Relation between trust theory and agency theory

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The global financial crisis (GFC) of 2008 has raised many issues in regard to the operations of business, particularly financial institutions. The most important issue is the loss of trust in the way financial institutions work. Some authors have called the economic crisis a crisis of trust (Eichengreen, 2009). Ernst and Young (2011) have conducted a global survey of banking industry in the aftermath of GFC. They found that the banking industry in mature markets such as USA, UK, Germany, France and Italy has experienced a shift in customer confidence and trust whereas banking industry in emerging markets such as India, China and Thailand have experienced lesser impact of Global financial crisis. Consequently banks in emerging markets have huge opportunity to expand internationally. Ernst and Young (2011) have observed that trust in banks in countries such as USA, UK, France, Germany, Italy has decreased considerably after the Global financial Crisis ranging from a fall of 51% for banks in Belgium to 61% in UK. They have not observed any change in customers’ confidence in the banks in China whereas they have observed an increase in customer confidence in banks in India. Among the reasons cited by customers for reduction in trust levels in banks in mature markets are under capitalisation of banks, over leveraging practiced by some banks and remuneration policies of banks. Two important issues have emerged from the above discussion. One Global Financial Crisis have raised and highlighted the issue of trust in business, particularly in banks as an important issue. The other issue is about agency problem in banks made significant through the remuneration policies pursued by some banks in the lead up to Global Financial Crisis.

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Introduction

The global financial crisis (GFC) of 2008 has raised many issues in regard to the operations of business, particularly financial institutions. The most important issue is the loss of trust in the way financial institutions work. Some authors have called the economic crisis a crisis of trust (Eichengreen, 2009). Ernst and Young (2011) have conducted a global survey of banking industry in the aftermath of GFC. They found that the banking industry in mature markets such as USA, UK, Germany, France and Italy has experienced a shift in customer confidence and trust whereas banking industry in emerging markets such as India, China and Thailand have experienced lesser impact of Global financial crisis. Consequently banks in emerging markets have huge opportunity to expand internationally. Ernst and Young (2011) have observed that trust in banks in countries such as USA, UK, France, Germany, Italy has decreased considerably after the Global financial Crisis ranging from a fall of 51% for banks in Belgium to 61% in UK. They have not observed any change in customers’ confidence in the banks in China whereas they have observed an increase in customer confidence in banks in India. Among the reasons cited by customers for reduction in trust levels in banks in mature markets are under capitalisation of banks, over leveraging practiced by some banks and remuneration policies of banks. Two important issues have emerged from the above discussion. One Global Financial Crisis have raised and highlighted the issue of trust in business, particularly in banks as an important issue. The other issue is about agency problem in banks made significant through the remuneration policies pursued by some banks in the lead up to Global Financial Crisis.

Trust Theory

Trust has emerged as an important issue in business accountability because society has become critical about business values in recent years. The role of business and commerce in the society is being evaluated critically and society is finding it hard to accept the unethical dimensions of the business in the name of preserving the bottom lines or creating economic values. According to Glover (1995, p.17) "Commercial interaction is now investigated more critically and the rightness of market outcomes is no longer passively accepted. A majority of the people, it is thought, find the uncorrected morality of the market place unacceptable." Modern economic theory may also have failed to recognise an impetus for human betterment (Whitehead, 1929) and focused on negative opportunism (Griensinger, 1990). The application of Trust Theory to business relationships has emerged as an expectation that another's action will be beneficial rather than detrimental (Gambetta, 1988). Trust is considered as "an important factor in all market transactions. Market freedoms could be inconceivable without a social order rooted in community norms including trust." (Etzioni, 1988; Granovetter, 1985).
According to findings of Uslaner (2010) roots of generalised trust and confidence in institutions after the onset of financial crisis is not the same as it was before the crisis. Although confidence in banks was higher than business in general and in government in particular, this confidence in banks has declined after the start of GFC. The lack of trust developed from the perception that executives of failed businesses and investment firms were using government bailout money to live a luxurious life while the financial crisis impacted upon ordinary people who lost their jobs. The lack of trust is supplemented by the perception that a considerable lack of transparency exists in financial markets and integrity and honesty of some people in business was very doubtful. The perception is that things are getting worse for people at the bottom whereas people at the top are getting benefits at the cost of poor. Guiso (2010) have concluded that global financial crisis has revealed opportunistic behaviour on the part of business engaged in financial services. Too much deregulation in the operation of financial markets, too relaxed monetary policy and too much power being wielded by some of the financial institutions are blamed for the onset of the financial crisis. This opportunistic behaviour which came open after the crisis may have important consequences for the operation of financial markets as the demand for financial products may decrease. People may not rely much on the advice of financial intermediaries while making financial decisions. These could result in increase in regulation for financial services. Guiso (2010) have also found that bankers are considered less reliable than average person. However banks are considered more reliable than bankers who work for them. The incentive structure within banks has contributed significantly to the lack of trust in bankers. Guiso (2010) have suggested a number of steps in restoring trust in financial institutions. They have argued for more regulatory measures to restore investor’s trust in banks, arrest opportunistic behaviours in bankers by developing policies aimed to modify incentive structures and punishing cheating and fraudulent behaviour of dishonest financiers.

Trust plays an important part within organisations. Trust is considered necessary for individuals and societies to function properly. Éricson (1968) considered trust as the "central ingredient of the healthy personality". Arrow (1974) regard trust as an important and extremely important lubricant of the social system. Trust is observed to reduce conflicts (Zaheer, McEvily and Perrone, 1996), improve individual performances (McAllister, 1995), promote interorganisational cooperation (Ring and Vandeven, 1994) and increase the commitment of foreign subsidiary managers (Kim and Mauborgne, 1993).

There are a number of approaches available in the literature on trust. Psychological approaches to trust concentrate on the personality traits of an individual (Rotter, 1980); Sociological approaches interpret trust as "individual characteristics perceived by others as trustworthy (Dasgupta, 1990) or "observed behaviour of individuals in situations that exposes them to the probability of risk (Worchel, 1979). Lewis and Weigert (1985) regard trust as "applicable to relations among people rather than psychological state of individuals" Dibben (2000, p.7) categorised trust into three layers: i. dispositional trust, the psychological disposition or personality trait of an individual to be trusting or not trusting; ii. learnt trust, an individual's general expectancy to trust or not to trust another individual as a result of experience; and iii. situational trust which is dependent on the situational cues that modify the expression of generalised tendencies." Dispositional trust depends upon one's disposition or the character trait. Learnt trust develops out of one's experience in dealing with another individual. Situational trust depends on the interaction with individuals in particular situations or circumstances.
According to Velez (2000) the study of trust requires multi level perspective and flexibility in understanding the concept of trust because trust is considered a complex phenomenon by them which can manifests itself at various levels. Trust can occur at the levels of individual, group and institutions. Trust can occur within an organisation between individuals in that organisation and also between the organisations. Each of these forms of trust has different causes and outcomes for the people or organisations involved in trust. Rousseau et al. (1998) suggest that researchers should separate trust at various units of analysis rather than mixing micro-level trust and macro-level issues within same study. They suggest that research on trust has explored various levels of trust (e.g. Individual, group, institutional) trust both within and between organisations and various causal roles of trust (e.g. trust as cause and outcomes and moderator)

There are many definitions available in the literature. The common element of these definitions, as agreed by researchers can be shortlisted to confident expectations and willingness to be vulnerable (Velez, 2000).

**Agency Theory Approach**

The second type of relationship used in finance literature concerns specific agency aspect of a relationship. The agency relationship is based on the agency theory of Jensen and Meckling (1976). Jensen and Meckling (1976, p.308) define the agency relationship as "a contract under which one or more persons (the principal(s) engage another person (the agent) to perform some service on behalf of the principal which involves delegating some decision making authority to the agent". Agency Theory is based on a contractual relationship between the principal and the agent.

There are three components of this definition given by Jensen and Meckling (1976). First is the existence of a contract between a principal and an agent. The second is a performance of a service. The third is delegation of decision-making authority. According to Berreca and Gupta (1999, p.184) the objective of agency theory is to design a contract that minimises the cost of service performed by the agent to the principal. The agent needs to work for the principal under certain constraints. The first constraint is known as the participation constraint when the agent needs to agree to work for the principal. The second is the incentive constraint when the agent needs to work hard for the principal despite disutility of the work for the agent. The principal bears the risk of his/her delegation to the agent and carry the cost and benefit of the delegation.

The objective of Agency theory is to identify agency problems that could arise in an agency relationship and to establish options for the principal which will help him or her in reducing agency costs. Eisenhardt (1989) have identified the following problems that may arise in an agency relationship. First the goal of principal and agent is in conflict. Second, it is costly for the principal to monitor and to evaluate the behaviour of the agent and third, it is difficult for the principal to monitor and evaluate the behaviour of the agent (Eisenhardt, 1989). These agency problems are identified in the literature as problems of horizon, effort differential risk preference and use of assets by Byrd, Parrino and Pritsch, (1998).

An effort problem occurs when the executive's (an agent) effort in creating value to the shareholders (the principal) is less than the expectation of the shareholder (the principal) towards him/her because he/she joins to the board of directors of another firm (Byrd, Parrino and Pritsch, 1998). The second problem is the horizon problem which may occur when the executive (an agent) of a firm have different horizon to stockholders (the principal) According to Byrd, Parrino, Pritsch, (1998), if an executive has limited time in the firm, he/she will prefer to implement strategies that produce short-term rather than long-term outcomes. The third issue addressed by principal agent relation is the differential risk preference problem. This problem arises when an executive of a firm (the agents) believes
that his/her responsibilities for the firm's poor performance are greater than his/her benefits received during the firm's period of good performance (Byrd, Parrino and Pritsch, 1998). This belief motivates the executives (agent) to take low risk in business and reduce the firm’s risk profile by adopting integrating or diversifying firm’s business to improve firm's performance even when it is costly to firm’s shareholders. The fourth issue addressed by principal-agent relationship is the asset use problem. An asset use problem may occur when an executive (as agent) of a firm uses a firm's asset for personal purpose or an executive makes an investment decision to increase firm's expansion which could result in an increase in income of the executive. The expense of the use of the asset (or perquisites) is met by the shareholders (as principal) and could result in decreasing the wealth of the shareholders (as principal). The agent could derive pecuniary benefit or non-pecuniary benefits from the relationship with the principal. The non-financial benefits may include “the physical appointments of the office, the attractiveness of the secretarial staff, etc. (Jensen and Meckling, 1976, p.486).

According to Eisenhardt (1989), the main focus of agency relationship is the selection of appropriate governance mechanisms between the principal and agent that will ensure an efficient alignment of principal’s and agent’s interests. The goal is to ensure that the agent will serve the interest of the principal thereby minimising the agency costs. Both outcome and behaviour based contracts are utilised as a means to achieve this end. The agency theory focuses on relationship that mirror the basic agency structure of a principal and agent who are engaged in a cooperative behaviour but have different goals and attitude towards risk.

According to Shankman (1999) the agency theory focuses on the agency relationship in which one actor and the group (the agent) has certain obligations which are fulfilled for another actor or group (the principal) by virtue of their economic relationship. The underlying mechanism with which the relationship is articulated is in terms of a contract between the principal and the agent. The firm is seen as a nexus of contracts between the principal and the agent. The agency theory, according to Shankman (1999) rests on the assumption that the desire and goals of the agent and principal conflict. That it is difficult for the principal to verify what the agent is doing. This is termed agency problem. The other difference arises when the principal and the agent have different attitudes towards risk and thus will prefer, all other things being equal, different course of action. This is problem of risk sharing. Agency theory provides many insights on agency relationships. First, the agency theory establishes the importance of incentives and self-interest in organisational thinking. Second, the agency theory introduces the notion of information as a commodity. Third, the agency theory examines the risk preference in cooperative relationship between individuals.

Ross (1973) has criticised the agency theory on the ground that it is rooted in economic utilitarianism. By narrowing focus on the principal-agent relationship and based on the assumptions, the agency theory provides predictions about what rational individuals could do if placed in a principal-agent relationship (Wright, 2001). The agency relationship is based on the opportunistic behaviour of a single principal and a single agent. The agent and the principal are perceived to be their own utility maximisers because the presumption of the theory is that agent will not act in the best interest of the principal (Jensen and Meckling, 1976). Wright (2001) considers agency theory to be restrictive because the theory discounts the possibility that different individuals may behave differently in economic situations.

**Comparison of Agency Theory and Trust Theory**

Compared to Agency theory perspective on principal-agent relationship as discussed above, Trust theory provides a different perspective on relationship between economic agents. The agency theory is built on a number of explicit assumptions about the behaviour of the agents.
Agency theory describes the agency relationship between the principal and the agent as a uni-dimensional relationship where only two individuals – the principal and the agent are the part of a relationship. The performance of the agent towards the principal is considered as a single component of the relationship which determines the quality of the relationship. In reality, most business relationships are multifaceted and multiplex. Trust theory takes into consideration these multifaceted aspects of the relationships into consideration through stakeholder’s perspective. Shankman (1999) has argued that it is in the interest of the principal to develop a trusting relationship with the agent because it drastically reduces the amount of resources that must be directed towards monitoring of the agent thereby returning more profit to the principal.

Agency theory assumes that a goal conflict exists between principal and the agent in an agency relationship. The principal (owner) derives financial benefits or costs from agency relationship. The agent derives not only pecuniary but also non-pecuniary benefits or costs from agency relationship. The non-financial rewards (or costs) are consumed by the agent only at the cost of principal. The goal conflict exists between the principal and the agent because of different utility functions of the agent and the principal. The agent’s decisions are considered costly to the principal. Trust theory supports a goal orientation between the trusted and the trustor. McClelland (1960) disputes the assumption of goal conflict and explains that in a different situation agents may enjoy performing responsibly because of their personal need for achievement. The agent under such circumstances may not mind exerting extra effort in their work because the utility associated with their sense of achievement on their particular job may dominate the disutility associated with the corresponding effort expended. This according to Barber (1983) is true when there are expectation of technically competent role performance between the principal and the agent. Trust is an expectation essential for achieving mutual cooperation and goal congruence and benevolence of trusted towards trustor. Trust, according to Hosmer (1995), is willing cooperation and with expectation that benefit will result from that cooperation. The object of trust is perceived to increase or facilitate cooperation and potential for joint cooperation resulting in benefits to both parties involved.

The agency theory includes the notion of costs and benefits that accrue in the relationship between the principal and the agent. The contracting and monitoring costs are incurred because principal has to negotiate and monitor detailed contracts to protect against the opportunistic behaviour of agents. Bromily and Cummins 91992, p.4) argue that trust could reduce transaction costs. According to them “Trust is the expectation that another individual or group will make a good faith effort in accordance with commitment, be honest in whatever negotiations preceded these commitments and not take excessive advantage of others when opportunity is available. Trust helps in reducing the monitoring and controlling costs for the principal and eliminating the need for putting in place control systems that were based on short-term results.

Relation between Agency Theory and Trust Theory

It can be argued that trust theory and agency theory differ on many variables in describing business relationship. The focus of agency theory is to put in place an incentive structure for agents so that agents can align their interests with those of principal. The objective is to minimise the agency costs for the agents. On the contrary trust theory focuses on mutual benefits that may occur to both trustor and trusted so that social capital can be maximised. Agency theory assumes differences in risk attitudes of agents and principal arising due to a goal conflict between principal and agent whereas trust theory assumes that trustor and trusted assume risk in relationship and willingly become vulnerable to each other’s action. This willingness to become vulnerable to trusting relationship arises due to
goal congruence between principal and agent. Agency theory assumes that relationship between principal and agent is task specific and short term and may be terminated after some time. Trust theory assumes that relationship is likely to continue over several stages for a long period with a potential to grow over a period of time. There is a scope for repair of relationship in trust if a decline in relationship occurs at any time whereas agency theory assumes that relationship will be terminated after some time.

Trust theory assumes that trustor and trusted may start relationship based on a rational calculation of cost and benefits of trust. The assumption is that outcome and result of creating and sustaining a relationship relative to cost of maintaining or severing is beneficial to both trustor and trusted. In agency relationship the principal starts with an agency relationship based on the expected benefit of relationship relative to the cost. The agency relationship is akin to the calculus based trust situation, where the trustor and trusted observe market oriented economic calculation. If the cost of relationship is more than the benefit the relationship may get severed. If the benefit of relationship is more than the cost the relationship could continue in future. The principal-agent relationship is however short term and may not continue in future. The first stage of calculus based trust relies on a threat and reward system, which is very similar to agency cost of monitoring the agents. The trustor may be able to reward a trusted for observing appropriate behaviour contributing towards and also impose penalty on the trusted if trust is violated. Similarly the principal may be able to impose agency costs on agent if the agent does not perform according to expectation of principal. In both situations, monitoring of trusted by trustor and monitoring of agent by principal are critical to the outcome of relationship. If trustor and trusted have remained in the relationship and observed each other’s behaviour and developed knowledge about each other in the first stage of relationship, they may continue their relationship to the second stage based on the outcome of first stage. In agency theory there is no such development of relationship based on knowledge and experience of principal and agent. Any new contract between agent and principal may have to be negotiated again.

The second similarity between Agency Theory and trust theory is about the issue of delegation. The Agency Theory argues for delegation by principal to the agent and focuses on the contract design to achieve an optimum outcome for the principal. The purpose of contracts put in place by principal is to deal with the opportunism of agent who may pursue their own self interest in the task delegated by the principal. In spite of monitoring and incentives, the opportunism of agent may continues due to adverse selection or moral hazard. In a trust relationship, the delegation is done when the trustor and trusted have evolved to the third stage of their relationship in identification based trust. In this stage, the trustor and trusted have been in relationship for a long time, have observed actions of each other and the trusted is willing to identify himself or herself with the trusted. The trustor is also willing to assume risk in relationship due to knowledge developed about the trusted by the trustor. The trustor assumes risk in delegation based on past relationship and knowledge of trusted, who is willing to identify themselves with the action of trustor. The purpose of delegation, according to agency theory is to provide governance mechanisms to principal to reduce the risk to principal which may arise due to agent’s opportunism. In a trust relationship, a trustor willingly assumes risk due to knowledge developed about the trusted. The purpose and context of delegation in agency relationship is very different from the one in trust relationship.

Conclusions

This study compares and contrasts the role of trust and agency relationship along various dimensions in a business context. It is concluded that although there are many differences between agency theory and trust theory in describing the business relationships,
there are some similarities between the two theories. It is concluded that agency theory provides a uni-dimensional context of business relationship whereas trust theory perceived the business relationship to be multidimensional. Agency theory refers to the self interest of economic agents. On the contrary, trust theory provides a basis for cooperation between economic agents and highlights the benefits of cooperation among economic agents. Agency theory advocates risk aversion among economic agents while trust theory recognises that risk taking is an essential part of any economic relationship. Agency theory assumes a goal conflict between principal and agent whereas trust theory support goal congruence between economic agents. Agency theory focus on a short term relationship between principal and agent while trust theory supports a long term perspective on relationship between and trustor and trusted spread over several stages.  

Two similarities among agency theory and trust theory can be observed from the discussion. First is that both trust theory and agency theory take in to consideration the cost and benefits in any relationship. In that context agency theory can be treated as specialised version of trust theory which may be able to explain the initial context of a relationship when cost and benefits of entering into a relationship become important. In view of short time horizon of agents as suggested by agency theory, it is not applicable to long term relationship which are better described by trust theory. The second similarity between agency theory and trust theory is about the issue of delegation. Delegation of task is described differently in both theories as motivation for delegation in agency theory is different from motivation in trust theory.

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