe as a coming "demographic tsunami" (Bershidsky 2014). An article by the Wall Street Journal (WSJ 2016) reports that the first wave of Gen Z's 1.8 million job candidates will enter the labor force in May 2016 and, like preceding generations, they come weighted with unique characteristics determined partly by the events and technology that helped shape their formative years. The same article highlights findings of a study from Randstad Holdings and Millennial Branding that portrays the digital dependency of this generation: 84 % of Gen Z sleep with their phones. More and more do we see headlines in popular media such as; "Gen Z is about to rock the banking industry" (WSJ 2016), "Generation Z' is entrepreneurial, wants to chart its own future" (Northeastern News 2014), and "The money mind-set of Generation Z" (Holland 2013).

To conclude, this chapter has portrayed a major concern for the financial services industry: the declining trust of customers and investors, and the concurrent loss of reputation. Understanding the dynamics underlying these developments will help financial services companies revamp their product and service offerings by adapting to the changing social, environmental and economic conditions. It is advised to particularly gain a deep understanding of the needs and demands of the newer generations and embrace their values. Secondly, transparency in management and reporting, with universally agreed upon rules and regulations, should be a de facto understanding across the industry.

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