Fast-changing technology and some dubious business practices are eroding customer and public trust, especially in the finance sector. **Paul Kofman** suggests some remedies

A Matter of Trust

Despite a lack of trust in financial institutions, we are increasingly reliant on their services for our daily payments, our investment loans and mortgages, and pension investments. Surely that cannot be a sustainable relationship between a financial sector and its customers?

Growing up in a small rural village, I remember that bankers were once held in high regard. The bank manager sat alongside the local GP, the police commissioner and the notary in public esteem… but that was before the bank branch closed its doors and the bank tellers retrenched, replaced by an ATM.

Of course, these structural changes were not unique to the banking sector. Over the years technology introduced a distance between service providers and their customers in many industries. Yet it seems to have disproportionally damaged our trust in the financial services sector. The local bank manager was entrusted with the finances of the community, was invested in the community and could be held accountable by that community. Suddenly, those connections were lost.

Mind you, in those days financial transactions were limited in number and variety, and straightforward to understand. Information asymmetry and complexity were minimal. Financial deregulation changed all that. It triggered intense competition for market share through product differentiation, diversification of business lines, and vertically integrated mergers and acquisitions. Banks turned into financial institutions that catered for all our financial needs – and created needs we didn't even know we had…

Financial advisory services became the key to encourage prospective (and existing) customers to benefit from an ever-expanding portfolio of banking services. Suitability and individual circumstances did not always feature prominently in the advice given. Compensation structures often provided incentives that tilted priority away from clients' interests.

Undeniably, all that choice enhanced customer satisfaction and provided many new opportunities to borrow, save and invest to achieve life's goals. I don't think there is much evidence to suggest that the public wants a return to reliance on the local bank branch. But along with deregulation came a marked and steady decline in the public trust in financial institutions – as conveyed by the annual trust-in-professions surveys.

Key features of Australia's financial system, including its "four pillars" policy and the independence of its Reserve Bank, allowed it to avoid the worst of the 1997 Asian Financial Crisis, the 2001 dot-com collapse, and the 2008 financial crisis. From a systemic point of view, this exceptional performance over a quarter century should have earned it the people's trust.

Other features of Australia's financial institutions include the banks' exceptional profitability given an apparent lack of competition and aggressive cost cutting via branch closures. Add to that an excessive focus on mortgage lending and (at times) a failure to pass on official interest rate cuts to home loan customers.

That concentration on home loans in bank portfolios also seems to have crowded out small business loans. It might not surprise that the public perception of banks' behaviour is one that sets prices and rations loans at the expense of its customers.

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To be clear, those trust surveys do not really distinguish between financial systems, institutions, practitioners, markets or products. Australia's financial system may be the envy of the world but a particular product (say a car financing loan) offered by an otherwise highly reputable bank could be grossly unfair or unsuitable for someone with limited financial means. Then who is to blame for that mismatch?

Where ethical mishaps were once attributed to rogue traders and fraudsters, the 2008 crisis highlighted institutional and systemic shortcomings across the sector. Failure to uphold ethical standards in a trading division of an investment bank affects the entire sector. It's everyone's problem and one that requires a shift in taking responsibility to repair trust.

Right now, with the global finance sector under scrutiny, Australia's *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* highlights much of what we already know from numerous inquiries into the sector. Invariably, they diagnosed and documented the problems. Yet their proposed recommendations for reform often got caught in party politics or legal loopholes.

Much of the evidence to date suggests that instances of misconduct or unethical behaviour can be traced to conflicts of interest. Finance professionals have a duty to their clients but do not always put that ahead of their duty to their employer. And private interests may also interfere.

Too many institutions consider a declaration of conflicting interests the gold standard. And it might be for a financially sophisticated client of an investment bank who will know how to discount biased advice. But consider retirees with limited financial literacy. Can they be reasonably expected to infer what that declaration means for the priority of their interests? Or what the financial consequences would be of biased advice? Clearly not.

In this latest inquiry, new examples of conflicts of interest and persistent failure in a bank's duty to its clients continue to surface – and suggest that little progress has been made to satisfactorily address compensation incentives that prioritise personal or institutional interest over client interest.

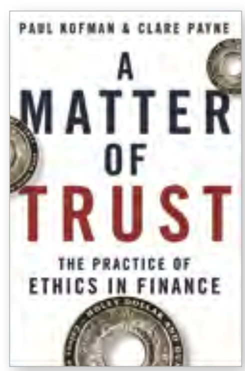
Whereas previous inquiries focused on the victims of unethical financial practices – and possible financial redress – the Royal Commission has so far uncovered that the practices persist, with banks arguing that competitive pressures prevent them from being first-movers to change incentive structures. That attitude may be short-sighted with traditional finance under threat.

We are on the cusp of the next technological disruption, bringing us block-chain, mobile payment devices and robot advice. It is different from the introduction of ATMs. No longer is it just the large major banks rolling out cost-saving technology; but small niche players – entrepreneurs – are picking off highly profitable business lines, market segments and products from the large conglomerate financial institutions.

By specialising in a single service platform customers may escape commission-driven conflicts of interest. Personal finance advice would be available at low-cost and in real-time. Fintech promises to shake up the industry profoundly and make it more competitive, accessible and trustworthy.

But it is not all good news. A robot's lack of understanding of personal circumstances and internet banking privacy breaches feature prominently on the Fintech ethical concerns list.

Over 450,000 individuals work in Australia's financial services sector and there are many good people among them who share our concern about a lack of trust. These individuals should be empowered and motivated to serve Australians and help to grow their wealth and prosperity.



Our book, *A Matter of Trust*, provides a practical guide for those in the sector and those wishing to join, so that they can raise the standards and ensure an ethical finance system that benefits all.

We believe that industry and academia can and should work together in rebuilding the trust in finance. Unlike accountants and actuaries, no generally accepted accreditation standards apply to finance practitioners.

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That needs to change; but it can only be achieved if the finance industry supports it. Training students of finance needs to include an understanding of the nexus between ethics and trust. Putting students and practitioners in training situations where they face typical ethical dilemmas will enable them to first recognise an ethical issue and then make an informed response based on a good decision-making model.

Fintech presents the opportunity to design fair and transparent markets and platforms from ethical principles. Our colleagues in the Economics and Finance Departments design market experiments and test financial service scenarios in a behavioural laboratory. This is an exciting new area for the social sciences that brings together the disciplines of finance and economics, with information science, sociology, psychology and even neuroscience.

Beyond the classroom, we need to work together on improving financial literacy throughout society. Despite the plethora of financial literacy programmes offered over the years by banks and regulators, we seem to make little progress. Too often, we find that financially literate people are making poor financial decisions. The problem is a mechanistic approach to financial literacy that ignores ingrained behavioural biases. There is a role for academia to offer independent financial literacy training that includes a behavioural bias module.

And then there is a duty on us, the engaged academics, to explain the role and inner workings of the financial system to the public. When the system is under threat – as it has been in the wake of the 2008 financial crisis – it is our duty to scrutinise its failings and reconnect the public to the long-term benefits of a fair and transparent financial system to economic growth and prosperity.

That requires a realisation that finance serves society rather than just its customers and shareholders. And that involves translating heightened community expectations into ethical business practices that engender trust in our financial sector.

About the Author

Paul Kofman is Sidney Myer Chair of Commerce and Dean of the Faculty of Business and Economics, University of Melbourne, Australia. He is co-author with Clare Payne of A Matter of Trust – the Practice of Ethics in Finance