Brent Sheather's
RESEARCH

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UNDERSTANDING FAIRNESS IN FINANCIAL SERVICES, OR NOT?: Part 1
THE FACTORS BEHIND "WHAT'S FAIR?"

Back in July the Financial Markets Authority (FMA) published a report, Understanding Fairness in Financial Services. Today we will kick off with the first of a four part (sorry) story on fairness including a deep dive on what impacts perceptions thereof, why most retail investors aren't equipped to have a s ensible view on fairness as it relates to the investment sector and how the whole fairness thing is increasingly driving regulatory settings. Describing the purpose and results of the report the FMA said *"The core purpose of the Financial Markets Authority (FMA) is to promote and facilitate fair, efficient, and transparent financial markets and to promote confident and informed participation in financial services. This report focuses on understanding fairness in financial services. The research in this report centres on a consumer survey conducted with the market research agency Ipsos which included 2,998 New Zealanders who answered questions about fairness, from June 14 to September 4, 2023. The survey addressed the topic of fairness in New Zealand overall and in financial services. To address fairness in financial services specifically, the survey included short 'real-life' scenarios that New Zealanders either have or could have experienced with financial providers. Survey respondents evaluated how fair each scenario was on a scale. A major finding was many New Zealanders generally agreed on what is and is not fair in these scenarios, suggesting many consumers have similar perceptions of fairness. The results in this report are designed to start a discussion about fairness in financial services." The report concluded that "overall this research has shown that when presented with specific customer focused scenarios, consumers have a remarkably consistent understanding of what constitutes fairness in financial services".*

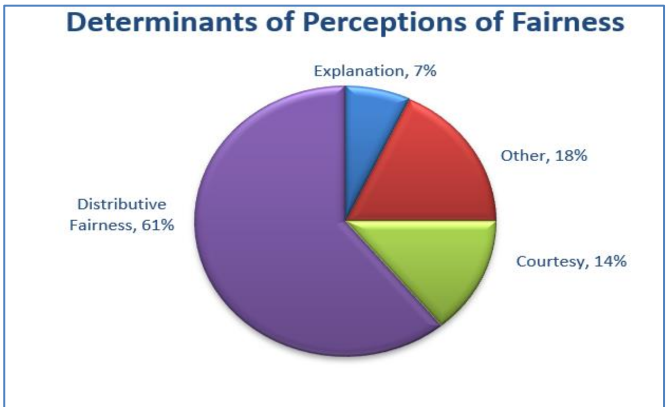
All of this sounds wonderful but are these results actually of any value? To understand fairness one has to understand what you will get from a transaction and what your counterparty will receive. In investing the first issue may not be clear for 15 years or longer and the cost side of things is increasingly complex and opaque, and that's if you have the time and skill to investigate.

My experience relates only to the investment sector but that is an increasingly important component of individuals' interaction with the financial sector. A vast body of academic research, both locally and overseas, and my conviction, from over 40 years in the retail investment advisory scene, is that the average retail customer is definitely not equipped with the skills and knowledge to make an informed judgment of "what constitutes fairness in the complex investment component of financial services". Indeed, when confronted with all the facts, many retail investors express horror at the extent to which their relationship with the investment industry was actually "unfair". Many Kiwisavers don't even know who their provider is, let alone the fees they are paying and most have absolutely no insight as to whether the fees are reasonable relative to returns. Very few retail investors appreciate how so many players, by virtue of the intersection of their investment banking arms and their retail DIMS operations, subordinate their responsibilities as regards prioritising the interests of their retail clients so as to discharge their obligations to their investment banking partners. The same degree of ignorance prevails as regards vertically integrated organisations owning both a retail advisory business and a fund management organization. IPO's pose a relatively obvious challenge to the illusion of " fairness " : how can a stockbroker act "fairly" when the organization has two clients with competing objectives. Reminds me of Animal Farm where "all clients are treated fairly but some will be treated more fairly than others".

To assess the validity of the FMA survey conclusions we need an appreciation of the key factors influencing consumers' perceptions of fairness in retail financial services. The following is from the Financial Services Research Forum, part of the Nottingham University Business School. The key factors are listed below:

1. **Distributive Fairness:** Consumers focus on how benefits and resources are distributed, impacting trust and perceptions of fairness, ie how the pie is shared out.
2. **Procedural Fairness:** This is the fairness of a firm's policy and procedures. It relates to impartiality (making sure that all customers are treated equally and that they are not biased towards certain customers like, for example, hedge funds overseas getting preferential access to attractive IPOs from their Prime Broker and, locally, high net worth individuals getting big allocations of attractive new issues like the energy companies in New Zealand, not so long ago), refutability (taking notice when complaints are made and willing to change things when customers are not satisfied), explanation (making sure that customers understand the information provided and what they are buying) and familiarity (making an effort to understand customers' circumstances and ensuring that advice is suitable).
3. **Price Transparency:** Clear and transparent pricing is crucial in shaping fairness perceptions. As noted earlier retail investors invariably do not appreciate all the ways that the fund management and retail advisory businesses appropriate their savings.
4. **Social Comparisons:** Consumers compare their experiences and prices with others, affecting their fairness judgments.

Analysis by the Financial Services Research Forum (FSRF) has identified the relative importance of each of the factors which influence perceptions of fairness. Their research shows Distributive Fairness (how the pie is shared amongst the provider and the client) as being by far the largest influence on consumers' evaluations of overall fairness, over four times as important as any other element of fairness. The relative importance of the determinants of perceptions of fairness are illustrated in the pie chart below. Distributive fairness relates to how



Source: Financial Services Research Forum, Nottingham University

the benefits of a relationship are apportioned between the firm and the customer. Customers evidently base their overall perceptions of fairness primarily on the view of whether their benefit from interactions is as great as the institution concerned and whether generally they perceive that they get a fair deal and appropriate terms and conditions. The FSRF comments "*that this is exactly the area where firms are perceived to perform poorly, then the* *challenge posed for financial services firms is evidently clear*".

Other relatively important drivers of overall perceptions of fairness are the Procedural Fairness element of explanation and the two components of Interactional Fairness, courtesy and communication. The FSRF notes that "*ensuring that consumers perceive that products have been explained clearly and that they are confident that they understand what they are buying is likely to prove more challenging, given the well-documented problems of product complexity and consumer understanding in financial services markets*".

The remaining sub-dimensions of fairness, all elements of Procedural Fairness, have only a small impact on overall fairness perceptions. Consumers appear relatively indifferent as to whether their institution is particularly familiar with their circumstances, or whether the institution is impartial in its treatment of customers. The FSRF comments "*We are particularly surprised by the small role played by refutability, which encapsulates the ability to change things on fair and reasonable terms and a willingness to listen to customer's complaints and suggestions and change things. We would have expected this factor to be a far more important influence on overall perceptions of fairness*".

That's more than enough for today. In two weeks time we will look at further research, including research on disclosure, which supports the contention that retail investors are not equipped to make a judgment on fairness as it relates to the investment sector of the financial services industry.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.