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THE RESILIENCY OF SYSTEMIC TRUST

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Introduction

In this paper I shall analyse the issues of reputation and power as they are at stake within auditing firms and rating agencies especially when conflicts of interest need to be managed correctly. More specifically, I will argue that a systematic analysis of these issues connected with auditing and rating can help us highlight some dynamics of institutional trust, and more generally of systemic trust, that have so far hardly been explored. I shall try to explain: i) why auditing firms and rating agencies have a growing role in financial markets; ii) how they gain a good reputation; iii) how they act as “diffusers” of both trust and distrust; iv) what happens when they issue wrong certifications that become publicly known. In this paper my aim is to emphasize the relevance of auditing and rating agencies for an analysis of institutional and systemic trust in contemporary societies, thus pointing out the insight that new economic sociology can provide to central issues in sociological theory.

1. Why auditing firms and rating agencies have a growing role in the financial markets

Auditors certify the correctness of a firm’s financial statements and accounting. Thereby they intend to reduce the information asymmetry between management and investors. Three aspects need to be emphasized here. Firstly, in the global market we can see a concentration of power in four mainly Anglo-American multinational auditing firms (Price Waterhouse; KPMG; Ernst & Young; Deloitte & Touche). Secondly, these firms have progressively provided non-audit services in areas of tax and strategic management, which has increased the potential conflict of interests when they provide auditing and consulting services to the same firm. In fact, there is potential pressure on auditors to bias their auditing in order to limit loss of fees from consulting services. Thirdly, the concentration of power in four multinational auditing firms implies that these work as private regulators of financial markets. Such a regulative task is tied to the progressive deregulation of financial markets in the last three decades. Rating agencies assess the credit risk of financial transactions (Kerver 2002) and aim to reduce the information asymmetries between borrowers and lenders, which arise as potential purchasers of debt instruments lack the information necessary to accurately assess issuers’ creditworthiness. The credit risk is determined by assigning a “credit rating” to a security or issuer (private or public). It ranges from AAA (very low credit risk) to D (default). Three issues also need attention in the case of rating agencies. Firstly, in the global market there is a great concentration of power in two Americans rating agencies (Moody’s and Standard & Poor’s) which control about the 80% of the global rating business (Levich *et al.* 2002). Secondly, starting from the 1970s the major rating agencies have begun to charge issuers for rating assessments and increasingly offer advice on the structuring of debt issues. The potential conflicts of interest result in rating agencies offering more favourable ratings in exchange for business (of rating and consulting). Thirdly, the rating agencies are playing a

growing role of private regulators of financial markets (Sinclair 1994) as a consequence of the deregulation of financial markets and of the declining bank control on financial intermediation related to the globalisation process.

The growing uncertainty that shapes the deregulated global financial system needs new mechanisms capable of reducing it. New organizational devices, new forms of insurance and certification, as well as new professional rules have in fact been put forward as possible solutions to such problems of uncertainty. However, these organizational and normative solutions are fallible and subject to manipulation; also, they are unlikely to solve all problems of uncertainty. There is in fact a mobile and shifty uncertainty that can be reduced only through trust and distrust relations. Exploiting the growing institutional pressures to quality certification, auditing and rating agencies have increasingly occupied this relational field. Yet, owing to the magnitude of the tasks undertaken, these agencies only partially succeed in transforming uncertainty into calculable risk. In part they transform the missing information into internal (cognitive and emotional) reassurance. They act as diffusers of trust and mistrust. These agencies produce certificates partially based on quantitative and checkable elements and partially based on qualitative evaluations that express “opinions” about data which are not available. But such opinions can be accepted only if these agencies have already achieved trust and good reputation.

2. How these organizations gain trust and reputation

It would seem reasonable to assume that the good reputation of auditing and rating agencies is based on the efficacy of the certifications produced. This efficacy testifies the presence of technical competence and impartiality. In reality, however, such a statement is more problematic than it seems. In order to protect themselves from class action, auditors have progressively concentrated their work on the observance of accounting standards (“Generally Accepted Accounting Principles”). This formalization of the auditing process has weakened the research of the real financial reliability of the firms certified. Thus there is a kind of “expectations gap” (Power 1999) between the investors that expect an accurate evaluation of the financial statements of the certified firms and the formalism of the auditing process. The relationship between investors and auditors is made even more problematic by the potential conflict of interests which arises when auditing and consulting services provided to the same firm can press for a more favourable judgement. Since the accuracy and the efficacy of auditing are not infrequently contested, other factors should be found that sustain the reputation of auditing firms. A main factor is the recognition of auditing firms as market regulators by public authorities, which considerably improves auditors’ reputation. We also have to remember the role played more subtly by power and symbolic dimensions. The concentration of the auditing industry in a few multinational firms favours dynamics of power and control that stimulates expectations of competence and independence of auditing firms among the general public of investors. The dark and esoteric character of the auditing process (that hides the qualitative and subjective dimension of the certification), the rituals and the operations of “impression management” that accompany the process of auditing are a good exemplification of these dynamics of power and control.

Rating agencies are subjected to similar problems. In order to protect themselves from class action they have progressively standardized the process of rating formation at the expense of evaluation quality. To this limitation we have to add the potential conflict of interests generated by the necessity of improving the business of rating and consulting. This potential conflict presses for more favourable ratings. Furthermore, we cannot tell whether the

judgements of rating agencies add new information to that already available through analysts' and auditors' reports. In fact we do not have systematic research on this topic (Levich *et al.* 2002). In this case as well, other factors have to play a major role in support of their reputation since the accuracy of the evaluations provided by rating agencies may be contested. The growing recognition by public authorities of rating agencies as financial markets regulators decisively improves their reputation. The strong concentration of the rating industry in two multinational firms activates dynamics of power which in turn stimulate expectations of competence and impartiality by the public of investors. The folklore and the partial secrecy of the rating process - that hides the subjective dimension of the evaluation - is part of this dynamic. It should be further stressed that markets react promptly to changes in ratings, with the effects of downgrades being stronger than those of upgrades. Such a power-effect operates even if we do not know whether, for example, a credit downgrade autonomously contributes to the weakening of a firm, or the downgrade simply makes a pre-existent weakness public.

In conclusion, the reputation of auditing firms and rating agencies is the product of a plurality of factors. The efficacy and validity of their professional action is surely one of these factors, but we do not have sufficient elements yet to argue that those are the most influential ones.

3. How they diffuse trust and distrust

Auditing firms and rating agencies do not assure complete knowledge of or undisputed faith in the private and public actors they certify. They do not spread certainty, but partially reduce the information asymmetries, and partially transform the missing information into internal reassurance, thus spreading trust and distrust. They work as diffusers of trust and distrust thanks to the good reputation they have previously gained.

At this point it is important to make an analytical distinction between advice and insurance. This distinction is absent in Zucker's (1986) and Shapiro's (1987) classical works, which may be responsible for the ambiguities present in these works about the role of institutional trust in complex organizational systems. Auditing firms and rating agencies - as diffusers of trust and distrust - offer advice, not insurance. Thus they do not guarantee the trustworthiness or the untrustworthiness of the certified actors to the point of directly paying the consequences of the unfulfilled expectations of the people who have placed their trust or distrust in the parties which have been certified. Insurance companies do pay these consequences as the insurance does in fact work as a substitute for trust and distrust. The trusting act is carried out with respect to the insurance company and not to those who are guaranteed. When auditing firms and rating agencies issue wrong certifications, they can lose trust and reputation but they do not have to pay for the damage suffered by those who have followed their wrong advice. Of course they can be sued in some form of class action, just like every professional agency. But such lawsuits are rarely successful due the lobbying effort made by the agencies to minimize the impact of legal measures menacing their autonomy (Swedberg 2004).

Auditing firms and rating agencies do not only spread focalized trust and distrust regarding specific public or private agents. Together, they also spread generalized institutional trust. This latent dimension of their action in its entirety needs special attention. The presence and pervasiveness of auditing and rating agencies greatly contribute to diffusing trust in the global economy among financial operators. These agencies contribute to make the

uncertainties of the global economy acceptable, by representing the market economy as more predictable than it really is. They are thus diffusers of systemic trust, that is trust in the effective functioning of the market economy and its rules. They contribute to improve systemic trust, independently of the specific theoretical assumptions made about the economic system (in this phase reflecting the American financial orthodoxy as argued in Stiglitz 2003).

4. What happens when they fail?

Accounting firms and rating agencies sometimes produce certifications and evaluations that eventually appear unsatisfactory or clearly wrong. Too benevolent certifications and ratings can result from conflicts of interest and concerns about losing clients. The same results can also derive from a concern to avoid waves of distrust, which are highly probable after a rating downgrade. Finally, evaluations of a too optimistic or too pessimistic nature are frequently influenced by the widespread optimism or pessimism induced by economic expansion or slump. More generally, many researchers have shown that auditing firms and rating agencies have been unable to predict the major changes and financial crises in the last fifty years (Levich *et al* 2002).

Just considering some recent events, we have to remember that Moody's and Standard & Poor's were unable to predict the Asian, Russian and Latin-American crises of 1997-98. Nor were they able to predict the Argentinean crisis of 2001-2002. In the Enron scandal the auditing firm Arthur Andersen went bankrupt, but Moody's and Standard & Poor's - who had given a good rating to Enron until four days before its bankruptcy (December 2, 2001) – did not face any consequence for their wrong evaluation. Standard & Poor's and Deloitte & Touche had not alerted anybody in time before the 2003 Parmalat scandal. Generally speaking, auditing firms and rating agencies did not work appropriately in the corporate scandals that involved not only Enron and Parmalat, but also WorldCom, Tyco Industries, Ahold etc. Thus, they were criticized for the excessive delay in denouncing the deterioration of the situation, but also for having been too hasty and severe in downgrading corporations and states once the crises exploded (Crockett *et al.* 2003). This “trigger-happy” action carried out when the crisis becomes public is part of the organizational rituals of impression management aimed to protect the agency's reputation. Moreover, in order to safeguard their reputation in presence of errors, auditing firms and rating agencies generally adopt defensive strategies by which they claim that: a) they have acted in accordance with the common standard of evaluation and certification; b) they have experienced difficulties in obtaining sufficient information from uncooperative actors; c) their certifications provide non-binding advice. Both the protection of the partial secrecy of the evaluation procedures and the safeguard of the impersonal character that surrounds auditing and rating processes follow the same line of defence. The secrecy and the strong impersonality encompassing these organizations are forms of seclusion that protect them from the judgment of the investors.

The market cannot easily sanction a loss of reputation of these agencies owing to these organizational strategies and to the enormous agency power that creates strong barriers to entry in the industry. Furthermore, the political system frequently strengthens the reputation of these agencies by recognizing their role of market regulators. Most of all, it intervenes to defend the reputation of these agencies when this reputation looks seriously threatened. Historically, this defence has been implemented through the creation of supervisory systems of external controls that “guard the guardians” (Shapiro 1987). We can briefly list some of these interventions. In the United States the Security and Exchange Commission (SEC) has

delegated the task of fixing the principles and rules for independent auditors to the American Institute of Certified Public Accountants (AICPA) and to its Auditing Standards Board (in the early 1970s). In response to the recent business and audit failures, the Sarbanes-Oxley Act (July 30, 2002) established the Public Company Accounting Oversight Board (PCAOB) that will define new standards for auditing under the SEC's oversight. The evolution of auditing standards has followed a similar path in the United Kingdom. The Institute of Chartered Accountants of England and Wales (ICAEW) and the Accounting Standards Board (established in 1990) have the responsibility of setting standards for auditing. In 2002, the European Commission published a report on auditing that fixed a set of fundamental principles. With respect to the rating agencies, in 1975 the SEC introduced the label of "National Recognized Statistical Rating Organization" (NRSRO). This label represents a recognition which aims to regulate the rating industry and inflict sanctions in case of violation of professional standards. Many other countries are promoting regulatory recognition of rating agencies. This trend has been favoured by the 2001 Basel Capital Accord.

The production of these supervisory processes aims to create a safety net for the auditing firms as well as the rating agencies as a whole. Although some agencies may fail (as happened to Arthur Andersen), the auditing and rating system in itself has to be preserved. The distrust in single agencies can be tolerated, but systemic distrust, i.e. the distrust of the financial system and its regulatory structures, cannot. Often simple cosmetic operations or new supervisory systems are sufficient solutions in order to safeguard systemic trust. Of course these solutions work only if investors think that they will not be sidestepped; in other words, these solutions need to be trusted by investors. Thus the issue of trust is placed on a higher level.

But who guards the supervisory system? Although the possibility of moving the trust problem up seems endless, it actually stops at some point. This point may be marked by the presence of a highly trusted institution or authority that operates as a diffuser of systemic trust of last resort. More frequently this resolution point is reached as a response to the maze of rules and certifications issued to stabilize systemic trust. This complex institutional maze generates a kind of pragmatic acceptance of its validity. Even if investors suspect that these institutional strategies are insufficient they accept them (more or less consciously) as a device to reduce anxiety. The pragmatic acceptance of these supervisory systems is more the product of their ultra-complex character and the awareness of a lack of alternatives, than the manifestation of "active trust" built on transparency, communication and negotiated responsibilities (Giddens 1995). Transparency, communication and dialogue with the general public of investors are in fact scarcely represented in auditing firms and rating agencies. Of course systemic trust in the financial system can collapse after a financial crash. Yet, as history teaches us, there is "disaster myopia" (Herring 2002) in the general public of investors that soon restores systemic trust. Resiliency of systemic trust thus prevails.

5. Conclusion

The analysis of auditing firms and rating agencies enables us to isolate some basic processes that sustain generalized trust in the global financial system. When a set of complex organizations rather than a single institution fails, a twofold process develops. The first process comes from the institutions themselves and is moved by the needs for organizational safeguard and power reproduction. The interventions of the political system to safeguard the generalized trust in the financial system and their regulators are part of this process. New

institutional architectures are built together with actions of impression management directed to avoid “domino effects” on institutional trust. These strategies of reassurance need a shifting of trust to upper institutional levels. They hide the fact that not all uncertainty can be reduced or changed into calculable risk and that financial exuberance and panic, boom and crash are always possible in the global financial market. Such a hiding operation usually works well due to the existence of a second process. This process is sustained by investors who need the reassurances coming from these institutional architectures in order to make choices under the condition of high uncertainty. The need for reassurance seems to be better satisfied if the institutional system is perceived as distant, opaque and bearer of a skilfully constructed reputation. The resiliency of systemic trust is therefore mainly based on a fatalistic acceptance of the effective functioning of ultra-complex and unknowable systems – which has been so well described by Simmel (1978) and Luhmann (1979). At the same time such a fatalistic acceptance cannot be always taken for granted, especially in situations of significant social change. The intense organizational work of auditing firms and rating agencies when their reputation is questioned and the vigilant action carried out by market regulators have shown that systemic trust needs to be reinforced by concrete actions when it is seriously threatened.

We can conclude with three general points. The first one concerns the distinction between systemic trust and generalized interpersonal trust. The specificity of systemic trust is shown by its resiliency, which means detachment and pragmatic acceptance of the effective functioning of ultra-complex systems. However this detachment does not involve the absence of a relational dimension, i.e. reference to other people. The trust placed in other people’s systemic trust is a relevant component of the generative process of systemic trust (Luhmann 1979). Although we do not fully understand how this expectation mechanism works, its concreteness is indisputable. As it includes strangers, generalized interpersonal trust as well rests on little informational basis. However, trust in people provides moral and psychological satisfactions that trust in abstract systems cannot offer (Giddens 1991). As recent research has shown (Uslaner 2002), generalized trust in people is grounded in specific experiences that act on the process of personality formation (some kind of family, of peer groups, of collective movements and voluntary associations). This outcome needs to be further investigated in order to better understand the specificity of generalized interpersonal trust and systemic trust, as well as the nature of their entanglement.

The second point is methodological. Our analysis has focused on big organisations and the strategies they employ as a means to influence investors’ expectations. The analysis tried to build a bridge between micro and macro analyses by introducing the role of power and organization in the complex process formation of investors’ expectations. Our aim was to avoid the limits of systemic analysis and the atomised view of standard economics. The relational dimension involves the relationship between organizations and between organizations and individual investors in the financial market. These relationships can generate unattended consequences and “emergent” properties that need to be further analysed.

The third point concerns the scope of our analysis. We have analysed only auditing and rating agencies. Our results thus need to be compared with the organisational action of other trust and distrust diffusers who act in the global financial market. Among them, we can mention: top financial analysts, the European Central Bank, The World Bank, the International Monetary Fund, many “independent” Authorities etc. These actors have been variously labelled as “guardians of trust” (Shapiro 1987), “intermediaries in trust” (Coleman

1990), and “reputational intermediaries” (Gourevitch 2002). These denominations can be considered interchangeable on condition that no confusion is made between advice - supplied by trust and distrust diffusers - and insurance - that is a substitute for trust and distrust.

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