

## Retail Finance: Thoughts on Reshaping Regulation and Consumer Protection after the Financial Crisis

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### Abstract

*The sale of retail financial products, such as investment funds but also mortgage products, is frequently combined with the provision of advice, which opens up the possibility of unsuitable advice and misselling. The article argues that despite recent legal changes in Europe, such as MiFID, there is still much scope for the improvement of both legal norms and supervisory activity. To obtain a logically consistent and workable framework, consumer protection, both generally and applied to the field of retail finance, must be put on a sound economic basis.*

**Keywords:** retail finance, consumer protection, unsuitable advice.

### 1. INTRODUCTION

The present financial crisis provides an opportunity to carefully rethink existing legislature and regulation governing the delivery of financial products to households, both on the ‘asset side’ of their balance sheet, such as savings and investment, and on the ‘liability side’, such as consumer credit and mortgages. Such a rethinking provides the chance to build future legislation as well as supervision on sound economic principles. More generally, a thorough assessment of the principles of consumer protection is also overdue in the light of past

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as well as ongoing initiatives of the European Commission, of which the Consumer Directive surely represents a cornerstone.<sup>1</sup> More specifically with MiFID, much progress has been made in the area of financial instruments, including retail finance.<sup>2</sup> But how do these various directives fit together, e.g., when it comes to the different treatment of insurance products that have a savings and investment character and retail financial products?

Other proposals and activities underline even more the need to rethink policies from first principles. Take the initiative to harmonise the law governing early-repayment clauses for mortgages across Europe. Presumably, one side effect of such harmonisation may have been the creation of a European market for mortgages and mortgage-related products, though presently, there may be little political appetite to support such a project. However, the idea to impose a minimum statutory repayment right, which mortgage takers would not be able to waive, has also received support based on the notion of consumer protection. European countries exhibit a baffling diversity in how households finance their mortgages, varying in their use of fixed versus variable interest rates or the amount of debt in relation to a property's value. Housing market conditions as well as national law may explain some of the differences. Also, the use of prepayment clauses or lock-in clauses varies widely.<sup>3</sup> An understanding of what drives these national differences is clearly a necessary first step before drafting a plan to harmonise existing laws or even imposing contractual uniformity across Europe.

This article focuses, however, on a different policy instrument: the disclosure of conflicts of interest and, thus, in particular, of commissions and 'kickbacks' that financial intermediaries or advisers receive. Such a requirement is part of MiFID, though it remains to be seen to what extent Member States and their national agencies, as well as courts, enforce compliance.<sup>4</sup> In addition, the article also speaks to the case of contractual lock-ins and the potential role of statutory

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<sup>1</sup> Council Directive 87/102/EEC of 22 December 1986 for the approximation of the laws, regulations and administrative provisions of the Member States concerning consumer credit, *OJ* 1987 L 42/48-53.

<sup>2</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (MiFID), *OJ* 2004 L 145/1-44.

<sup>3</sup> Cf., S. Schaefer, 'Early Repayment of Fixed-Rate Mortgages: There Is No Free Lunch', 36 *Financial Market Special*, Deutsche Bank Research (July 2006).

<sup>4</sup> In Germany, a client can demand the unwinding of a contract if an investment firm fails to disclose inducements such as 'kickbacks', which may lead to a conflict of interest, cf., the German Federal Supreme Court's decision BGH 19 December 2006, BGHZ 170, 226; NJW 2007 p. 1876; and, more recently, BGH 12 May 2009, BB 2009 p. 1137. Also, according to § 31d WpHG n. F. [Securities Trading Act], financial intermediaries are obliged to disclose any remuneration received from an investment firm in response to a successful transaction.

provisions for early cancellation. What will tie these two topics together is the focus on the role of financial advice.

This article concludes with some remarks on the role of competition and innovation. Viable competition, when governed by an adequate set of rules, remains the best recipe to ensure the protection of (almost) all consumers, generally and also with respect to financial products. That being said, as this article also emphasises, this still leaves ample scope for an active consumer protection policy that sets rules and sanctions misbehaviour.

## 2. PUTTING CONSUMER PROTECTION AND REGULATION IN RETAIL BANKING ON A SOUND BASIS

Households' financial decisions have increasingly attracted the attention of academics. Key drivers of this increased interest are profound changes to households' personal balance sheets: they became longer, as homes substantially increased in value; on the asset side, expected payouts from pay-as-you-go pension schemes were replaced by contributions to pillar II or pillar III pension schemes;<sup>5</sup> and on the liability side, we witnessed, at least in some countries, a massive increase in secured and unsecured debt.

The academic literature, most notably the large literature on household finance, has almost completely ignored the role of the supply side. But for retail finance, this is crucial. Retail financial products are often 'not bought but sold': the initiative is taken by a broker or a client's relationship banker. Moreover, with the exception of the most sophisticated investors or those brave or unknowing enough to take bets with online brokers, retail financial investors also rely on advice.

### 2.1 Mapping the trilateral agency problem with financial advice

In countries like the UK, independent financial advisers play a key role.<sup>6</sup> They may either advise customers on a fee base or, more often, earn profits through more or less hidden commissions and product-based charges that reduce yield. Irrespective of whether products are sold through a firm's integrated channel, as in the case of many retail banks, or whether sales rely on third parties, as is often

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<sup>5</sup> Pillar II and pillar III pension schemes comprise public and private mandatory or company-sponsored pensions, in contrast to purely private and voluntary retirement savings.

<sup>6</sup> About half of all new life and pensions business in the UK is made via financial advisers who are not tied to an investment firm, cf., Oxera, *Retail Distribution Review Proposals: Impact on Market Structure and Competition* (June 2009). Moreover, in a recent publication, the FSA outlines its plans to ban automatic commissions altogether, cf., *Distribution of Retail Investments: Delivering the RDR*, FSA Consultation Paper 09/18 (June 2009).

the case with insurance, a trilateral agency problem arises: between the customer, the agent or employee, and the product provider. What is more, the respective agent, be it an insurance broker or a financial adviser, may undertake multiple tasks. These tasks may include searching for customers, getting acquainted with new products, getting to know a customer's personal circumstances, and finally, providing advice and concluding a sale.

Commissions paid to these agents have thus multiple roles to perform. Policy intervention that will stifle commissions or impact on their form may have beneficial implications along one task, say to reduce the bias of advice, but they may generate unintended consequences along other tasks, resulting ultimately in a reduction of social efficiency.

In a string of recent work, most with Marco Ottaviani from Kellogg, we have looked into the multiple functions that commissions play and the impact of policy intervention.<sup>7</sup> Take the case of a mandatory disclosure of commissions.

When customers do not hold appropriate expectations about the level of commissions, the market will clearly malfunction, as they underestimate the prevailing conflict of interest. Take one example outside the area of retail finance: as work in the UK on doorstep selling has shown,<sup>8</sup> the margins earned by sellers are sometimes incredibly high, given that the targeted customers seem to be reluctant shoppers. This explains sometimes stupendously high commissions and, thus, obviously high incentives to coax customers into a purchase. There, a case for disclosing commissions to unknowing or even naïve customers is clearly warranted.

Our research shows, however, that mandatory disclosure can be socially harmful by stifling the roll-out of more efficient products. In essence, while disclosure will minimise bias in advice, by stifling sellers' incentives to aggressively compensate their sales force or independent advisers, market penetration is slower or remains altogether lower. Here, non-disclosure may compensate for otherwise inefficiently low incentives, which, in turn, are due to several factors: a 'rent extraction' problem between the product provider and its sales force, non-appropriated consumer surplus, and possibly a 'common agency' problem as the particular adviser or independent agent is not tied to one product provider.

Further, while reducing bias in advice, such disclosure may also stifle the acquisition of information by advisers. Overall, this may imply that the quality of

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<sup>7</sup> Cf., R. Inderst and M. Ottaviani, 'Misselling through Agents', *American Economic Review* (forthcoming, 2008a); R. Inderst and M. Ottaviani, *Intermediary Commissions and Feedback*, mimeo (2008b); R. Inderst and M. Ottaviani, *Sales Talk, Cancellation Terms, and the Role of Consumer Protection*, mimeo (2009). See, also, for earlier work, R. Inderst, "Irresponsible Lending" with a Better Informed Lender', 118(532) *Economic Journal* (2008) pp. 1499-1519.

<sup>8</sup> Cf., Office of Fair Trading 716, *Doorstep Selling: A Report on the Market Study* (May 2004).

advice deteriorates. Such negative effects of disclosure are, however, likely to occur or to have sufficient weight only when customers are wary and rational, i.e., they rationally anticipate sellers' and advisers' own agendas, and when without an active sales policy buyer inertia or other factors would lead to a socially inefficient underprovision of the respective (savings and investment) products.

Our research also sheds light on when we should expect problems of unsuitable advice and misselling to be more pervasive, and when not. When product providers' own agency problems with their employees or, likewise, with independent advisers or an independent sales force become more severe, misselling is more likely. Such agency problems are more severe when early customer feedback is less likely and less informative and when compliance checks are more costly.

Competition can also be inductive to problems of misselling, as fiercer competition among agents forces firms to restructure their commissions more aggressively, though consumers may still benefit from more competition. The driving force here is the fact that competition both makes it harder to retain previously loyal customers while it makes it easier to poach customers from other firms. This, in turn, makes it profitable for firms to provide their agents with steeper incentives, which finally makes it more costly to implement a given 'standard of advice' (i.e., to ensure compliance to such a firm-level standard).

Furthermore, when advisers earn their profits only through an hourly fee and no longer through commissions based on subsequent sales, biased advice becomes clearly a lesser concern. But the overall quality of advice and, thus, of households' investment or credit decisions may still suffer when regulation intervenes by favouring a particular way of paying for advice. As our research shows, earning a commission on a subsequent sale may be necessary to provide an agent with sufficient incentives to exert effort and provide valuable advice.<sup>9</sup>

Without understanding the economics of advice, any interference in the market is doomed to generate unintended consequences. Clearly, not every effect that a theoretical model generates is of first-order importance in a particular market. This is where institutional knowledge, as well as empirical analysis, must meet up with sound economic theory.

## 2.2 Principles of consumer protection

With great simplification, two views of consumer protection seem to exist. One view holds that consumers must be protected from other parties, that is, firms' possibly hazardous products or misleading advertising and aggressive sales strategies. The other view holds that consumers must be protected from them-

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<sup>9</sup> This is due to a moral hazard problem at the advice stage. See, for details of the formal model, F. Hoffmann and R. Inderst, *Selling Information to Customers*, mimeo (2009).

selves: even when given full information, a wide range of products and services, as well as access to valuable advice, consumers will make choices that are, so the argument goes, not in their own long-term interest.

Arguably, the complexity of many financial products poses substantial challenges to consumers. This holds, in particular, for countries where financial literacy is low and where households have not gained long-term experience with making financial decisions.<sup>10</sup>

The area of household finance has made advances in documenting and explaining household portfolio choice. Research on this frontier is driven by puzzles, such as low stock market participation, underdiversification or, on the credit side, the sluggish refinancing behaviour of mortgage holders.<sup>11</sup> Literature on behavioural finance documents further ‘biases’, at least among some investors, such as overconfidence.<sup>12</sup>

Policy makers should be warned to draw too strong conclusions from the existing academic literature. Many studies are based on experiments – and there is substantive doubt also on the interpretation of these results. With regard to field studies, it must be borne in mind that the results may be very sensitive to the particular country and, therefore, the social and cultural background of the respective customers. For instance, an influential strand of the literature presumes that the typical consumer procrastinates. Proponents of this view then suggest that consumers are ill-served by credit products that tempt them, say through low teaser rates, to consume more and save less than what is actually best for them. Indeed, the assumption of such procrastinating behaviour is often justified by households’ low savings rate. Needless to say that this view is based on observations from the US and not from, say Germany with a much higher savings rate.

Clearly, with retail financial products there is much scope for firms to misrepresent information, say on costs or risk, and there is much scope for households to misinterpret information. To the extent that the industry collectively fails to develop and adhere to sufficiently high standards, policy intervention is called for in the interest of both consumers and firms with a long-term view. That being said, the key principle of consumer protection with retail financial products should still be to protect consumers from misbehaving firms, and not so much from their own biases or follies. And even then, the first reaction of an economist should be to ask why the market cannot be trusted to provide a solution without policy intervention. Clearly, the answer to this will be specific to the circumstances, taking into account, in particular, the nature of products, the industrial organisation of the market, and the capability of customers.

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<sup>10</sup> Cf., A. Atkinson, S. McKay, S. Collard and E. Kempson, *Levels of Financial Capability in the UK: Results of a Baseline Survey*, FSA Consumer Research 47 (March 2006).

<sup>11</sup> E.g., J. Campbell, ‘Household Finance’, 62 *Journal of Finance* (2006) pp. 1553-1604.

<sup>12</sup> E.g., T. Odean, ‘Do Investors Trade Too Much’, 89 *American Economic Review* (1999) pp. 1279-1298.

Take the case of, in general terms, mandatory minimum cancellation rights.<sup>13</sup> This seems particularly relevant with respect to savings and investment products that are wrapped into insurance products. Such cancellation rights protect consumers when buying without perfect information about their preferences, for instance, as they will learn over time.

As we explore in current research, cancellation rights also protect rational customers from being ill-advised by sellers who, in particular with complex products, may possess superior information at the time of a purchase. Generous cancellation rights then make unsuitable advice more costly for the seller. Or, put into economic lingo, they make ‘cheap talk hard’. But with such wary, rational consumers, there is no need for policy intervention. Firms have every incentive to offer the so-called second-best efficient contractual terms, given that they can extract any additional value that is created by commitment to better advice through higher prices. However, as we show, policy intervention is warranted when some consumers are excessively credulous in that they do not see through a seller’s strategic talk and are blind to the conflict of interest.

Interestingly, a minimum statutory right of cancellation may be effective even when it is ‘not binding’, given that many or even all firms end up offering more generous terms. This is the case as such a minimum statutory right makes it relatively less profitable for firms to target only credulous consumers compared to targeting all consumers. But when firms cater to both wary and credulous consumers, then the former essentially take care of their less sophisticated fellow consumers. Our research also suggests that a different regulatory approach may be appropriate for different sales channels.

### 3. CONCLUDING REMARKS: COMPETITION, INNOVATION AND CONSUMER PROTECTION

Competition is the most powerful ally of consumers. And, in contrast to some often made claims, there is also no clear-cut trade-off between financial stability and competition.

Admittedly, a long tradition in the theory of banking argues that more competition leads to more risk taking and, thus, to higher default risk, which brings us

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<sup>13</sup> For instance, Article 6 of the Distance Marketing Directive specifies a ‘cooling-off period’ for certain long-term financial contracts. More precisely, customers should have the right to withdraw from a contract without penalty and without giving any reason within a period of 14 calendar days, which shall be extended to 30 calendar days in distance contracts relating to life insurance (cf., Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC, *OJ* 2002 L 271/16-24).

back to the present financial crisis. More recent work qualifies this view, however, both theoretically and empirically.<sup>14</sup> Moreover, when such a negative trade-off between competition and stability exists, policy and supervision are the first to blame: either because regulation and government intervention created exploitable situations in the first place; or because supervision did not react flexibly enough. Moreover, the present financial crisis cannot be seen as a verdict on the superiority of government intervention and regulation compared to market forces. To the contrary: government interference in the subprime market created the seeds of destruction and, at least in some countries such as Germany, it were in particular banks with politicians on their boards, such as the *Landesbanken*, who took the worst gambles.

Competition is also a key force to generate innovations. Admittedly, even without talking about ‘weapons of mass destruction’ in the disguise of new financial products, one could agree with M.H. Miller<sup>15</sup> (1986): ‘The major impulses to successful innovations over the past 20 years have come, I am saddened to have to say, from regulation and taxes.’ Still, financial innovations arguably complete the market, address agency concerns and information asymmetries, minimise transaction costs, or respond to new risk factors or new technological developments.<sup>16</sup> There are abundant examples in retail finance, including the distribution of exchange-traded funds, the introduction of internet banking, or process innovations such as credit scoring.<sup>17</sup>

Often, shifts are more gradual, as in the case of mortgages. A key part of the innovative process is that firms experiment with the marketing of well-known products.<sup>18</sup> But this shall not suggest that every newly introduced contract was to the benefits of customers.<sup>19</sup> For instance, ‘endowment’ or ‘savings and equity’

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<sup>14</sup> On the theoretical side, see R. Inderst, H. Doluca and U. Otag, *Bank Competition and Risk-Taking When Borrowers Care about Financial Prudence*, mimeo (2008). On the empirical side, see J. H. Boyd, G. De Nicolo and A.M. Jalal, *Bank Risk-Taking and Competition Revisited: New Theory and New Evidence*, IMF Working Paper 06/297 (2006).

<sup>15</sup> M.H. Miller, ‘Financial Innovation: The Last Twenty Years and the Next’, 21 *Journal of Financial and Quantitative Analysis* (1986) pp. 459-471.

<sup>16</sup> See P. Tufano, ‘Financial Innovation’, in G.M. Constantinides, M. Harris and R.M. Stulz, eds., *The Handbook of the Economics of Finance* (Elsevier North-Holland 2003) pp. 308-331; or R.C. Merton, ‘Financial Innovation and Economic Performance’, 4(4) *Journal of Applied Corporate Finance* (1992) pp. 12-22, for a more detailed discussion.

<sup>17</sup> E.g., W.S. Frame and L.J. White, *Empirical Studies of Financial Innovation: Lots of Talk, Little Action*, Federal Reserve Bank of Atlanta Working Paper 12 (2002).

<sup>18</sup> A consequence is that shifts across countries are not homogeneous. For instance, fixed-rate contracts have picked up in some European countries, as in the UK, while variable-rate contracts have become more common in others, as in Denmark. See D. Miles and V.C. Pillonca, *European Economics: Financial Innovation and European Housing and Mortgage Markets*, Morgan Stanley Research (2007).

<sup>19</sup> See, e.g., K. Scanion and C. Whitehead, *International Trends in Housing Tenure and Mortgage Finance*, Council of Mortgage Lenders Research (November 2004).

mortgages may offer tax advantages to some households; but other households may have simply underestimated the risk of the bundled-in equity-investment plan.

Still, there may be plenty of scope for beneficial innovations. For instance, a roll-out of fairly-priced reverse mortgages could potentially benefit many aging households.<sup>20</sup> Also, the further development of credit scoring will continue to reduce transaction costs and to facilitate entry into local markets, bringing down interest rates and broadening access to loans.<sup>21</sup> For the US, various studies indeed find that the market for borrowing has become more perfect, as measured by reduced volatility of consumer spending or a closer alignment of consumption and long-term income prospects.<sup>22</sup>

But who are the main innovators? While this is a key theme in Industrial Organisation, the literature on retail finance is thin. Earlier studies suggest that size is important, in particular for the introduction and roll-out of new services.<sup>23</sup> More recent studies suggest, however, that smaller firms are more innovative.<sup>24</sup> According to a recent study that exploits articles from the business press, the by far most innovative firm in the US was Merrill Lynch.<sup>25</sup>

The present crisis provides an opportunity to rethink consumer protection in the area of retail finance. Consumer protection policy can and must be put on a sound economic basis, though surely enriched with insights from other disciplines

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<sup>20</sup> Furthermore, in the absence of inflation indexing, once inflation picks up, many mortgages may have an excessively skewed repayment profile, in terms of 'front end loading'. E.g., J. Campbell and J. Cocco, 'Household Risk Management and Optimal Mortgage Choice', 118 *Quarterly Journal of Economics* (2003) pp. 1449-1494.

<sup>21</sup> R. DeYoung, W.C. Frame, D. Glennon, D.P. McMillen and P. Nigro, 'Commercial Lending Distance and Historically Underserved Areas', 60 *Journal of Economics and Business* (2008) pp. 149-164, for instance, document this for small business lending, where the form of borrowing is similar to that of unsecured household loans.

<sup>22</sup> E.g., K. Gerardi, H.S. Rosen and P.S. Willen, 'The Impact of Deregulation and Financial Innovation on Consumers: The Case of the Mortgage Market', *Journal of Finance* (forthcoming 2009); or K.E. Dynan, D.W. Elmendorf and D.E. Sichel, 'Can Financial Innovation Help to Explain the Reduced Volatility of Economic Growth', 53 *Journal of Monetary Economics* (2006) pp. 123-150.

<sup>23</sup> E.g., Frame and White (2002), *supra* n. 17, or Tufano (2003), *supra* n. 16.

<sup>24</sup> See J. Lerner, 'The New Financial Thing: The Origins of Financial Innovations', 79 *Journal of Financial Economics* (2007) pp. 223-255.

<sup>25</sup> This brings to mind the following well-known story. (In)famously, in 1977, it was also Merrill Lynch that invented the Cash Management Account, in effect allowing non-banks to circumvent the equally infamous Regulation Q. As some will know, this Regulation capped deposit rates and forbade banks from paying interest on checking deposits. The market's innovations forced regulators to phase out Regulation Q and to override state usury ceilings. (See, e.g., R. Gilbert, 'Requiem for Regulation Q: What It Did and Why It Passed Away', 68 *Federal Reserve Bank of St. Louis Review* (1986) pp. 22-37; and S. Cocheo, '25 Years Later Merrill's CMA Is Still Making Waves', 95 *ABA Banking Journal* (2003)). The benefits that this innovation brought to ordinary savers should be obvious.

such as psychology. Vigorous competition should be seen as a key ally to consumer protection. This is not meant to say that competition policy is an adequate substitute for consumer protection policy. Healthy competition relies on a set of rules constraining firms' opportunistic behaviour, irrespective of whether these rules are self-imposed by industry standards or through policy intervention.

One would hope that there will be as much progress of good economics in the area of consumer protection as there has been over the last decades in the area of competition policy. This applies not only to academics but, more importantly, to the policy practised by the relevant agencies, most notably the European Commission. By setting high standards of good economic practice, both in terms of valid and consistent arguments and in terms of empirical evidence, the European Commission's competition policy has recently provided a valuable motivating and disciplining force for national agencies in Europe. What is more, in the area of competition policy, the process of drafting new rules and guidelines is by now heavily influenced by sound academics. There is much to be gained if a similar direction is taken in the area of consumer protection in financial services, again with a leading role taken by the European institutions.