Environmental or System Trust: An interplay between Institutional Theory and Agency Theory?

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This developmental paper addresses one of the key dilemmas of Agency Theory, specifically how does the principal in a relationship evaluate and assess that the agent in the relationship is conducting themselves in an appropriate manner and behaving in their best interests and with integrity utilising the context of the purchase of a high risk credence product where information asymmetry exists between the principal and the agent.

In such circumstances it is not possible for the principal to use either an outcome based mechanism or information system mechanism as suggested by Eisenhardt (1989) to resolve this dilemma leaving the principal at considerable risk.

This developmental paper proposes that in such circumstances the principal relies upon '*environmental*' or '*system*' trust to resolve the dilemma, and in doing so demonstrates that '*environmental*' or '*systems*' trust can be seen as interplay between institutional theory and agency theory.

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Introduction

One of the central principal/agent relationship dilemmas addressed by agency theory (Eisenhardt, 1989) is how does the principal in a relationship evaluate and assess that the agent in the relationship is conducting themselves in an appropriate manner and behaving in their best interests and with integrity (Eisenhardt, 1989).

Agency theory suggests two mechanisms that may be used by the principal to resolve this dilemma; (i) outcome based mechanisms, whereby the principal assesses and judges the performance of the agent on the basis of the outcome of the transaction and (ii) information system mechanisms, whereby the principal is informed about the activities of the agent and uses that information to assess and judge the performance of the agent (Eisenhardt, 1989).

However, in certain circumstances, such as the purchase of a high-risk credence service or product where information asymmetry exists between the principal and the agent, this may not always be possible. Utilising a scenario where it would not be possible to use either mechanism, the purchase of a complex investment or pension product sold through a financial adviser, this developmental paper proposes that *environmental* or *system* trust provides is an alternative mechanism for resolving this dilemma, and in doing so hypothesises that *environmental* or *system* trust is an interplay between institutional theory and agency theory.

The Purchase of High Risk Credence Products

Credence products are those where the consumer cannot judge or assess the attributes of the product confidently even after purchase and consumption, and often perceive high levels of risk when purchasing them (Darbi and Karni, 1973; Mitra *et al.,* 1999).

In the case of a complex long term financial service product, whilst some attributes are known at the time of purchase such as the charging structure, other factors that have a significant impact upon the success or otherwise of the transaction, such as the investment return, often cannot be reliably or accurately predicted at the time of purchase, and only become apparent many years, if not decades, later. Consequently, it is often impossible for a consumer to judge the success of the purchase in terms of quality or value for money (Gough, 2005). Effectively in such a situation it is impossible for the principal (the consumer in this example) to use an outcome based mechanism to judge the performance of the agent (the financial adviser who sold the product).

Furthermore, the purchase of complex long term financial services products is an infrequent if not once in a lifetime purchase for many consumers (Ennew, 1992, Gough and Nurullah, 2009) which carries the implication that many consumers will purchase financial services products without the benefit of previous experience. This has been found to cause information asymmetry between consumers and their financial advisers (Diacon and Ennew, 2007). Consequently, it would also effectively be impossible for the principal (consumer) to use an information system mechanism to judge the performance of the agent (financial adviser), as often the principal would not have enough information to make that assessment, or in circumstances where the information was available, given the inherent complexity of financial services products and the financial services industry, may not be able to comprehend that information to the extent needed to judge the performance of the agent.

This would leave the consumer at considerable risk, not only due to the intrinsic financial nature of the product they are purchasing, but also as they are effectively placing themselves at considerable further risk by their reliance upon an agent, in this case a financial adviser, to act in their best interests when recommending products for them to purchase, without an effective means of judging their performance.

Consequently, in the scenario of the purchase of a complex financial services product through a financial adviser, the level of trust held by a consumer for their financial adviser is often the basis upon which the advice given by that adviser to purchase a particular product is evaluated by a consumer (McKechnie, 1992). This not only demonstrates the importance and central role of trust in the purchase of a high-risk credence product, but also that trust is a means of helping consumers overcome or reduce perceptions of risk (McKnight *et al.,* 2002).

Given this role of trust as a risk reduction mechanism in this scenario, this suggests that trust may be being utilised by the principal to solve the agency theory dilemma of how to ensure that the agent is conducting him/herself in an appropriate manner, behaving in the best interests of the principal and also with integrity (Eisenhardt, 1989).

However, in the given scenario, due to the infrequency of purchased noted above, the consumer will often have little or no knowledge of the financial adviser during the early stages of the relationship which carries the implication that the consumer is not relying upon interpersonal trust based upon their knowledge or experience of dealing with a particular agent, but rather on wider '*system*' or '*environmental*' trust as a risk reduction mechanism. This carries the implication that the principal (consumer) is using '*environmental'* or '*system'* trust as the governance mechanism to resolve this specific agency dilemma and constrain the behaviour of the agent (financial adviser) within the bounds of acceptability and ensure that the agent acts in an appropriate manner, with integrity and in their best interests.

'Environmental' or 'System' Trust

'*Environmental'* or '*system*' trust is defined as circumstances in which an individual 'believes, with feelings of relative security, that favourable conditions are in place that are conducive to situational success in a risky endeavour or aspect of one's life' (McKnight and Chervany 2001, p. 37) and does not therefore refer to trust placed in the individuals involved

in a transaction, but rather refers to trust placed in the structure surrounding the transaction, thereby making vulnerable individual(s) more comfortable about engaging with a third party and is comprised of two sub-components; *structural assurance* and *situational normality* (McKnight and Chervany, 2001).

Structural assurance reflects the arguments of Zucker (1986) and Neu (1991) that rules and regulations create trust by standardising organisational behaviour across a particular marketplace. In practice an individual relies upon the regulatory framework that surrounds the industry within which they wish to transact to constrain the actions of a particular third party within acceptable limits and boundaries (Sitkin and Roth, 1993). Such rules and regulations may be provided by formal governmental institutions or by self-regulation through membership of professional bodies and associations (Zucker, 1986; Neu, 1991; Atchinson, Blois, 2013) with membership of such an organisation signalling a willingness to conform to societal expectations, particularly where the membership of such a body is dependent upon formal qualification (Neu, 1991).

Situational normality refers to a situation or environment that a consumer finds to be normal, customary and properly ordered, and therefore conducive to the success of any particular transaction (Gefen et al., 2003; Pennington *et al.,* 2003; McKnight *et al.,* 2011). Where a situation is observed as being normal then an individual 'has a basis for trusting people in the situation' (McKnight and Chervany, 2001) with individuals often extending a greater level of trust where they perceive the nature of a transaction to be both typical and as expected (Gefen *et al.,* 2003).

Environmental or system trust therefore not only reflects the arguments of authors such as Zucker (1986) and Sitkin and Roth (1993) that rules and regulations foster trust by governing how transactions are conducted, but also in many ways reflects institutional theory which

emphasises the culture and institutions that shape the business environment thereby providing stability and meaning to social life (Scott, 2014; Doherty *et al*., 2014).

The Three Pillars of Institutional Theory

A potential theoretical underpinning of '*environmental*' or '*system*' trust may therefore be found in the three pillars of institutional theory put forward by Scott (2014); Regulative, Normative and Cultural-Cognitive.

The Regulative Pillar reflects the regulatory processes that establish rules, the ability to inspect the adherence and compliance to those rules, and where necessary, the ability to manipulate future adherence and compliance with those rules by means of reward or punishment. The basis of legitimacy is through the legal sanctioning of those rules by the State, which is also ultimately the source of coercive power to ensure adherence and compliance with the rules, often through highly formalized mechanisms such as the police and courts. The regulative pillar therefore relates to structural assurance fostered by governmental rules and regulations together with the associated sanctions and punishments for breaching those rules and regulations (Zucker, 1986; Sitkin and Roth, 1993).

The Normative Pillar reflects the desires to adhere and conform to social obligations together with the values and norms of wider society. Values are essentially a conception of what is a desired or preferred standard of behaviour that can be compared with others and assessed, whilst norms define both legitimate and appropriate goals together with legitimate and appropriate means and methods of pursuing and achieving those goals, with what constitutes being legitimate and appropriate often being defined by standard setting bodies such as professional associations. The basis of legitimacy is therefore morally governed through what is deemed to be socially acceptable both in terms of objectives and behaviour with social constraints placing limits on what is acceptable. The basis of compliance is therefore the

binding expectation and appropriateness of conforming to societal obligations (Scott, 2014). The normative pillar therefore relates to structural assurance fostered membership of professional bodies and industry associations, effectively self-regulation (Neu, 1991; Atchison, 1995; Blois, 2013) as accreditation by and membership of such an organisation signals a willingness to conform to societal expectations and is a means of promulgating high standards through an industry (Somers, 1969; Neu, 1991).

The Cultural-Cognitive Pillar reflects a shared understanding or common belief of what constitutes social reality and how meanings are determined, with such meanings being used to make sense of the environment and events within that environment. The basis of legitimacy is therefore what is, or ought to be, comprehensible, recognizable and culturally supported with the basis of compliance being the meeting of an expectation of an orthodoxy, shared understanding or schema that provides certainty when present or uncertainty when absent (Scott, 2014). The cultural-cognitive pillar therefore relates to situational normality fostered by an environment perceived to be normal, customary, as it ought to be, or properly ordered (Lewis and Weigert, 1985; Zucker, 1986; McKnight *et al.,* 1998).

The three pillars taken together can therefore be seen to represent the components of environment or system trust discussed earlier with the regulative and normative pillars underpinning the regulatory and self-regulatory components of structural assurance respectively and the cultural-cognitive pillar underpinning situational normality. Given this, together with the role that '*system*' or '*environmental*' trust appears to play as both a risk reduction mechanism and also a mechanism to resolve the central dilemma of agency theory by ensuring that an agent is conducting themselves in an appropriate manner and behaving in their best interests and with integrity, *environmental* or *system* trust can therefore be seen as an interplay between institutional theory and agency theory.

Further Development

Further developmental work will be undertaken on this paper to refine the conceptual basis of the central proposition of this study, that environmental or system trust is an interplay between agency theory and institutional theory, and also to anchor this study within existing literature focussing upon environmental or system trust. Additional developmental work will also be undertaken with the aim of establishing an appropriate research design and methodology for testing this central proposition including identifying an appropriate context.

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