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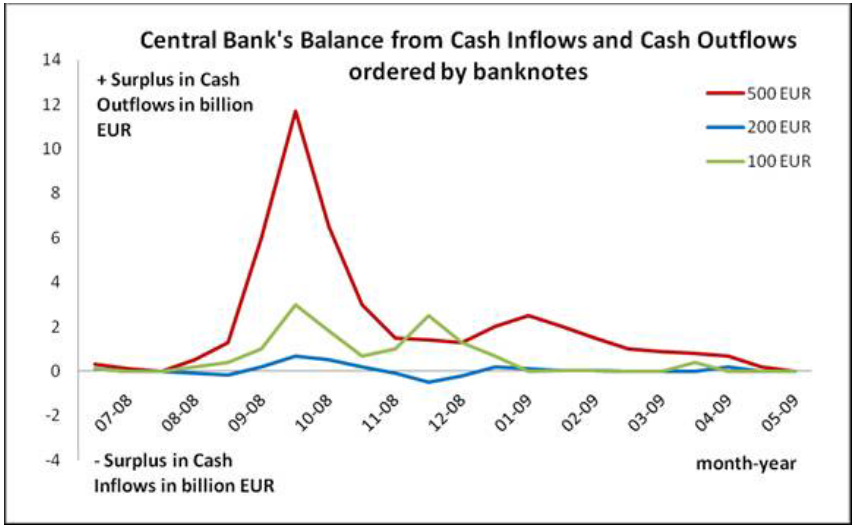

Developing and maintaining trust in retail banking business

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Sustainable Enterprise Conference, Pittsburgh
September 14, 2009

Agenda

1. Meaning of trust management for retail banks
2. Attributes of retail banking products
3. The banking crisis 2007 / 2008 and its impact on trust in banks
4. Barriers to develop trust in retail banking
5. Proposals to maintain trust in retail banking

What happens when trust in banks ends in smoke?
German government announces blanket guarantee to avoid bank run.

Source: DPA

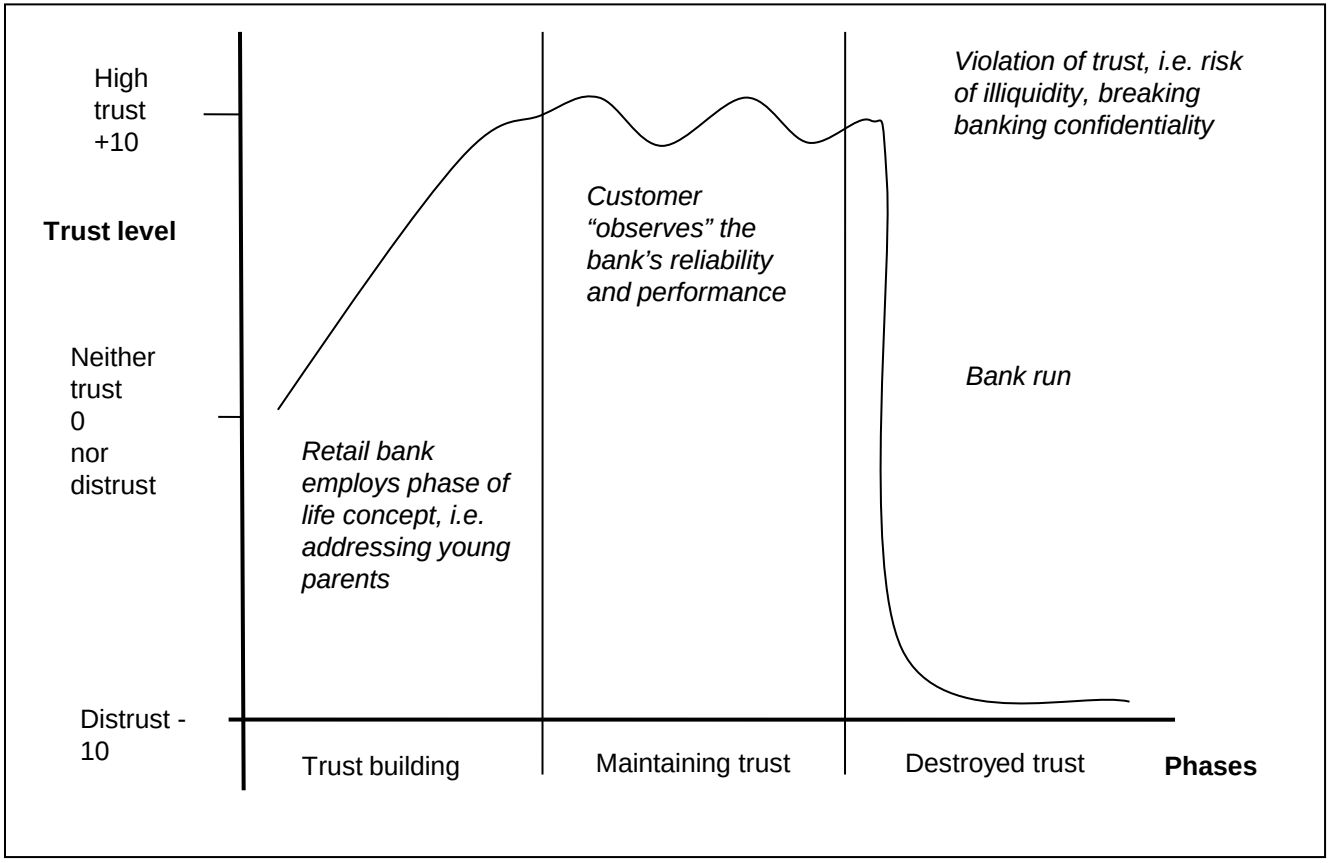
October 5, 2008
2:30 p.m.

Chancellor Angela Merkel and her Minister of Finance Peter Steinbrück announce a general deposit guarantee by the government

Trust is the decision to rely on another party under a condition of risk.
It offers several functions that can be applied to retail banking business.

Functions and attributes	Sources
Reduces complexity	Parson (1962)
Establishing and maintaining a long-term relationship between sellers and their customers	Moorman et al (1993)
Trustor (who trusts?) and trustee (who is trusted?)	Mayer et al (1995); Wang and Emurian (2005)
Promoting adaptive organizational forms, managing complexity and uncertainty	Luhman (1979); Lane (1998)
Reducing costs of transaction	Colemann (1994); Uzzi (1997)
Enhancing competitive advantages	Barney and Hansen (1994)
Offering true economic value	Grudzewski et al (2008)
Support effective personal and organizational performance	Lee (2009)

The trust process by CURALL and EPSTEIN (2003): Three different and evolutionary stages applied to retail banks



There is a steady flow of trust relevant evidence based on the trustee's behavior and measures. Trust is not a stable condition. Inter-personal trust between customer and consultant serves as context for trust building between customer and bank.

Relationships between trust, risk and retail banking

Trust involves reliance and risk …

- Reliance
  - Action trough which one party allows its fortune to be decided by another party
  - Fundament: Positive expectations of another party's trustworthiness
- Risk
  - Potential that the trustor will face negative outcomes
  - Reciprocal relationship between reliance and risk without implying causality ➔ risk creates opportunity for trust ➔ risk taking (ROUSSEAU et al, 1998)
  - Vs.
  - Causality but not clear about the direction "unclear whether risk is an antecedent to trust, is trust or an outcome of trust" (MAYER et al, 1995)

…which means in retail banking

- Expecting competent and reliable performance as well as ethical behavior (i.e. customer orientation, goodwill)
  - To develop or to create financial solutions, i.e. a sound financing structure, selecting appropriate products
  - Customer hypothesis: the bank consultant will act on the behalf of the customer, analyses personal needs and transfer all relevant information
- Customer risks
  - Subject to financial products
  - Loans: inappropriate mix of loan types and repayment periods ➔ Risk of illiquidity, risk of overspending
  - Savings/investment: inappropriate asset class and repayment periods: loss of capital, lower returns, risk of illiquidity

➡ Other characteristics of the consultant (i.e. likeability and similarity) can also play a major role in building trust.

There are different levels and perceptions of “trust in banks”.

„My consultant is a trusting soul.“

- Trust as **personal trait**
- Expresses the individual expectation twoard others
- Reflects the customer‘s experience in doing business with the bank consultant

„I trust my bank.“ / “I trust the brand”.

- Trust as **relational property**
- Constructed criteria of the customer-bank-relationship
- Source: Grudzewski et al (2008)

„We all recognize that banks are trustworthy.“

- Trust as a **feature of collectives**
- Collectivity‘s conformance to certain normative expectations

„I trust banks.”

- Trust as „**consumer trust“**
- Perceived bond between trustee (banks) and a specific agent (consultant)
- Source: SAPP et al (2009)

Profile and importance of retail banking

Profile

① **Banking business with private customer and smaller corporate customers / freelancers**

② **Core product structure: current account business, deposit banking, loan business and securities business**

③ **Characteristics: High number of customer relationships, high repetition rate of identical customer processes, large number of services rendered annually**

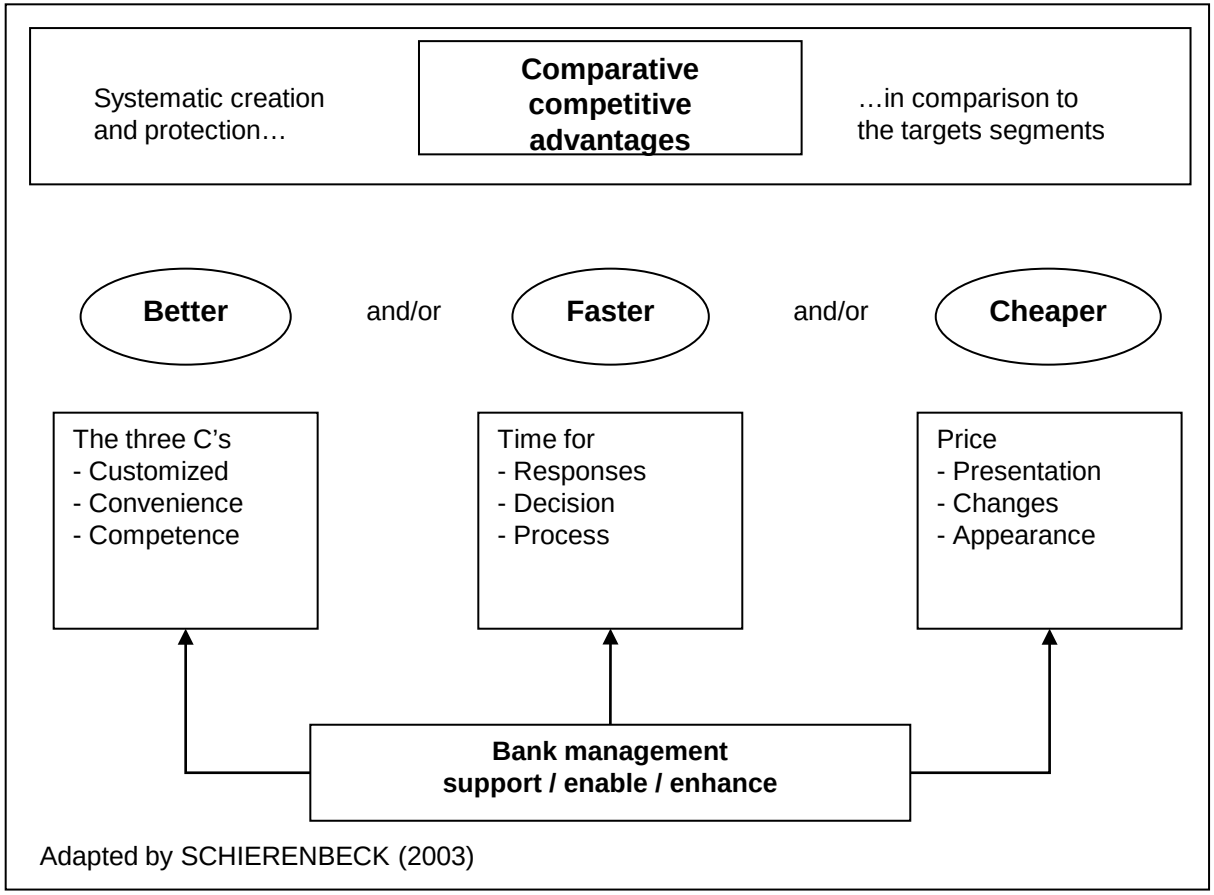
④ **Market: Large customer potential, low increase in sales and (high) fixed costs block**

⑤ **Strategic importance: Stable source of profits, stable funding source**

⑥ **Strategic outlook: Vast numbers of unbanked consumers in emerging markets will take up banking relationships over the next generation.**

In 2006, the retail banking business accounted for 57 percent of the global banking revenue pool of EUR 2,15 trillion (BCG, 2007).

Retail banks can address three issues to achieve differentiation.



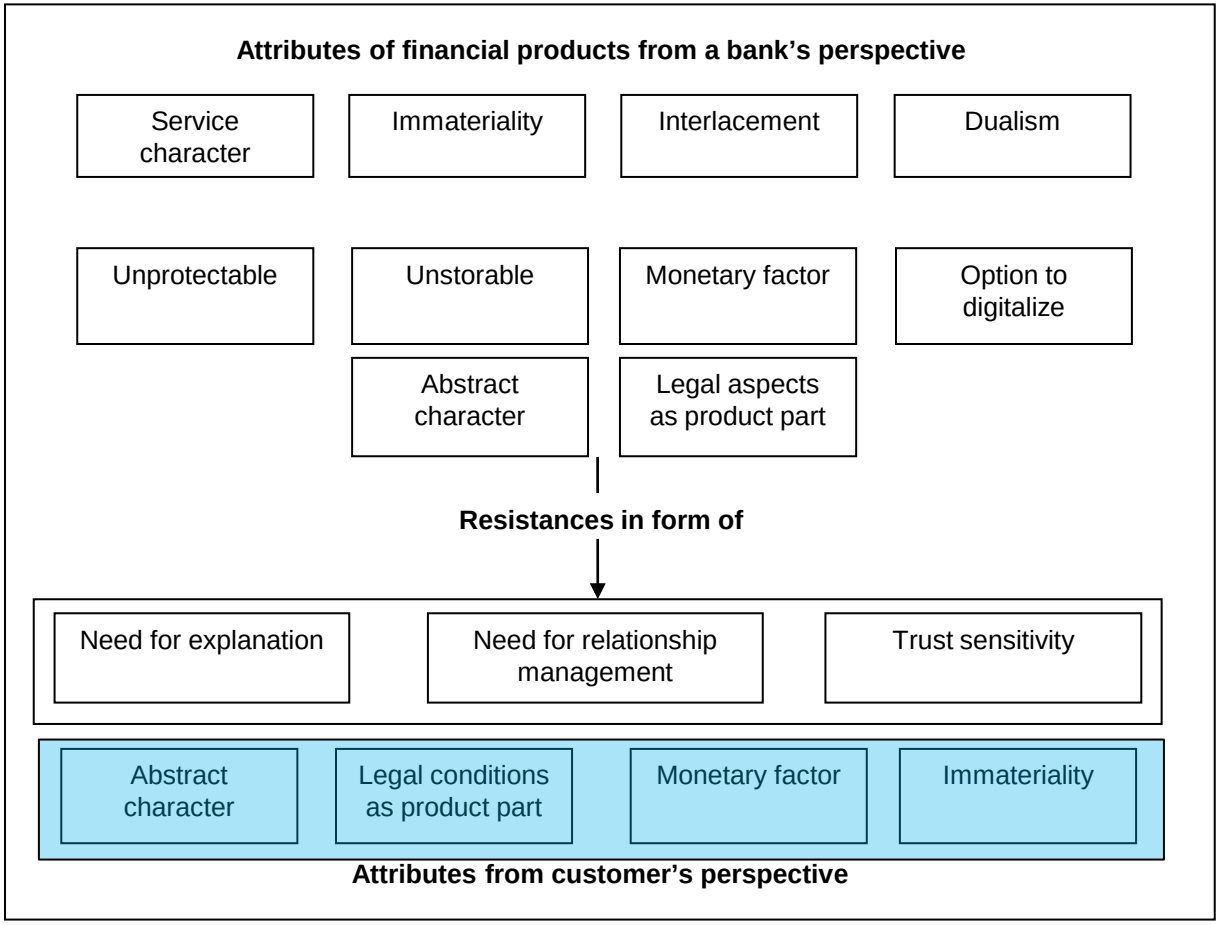
Just like customers of other organizations bank customers expect quality in the delivery of financial services and products…but on a higher level of precision

Trust in banks can be a source of competitive advantage.

Better The three C's - Customized - Convenience - Competence	**Customers.** Customers expect „quality" in the delivery of financial services and products ▪ Examples for quality: error free statement, reliable and competent consulting, checks printed correctly, error free money transfer **Competition.** Banks require higher levels of precision compared to their non bank competitors. One source of advantage is in trust customers place in banks to manage their assets (FREI et al (1995)) ▪ Profit potential. Bank customers may be willing to pay a premium what they perceive to be precision to their needs ▪ Organizational processes. Precision in operations can be an approach to protect market share ➔ Banks have to identify approaches to express their competence and precision to customers

Competence and precision in organizational processes are essential to develop and to maintain trust in retail banks.

The nature of retail banking products is characterized by a mixture of features that makes it difficult for retail customers to have an overview about all aspects.



In particular the immateriality of banking products causes abstractness from the perspective of the customer. In addition bank's marketing influences product perception.

Due to their characteristics banking products have a specific "demand for trust."

Customer has to have expectations of competent and reliable performance*

(i.e. expectations of financial expertise, payback of capital,

consulting on behalf of the customer)

- Require detailed explanation and communication to customers
- Products may be difficult to understand and/or to compare

Abstractness , legal terms and monetary factor

- Product can not be tested in advance
- Products may be difficult /to understand and/or to compare
- Co-production of the customer requires exchange of sensitive information

Immateriality

- Products require a high level of economic expertise
- Information asymmetry between bank and customer

Legal terms and financial characteristics

* KELTON et all (2008)

Definition of a systematic banking crisis (LAEVEN, VALENCIA, 2008)

- Country's corporate and financial sectors experience a large number of defaults
- Financial institutions and corporations face great difficulties repaying contracts on time
- Result:
  - non-performing loans increase sharply and
  - all or most of the aggregate banking system capital is exhausted.
- Situation may be accompanied by
  - depressed asset prices (such as equity and real estate prices) on the heels of run-ups before the crisis,
  - sharp increases in real interest rates, and
  - a slowdown or reversal in capital flows.
- In some cases, the crisis is triggered by depositor runs on banks, though in most cases it is a general realization that systemically important financial institutions are in distress.

The current banking crisis follow a specific pattern. The development of banking crisis require the concurrence of two specific circumstances.

Link
to genesis chart

Financial injury

- Major changes in the conditions of financial markets
- Mistaken adaptation and balancing strategies including misjudgment of the development and stability of certain market segments (i.e. real estate markets)
- Weak points and gaps in regulation (framework) and supervision (execution)
- Entering into business ventures with a „Arbitrage Fata Morgana" (BONN, 2008)
- Lack of shock absorption techniques in particular markets
- Inappropriate risk management system

+

Vulnerability

- Lean equity ratio and leveraged refinancing structure including term transformation

In the period 1970 – 2007 around 124 systematic banking crisis can be identified (LAEVEN, VALENCIA, 2008).

Excursus: A sequence of events changes the perception of the banking industry and trust in it. (1 of 2)

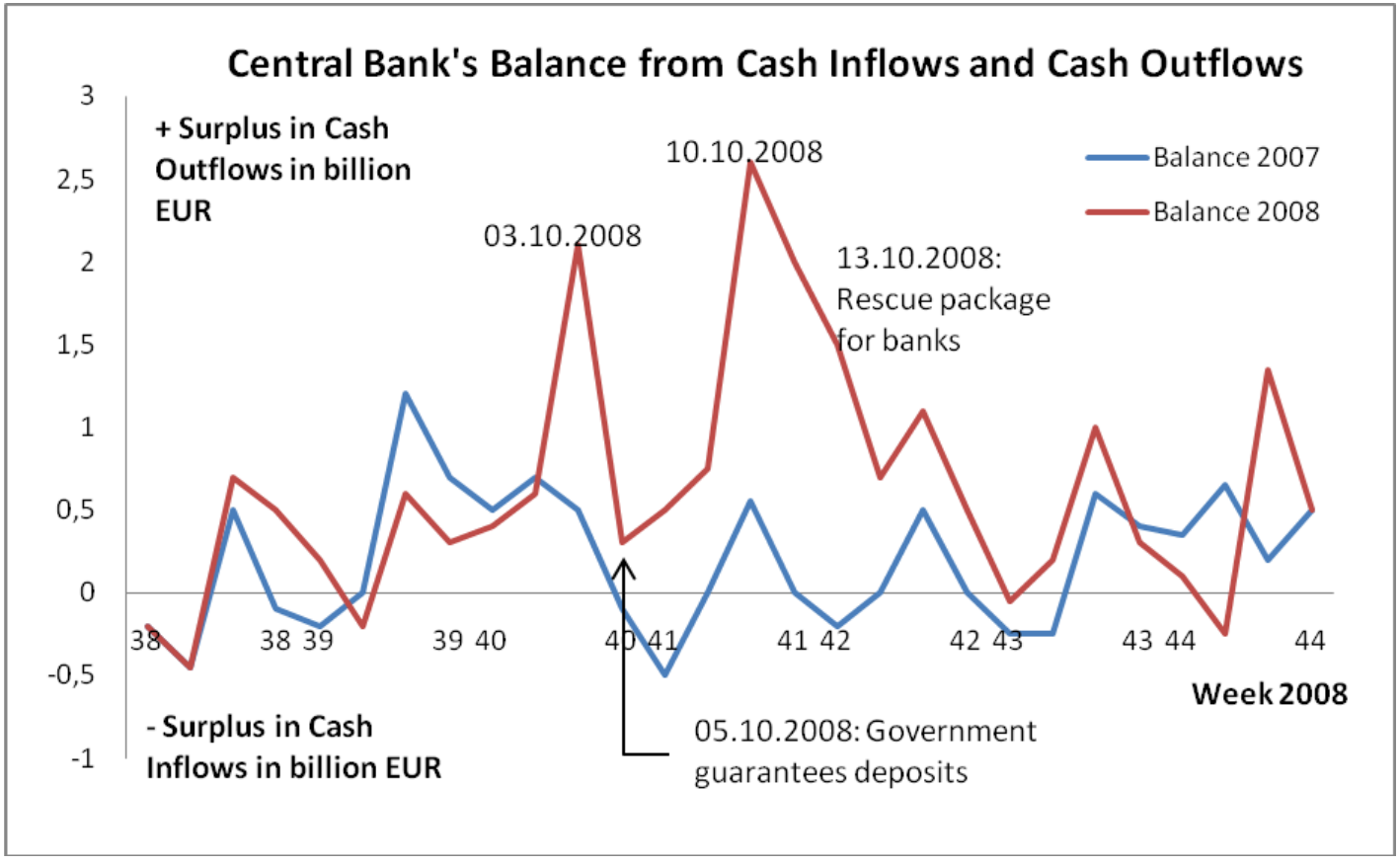
Date	Event
September 14, 2008	Lehman Brothers files for chapter 11 bankruptcy protection
September 17, 2008	AIG receives a loan about 85 billion USD from FED.
September 26, 2008	Washington Mutual collapses after serious liquidity problems
September 28, 2008	German Government and large banks agree on a rescue plan over 35 billion EUR for Hypo Real Estate bank to avoid bank's collapse.
September 29 – October 1, 2008	Netherlands, Belgium and Luxembourg protect FORTIS with 11,2 billion EUR. German central bank identifies increase in total cash demand and a skyrocketing demand for 500 EUR bank notes. The chairman of the central bank Prof. Weber informs the Chancellor and the Minister of Finance.

Excursus: A sequence of events changes the perception of the banking industry (2 of 2)

Link
to all events

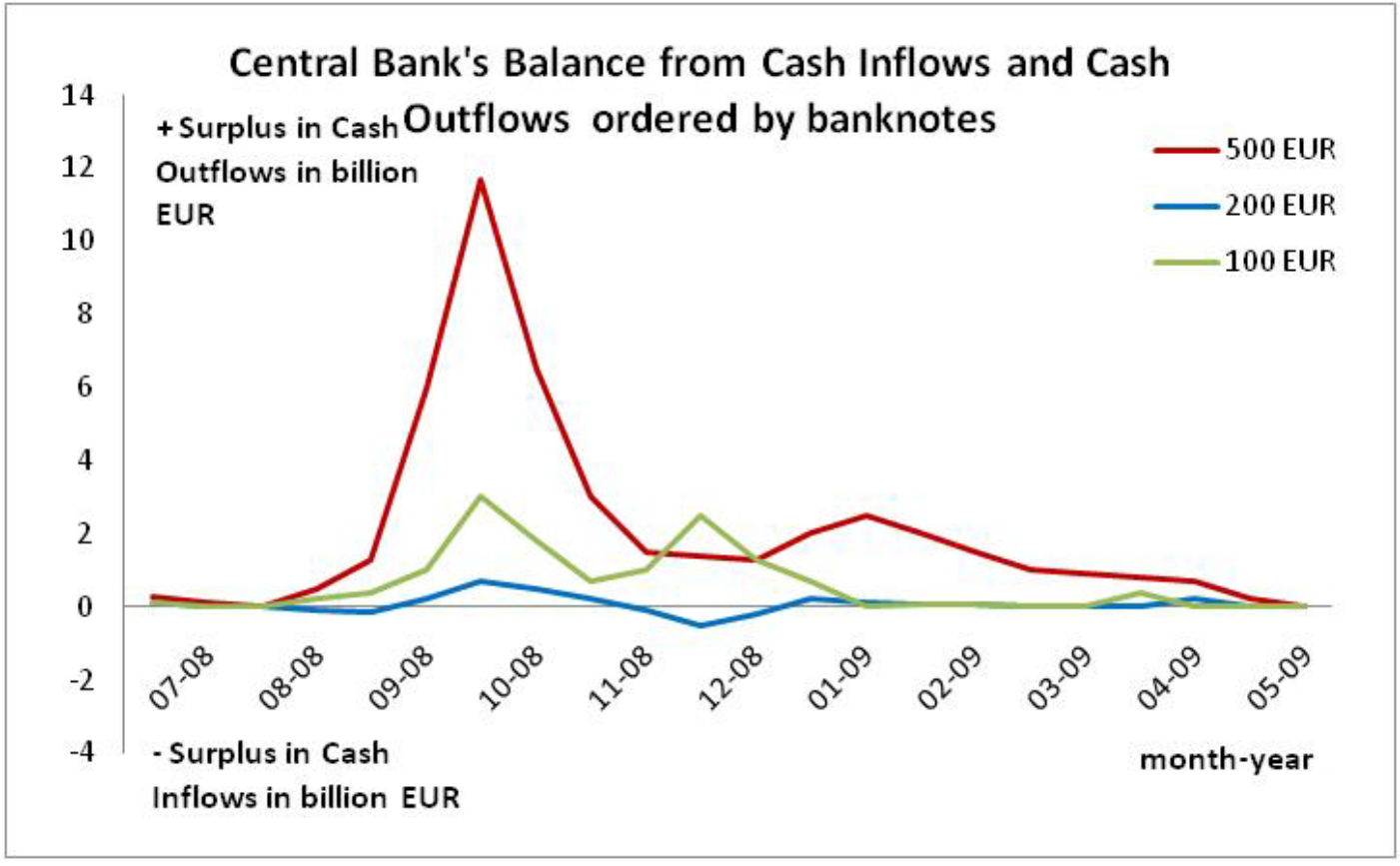
Date	Event
October 2, 2008	Due to a technical malfunction several thousand savings banks' ATM stop their operations in Germany. Islandic GLITNIR bank has to be rescued by governments. Central bank's surplus in cash outflows has a four time high compared to 2007.
October 5, 2008	Hypo Real Estate bank announces that the rescue package did fail. At night government and private banks agree on a new rescue plan about 50 billion EUR. The federal president Mr. Köhler and the head of Federal Institute for Financial Services Supervision Mr. Sanio recommend to the Chancellor to announce a government guarantee for all deposits. At 2:30 p.m. the government announces it.
October 6, 2008	The level of withdraws remains high. The Minister of Finance informs about a plan for a rescue package worth 480 billion EUR to protect the stability of the banking system.
October 8, 2008	

Excursus: Based on its statistical data the German Central bank was able to identify an increase of cash withdraws.



Loss of confidence and trust results in the loss of legitimacy, and when this occurs, commercial activity and business performance do not simply dissipate and decline, they disappear." (LEE, 2009)

Excursus: In particular the details confirmed the assumption that bank customers in Germany began to bank run.



The level of trust in banks and their representatives faced a tremendous drop between 2007 and 2009.

Country	% of respondents who trust banker Fall 2007	% of respondents who trust banker Spring 2009	Change
United Kingdom	47	33	-14
Austria	67	Not applicable	n.a.
Switzerland	73	68	-5
France	38	35	-3
Germany	71	63	-8
Poland	66	59	-7
Hungary	31	38	+7
Average	**56,14**	**49,33**	

Sources: GFK Custom Research 2008 and 2009

In 2008 customers became aware that decisions in financial belongings need to consider risks. This awareness offers new options for banks, too.

A mix of traditional fee structures, product range management and profit orientation establishes a barrier for consulting on customer‘s behalf.

Critical issues

Customer demand

- Retail customers are not used to pay for consulting ➔ instead cherry picking behavior
- Customers expect a broad product range and accept external products. (Steria Mummert, 2006)

Bank response

- Banks establish relationships to external providers (open architecture, interlacement) and receive different profit margins.
- Provisions on external products represent an important profit source.
- Including external products supports banks to develop competencies and to fulfill legal requirements.

Impact on trust

Organizational reaction and exploitation of information asymmetry

- Organization: Selection of product suppliers and products is profit driven (not best of its class)
- Marketing: Highlighting and pushing products with highest provisions
- HR: Staff training to stop customer argumentation. Reward system focuses on profit contribution.

Impact on trust

- I do not trust my bank consultant (low inter-personal trust)
- I do trust my bank consultant, but the bank forces my consultant to do….(low institutional trust)

Characteristics of retail banking	Importance	Areas for response
Legal terms, abstractness	Information asymmetry	**Market based mechanism to improve inter-personal trust**
Co-production of the customer	Sensitive information is needed for sound consulting	Managing the relationship between customer and bank
Monetary factor	Can determine the entire financial situation of the customer	**Government managed programs to improve institutional trust**
Resistance from the general service attributes	Trust in the entire bank system makes or breaks the function of the financial system.	**Market based mechanism to improve institutional trust**

Both the authorities and the industry should make a contribution.
But: A truly effective development of trust must be left as responsibility of each organization (LEE, 2009)

- **Government managed programs**
  - Improved communication of legal deposit protection including harmonization (level playing field) at least in EU

- **Market based mechanism**
  - Trust reporting by banks
  - Standard product signing (SPS) as an instrument to inform customers (uniform labeling system)

To avoid further erosion in public trust the retail banking industry has to initiate measures to improve its tarnished ethical image. Core trust-driving factors are manifested in the behavior of the retail bank and requires that banks keep their promises

Trusting in banks in terms of an institution in everyday life means to bind a personal situation to a particular framework. This framework can be found in a specific regulatory environment.

Country	Deposit guarantee per customer and bank in EUR	Cov.	Public guarantor
France	70.000	100 %	Deposit Guarantee Fund (Fonds de Garantie des Dépôts)
United Kingdom	app. 63.000	90 %	The Financial Services Compensation Scheme
Austria	20.000	100 %	Deposit Protection Company of the Commercial Banks (Einlagensicherung der Banken & Bankiers Gesellschaft m.b.H.)
Germany	50.000	90 %	Several organizations for different segments in the banking industry
Poland	1.000 22.500	100 % 90 %	Bank Guarantee Fund (Bankowy Fundusz Gwarancyjny)
USA	app. 70.000	100 %	Federal Deposit Insurance Corporation (FDIC)

A single framework could reduce customers' efforts to understand the deposit protection.

- A multitude of legal definitions characterize the entire guarantee system.
- Customers are not aware about the details of this deposit guarantee.
- Customers have to make a great effort to understand the entire system and their coverage, in particular when keeping accounts with several banks.
- Hence it can be recommended that under similar circumstances the legal deposit protection should be harmonized, in particular within the EU where retail banks employ Pan-European Market strategies.
- This should include
  - a harmonization in terms of definitions, i.e. which products are covered, as well as
  - size and scope of the deposit protection.
- Furthermore the legal protection should have an appropriate size and should reduce the current gap between size of legal protection and voluntary systems.

⇨ Bank customers will be better informed about the deposit protection; hence their trust in legal regulations will increase. A side benefit is a further level playing field for retail banks in the EU

To address certain normative expectations ("we all recognize that banks are trustworthy") banks can present a trust report and establish a link between trust indicators and their management reward system.

- Report's focus should be on
  - stakeholder experience
  - how profit and growth of a bank is generated and
  - how sustainable this profit is.
- Reward can be linked to both financial returns and stakeholder performance the retail bank achieves.
- Measure points for a modified and improved reward system can be found within certain trust indicators, i.e.
  - community trust in the bank,
  - non-exploitative supplier relations,
  - employee commitment and
  - customer satisfaction.

If bank managers' reward is linked to those criteria, they have to monitor and to know how to develop the underlying core of the banks business: the reputation of the bank and the stakeholder trust.

The report should present trust related information as well as reputation and stakeholder relationships, i.e. objects of trust, receivers of trust, and purpose.

- **Objects** of trust – matters stakeholder really care about
  - financial soundness, appropriate investor relations, fair fees and good interest rates, qualified consulting, or emotional appeal.
  - Address perceptions which make stakeholders feel good about a bank.
  - summarize enough facts for an appropriate understanding of key stakeholders including customers
- **Receivers** for judging trust and reputation of a bank
  - Primary stakeholders
  - other groups in the surrounding of a bank that can have an impact of the perception of the bank, i.e. media including local press, analysts, and competitors
- **Purpose** - issues that are important to stakeholders and important to bank managers
  - i.e. in terms of customer loyalty, employee commitment, rating stability, stability of relationships to other financial organizations, or reputation from the perspective of the financial regulator.

Banks have to ensure that customers receive appropriate products and understand product’s nature. Hence banks have to close a gap.

- Retail banks employ different approaches to transfer essential information to customers,
  - i.e. in Germany customers receive a 169 page handbook which informs about asset types, economic relationships, chances, and risks.
  - Furthermore customers have access to comprehensive sales brochures, which can easily reach 28 pages.
  - Banks use marketing techniques, i.e. “certificates” or “100 % capital guarantee” to cover the true nature of the product
- Overall purpose of these documents is to protect the legal position of the bank by fulfilling legal requirements.
- The primary purpose is not to inform the customer about the specific product nor is it to reduce the information asymmetry between customer and bank.

Since some of the financial products consist of a number of different elements, customers may have problems to understand their entire product. But product transparency in such matters is crucial.

A standardized product signing (“SPS”) should illustrate both the nature and the major characteristics of the product. “SPS”-information should be displayed in a way of a prominent logo.

- It informs about
  - basic nature of the product,
  - major characteristics of the product, and
- Its structure makes it applicable to a number of asset classes.
- In order to inform about the major characteristics of the product, “SPS” should deliver
  - information about several **financial aspects** (currency, interest payments, maturity, and assessment of value),
  - **risks and their coverage** (legal deposit protection, and relevant risk classes) and
  - the **underlying investment object** from the perspective of the customer

Sector wide bodies or governments should support the development of trust (LEE, 2009), hence these bodies should at least promote the “SPS”. Furthermore it is recommended that external organizations, i.e. auditing firms or consumer protection organizations test and report the correctness of the ”SPS”.

SPS example for an “5 year 100 % capital guarantee index certificate on the Indian equity market with ”, issued by an US investment bank

1. Basic nature	Bearer bond
2. Currency	USD
3. Interest payments	--
4. Maturity	5 years
5. Assessment of value	fluctuating market value
6. Size and scope of legal deposit protection	No coverage
7. Relevant risk classes	**Credit Risk**: Default of investment bank **Equity price risk**: Reduction in equity prices within the index during the maturity **Liquidity risk:** A decline in demand for certificates reduces the value of the certificate during the maturity
8. Fundamental investment object	Debt capital for investment bank

II. Final conclusions and outlook for further research (1 of 2)

- The presentation provided an overview of the nature of trust and retail banking products from multiple disciplinary perspectives. It also reviewed current studies that investigate the development of trust in banks.
- Trust reduces complexity and hence the customer's effort to make decisions in terms of financial belongings.
- Due to their characteristics banking products are trust sensitive; it can be argued that the need for trust in banks and products is higher compared to other industries.
- The financial crisis 2008 has violated the expectations and trust in the banking system including retail banks among customers, regulators and other stakeholders.

II. Final conclusions and outlook for further research (2 of 2)

- A report on trust relevant issues can support banks to improve the “trust in the banking” industry.
  - The trust report can represent an option to consider the sustainability of bank’s return, too.
- In order to address the needs of customers it was recommended to harmonize the legal deposit protection.
- Alternative: “Standardized Product Signing”
  - It helps customers to understand the nature of banking products at first sight and to verify their financial decisions.
  - Furthermore a “Standardized Product Signing” would reduce the information asymmetry between customer and bank.
- Further research should be directed to investigate how a new product signing increases the trust level among customers.
  - It should be tested which presentation would offer the highest acceptance. For this purpose different forms and places of the product signing should be tested.
  - Furthermore it should be tested, which kind of trust triggers can increase the acceptance most.

Thank your for your attention!