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The Importance of Trust to Financial Markets and Institutions: Exploring the Current Literature

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Abstract

Human trust is a strong belief that the interactions between two or more people are based on reliability and truth. It is a straightforward concept but is often a difficult one to measure. In this paper, we review trust from a financial economic perspective, which involves financial transactions that occur in various markets. These transactions are made by individuals on their own behalf or as agents for other individuals or legal entities and are typically abetted by appropriate financial markets and institutions. Our survey covers more than 70 economic and finance journal articles and related publications that, with a few notable exceptions, were published in the last 25 years. The studies show that, among other things, trust is positively related to the completeness of financial contracts, increased participation in stock markets, and acquisition of insurance. Study results on the interaction between individuals and their financial advisors are mixed. Although some advisors may provide helpful guidance, many are driven by their own self-interest, although this may be mitigated by a close personal relationship between the two the advisor and advisee. These findings give support to the belief that private and public efforts should be made to increase financial literacy to help individuals find an advisor they trust.

Keywords

Trust, Unwritten Agreements, Mutual Cooperation, Social Relationships, Financial Scandals, Financial Literacy

1. Introduction

Trust lies at the center of most financial transactions. When these transactions are conducted over time, along with a non-trivial probability that the parties in-

volved in the transaction might default on contractual obligations, trust affects both the level of market participation and prices. Market participants need assurance, whether unwritten or written, that the transactions they make are completed as described in the contracts. This need not only requires mutual cooperation between parties but also often puts financial intermediaries as crucial players in the business of trust.

In this article, we survey contemporary work on the economic importance of trust in the financial intermediation sector in which trust plays a particularly important role in overcoming the issues associated with incomplete contracts. We begin by reviewing the literature on the role of trust in financial development and what determines trust in society. We then discuss the research that has studied how trust shapes financial transactions, with an emphasis on how trust impacts the development of the financial advisory industry. Our objective is to provide a comprehensive source of information concerning this important topic. To do so, we turn our attention to the risk-taking and investment behavior of firms and individuals, with a particular focus on the financial advisory industry.

2. Trust and Financial Development

Financing is essentially exchanging cash flow today for a promise to receive more cash flow in the future. In a world with unavoidable incompleteness of contracts, whether such an exchange can occur depends on the degree to which parties to the transaction trust each other. In this spirit, trust exerts an impact on finance by extending interaction among people and allowing exchange between people unknown to each other. Using detailed microeconomic data across different parts of Italy, Guiso et al. (Guiso et al., 2004) study the effect of social capital and the trust it engenders in the financial system and find that households located in high social capital areas invest a larger proportion in stock and are less likely to obtain informal loans (e.g., from a relative or friend). Their cross-sectional test confirms the theoretical prediction that social capital or trust exerts a stronger impact when legal enforcement is weaker, and households are less educated. In addition, by examining the behavior of people who migrated over the course of their lifetime, they document the amount of social capital in the region where people are born and reared has a long-term impact on their subjective priors about other people's behavior as well as their financial decisions.

In later work, Guiso et al. (Guiso et al., 2006) focus on individual-level data and examine the relationship between individual trust and the labor market decision. Using the General Social Survey data, they find that individuals who reveal a willingness to trust others are significantly likely to become entrepreneurs in the United States. In a follow-up study, Guiso et al. (Guiso et al., 2008) investigate whether and how individual trust has an impact on the stock market participation of individuals. In particular, they find that low-trusting individuals are less likely to participate in the stock market, which suggests lack of trust is an

important factor in explaining the stock market participation puzzle.

In addition to risky investments, trust also affects risk management. For example, Cole et al. (Cole et al., 2013) use randomized experiments in rural India to examine the importance of trust to household risk management as measured by the adoption of rainfall insurance. They find the rainfall insurance take-up rate is higher when a trusted local agent educates local households about the insurance contracts, suggesting lack of trust is a significant non-price friction that creates barriers to household risk management.

The relevance of trust to risk management is also reflected by its impact on insurance contracts. Using a theoretical model, Gennaioli et al. (Gennaioli et al., 2020) predict that trust reduces transaction costs in the homeowner insurance market and improves welfare for both homeowners and insurance companies. Specifically, trust is predicted to be associated with a reduction in disputes over claims, the weight of rejected claims, the share of unpaid claimed value, as well as general expenses made by insurance companies as a share of total premiums. Using a dataset on homeowner insurance claims from a multinational insurance company with subsidiaries operating independently in 28 countries, they find consistent empirical evidence to support their theoretical prediction.

Given the documented positive effects of individual trust, trusting too much, however, is not always beneficial for individuals. Butler et al. (Butler et al., 2016), using data from the European Social Survey, study the relation between intensity of trust and individual income. They find that both overly optimistic and overly pessimistic trust beliefs lead to lower earnings compared with approximately accurate trust beliefs, which suggests a hump-shaped relation between trust behavior and earnings. Their interpretation is that having less trust in others leads to missed opportunities to make beneficial exchanges and being frequently betrayed by others hurts earnings or individuals.

Trust impacts not only the financial decisions of people but also matters for the performance of firms. During the 2008-09 financial crisis, the level of trust between a firm and its investors positively affects firm performance in the equity market (Lins et al., 2017). As a borrower, the trustworthiness of a firm also impacts the terms of loans they receive from lenders (Fotak et al., 2023). As for lenders, how depositors or investors judge their lending practices also affects their business activity in the credit market (Thakor & Merton, 2018; Homanen, 2018).

When contract incompleteness is given in a transaction, agents make economic decisions based on the level of trust between the two parties. However, in many cases, contracts are not fixed but are instead determined by the involved agents in the transaction. Then, trust between the agents might have an impact on the completeness of the contract. To empirically test this conjecture, D'Acunto et al. (D'Acunto et al., 2020) collect a unique sample of U.S. consulting contracts that can be measured by their degree of completeness and find that low trust between parties increases the completeness of contracts. Limback et al.

(Limback et al., 2023) find that trust between financial professionals declined from 1979 to 2016. Compared to trust in general in the U.S. population, their trust began higher, then declined, and at the end of the study period, it was lower.

In the first quarter of 2023, there was a recent major outflow of uninsured deposits from the Silicon Valley Bank (SVB), which is located in a technical hub in the San Francisco Bay Area of California (U.S.). Cookson et al. (Cookson et al., 2023) find that this outflow event was amplified by Twitter (now X) sending messages to a large audience of subscribers predicting stock market losses, especially for those banks with abnormally high balance sheet risks. Cookson et al. (Cookson et al., 2023) investigate the influence of social media on bank runs using SVB as an example. They show how social media activity, especially a large number of negative tweets, contributed to the acceleration and amplification of bank runs and subsequent financial distress of banks. It demonstrates that banks with higher pre-run Twitter exposure experienced more significant stock market losses and deposit outflows. The article highlights the role of social media in financial market dynamics and shows that it can significantly increase risks in the banking sector.

Drobetz et al. (Drobetz et al., 2023) investigated equity portfolio allocations of over eight thousand global investors in 33 countries from 2000 to 2017 and found that investors in high-trust countries tend not to underinvest in foreign stocks and lean toward cross-country diversification. They also find that high social trust is especially important if the host country has weak formal institutions and is associated with high information asymmetries.

Dak-Adzaklo & Wong (Dak-Adzaklo & Wong, 2024) examine the interplay between corporate governance reforms and societal trust in influencing corporate financial decisions. After analyzing thousands of firm-year observations from 35 countries, they demonstrate that corporate governance reforms positively impact corporate financing and investment. The authors reveal that this effect is more pronounced in countries with lower societal trust and report that formal changes in corporate governance led to an increase in new investment, especially in low-trust companies.

Lel et al. (Lel et al., 2023) investigate the consequences of corporate misconduct on institutional investors. Their study reveals a significant market value discount in institutional investors' portfolios, excluding the misconduct firms, averaging $92.7 billion in losses per year. They explore various spillover channels, including the loss of embedded monitoring value and enforcement activities. The authors note significant abnormal outflows from misconduct-linked institutional investors and this adverse effect, thereby highlighting the importance of management changes in restoring trust and reducing the cost of debt.

Booth & Karagiannidis (Booth & Karagiannidis, 2023) examine the Libor scandal that became known to the public in 2012 but was found to have started during the 2007-2008 credit crunch, although it may have begun as early as 1991.

The scandal involved several large U.S. and European banks submitting interest rate estimates to the British Bankers Association in order to manipulate the Libor rate in their favor. Once this behavior was discovered, the countries that used Libor decided that it should be discontinued and replaced with a new system of interest rates that would be harder to manipulate and be a better measure of current economic conditions. Some countries developed their own rate, others grouped together to create a joint rate, and still others decided to rely on already existing rates. For example, the U.S. now uses the Secured Overnight Financing Rate (SOFR) and most European countries rely on the Euro Short-Term Rate (€STR). China uses the Pledged Depository-Institution Rate (DR) instead of Libor.

Kapoor (Kapoor, 2023) describes in detail the 2022 FTX scandal and its ramifications. It began in 2017 when Sam Bankman-Fried (SBF) recognized that he could profit by arbitraging bitcoins between exchanges. To manage this strategy, he created Almeda, which eventually led to the construction of a cryptocurrency exchange, FTX SBF saw an opportunity to profit in the venture capital arena. He then proceeded to have Almeda borrow money to exploit this opportunity. However, the purchased assets were illiquid and when Almeda's loans were called, they could not be repaid. SBF tried to raise funds from other sources but was unsuccessful. Not being able to make up an $8 billion dollar shortfall, FTX filed for bankruptcy and in 2023 SBR was found guilty of fraud.

3. Trust and the Financial Advisory Industry

Many households are ill-equipped to know how to invest. The lack of investment knowledge limits stock market participation (Guiso et al., 2002; Mehra & Prescott, 1985; Dimson, 2006). Moreover, a lack of investment knowledge leads to investment mistakes, such as under-diversification of portfolios (Blume & Friend, 1975; Calvet et al., 2007), inertia in asset allocation (Agnew et al., 2003; Calvet et al., 2009; Madrian & Shea, 2001). Empirical evidence suggests investors who are less experienced and knowledgeable about investing are more likely to suffer from investment biases such as the disposition effect (Shefrin & Statman, 1985), as well as overconfidence (Odean, 1999; Barber & Odean, 2000).

Given the welfare implications of investment mistakes, it is crucial to find solutions that can help investors. As Campbell (Campbell, 2006) points out, consumer regulation, default options, and financial education are potential ways to limit the incidence and adverse impact of these mistakes. In practice, the financial planning and advice industry provides services to households to help them avoid investment mistakes in exchange for compensation. Some evidence suggests that financial advice helps investors achieve better portfolio diversification (Kramer, 2012; Gaudecker, 2015). In recent years, the demand for investment advice has led to sustained growth of this industry in the United States and has resulted in an estimated market value of $57 billion in 2019.

Gennaioli et al. (Gennaioli et al., 2015) point out that the trust between inves-

tors and financial advisers is similar to the relationship between patients and doctors. To formally illustrate how trust matters in delegated asset management, they build a theoretical model in which investors' trust in managers allows managers to charge fees because investors have lower perceived risk toward the assets recommended by managers' investments. The more trust an investor has in a manager, the less uncertain they perceive the returns as risky when associated with this manager. Since managers differ in their trustworthiness in the eyes of investors, competition between managers does not lead to zero fees. In equilibrium, fees grow proportionally with expected returns and risk. On average, managers underperform the market net of fees. Furthermore, the model suggests that managers tend to pander because doing so makes irrational investors trust the managers more and, thus, are willing to make more investments at a larger fee. The key mechanism of this model is confirmed in an experimental setting by Germann et al. (Germann et al., 2018) which shows that investors undertake substantially higher risk if a money manager is more trustworthy, regardless of the fee level charged by the manager.

To understand how trust is formed in a client-adviser relationship, Agnew et al. (Agnew et al., 2003), Agnew et al. (Agnew et al., 2018) conducted an incentivized discrete choice experiment in Australia. They observe irrationality exhibited by investors when forming judgements of adviser quality. In particular, investors tend to follow advisers who make a good first impression by confirming their view, and, as a result, their opinion of adviser quality can be easily manipulated by using a catering strategy.

Egan et al. (Egan et al., 2019) analyze more than 1.2 million FINRA financial advisers from 2005 to 2015 and documented the scope and pattern of financial adviser misconduct in the United States. They show that the number of financial advisers with a record of misconduct is surprisingly high (up to seven percent) and this rate goes up to more than 15 percent at some of the largest firms. Repeat offenders are common, representing about one-third of advisers with a record of misconduct. A large number of offenders still remain in the industry, suggesting the labor market in the industry potentially undermines firm-level discipline against misconduct. Using a novel dataset of U.S. financial advisers, Dimmock et al. (Dimmock et al., 2018) show that misconduct behavior may be contagious, i.e., individuals become more likely to commit financial misconduct if their office incorporates new coworkers with a history of misconduct, due to the merger of financial advisory firms.

Once investors lose trust, they may withdraw their investment. Gurun et al. (Gurun et al., 2018) exploit the Ponzi scheme (Monroe et al., 2010) perpetuated by Bernie Madoff (Hayes et al., 2023) to test this prediction. To infer causality, they employ difference-in-differences tests by exploiting the variation in relative concentration of victims across different regions in the U.S. They find that after the uncovering of the Madoff fraud in December 2008, residents in areas that were subject to the fraud subsequently withdrew assets from investment advisory

firms and transfer deposits to banks, leading increased probability of closure of exposed financial advisory companies. In addition to the discovery of misconduct by financial advisers, the financial crisis is another trigger for investors to lose trust and as a result withdraw their investment in delegated managers (Dorn & Weber, 2017).

While Gurun et al. (Gurun et al., 2018) document the impact on asset flows from clients losing trust in regulators, Kostovetsky (Kostovetsky, 2016) focuses on the importance of trust in investor-fund manager relationships by examining mutual fund flows following the announcement of ownership changes in mutual fund management companies. Kostovetsky (Kostovetsky, 2016) shows that clients place trust in firms rather than fund managers. Along similar lines, Gurun et al. (Gurun et al., 2021) show that clients' trust in advisers, rather than advisory firms, shapes asset flows in the financial advisory market. In particular, they exploit firm-level variation in adoption of the Broker Protocol, which enabled clients to follow their advisers to member firms without fear of litigation (assuming that the client initiates the change). They show that an adviser's ability to maintain client relationships is a significant predictor of their employment decisions. When employees break up with their firms and move to another firm, they move close to 40 percent of their client assets with them. Clifford & Gerken (Clifford & Gerken, 2021) use the same setup and show that advisors are more likely to invest in their human capital by obtaining licenses after the adoption of the Broker Protocol.

The root cause of much misconduct is the conflict of interest inherent in an investor-adviser relationship, which is empirically difficult to identify. When investors are not sufficiently wary of the existence of such conflict, financial advice might turn into curses instead of blessings for them (Inderst & Ottaviani, 2012b; Guiso et al., 2008, 2011). A large strand of literature provides both theoretical and empirical evidence of conflicts of interest in the financial advisory industry (Gomes et al., 2021). Inderst & Ottaviani (Inderst & Ottaviani, 2009) model the inherent conflict among the three parties in the financial advisory industry: investors, advisors, and financial advisory firms. They argue agency problems become acute when employing firms hire the same adviser to sell products and provide investment advice to customers. When advisors face steep sale incentives from employing firms, they tend to sell investors products that are unsuitable for their investment needs. Without compliance with a standard of advice, this behavior makes firms bear the risk of lawsuits or regulatory sanctions. In later work, Inderst & Ottaviani (Inderst & Ottaviani, 2012a) predict that imposing obligatory disclosure and caps on commissions leads to unintended welfare consequences if product producers pay adviser-disclosed commissions or hidden kickbacks when their products are sold by advisors to investors.

Many empirical studies document that investors pay substantial fees for financial advice, which often leads to underperformance. Bergstresser et al. (Bergstresser et al., 2009) show that between 1996 and 2004 direct-sold equity,

bond, and money market funds outperformed corresponding broker-sold funds by 14 to 90 basis points before considering distribution fees (compensation for the adviser). They also find little evidence of superior asset allocation or market timing skills among advisers. Consistent evidence is found by Friesen & Sapp (Friesen & Sapp, 2007) based on individual fund-level cash flow data. They find that investors in load funds experience 194 basis points loss due to poor market timing as compared to 96 basis points loss for those in no-load funds. Given load funds are typically purchased through a broker or investment advisor, they suggest that relying on financial advice results in poorer performance from an investment timing perspective.

Christoffersen et al. (Christoffersen et al., 2013) provide evidence that payments advisors receive influence their recommendations. Along the same lines, Chalmers & Reuter (Chalmers & Reuter, 2020) find investors using university-sponsored retirement plans who receive conflicted investment advice underperform self-directed investors up to 125 basis points. Gelman et al. (Gelman et al., 2022) undertake a cost-benefit study and find that instances of misconduct increase as the stock market declines in value. They attribute this counter-cyclical behavior to a loss of income by financial advisors. Gurun & Booth (Gurun & Booth, 2020) point out that from firsthand experience some financial advisors appear to be employed to ensure that their firm's clients stay with the firm regardless of its investment performance. In addition, Lel et al. (Lel et al., 2023) show that institutional investors who are impacted by misconduct by a firm in which they have a substantial stock position experience significant financial outflow.

For investors who receive conflicting advice, the flow of their portfolios is sensitive to the level of broker fees. When broker fees rise, the allocation to high-fee funds climbs. However, when advisers do not gain from those fees, they tend to suggest investors stay away from high-fee funds. In Del Guercio & Reuter (Del Guercio & Reuter, 2014), passively managed broker-sold funds outperform actively managed broker-sold funds, even after considering distribution fees. Mullainathan et al. (Mullainathan et al., 2012) use experimental data to show that financial advisers tend to recommend investment strategies that are in line with their own financial interests. They introduce clients to high-fee, actively managed funds rather than low-fee, passively managed funds. The existence of distortions in financial advice is confirmed using various empirical datasets and methods (Hackethal et al., 2012; Hoechle et al. 2017; Hoechle et al. 2018; Egan, 2019).

Similar distortions are documented in other financial industries. Anagol et al. (Anagol et al., 2017) conducted a field experiment in India and reported that life insurance agents recommend dominant products to clients in order to obtain high commissions. For the Italian housing market, Foa et al. (Foa et al., 2015) reveal the existence of distorted advice on mortgage loans, and in a related work, Guiso et al. (Guiso et al., 2018) estimate the welfare implication of such distor-

tions.

Gelman et al. (Gelman et al., 2022) investigate the relationship between stock market cycles and investment advisor misconduct and offer critical insights for policymakers and highlight the need for vigilant monitoring processes in the investment advisement industry. They demonstrate that occurrences of misconduct by investment advisors increase with declines in the stock market. The study suggests that income variations driven by market cycles significantly influence advisors' propensity for misconduct.

Assuming conflicts of interest are mitigated through contracting or regulation, does financial advice always become beneficial to investors? Recent studies suggest that the answer is no. Linnainmaa et al. (Linnainmaa et al., 2018) find evidence that the misguided beliefs of financial advisers might be an alternative to the explanation of costly and low-qualify financial advice. They observe that a large sample of Canadian financial advisers invest very similarly to their clients. The investment strategies employed by these advisers often underperform. These include portfolio under diversification, frequent trading, chasing returns, and favoring expensive and actively managed funds. In addition to misguided beliefs, Foerster et al. (Foerster et al., 2017) find financial advisers do not customize investments for investors with different characteristics such as risk tolerance and age. This one-size-fits-all advice on average costs investors 2.5 percent of asset value per year. Finally, even with unbiased financial advice, the welfare improvement for retail investors is not necessarily satisfactory. Bhattacharya et al. (Bhattacharya et al., 2012), using a field study performed by a large brokerage firm in Germany, find that the investors who accept the offer of unbiased financial advice are not the ones who need the advice the most. They find that investors who accept the offer are more likely to be financially sophisticated, older, richer, and male. Interestingly, those who accept the offer of advice often do not follow the financial advice.

4. Concluding Remarks

As indicated above, trust is important for financial institutions and markets to fulfill the role assigned to them in modern society. As a result, governments around the world have created laws and have agreed upon guidelines in an effort to ensure that their financial system meets the needs of their economy and its ability to interact with other economies throughout the world. These guidelines are currently under the jurisdiction of the International Organization of Securities Commissions (IOSCO). Specific guidelines related to financial intermediaries of all types include 1) meeting capital and liquidity requirements commensurate with their risks, 2) being managed and organized to ensure adequate protection of clients and 3) having procedures to limit loss to investors and contain systematic risk in case of failure. The content of these guidelines is modified whenever it appears to be appropriate.

How do individuals initially learn that a financial institution or advisor is

trustworthy and continues to be trustworthy over time? The answer is straightforward: The individuals should be financially literate. In other words, they must understand basic financial principles and be able to ask pertinent questions until they clearly understand the answers. Unfortunately, currently, many individuals do not fall into the financial literate category. For example, Lusardi and Mitchel (Lusardi & Mitchel, 2010) indicate, among other things, that 1) years of general education is not a very good proxy for financial literacy, 2) there are ethnic-racial differences, and 3) city-dwellers tend to be more informed than those that live in rural areas (see also, Lusardi & Messy, 2023; Lusardi & Mitchel, 2021; Lusardi & Mitchel, 2023; Ram, 2023). Moreover, a survey by Standard & Poor's Ratings Services (Klapper et al., 2015) indicates that financial literacy varies by country. The most literate countries are Denmark, Norway, and Sweden with 71 percent of adults being considered financially literate, and the least literate country is the Republic of Yemen (13 percent). Not surprisingly, there is a strong relationship between literacy and a country's wealth. For example, the correlation between the Standard & Poor's literacy rate (Klapper et al., 2015) and the estimated Gross Domestic Product (GDP) per capita for 2023 (International Monetary Fund, 2023) for 136 countries for which both data are currently available is 0.702 (with a standard error of 0.062). For the 10 largest GDP countries the correlation is 0.827 (with a standard error of 0.107).

It is well known that correlation does not mean that there is a causal relationship. Nevertheless, it is consistent with the notion that financial literacy improves an individual's financial decisions, which in turn increases a country's per capita GDP, and this increase results in more funds to spend on increasing financial literacy. This relationship and its corresponding benefits are beginning to gain traction in the academic world. For instance, mainstream journals are becoming interested in the topic, a new journal was started in 2023 with a prime focus on the topic, and in 2019 the Journal of Economic Literature (JEL) established Household Finance (G53) as a stand-alone research area. We hope that this article not only will help to promote research on this important topic but also add impetus to educational institutions and governments throughout the world to begin or increase their efforts to address and improve financial education.

Conflicts of Interest

The authors declare no conflicts of interest regarding the publication of this paper.

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