"Trust is a must"

Speech by Michiel Denkers, Head of Supervision "Treating customers fairly" of the AFM at the VU University Symposium on Trust, Compliance and Regulation.

1. Ladies and gentlemen, I very much welcome this opportunity to reflect on the theme of trust. Not in the last place, because Juan's thesis on this subject arrived just in time to introduce some academic rigour into a casual conversation I was having with my wife last week.

2. I told her the story about a lady I had met the at the check-out counter of my local supermarket. She had collected some groceries worth 6 euro and as it turned out, she had left her wallet at home. I offered to pay for the goods and give her my account details so she could pay me back later.

3. "Why on earth would you do that?" exclaimed my wife when I related this story to her. "Why would you give 6 euro to someone completely unknown to you?" "That's because I trust people", I answered. Upon which my wife looked at me with an expression of disbelief bordering on disdain, in a way that only she and my 10 year old daughter can. "That has absolutely nothing to do with trust" she said. "This is what you call complete and utter foolishness, or naivety and misplaced altruism at best". "You only do that to make yourself feel better".

4. As you can imagine, this conservation got me off to a flying start thinking about the notion of trust. In a room full of academics I will stay on the safe side and restrict myself to what I see in practice as a financial regulator. Note that the words regulator and supervisor are often used interchangeably. Strictly speaking, of course, the regulator is the one who sets the rules. The supervisor the one who carries out the monitoring activity and enforces compliance with these rules. That is what my job is about. For the purpose of this discussion though, I will refer to the AFM as a regulator.

5. For those of you who don't know the organization that I represent a very brief introduction. The AFM is a so-called conduct of business regulator. "I am in the business of behavioural change management", I sometimes say at birthday parties. Our mission is to promote better functioning financial markets. 'Fairness', 'transparency' and 'safety' being the operative words. We are a cross-sectoral regulator, which means our remit spans the markets for savings, lending, insurance, investments and pensions. And depending on how you count, around 12,000 firms fall under our supervisory mandate. As you can image, this requires a smart approach.

6. As even the most disengaged bystanders will appreciate, 'trust' is probably one of the most frequently used words in relation to the financial world since the outbreak of the financial crisis. Often in combination with the word 'compliance', or lack thereof (non-compliance) and 'regulator', who is seen to be both instrumental in restoring the breakdown in trust and one of the main culprits in allowing for this situation to arise in the first place.

7. Clearly, there has been a major break down in trust. Most notably between society and the sector. But events in recent years have also put a huge strain on the relationship between regulators and firms and the sector as a whole.

8. Only this weekend 'Het Financieele Dagblad', the Dutch financial newspaper ran a large front page article citing various leading industry executives -including Board Members of some the biggest financial institutions- who argue that the interventions of regulators such as the AFM and the Dutch Central Bank "are going much too far` and that `the balance between regulation and free enterprise has shifted far too much, to the deterioration of industry´. This –they proclaim- is caused by regulators who have a growing and unhealthy fear of public opinion, parliament and social media. This leads to extreme risk aversion on the part of regulators -they say- and as a result they observe a sharp decline in the level of trust.

9. So anyhow, from whatever perspective you look at it, it seems that Juan´s research and our discussion on the topic of trust, compliance and regulation is extremely timely.

Defining trust

9. When I sat down last night to prepare for my discussion with you this morning, and before reading the early chapters of Juan's thesis, I spent some time pondering the notion of trust. I noticed it is quite easy to get lost in all sorts of philosophical deliberations about it. So I quickly left that path on the lookout for a more practical approach.

10. But the question that stuck in my head was: should I think of 'trust' as an instrument, something that is just there, something both sides of a relationship have at their disposal. Something we can give away as we see fit? Or is trust an outcome? A condition. A state in a relationship.

11. If the former view holds true –then trust can be viewed as an *ingredient* that we regulators have at your disposal and which we can unilaterally decide to add -in quantities large or small- to our broader mix of interventions. 'Trust' as a regulatory tool. In this view, the trust we place in the firms that we regulate does not necessarily need to have a solid basis. Maybe we are just curious to see what happens if we look the other way? More likely though it will be based on positive expectations of a firm's behaviour that have been formed over time.

12. In the second view, trust (or distrust) is an *outcome*. An outcome which is the result of past experiences and repeated interaction. In our case, between ourselves and financial firms. For this outcome to be achieved, by definition you have to take risks and put yourself in a vulnerable position. How else would you find out how the other will behave in circumstances where you are looking the other way?

13. If you look at it this way, it becomes apparent that the two views go hand in hand. You place trust 'the ingredient' in someone because it is the only way to form an expectation of someone's behaviour. From this it also follows that as a regulator, one of the strategic choices you make concerns the willingness to take risks and ´expose´ your organisation by creating circumstances that are necessary for trust to grow. You will appreciate, this requires a self-assured organisation.

14. Of course the regulator still has a choice whether or not to *act* in accordance with the level of trust which has been build up. Because of external influences -such as a strong political or public sentiment- a regulator may shy away from being seen to be too trusting. After all, he runs the risk of being perceived to be captive, foolish and naive. With people like my wife around, you will not be surprised. As it happens, this is essentially the complaint made by the executives that I cited earlier.

15. Anyway, taking some big steps forward now, I propose, based on experience, that some level of trust is crucial in a regulatory relationship. Complete trust is unrealistic. Complete distrust is dysfunctional and costly. I would also add that for trust to be long-lasting, by definition it must be mutual. If it is not, there is an unhealthy equilibrium which eventually leads a breakdown and mutual distrust. In this regard, it resembles a prisoner's dilemma**.** So we must look to establish an optimal level of trust, which of course may vary from sector to sector and also over time.

16. Why is trust important? Again, let me offer my opinion as a practitioner. On the most basic level because we need information to do our work. And the willingness to share information, or to give an insight into the control environment of a firm, will to a large extent be influenced by their expectation of how we will act in a situation where potential shortcomings or concerns emerge. Perhaps more importantly, it can contribute to creating an environment in which firms feel free to exercise their own sound judgment and have the self-confidence to act accordingly. This is essential, particularly in a regulatory environment such as ours where much of the rules are principles-based. Let me expand on that.

17. The AFM applies a problem oriented approach to regulation. In other words, it has a strong focus on solving ´real´ problems and achieving measurable outcomes. In the end firms are best placed to assess how they can contribute to the delivery of these outcomes. If the level of trust is insufficient and the relationship is impaired, firms will have a tendency to play it safe. They will be inclined to stick as close to the letter of the law as they can. And to devote equal attention to important and less important things. Important that is, if you look at it from a problem-oriented, material point of view.

18. Firms will think "they say that they focus on real outcomes, but they pillory us if we are found to be non-compliant with a rule, even if no harm is done". In the same spirit, lack of trust can stifle innovation. Firms will be reluctant to experiment and innovate -even when they have a strong belief that this may to the benefit of consumers or the wider market place- for fear of meeting an unfavourable response or intervention from the regulator. In an extreme situation of mistrust, they will even be reluctant to discuss these ideas out of fear for repercussions for the relationship ("How on earth could they come up with such an idea, it is obvious they still don't get it?").

19. So if trust is important and an outcome, something we need to work at and something which is not just there, something which involves some risk taking on both sides, what conditions can we create that contribute to building to up a trust-based relationship?

Creating conditions that contribute to building up trust

20. From my own experience, I have found that it is very hard work to build up and *attain* a certain level of trust. It is even harder to *maintain* that level of trust. I would say that the key to success - at the end of the day- is about being predictable and consistently meeting the (positive) expectations that firms have about your behaviour.

21. If that is true it follows that for a large part building trust is about shaping and managing expectations. That is not the same as saying that the actual outcome of a regulator's actions always has to be looked at favourably by the firm. It is as much about how the outcome has come about. About the perceived procedural (and distributional) fairness. About the transparency about that process, and whether the outcome comes a surprise. Trust asks for predictable behaviour.

22. That does not mean that a regulator should necessarily publish a copy of its inspection programme, although many inspection agencies are increasingly transparent about their agenda. But firms should have a good sense of how you behave in certain situations. Erratic behaviour is killing for a trust relationship. Although -as with any relationship- the stronger the basis, the more solid the track record, the more resilient trust is for a mistake on either side.

Trust in practice

16. Over the years, we have tried to incorporate the idea of trust in our regulatory strategy in many different ways. Let me share with you a recent example which involves the population of firms that was also the subject of Juan´s study. This is a large group of approximately 8,500 firms. Mostly small scale, owner operated independent businesses. They typically serve the local community by offering -amongst other things- insurance products and mortgage advice.

17. In the past years various studies have laid bare a vast trust gap between this population and the AFM. These findings are consistent with the findings our annual stakeholder survey. These studies and the surveys have given us various pointers as to the underlying drivers of this breakdown. These served as a useful starting point for an action plan which we put in motion about a year and a half ago.

18. What we found -perhaps not surprisingly- is that the high level of distrust for a large part could be attributed to some very strong and persistent perceptions about our beliefs and attitudes towards this group of firms that were not necessarily in line with our actual beliefs. Apparently, though, our behaviour sent out a different message.

19. One of the perceptions that impacted hugely on the level of trust and which we unconsciously kept on feeding was the idea that we would –contrary to our stated objective- heavy handedly enforce non-compliance in seemingly harmless situations. It turned out that this perception was mostly influenced by the publication of administrative fines imposed on firms. Apart from revoking a license, a fine is the most severe punitive instrument that we can use.

20. When the AFM imposes an administrative fine, we are legally obliged to publish the fine including the motivation for imposing the fine in the given situation. The idea is that publication will act as a deterrent for other firms, but also have a positive signalling effect towards compliant firms ("you see, we will protect the reputation of your sector and a level-playing field by being tough on those who don't play by the rules"). Furthermore, publication of the underlying motivation for imposing the fine is meant to provide learning opportunities for other firms.

21. However, the content of this kind of publications is guided by fairly strict rules and for some time we took a fairly technical, restrictive view on this. The result was that on some occasions these publications only showed the tip of the iceberg, whilst leaving out more persistent patterns of harmful behaviour that had been building up over time. In one instance, this left firms with impression that a huge fine was imposed because a copy of bank statement was missing in a mortgage advice file. This contributed to creating a culture of fear that has put an unproductive strain on the relationship.

22. With the help some industry practitioners we are now writing up these publications so as to align the perceptions that it creates as much as possible with the actual situation. Before each publication, we put the wording to a panel of industry representatives to assess their interpretation of the message.

23. Another factor that strongly impacted on the trust-relationship was their beliefs about our ability –or rather inability- to understand their business and relate to their 'inner world'. "How can we trust them if we don't show an understanding how my business works? Or show an appreciation of the challenges we face?" "How can we trust them if they speak in a completely different language? And act from their ivory tower?"

24. Perhaps more importantly, they felt that everything in our approach, and particularly in our public statements, radiated distrust. In turn, this fuelled their distrust of us. "If you don´t trust, then surely you cannot expect us to trust you?"

25. As I said, we have put a programme of activities in place to try to narrow the gap. Let me draw out a few elements.

26. The single most important of this programme is to create more opportunities to meet each other in more informal settings. To engage in a frank and open dialogue. A dialogue that contributes to a good understanding of each other's objectives, key priorities, challenges and concerns. As for the AFM, it gives us an opportunity to explain how we see our role, our mission. But also to give a more detailed insight in the priorities we set in a given year. And how we supervise in practice.

27. This also provides us – and the firms- with an opportunity to discuss the constraints that we face. What are our limitations in terms of what we can achieve? And what are the consequences of the choices we make. For example, the perception of seemingly letting a highly visible offender off the hook can impact hugely on the level of trust. This risk can be mitigated by explaining the rationale for focusing your attention in another area or your inability to act in certain circumstances.

28. Again, critical to developing this kind of understanding is the ability to put yourself in the shoes of the other and demonstrate that you understand. To this end, we have begun to send AFM staff on regular practice days hosted by intermediary firms. In addition, we have established a practitioner panel, which we consult informally on various kinds of interventions and communications.

29. A step further is to give firms an opportunity to influence our policies or priorities. For example, by putting the supervisory agenda or certain reports out for formal consultation. But -as we learned from experience- this can impact negatively on the level of trust if firms believe that we are paying mere lip service to this idea. If we do it we need to do it well and show what we have done with the feedback that we have received. A demonstration that we have taken one or two ideas on board undoubtedly helps, but as a minimum we have to show that we have processed the input and motivate why we have decided to put ideas aside.

30. Currently, we are experimenting with various forms of formal and informal consultation, at various stages during the problem solving process.

31. As I mentioned earlier, for a trust-relation to flourish you need be consistent and take a coordinated view. With consistent I mean consistent over time, but also consistent in terms of your approach. There should be no discrepancy between what you say and do. For example, a commonly heard complaint by these firms –which is echoed by the industry executives that I referred to earlier- is that they experience a huge difference between what is being said in face-to-face meetings and what is subsequently put to them in formal writing. Needless to say, this is not conducive to creating a relationship of trust.

32. As any organisation is made up of individuals, the behaviour of these individuals key. Particularly the behaviour of those who have a high profile. Also here there is a need to be consistent, to be on message and to be on tune. And good personal relationships are instrumental in building trust. But it is also vulnerable if trust depends too much on that. It needs to be institutionalized.

33. This is a final dimension of consistency: the need to be consistent across the entire organisation. Various parts of the organisation and even more individuals within our organisation, interact with this group of firms. Not only different groups of supervisors. But, for example, also the accounting department that collects the levies of firms. This is one of the most challenging aspects to manage. The fruits of a prolonged effort of carefully cultivating a more constructive and sensitive approach can be wiped out overnight as the result of an innocent by-line in an interview with a senior executive.

34. To add to the challenge, we have found on many occasions that our actions or communications directed at other populations than the group of intermediary firms in question can impact as much on the relationship as the actions and communications aimed directly at the intermediary firms themselves. Furthermore, we are dealing with a heterogeneous group who themselves have different attitudes to regulation and the AFM. However, it is difficult to direct your actions and communications at a specific segment of the population. Consequently, the level of trust in one segment may be negatively affected by the actions aimed at another segment.

35. Apart from increasing awareness within our organisation, as a practical solution we have put a single gateway in place for all impactful and mass communications with this group of firms. The purpose of this gateway is to screen all communications -both in terms of contents, use of language and tone of voice- so as to ensure a more consistent approach.

36. By the way, firms often give back to us is that face to face meetings with AFM supervisors work well to raise the level of trust. The problem is that –particularly given the size of this population- it is impossible for us to touch on every single firm. The trick is therefore to find clever ways to leverage the experiences of individual firms who have been touched.

Concluding remarks

35. Let me conclude. I have suggested that regulators have no option but to trust firms and work towards establishing a level of trust. Hence the title of my talk: trust is a must. I have put forward that it allows for more effective and less costly regulation. I have offered no scientific evidence to support this whatsoever, but I trust there are plenty of people in the room that are keen to either prove or disprove my observations.

36. What the optimal level of trust is I don't know. That will vary over time, influenced by the context in we operate. Trust in a regulatory relation is very vulnerable. It is highly susceptible to a seemingly innocent slip-up, outside influences and unpredictable incidents. It is hard to gain and easy to lose. Trust dissolves easily.

37. For this reason, building trust requires a consistent, coordinated approach. But also a long term view. Perceptions are very sticky. And –as always- at the end of the day the proof of the pudding is in the eating. Firms have to experience for themselves that the regulator can indeed be trusted. In practice that means they will have to have been in position of vulnerability -either caught by us or because they put themselves into it- and experienced behaviour that was consistent with the positive expectations they had formed.

38. It is not always easy for a regulator to deliver on this ´promise´ -particularly in situations where there is as a strong public sentiment about something. The challenge for the regulator is to stick as much as possible to its own chosen course, values and principles. This requires a well-balanced, self-confident organization, who itself shows a willingness to be vulnerable.

39. To avoid any misunderstanding, I am not recommending that regulators should put *blind* trust in someone based on idealistic, but otherwise irrational grounds. Leave that up to me, in my own time, and with my own money at stake. Even if it is only to make myself feel better.

40. I thank you all for you attention.

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