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Talk of reforming toxic banks is misguided: improve the product and culture will follow

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Abstract

The recent and strident language from financial regulators, politicians and credit ratings agencies about financial services culture is a sure indicator that something is seriously amiss in the sector.

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Can culture be regulated? AAP/Dean Lewins

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The recent and strident language from financial regulators, politicians and credit ratings agencies about financial services culture is a sure indicator that something is seriously amiss in the sector.

This spike in hostility has arisen from some despicable behaviour and outcomes; however, neither reform of culture nor technological innovation are panaceas, as ideologies cannot replace a clear understanding of these complex businesses.

There are several markers in this conversation which need to need to be teased out because there is a real danger that consumers could end up suffering higher costs, achieve even less peace of mind dealing with financial services providers, and potentially transfer huge enterprise value to disruptive players which may ultimately misplace consumers' trust in even quicker time than the so-called legacy institutions.

Firstly, understanding and addressing culture is far more complex than expressing a reactive political and regulatory narrative. As conduits of reasonable anger and disillusionment, politicians express a belief that parentalism will ensure that consumers are protected from harm. There are limitations to the regulatory narrative. Columbia University Law School Professor John Coffee identifies the causal and lagged link between appalling market outcomes and regulatory response.

On the other hand, industry participants need to re-assume authority over both narratives and rebuff further regulation.

This authority should arise from their constant and deep engagement with customers. Financial services firms own the benefits of information asymmetry (including emerging issues and product failures). This reinforces their authority.

Second, financial services institutions are complex businesses with many moving parts. Their interactions with customers occur in highly varied contexts or "customer-product interfaces". Not surprisingly, it is a challenge to articulate an authentic cultural message for a financial services conglomerate.

Aggrieved customers and stakeholders mean that the term “customer-centric” is hollow. The customer’s wallet is the centre of what financial conglomerates do.

This commercial imperative is the legitimate reason that financial services exist. Similarly, financial innovation occurs because of the need to address customers’ economic needs, rather than mere predation. It solves customers’ problems and achieves a reasonable return for the provider within a highly regulated sector of the economy.

Providers of financial services therefore need to better explain what they actually offer and from there consumers can make informed decisions. There have been advances. The industry communicates in plain English and consumers are savvy enough to intuit that this industry provides a range of largely intangible things.

On the other hand, the industry seems to have difficulty in levelling with consumers about this, preferring to maintain institutional mystique (“trust us, there’s something more to it”).

The real challenge (and opportunity) is to reassure consumers in product interfaces, to clarify what is being provided, and if and when any trust is actually warranted. In other words, providers need to unbundle and explain simply what their products entail so that consumers (personal and institutional) understand what they are buying, if it suits their circumstances, and what (if any) trust is involved. Some examples are set out in the figure:

Product interface	**Trust required?**	**Institutional requirement/Customer trust statement**
Saving	Consumer	Consumer needs to trust that the provider will hold their funds safely, pay any interest promised, and effect transactions ordered by the customer.
Borrowing	Provider	Consumer just needs the loan.
Wealth management	Mutual	Providers must explain that they cannot predict the future with certainty but promise to monitor conditions, reliably capture and pass through returns from investment opportunities.
Risk	Mutual	Providers must explain about contingencies and events, make reasonable promises that reduce risk to consumers who pay a fee, and pay on events to fulfil these promises.
Trading	Mutual	A provider will charge its customers a margin to transact in financial instruments and markets. It may also make a market which would otherwise not exist, to effect the transaction.

Third, criticisms of culture are entwined with questions of morality. Legislation and regulation set boundaries informed by knowledge and conventions, and within this perimeter and the associated contested marketplace, providers must organise their businesses sustainably.

At a high level, it is important to acknowledge that financial services firms are a mirror on their customers which have varying ethics and values. This must be the case, because otherwise they would not remain in business.

Society’s mores do change over time. Witness the prevailing household debt culture, the post-GFC emergence of government bailouts, the shallowing of thought and synthetic reasoning. However, it is unreasonable to expect the financial services industry to lead morality debates: rather that is the domain of legislators and regulators who need to both represent society and understand existing product markets.

Finally, informed regulation is especially important because digital technologies are being aggressively deployed to unbundle highly-regulated financial services. Innovations and industry disruption need to be carefully assessed so that consumers do not suffer from misunderstandings, broken promises and a loss of trust.

Although technology generally may suggest individual freedoms, transparency, engagement and creativity, when applied within financial services it is largely used for the more mundane functions of customer aggregation, processing documentation and bulk communications.

Informed regulators and providers therefore must work together to carefully consider if in fact innovation and disruptive technologies can genuinely resolve economic trade-offs and maintain a durable consumer trust. This will usually require an old-fashioned - but perennially trendy - strong balance sheet.

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