The 2007-2009 Banking Crisis has had significant impact on the extent to which financial institutions trust each other especially with regard to extending credit and dealing in securities and other financial products. Trust is vital to whether banks succeed or fail in a highly competitive market. In the case of financial markets, trust can be defined as “faith or confidence in the loyalty, strength, veracity, of a person or thing without examination”. During the banking crisis, issues of trust or mistrust led to the failures of some commercial banks, like Northern Rock, and some investment banks, such as Lehman Brothers. In the world of finance, trust means a number of things to the people who run the institutions i.e. bankers, and also their customers.

A study from the Tipping Points project finds that trust will continue to be vital when it comes to the effective functioning of financial markets and the governance of financial institutions. Finding ways to promote genuine trust within global financial markets may be key to preventing or reducing the impact of future financial crises. It may seem surprising that the human value of trust is depended on by so many highly sophisticated, financial institutions. Although each institution possesses a wide range of expertise and advanced computing technology it is still vulnerable to the opportunistic behaviour of others.

Despite a highly technical and efficient financial system with a range of innovative products to offer, risks increase where trust is violated. This is clearly illustrated by the subprime mortgage crisis in the US and UK, where mortgage loan originators were trusted by the loan underwriters who subsequently did not carry out their own assessments of the quality of these loans.

In effect, they ‘trusted’ the mortgage loan originators to only originate decent loans and therefore they did not bother to ‘verify’ the ‘decency’ of those loans. Such ‘trust’ is misplaced when the originators are not the ones who will bear the loss (costs) for not doing the proper screening of those to whom the mortgages have been granted, in effect generating a sort of moral hazard.
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It was this misplaced trust that was instrumental in the mortgage lending crisis that led to the US banking crisis and, in turn, the global financial crisis, where illiquidity — absence of cash — was rampant throughout the entire financial system; many banks simply did not have any money to lend.

The Global Financial Crisis has shown how important liquidity is to the financial system. It has also shown that liquidity is largely dependent on trust. When confidence (trust) was eroded, liquidity disappeared. The erosion of confidence was signified by, for example, the collapse of confidence in RMBS and CDOs.

Northern Rock, the first of several banks to go bust during the Banking Crisis in the UK, violated the trust of their customers when its managers led the bank into illiquidity and then insolvency after other banks would no longer lend to it in 2007. It relied primarily on ‘medium-term wholesale funding’ from capital markets and did

**Definitions of products and key concepts:**

- **Alt-A loans**
  A type of mortgage that encourages fraud by giving applicants incentives to provide false information on loan applications. They can lead to huge losses for the lender or underwriter.

- **Asset-Backed Commercial Paper (ABCP)**
  A short-term investment vehicle issued by a bank or other financial institution. The sale of ABCP on the global capital markets contributed to the financial collapse of Northern Rock as it was used to fund its mortgage portfolio.

- **Asset-Backed Security (ABS)**
  Loans advanced to customers from banks that have been re-packaged as ‘marketable securities’ and are traded on global capital markets.

- **Collateralised Debt Obligations (CDOs)**
  A form of Asset-Backed Security used by commercial and investment banks as a source of finance for new loans. They are also included in a range of investments made by banks along with hedge funds, pension funds and other financial institutions.

- **Residential Mortgage-Backed Securities (RMBS)**
  A form of Asset-Backed Security backed by residential mortgages rather than other types of loans.

- **Financial Leverage**
  The use of borrowed money (debt financing) to increase the amount of money invested, and in so doing, increasing the amount of potential returns if the investment is successful. It will, however, increase the amount of losses if the investment is unsuccessful. Its excessive use has been identified as a practice that contributed to the global financial crisis because it magnified the losses sustained on unsuccessful investments.

- **Moral Hazard**
  Moral hazard is when an individual or institution does not have to take responsibility for its actions because another party will bear the consequences. Bailing out struggling banks will entrench moral hazard because it sends the message to the bankers that society will cover the costs (bear the consequences) of their bad decisions and excessive risk-taking.

- **Information Asymmetry**
  A situation where one party part of a transaction (usually the seller) has more information pertaining to the transaction (for example information on the quality of the good or service being sold) than the other party (usually the buyer). It arises in finance when a financial institution knows, but does not disclose all of the relevant information about a transaction.

- **Creative Accounting**
  Accounting techniques used to misrepresent companies’ income, assets, debt and other figures. It includes methods used to conceal information from shareholders and credit rating agencies provoking mistrust.
not take out adequate insurance to cover its losses. News of Northern Rock’s failed strategy caused its depositors to promptly withdraw their money. Northern Rock had violated its trust relationship with its customers and, due to a shortage of funding, could no longer survive. The bank had to be saved by the UK government with £1.4 billion of taxpayers’ money.

In the case of Lehman Brothers, which was once the fourth largest investment bank in the US, breakdowns of trust, coupled with the misuse of financial leverage, played a central role in its collapse. Lehman Brothers used what is known as ‘creative accounting’ to conceal the true nature of its assets, which were eventually discovered by the financial markets to be of very poor quality. Upon this discovery all the participants in the financial markets ceased doing business with Lehman Brothers and this ultimately led to its demise.

The collapse of Lehman was particularly significant for a number of reasons. The most significant of these is that it proved to be the tipping point, in which a credit crunch and loss of confidence in some financial firms, transformed into a full-blown systemic financial crisis. It is also significant because Lehman was the only financial firm that failed to secure privately or publicly funded financial assistance, it ultimately had to file for corporate bankruptcy.

Investment banks such as Goldman Sachs were also heavily involved in transactions that eroded trust in financial markets. This is well-illustrated in a case involving the investment bank Goldman Sachs and Paulson & Co, a hedge fund run by multi-billionaire John Paulson. Hedge funds take on a diverse variety of investments and take advantage of a number of different aggressive investment strategies, including financial leverage, in order to gain large returns. A CDO transaction designed by Goldman Sachs and Paulson, known as ‘ABACUS’, consisted of RMBS that Goldman Sachs and Paulson knew to be worthless. Paulson was betting against the ABACUS CDO. Goldman Sachs’ role was to find another party to be on the other side of the transaction and therefore on the other side of Paulson’s bet.

Goldman Sachs used the bond issuer, ACA Management LLC, as the collateral manager for the transaction because of its credibility with investors. The information provided by Goldman Sachs to ACA, and to the investors who trusted ACA, did not show that Paulson played a role in structuring the ABACUS CDO and was betting against it. The US Securities and Exchange Commission (SEC) has indicated that Goldman Sachs misled investors by not mentioning the fact that Paulson’s economic interests were contrary to that of investors. Goldman Sachs was fined $550 million by the SEC for violating provisions of the US Securities and Exchange Act. However, Goldman Sachs neither admitted nor denied allegations of fraud. Despite the fine, Goldman
Sachs still made large profits from ABACUS. The Paulson hedge fund made substantial profits from this and other similar trades, which turned out to be some of the most profitable hedge-fund trades in history. The Goldman Sachs affair likely had an adverse impact on trust in financial markets overall, and has shown clearly how non-disclosure and information asymmetry pose threats to the effective functioning of financial markets.

In learning from these different case studies on the financial crisis where failure of trust led to imminent collapse of once powerful financial institutions, trust clearly has a significant role to play in regulatory policy. Trust strengthens the financial system by reducing the costs to institutions of doing business with each other. This is because in an environment where there is trust the institutions comply with laws and with other ethical business standards even if they are not specifically defined in the law. If trust is accepted as crucial to the evolution and stabilisation of the global economy then preserving and increasing levels of trust is essential to the resilience of financial markets. This report illustrates how important it is to focus on human behaviour and to avoid excessive reliance upon mathematical or economic models of markets.

Advice on how to increase the resilience of global financial markets by restoring trust:

- Preserve trust between intermediaries (‘Gatekeepers’) and financial institutions by ensuring that gatekeepers such as credit rating agencies provide meaningful credit ratings.

- Apply checks on behaviour of credit rating agencies through government regulation or civil action.

- Shareholders and investors cannot rely on an institution’s financial reports alone to track the security of their investments and to mitigate risk. And reports must present information honestly and transparently, without relying on ‘creative accounting’ methods to artificially boost confidence and breach trust.

- Focus on a ‘principles-based’ approach to financial and accounting regulation and shift from technical compliance to substantive compliance.

- Financial markets need to guarantee that they will be able to make their decisions based on all available information as withholding essential information leads to a failure of trust and undermines market integrity.

- Commercial or business contractual relationships must be underpinned by obligations of good faith, solidarity, role integrity and mutuality. Market participants need to be truthful, open and honest with each other.