Trustworthiness in the financial services industry was eroded by deregulation and the changes to industry structure and remuneration which followed. Deregulation was based on a belief that the self-interest of individuals would produce good outcomes (Adam Smith’s ‘invisible hand’) and economists’ belief in efficient markets took this idea further by assuming that all individuals are selfish, and have no regard for the interests of other people. However although Smith accepted that individuals may be self-interested, he also believed that they have ‘other-regarding’ motivations, including a desire for the approbation of others. This book argues that the trust-intensive nature of financial services makes it essential to cultivate such motivations, and provides proposals for how this might be done. The book suggests reforms of governance, and of legal and regulatory arrangements, to address these issues by seeking to change the ethical culture to one that reinforces other-regarding behaviour. Such proposals would encourage firms and individuals in the financial services industry to act in a more trustworthy manner by focusing on four key requirements: the appropriate definition of obligations, the identification of corresponding responsibilities, the creation of mechanisms which encourage trustworthiness, and the holding to account of those involved in an appropriate manner. Financial reforms at present lack sufficient focus on these requirements. The book explores how these requirements can be better met in specific parts of the financial services industry so as to bring about better outcomes.

Part I: What went wrong?

1. **Why Trustworthiness Is Important**
   
   Sue Jaffer, Nicholas Morris and David Vines

This chapter provides an overview of how it might be possible to rebuild the trustworthiness of the financial services industry. It summarises the main arguments of the book and shows how the various chapters contribute to these. In doing so the chapter considers the problems that arose following deregulation of the financial sector, and argues that it is essential to rebuild the trustworthiness that has been lost. The chapter then examines incentives and motivations: identifying the inability of current remuneration arrangements to secure trustworthy behaviour and describing the adjustments that are needed. It makes a number of proposals for reforming governance, legal and regulatory arrangements. At their heart these proposals seek to harness values and norms to introduce and reinforce ‘other-regarding’ behaviour in the decision-making processes of financial services firms, and individuals.

* The biographies of the authors are described in the book.
2. How Changes to the Financial Services Industry Eroded Trust

Sue Jaffer, Nicholas Morris, Edward Sawbridge and David Vines

This chapter describes how the previous structure of the UK industry maintained relationships of trust. Financial firms were specialised, with retail and commercial banks managed separately from investment banks, which avoided potential conflicts of interest and contained moral hazard. Investment banks saw their role as serving clients and earning fees from doing so. However financial deregulation eroded the conditions required for trustworthiness. The industry consolidated into universal banks which were ‘too big to fail’, and greatly expanded demands for mortgages and pensions created commoditised services. The eventual dominance of ‘sales’ people over ‘relationships’ people within universal banks created conflicts of interest between different employees and between employees and customers. It also saw the spread of high-powered incentives to sell products and to undertake excessive risk taking. The capital for proprietary trading was no longer provided by partners and instead the money from bank depositors, creditors, and ultimately taxpayers was put at risk.

3. The Limits of Compensation Strategies

Thomas Noe and H. Peyton Young

Performance bonuses have become commonplace in financial institutions and now constitute a major part of employee compensation. Such practice followed academic work on principal-agent contracts, which argued that bonuses would better align the interests of managers and shareholders. This chapter argues that such schemes are not well-suited to aligning these interests for two reasons. First, new financial products make it easy to create the appearance of superior performance over long periods of time, with outsized returns driven by hidden tail risk. Second, the complexity of new products and the size of financial institutions make it extremely difficult (and costly) to monitor risky activities directly. Compensation schemes are inefficient because it is easy to escape detection for long periods of time. A greater emphasis on ethical values, reflecting duty of care to customers, clients, and shareholders, is more likely to produce effective reforms.

4. A Short History of Financial Crises and Reforms

Richard Davies

Crisis and reform go hand in hand in banking: crashes lead to new rules, regulations, and institutions that have an impact for decades. Focusing on five episodes from 1792 to 1929–33, this chapter argues that these crises provide lessons for today. First, the ‘search for yield’ and a systematic underestimation of risk were always present. Second, following a crisis the state often increased the safety net that underpins the financial system. Over time this has driven a wedge between the interests of banks’ managers and their owners and creditors. Loosening the link between a bank’s financial stability and the rewards of its managers changes the environment in which non-economic incentives like duties and social norms operate and makes regulation harder. Finally, getting regulation right matters as it shapes finance for decades to come. Some of today’s problems, including ‘too big to fail’, rest on regulatory decisions made long ago.
5. Failures of Regulation and Governance
Sue Jaffer, Susana Knaudt and Nicholas Morris

This chapter looks at the evolution of regulation over time and how reliance on trust and relationships has changed. It also examines the nature of the failures which occurred. In some cases these were errors of omission. In other cases the problems were intrinsic to the regulatory process, although they were worsened by changes to industry structure and incentives. Yet other problems were created or seriously exacerbated by regulation itself. Misplaced faith in the efficient market hypothesis and the risk models developed on the back of this theory allowed systemic pressure to go unchecked. Governance arrangements in the financial industry were also found wanting during the GFC. The chapter finishes by identifying the lessons that have been learned and examining the issues that remain: —issues which require an explicit focus on encouraging trustworthiness and the use of mechanisms which reinforce appropriate values and norms.

Part II: Trustworthiness, motivations and accountability

6. Trustworthiness and Motivations
Natalie Gold

Neoclassical economics assumes that agents are self-regarding, pursuing their private interests in ‘unsympathetic isolation’. The neoclassical analysis of trust explores how trustworthy behaviour can be sustained, based on self-regarding motivations. However, most philosophers agree that trustworthy behaviour must not spring from wholly self-regarding motivations. The chapter distinguishes weak trustworthiness, as studied in neoclassical economics, from strong trustworthiness, which must include a non-self-regarding motivation. Strong trust is ubiquitous, efficient, and often a precondition for effective sanctions. Strong trust is important in finance because of product complexity: customers rely on truthful assessments by designers. To understand the causes of untrustworthy behaviour the chapter examines peoples’ motivations and the ‘framing’ of situations. Regulations need to be enforced by sanctions, to incentivise wholly self-regarding agents to be at least weakly trustworthy. But sanctions by their nature can work against strong trustworthiness. A change of culture is needed to improve trustworthiness, ensuring that agents see strong trustworthiness as expected and appropriate.

7. Regard for Others
Avner Offer

Adam Smith rejected Mandeville’s invisible-hand doctrine of ‘private vices, publick benefits’. In The Theory of Moral Sentiments his model of the ‘impartial spectator’ is driven not by our sympathy for other people, but by their sympathy for us. Approbation needs to be authenticated, and in Smith’s model authentication relies on innate virtue, which is unrealistic. In this chapter an alternative model of ‘regard’ is applied, which makes use of signalling and is more pragmatic. Modern versions of the invisible hand in rational choice theory and neo-liberalism are shown to be radical departures from the ethical legacy of Enlightenment and utilitarian economics, and are inconsistent with Adam Smith’s own position.
8. **Trust, Trustworthiness, and Accountability**

Onora O’Neill

Current public debates often see trust as obsolete in public and institutional life, and recommend accountability as its successor. However this is only made plausible by advancing incomplete conceptions of each idea. Such conceptions of trust see it as a matter of attitude or affect; the favoured conception of accountability sees it as imposing a further layer of management. There are no good reasons for favouring these conceptions of trust and accountability, or for rejecting or neglecting others. More intelligent conceptions of both are available. Intelligent accountability takes explicit account of links between basic normative claims—duties and rights—for which agents may be required to render an account of (non-) performance, and others to hold them to account for (non-) performance. Forms of accountability can be made to support rather than supersede intelligent forms of trust.

Part III: Problems with the legal and regulatory system

9. **Financial Crisis and the Decline of Fiduciary Law**

Joshua Getzler

Fiduciary duty requires that fiduciary agents serve their client’s ‘best interests’. In practice this resolves into component duties to avoid unauthorised profit, to eschew unauthorised conflict of duties, to apply prudent and diligent judgement to client business, and to perform primary duties rather than offer remedial damages for efficient or non-harming breach. Classical fiduciary duties support well-functioning markets, but fiduciary law has declined and no longer performs as it ought. In finance, fiduciary duties are often attenuated by implicit or explicit agreements that give intermediaries too much unmonitored power over beneficiaries, allowing incompetent or predatory performance. In addition, judges and legislators have cut the scope of duties and weakened the remedies. To restore fiduciary law to full efficacy, agreements that reduce presumptive fiduciary duties should themselves be subjected to fiduciary standards of loyalty and informed consent. Also, extant fiduciary relationships should be upheld through the classical approach enforcing primary duties.

10. **Professional Obligation, Ethical Awareness, and Capital Market Regulation**

Justin O’Brien

This chapter argues that it is essential to challenge the norms governing the financial industry, to place ethical judgement above legal permissibility and technical compliance. It explores the ethical and normative foundation of the current market conduct and disclosure regime, as established at the time of the New Deal in America. However there has been progressive erosion of that compact, with powerful lobbying by the industry aimed at preventing such a compact being re-established. The gatekeepers of market integrity, the legal and audit communities, have contributed to the decline in ethical behaviour through their elevation of technicalities above substantive ethical considerations. Two Australian examples of malpractice demonstrate the need for change in professional behaviour: the marketing of complex financial products and the pronounced deterioration in the quality of audit work. Extending responsibility and
accountability requires regulation to integrate normative objectives and to move beyond a deceptive concern for efficiency.

11. **Systemic Harms and the Limits of Shareholder Value**  
    **John Armour and Jeffrey Gordon**

The generally accepted framework for analysing corporate law and governance implies that those running a corporation should seek to maximise shareholder value as measured by the stock price. However for share price maximisation to enhance social welfare, a range of mechanisms—contracts, liability rules, and regulation—need to ensure that any costs which a firm’s activities impose on other parties are internalised into the profit function. The extent to which traditional private law mechanisms—in particular, the law of tort—fail to internalise ‘economic’ or indirect harms has been underappreciated. The case of banks illustrates dramatically the problems caused by the maximisation of shareholder value, because bank risk taking has a systemic, as opposed to firm-specific, character. The chapter proposes a corporate governance solution, using ‘old-fashioned’ liability rules to affect the pay-offs of those controlling the firm, as opposed to external measures designed to affect the firm’s profit function.

**Part IV: Crafting the remedies**

12. **Ethics Management in Banking and Finance**  
    **Boudewijn de Bruin**

This chapter discusses how the values which individuals hold will help to frame choices and so influence the choices that are made. If ethical issues in finance have limited ‘moral intensity’ in comparison to other industries, banks will, more often than in other industries, fail to recognise an ethical issue and to engage in ethical behaviour. Therefore the primary task of ethics management in banking is to ensure that norms of behaviour make reference to values, and to develop tools to help management and employees to recognise ethical issues. The chapter suggests that the financial services industry would benefit from using deliberative polls, a newly developed decision-making tool. It gives an example of an ethics training programme and considers codes of ethics.

13. **Toward a More Ethical Culture in Finance: Regulatory and Governance Strategies**  
    **Dan Awrey and David Kershaw**

In theory, culture and ethics represent potentially powerful constraints on human and organisational behaviour. In practice, however, these constraints are often ineffective—crowded out by other, countervailing, influences. This chapter explores how the law and regulation might be utilized to tilt the battleground of norm formation at both the individual and organisational levels in favour of a more ethical culture. It explores the potential efficacy of both regulatory strategies (e.g. process-based regulation) and governance strategies (e.g. corporate objectives, directors’ duties, ethics committees, and remuneration) as mechanisms for introducing a norm of ‘other-regarding’ behaviour into the decision-making processes of financial services firms. The chapter does not profess to have all the answers. Rather, it asks some important (and too often neglected) questions about the role of culture and ethics in finance and offers a framework for a more serious and rigorous discussion.
14. **Trust, Conflicts of Interest, and Fiduciary Duties**

Seumas Miller

This chapter describes the Future of Financial Advice (FOFA) legislation introduced in Australia to deal with problems in the professional ethics of financial advisors. The legislation bans various forms of conflicted remuneration for financial advisors and attaches fiduciary duties to their roles. The chapter provides a conceptual analysis of the key ethical notions of trust, fiduciary duties, and conflicts of interest as they pertain to financial planning. The FoFA legislation is part of the overall integrity system for financial services, the four dimensions of which are regulation, market incentives, reputational incentives, and underlying moral beliefs and attitudes. The FoFA legislation incorporates several measures designed to contribute to the process of transforming sales personnel into a profession, but there remains a question as to whether the culture of members of the occupation of financial advisor will shift from a sales-based culture to the culture of a profession in this macro-institutional context.

15. **A Warrant for Pain: Caveat Emptor vs the Duty of Care in American Medicine**

Avner Offer

Bad ethics can make for bad economic outcomes. Bad ethics are defined hedonically as the infliction of pain on others for private advantage. The infliction of pain is often justified by ‘Just-World Theories’, which state that everyone gets what they deserve. Market liberalism (and its theoretical underpinning in neoclassical economics) is one theory of this kind. This chapter considers an example of these outcomes. It examines both the micro and macro underperformance of the American health system c.1970–2010 which is explained in terms of the shift in policy norms from the fiduciary norm ‘first do no harm’ to the neo-liberal market norm of ‘let the buyer beware’ (caveat emptor) since the 1970s.

16. **Restoring Trust**

Sue Jaffer, Nicholas Morris and David Vines

Trust and trustworthiness are important in the financial services industry, in market transactions and in a wider economic sense, because their lack results in poor outcomes for the economy. The chapter suggests four steps for developing trustworthiness: defining obligations, identifying those responsible for delivering obligations, identifying mechanisms for encouraging trustworthiness, and holding those responsible to account. The chapter considers a number of case studies on the mechanisms that have been applied in other industries, as these provide useful lessons for financial services. The chapter summarises the key obstacles to trustworthiness and the regulatory responses that have emerged to date. It suggests that the reforms underway are important because they will remove or reduce adverse incentives. However they will do little to strengthen trustworthiness by encouraging other-regarding motivations. As a consequence, the chapter concludes by recommending a number of further actions that could be taken to improve trustworthiness by bringing other-regarding motivations into play.