Consumer Protection and the Role of Advice in the Market for Retail Financial Services

by

ROMAN INDERST*

This paper offers a review of key stylized facts of the market for retail financial services. Financial advice plays a key role in this market. The paper then discusses the relevant academic literature and, in particular, recent contributions that deal with the role of advice in this market. Various policy options are discussed as well. (JEL: D1)

1 Motivation

The ongoing financial crisis has sparked a debate about the need for a profound shake-up of financial regulation. Admittedly, most of the discussion concerns commercial and investment banking rather than retail banking. Still, the crisis has brought to light numerous failures in the market for retail financial services, such as mortgages or investment products. In particular, the crisis has highlighted problems in the provision of professional advice that households receive from banks, brokers, and other information intermediaries:

"Impartial advice represents one of the most important financial services consumers can receive [...] Mortgage brokers often advertise their trustworthiness as advisors on difficult mortgage decisions. When these intermediaries accept side payments from product providers, they can compromise their ability to be impartial. Consumers, however, may retain faith that the intermediary is working for them and placing their interests above his or her own, even if the conflict of interest is disclosed. Accordingly, in some cases consumers may reasonably but mistakenly rely on advice from conflicted intermediaries." (U.S. DEPARTMENT OF THE TREASURY [2009, p. 68]).

Also other countries and jurisdictions are considering a serious overhaul of their retail financial-service regulation in the face of potentially widespread misselling of credit and investment products. As I discuss in more detail in the following sections, this is, for instance, the case in the UK and Germany.

The economics profession has long been interested in the performance of markets with imperfect information – and how intermediary services could help to bridge an

* Johann Wolfgang Goethe University (IMFS), Frankfurt/Main.
information gap between the providers of products and services and their customers. Advice can also enhance market efficiency when customers suffer from behavioral biases in how they process information and make decisions. For instance, it has been suggested that overconfident investors may overestimate how precise or important their own information is, compared to that of other market participants. Likewise, while all that matters at the age of retirement is the overall value of their portfolio, households' trades may be based on a more narrow framing. In view of such potential biases, provided that they are of first-order importance, advice could help consumers to make better decisions. Equally plausible, however, may be the view that through advice customers' biases and naïveté could be exploited. For instance, financial advisors who are paid commissions may find it easier to increase revenues through churning when customers already have a bias towards excessive trading.

This article explores some of the reasons why markets with advice may malfunction. It also discusses the potential merit of various policy proposals. In particular, I discuss the roles of mandatory disclosure policies, the imposition of higher liability standards for both product providers and (information) intermediaries such as brokers, and the outright regulation of the size and structure of commissions.

For instance, various U.S. states require mortgage brokers to maintain a minimum net worth or to post a surety bond (see PAHL [2007]). The risk of losing this surety bond should have a disciplining role on the market for advice. Further, with the objective of better aligning the interests of customers with those of their advisors, regulation could impose limits on the fraction of an advisor’s commission that can be paid up-front instead of over the duration of a contract (trail commission). More extremely, intervention could ban commissions altogether and thereby steer an industry towards a more direct form of compensation for advice.

I also discuss mandatory disclosure of any payments that are made between product providers and intermediary agents. For example, in November 2008 the U.S. Department of Housing and Urban Development strengthened the requirement imposed on third-party brokers to disclose to homeowners the payments they receive for intermediated mortgage agreements. Also, the Federal Trade Commission (LACKO AND PAPPALARDO [2007]) has proposed rules that would require brokers to enter with customers into an initial agreement that must state that the consumer will pay the entire compensation, even if all or part is paid directly by the lender. In the European Union, the Markets in Financial Instruments Directive (MiFID) requires the disclosure of commissions on retail financial products.

The rest of this article is organized as follows. Section 2 describes key features of the market for retail financial services. I highlight the role of limited financial literacy and sophistication, the scope of potential behavioral biases, and the complexity of the product space. Together, these features emphasize the important role that

\footnote{Compensation that may have to be paid to customers can be substantial. Financial institutions in the UK reportedly paid out a total compensation of £12 billion for alleged misselling of private pensions; in the case of endowment mortgages, which bundle mortgages with risky (stock market) investment, until 2009 already in excess of £2 billion had been given to policyholders in redress.}
professional advice could play, to which I then turn in section 3. Section 4 discusses various policy proposals that all intend to make advice serve better the needs of customers. In that section, I also discuss in detail recent academic work. Section 5 offers some concluding remarks.

2 The Market for Retail Financial Services

2.1 Sophistication and Financial Literacy

Financial capability involves the knowledge and skills that it takes to make investment decisions to promote one’s own long-term interests. Recent research papers, as well as policy reports across the world, suggest that many households do not possess a “sufficient” level of financial capability. For the U.S. and the UK, it has been shown that many adults do not possess basic knowledge of interest rates, inflation, or risk, though better-educated households have a higher level of the relevant knowledge. Very young adults appear to lack knowledge, especially when their parents have less education and do not themselves exhibit a high level of financial sophistication. More recently, there has been much emphasis on the role of cognitive skills and ability. AGARWAL et al. [2009] show how errors in financial decision-making are least likely when households have accumulated expertise and also possess good cognitive skills (see also LUSARDI AND MITCHELL [2006]).

Can households learn over time and adjust their behavior accordingly? In particular when decisions are made only infrequently, this seems unlikely. The same applies when there is limited feedback that would allow consumers to learn about the quality of their decisions. This should apply, in particular, to long-term investment products such as savings plans or insurance. Can the lack of financial capability be overcome through policy intervention in the form of financial education? Some researchers, especially those in the area of behavioral economics, have their doubts. They believe that what limits financial capability is not information and the knowledge that it takes to process this information, but, instead, potentially deep-seated cognitive biases. This view is, for instance, expressed in a survey conducted for the UK’s financial regulator3 (FSA [2008b]; see also MANDELL [2004]). Likewise, BENARTZI AND THALER [2001] report on the limited success of employer-sponsored programs. But not all share these pessimistic conclusions. From a broad review of studies, authors from the UK’s Personal Finance Research Center (FSA [2008a, pp. 14f.]) conclude that “[e]ven by considering the totality of the evidence we know virtually nothing about the impact of initiatives on particular aspects of financial capability, or the most appropriate delivery mechanisms for use with particular groups, or to cover particular information.”

If poor financial capability is, however, indeed a matter of psychology rather than one of information, then information-based approaches to educating households are

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2 On learning (and delearning) see also AGARWAL et al. [2008].
3 The Financial Services Authority, London (FSA).
likely to, at best, improve outcomes only modestly. To our knowledge, though, there is so far little experience with programs that try, instead, to inform people about these biases and thereby to induce different long-term behavior. Such information could come, for instance, from financial advice. Advice could, in addition, make up for households’ lack of information. We return in detail to the subject of financial advice in section 3.

2.2 Behavioral Biases

When making financial decisions, people will clearly make the same common mistakes that they make in other areas. For instance, they may be influenced by irrelevant aspects of the decision problem, such as its presentation.\(^4\) People may also apply heuristics to save on decision-making costs. Such heuristics work well in some situations but may result in serious mistakes in others. To stick with the status quo may be such a heuristic, which could explain why participation in government- or company-sponsored retirement plans depends so much on the default option.\(^5\)

Research on behavioral economics has identified a number of decision-making biases that may be particularly applicable to financial decisions. Several surveys deal with the intersection of behavioral economics and retail investment. Tapia and Yermo [2007] identify six main obstacles to good investment decisions that are, as they note, widely accepted in the literature on behavioral economics: (1) choice and information overload; (2) unstable or undefined preferences; (3) heuristic decision-making; (4) framing effects and investment menu design; (5) procrastination and inertia; and (6) overconfidence. These are also the main factors identified in the detailed literature review carried out by the PFRC (Personal Finance Research Center) for the UK (PFRC [2009]). These results complement those of an earlier survey of behavioral economics and financial capability by the FSA [2008b]. Gallery and Gallery [2005] cover, in particular, issues related to pension products.

Some people may delay taking an action even though they should be aware that prompt action would be better. A common explanation in cognitive psychology is that, for these people, immediate costs and benefits are unduly salient. For instance, this has been proposed as an explanation why some households continuously roll over credit card debt at high interest rates. In economics, recognition of such procrastination preferences goes back at least to Strotz [1956]. Some observers claim that it may account for low savings rates and the reluctance to participate in government- or company-sponsored savings plans (e.g., O’Donoghue and Rabin [1999]). Though a tendency to procrastinate is often claimed to have a deep foundation, it is striking that other countries, such as Germany, have neither a low savings rate nor high (revolving) consumer debt, which are arguably the most common

\(^4\) For instance, Choi, Laibson, and Madrian [2006] show that such mistakes in the choice between index-tracking funds were even common among MBA students.

\(^5\) For pioneering work in economics on the tendency to favor the status quo see Samuelson and Zeckhauser [1988].
supporting stylized facts for procrastination that are reported by researchers in the U.S. and the UK.

Further, people may see risks in isolation rather than considering the whole picture, e.g., where a particular investment only accounts for a small fraction of their total wealth. It has been argued that such a tendency may explain why some people altogether shy away from risky investments such as stocks. FELLNER AND SUTTER [2009] have shown that when subjects receive less feedback on their investment choices and have to take a more long-term decision, then they are willing to take on more risk. Mental accounting refers to the cognitive method of treating different decisions in isolation, e.g., the decision to save for retirement and the decision to borrow for short-term consumption (e.g., THALER [1985]).

Various biases in how people process information may be particularly relevant in the financial services industry. Some may altogether refrain from choosing a particular financial product when the choice set is too large. The high and growing number of different financial assets that retail investors have access to may generate such choice overload.

Risk is inherent when financial decisions are made. Economic theory often assumes that financial risk is “objective,” as measured, for instance, by the volatility of yields. However, investors may not perceive risk and uncertainty simply as some probability distribution over all possible events. In particular, when they have little experience, they may perceive outcomes as ambiguous and further discount their perceived utility from investments or choose not to choose at all.6

When do investors buy and when do they sell stocks (or other assets)? There is a large literature on behavioral finance that, building mainly on data from online brokerages, reports possibly excessive trading by retail investors. Their trading may be triggered by overconfidence about their own ability (e.g., BARBER AND ODEAN [2001]) or by attention to noninformative news (e.g., BARBER et al. [2009]). Also, their trading decisions may be affected by a tendency to apply reference points and to narrowly frame a particular investment decision, which may induce selling winners and holding on to losers.7

Several of the mentioned biases may affect behavior more strongly (or even only) when people lack the necessary knowledge and skills to make an informed decision. Without the necessary financial capability, investors may fail to even consider the factors that should affect their decisions. Consequently, some of the research on household finance has turned the question about financial capability or sophistication around and starts, instead, from people’s observed investment mistakes (e.g., to underdiversify), thereby analyzing which personal characteristics reduce the likelihood of such mistakes. Three characteristics – education, wealth,

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6 Possibly consistent with both information overload and ambiguity aversion, MADRIAN AND SHEA [2001] provide evidence that complexity of decision-making leads to procrastination.

7 Such momentum behavior may also depend on psychological traits that differ between countries; see, e.g., CHUI, TITMAN, AND WEI [2010].
and past experience with risky investments – have been shown to make an investor less likely to make such mistakes (see CALVET, CAMPBELL, AND SODINI [2009]).

2.3 Products

Arguably, the decision space faced by retail investors is vast. The difficulty in choosing from such a vast product space is exacerbated further by the considerable complexity of many of the products themselves. As a result, observed diversification strategies often follow very naïve approaches such as the so-called 1/N heuristic, in which investment is allocated evenly across the different options within a fund or plan.

Even in a simple product class, prices, in the form of additional expenses and fees, seem to vary substantially. For instance, HORTACSU AND SYVERSON [2004] find significant variations in expense ratios among (homogeneous) S&P 500 index funds; and they attribute the fact that the more expensive funds are still bought to search and switching costs.

As noted above, the inability of customers to select the lowest price may be partly due to information overload. Further, some of the fees may be hidden or not adequately recognized as costs. Complexity of products may be particularly problematic for relatively opaque retirement savings products. In fact, many participants in a UK survey were not aware that pension funds were often invested in the stock market or whether they had a defined-benefit or a defined-contribution pension plan (BUNT et al. [2006], CLARK AND STRAUSS [2008]).

Unfortunately, research and policy work that investigates how people actually purchase investment products, including their search for information and advice, is scarce. In a study conducted for the UK’s FSA, people who had recently bought financial products or were considering doing so were interviewed (FSA [2009a]). The majority reported that they had consulted only one source of information. And they think that information in the marketplace is difficult to use and trust. We return to the issue of trust in detail in the following section.

3 Financial Advice

Advice is important in the retail finance industry. For instance, a large cross-country survey in Europe showed that close to 90% of respondents in several countries expect financial institutions to provide advice – and the vast majority of customers say that they trust the advice they receive. In the UK, 91% of intermediary mortgage sales are “with advice” (FSA [2009b]). In the U.S., people overwhelmingly

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8 On limited transparency see also CHRISTOFFERSEN AND MUSTO [2002] for money market funds, BERGSTRESSER, CHALMERS, AND TUFANO [2009] for mutual funds, GREEN, HOLLIFIELD, AND SCHURHOFF [2007] for retail municipal bonds, and MITCHELL et al. [1999] for life annuities, to name a few. However, people may learn, and the market is then forced to react accordingly.
purchase mutual funds and equities (apart from employer-sponsored plans) after receiving financial advice (see Bergstresser, Chalmers, and Tufano [2009]). Hackethal, Inderst, and Meyer [2009], using trading as well as survey data from a sample of customers of a large German bank, find that over half of the surveyed customers state that they consistently rely on the advice of their personal advisor. These customers are, perhaps predictably, less informed about financial products and do not perceive there to be a large conflict of interest – and they end up trading substantially more and generating higher revenues for the bank.

Despite the pervasiveness of advice, until recently the role of advice has been largely overlooked by much of the empirical literature that deals with the analysis of households’ borrowing, saving, and investment decisions. The standard household finance paradigm may describe some investors well, most notably those trading frequently through online brokers, but it fails to capture a key determinant of the behavior of other, less-sophisticated investors who heavily rely on financial advice. As a facilitator, an intermediary who both provides advice and helps carry out transactions may reduce investors’ transaction costs. Further, an advisor may help to overcome people’s inertia, in particular when savings and investment decisions are not high on their priority list. In the decision process, advisors could provide information not only about products, but also about possible biases – e.g., arising from wrongly applied heuristics.9 The process of receiving advice forces the decision-maker to think about the problem – perhaps differently from the way he or she would have done without advice.

Paying for Advice. In the retail finance industry, customers are frequently not charged directly for advice, but end up paying indirectly through distribution fees, commissions, and other inducements that flow from product providers to brokers and (supposedly) independent financial advisors. These inducements may take the form of kickbacks that customers do not directly observe.

When advice represents, at least to some extent, a credence good, then advisors’ private interest in eliciting purchases may compromise the value of the advice. Bolton, Freixas, and Shapiro [2007] and Inderst and Ottaviani [2009a] show this in a model of cheap talk applied to the financial industry. In these models, reputational concerns and the threat of legal prosecution are what mitigate a conflict of interest. In Stoughton, Wu, and Zechner [2008], a fund advisor charges an advisory fee based on the end-of-year value of the client’s portfolio.

There is, indeed, much anecdotal evidence that the fee structure of investment products, rather than their suitability, drives their sale to customers. In the U.S., evidence suggests that mutual funds sold through broker/agent networks underperform, and that funds with higher fees (loads) improve distribution through higher commissions, thus negatively affecting fund return.10 Financial advisors may also

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9 For a review on debiasing, see Larrick [2004].
10 See Bergstresser, Chalmers, and Tufano [2009], Edeleanu, Evans, and Kadlec [2008], and Chen, Hong, and Kubik [2006].
want to increase the turnover in their clients’ portfolio (churning) when they earn additional fees or commissions with every new purchase.

Are Customers Wary? The influence of commissions on the quality of advice depends not only on whether these are made transparent to customers, but also on customers’ wariness. Do customers rationally anticipate the influence that such payments may have on a possible conflict of interest with their advisor and, thus, on the resulting quality of advice? Not all customers may be equally wary. The Federal Trade Commission’s staff report (Lacko and Pappalardo [2007]) on disclosure rules for mortgage brokers suggests that “many consumers purportedly view mortgage brokers as trusted advisors who shop for the best loan for the consumer. Studies of investors’ reactions to analysts’ recommendations suggest that at least some investors are naïve about analysts’ incentives. In addition, some experimental evidence suggests that many subjects are willing to follow advice rather blindly. Even when subjects are informed about a conflict of interest, this knowledge does not seem to always make them sufficiently wary. In Cain, Loewenstein, and Moore [2005], subjects are paid for the precision of the estimates of the number of coins in a jar. They can rely on the additional judgment of an advisor, who can closely inspect the jar. While in a first treatment advisors are paid for the accuracy of the subjects’ guesses, in a second treatment they are paid more when the guess is high. The estimate of the subjects is 28% higher in the second treatment.

Persuasion. Persuasion can affect behavior when it changes the receivers’ beliefs. Receivers may ignore the senders’ incentives. We referred to this above, when noting that some households may naively rely on advice. In addition, persuasion may successfully influence beliefs through effects such as framing, salience, and attention. In the latter case, even repetition of the same information can have effects upon beliefs. Evidence from noninformative financial advertising suggests that it succeeds by tapping into consumers’ existing beliefs. For formalizations in the behavioral-economics literature, see, for instance, Mullainathan, Schwartzstein, and Shleifer [2008] or Demarzo, Vayanos, and Zwiebel [2003]. There is also a long tradition in the economics literature allowing for the fact that advertising enters consumers’ utility function directly – i.e., it affects preferences, thereby shifting demand. In this case, the content of messages can affect behavior even when it does not convey information. In a field experiment for financial products, for example, Bertrand et al. [2010] show how the inclusion of a picture of an attractive female affects the likelihood of product uptake, albeit they do not organize their results around any particular theory of how such content matters. For a detailed account on empirical studies, see Dellavigna and Gentzkow [2010].

11 See Malmendier and Shanthikumar [2007] and Hong, Scheinkman, and Xiong [2008]. For a model of the underlying bounded strategic rationality see, e.g., Crawford [2003].
Further, face-to-face contact plays a key role in the market for retail financial services. Unfortunately, economics does not have much to say on this. For instance, the experimental literature in economics has, for the most part, taken care to abstract, as much as possible, from any uncontrolled contextual factors that such face-to-face encounters could generate. An advisor should be able to manage the advisee’s emotions and, thereby, affect his willingness to trust. Research has shown that positive emotions – e.g., happiness – increase people’s willingness to help, to cooperate, and to trust in negotiations. In addition, willingness to concede in negotiations was found to depend also on the counterparty’s displayed emotions, such as worry, disappointment, or guilt.\(^{12}\)

**Trust.** Trust in advisors is important if customers shall rely on recommendations. But people must also trust that the investment products they purchase are safe – i.e., that they will not be defrauded by brokers or that the stock market is not marred by insider-trading problems, and so on. More broadly, they must trust the financial institutions through which the product is bought or managed. Guiso, Sapienza, and Zingales [2008] have shown that whether people trust others has a large effect on their willingness to hold stock or other risky assets. Georgarakos and Inderst [2010] analyze how the willingness to hold risky and more information-sensitive assets depends on households’ perception of whether their rights as consumers are protected. For less-educated households trust in advice matters. Better-educated households may see less need to rely on recommendations. Though households in a given country or region face the same objective level of protection by institutions, including laws and their enforcement through courts, the analysis shows that individuals’ perceptions seem to differ significantly.

## 4 Making Advice Work

The preceding discussion of the market for retail financial services and of financial advice has underlined the importance of reliable financial advice as well as the present shortcomings. I discuss next various policy measures. Note that a customer may be in a position to understand and, when necessary, validate the information that is provided to him. In this case, the role of the advisor is essentially that of a facilitator, as he provides information or assists in information acquisition, or helps in other ways, but does not necessarily furnish recommendations. In what follows, I will, instead, focus on the case where such recommendations are given and, to some extent, followed by customers.

### 4.1 Regulating Payment for Advice

As discussed above, it is common that customers pay *indirectly* for advice through higher product prices, part of which is then passed on to the respective advisor in

\(^{12}\) We refer to Andrade and Ho [2009] for references.
the form of commissions or other contingent payments. When the customer must, at least to some extent, rely on the advisor’s recommendation and when reputational or liability concerns are not sufficiently strong, this practice is bound to lead to biased advice.

INDERST AND OTTAVIANI [2009b] develop a model that endogenizes the way customers pay for advice. In the model, there are two types of customers: naïve customers and wary customers. I take now first, for simplicity, the case where only naïve customers are present in the market. Naïve customers, by definition, are not aware of the commissions that advisors receive from product providers. If the commissions are not revealed, these customers fail to form rational beliefs. In equilibrium, it is found that naïve customers will pay for advice exclusively through higher product prices, which are associated with higher commissions. They will not pay a fixed fee for advice. Naïve customers who are offered the chance to pay for advice indirectly underestimate the likelihood with which they ultimately purchase a product (or, likewise, a product with a higher commission). Firms can then maximally exploit this misperception by charging customers no fee but higher product prices, while advisors are paid through commissions (or distribution fees) when a purchase is made. Even though customers seemingly do not pay for advice, they are seriously shortchanged through biased advice and higher product prices.

In this case, there are two benefits of policy intervention that would require firms to make customers pay directly for advice. First, a cap (or, ultimately, a ban) on contingent commissions increases consumer surplus by restricting the extent to which firms can exploit customers’ naïve beliefs. Second, such a cap also enhances social efficiency.

However, any policy that would interfere with business practice is bound to reduce efficiency and, provided competition prevails, ultimately consumer surplus, when this practice is chosen vis-à-vis wary customers. Paying advisors a higher margin if their advice results in a sale may be efficiency-enhancing, as it may induce advisors to acquire information in the first place, e.g., by reading detailed material about particular products, keeping themselves informed about market developments, or ultimately acquiring customer-specific information so as to provide advice that is tailored towards a customer’s specific needs. To illustrate this, consider an advisor who is only paid a fixed fee or by the hour, but who has little at stake with regard to losing repeated business and reputation. There is then little that would incentivize the advisor to work hard. If, instead, he can expect to earn a commission only if the customer subsequently purchases, this may motivate him to work harder so as to thereby convince the customer that he is able to make a better recommendation.

The argument in INDERST AND OTTAVIANI [2009b] is, however, more subtle. In a model of cheap talk, where advice remains a credence good, the quality of advice depends not only on the advisor’s bias at the stage when he makes a recommendation, but also on how much effort he exerts to generate information in the first place (e.g., information about the suitability of various products for the particular needs
of a given customer). The paper identifies circumstances when the second-best efficient outcome involves biased advice, as this leads to higher incentives to acquire information.

Mandating caps on commissions or mandating that customers negotiate with advisors a price for advice can thus have both beneficial and detrimental effects. Whether policy-makers should interfere depends, in particular, on whether customers who buy the particular product through the particular sales channel can be considered to be sufficiently wary of how advisors are compensated. If mandatory disclosure of commissions makes also naïve customers wary, then in the discussed setting such a policy would be preferable. I discuss next in more detail a policy of mandatory disclosure.

4.2 Mandatory Disclosure of Commissions

Suppose that customers know the margins that product providers earn. Even when customers do not observe how much commission advisors earn on a particular product, they could then rationally infer their size in equilibrium and should thus, for instance, discount the advisor’s recommendation by more when the margin that firms realize is higher. Still, even in this somewhat extreme case of very wary customers, there can be a rationale for mandating disclosure of commissions. This is the case when product providers would like to commit vis-à-vis customers not to give advisors steep incentives to recommend their product, as such a commitment would increase customers’ willingness to pay, allowing the provider to charge a higher price. Without regulation, firms might fail to uphold such a commitment, as they would want to push sales further by providing additional, secret kickbacks. Then, mandatory disclosure of commissions and its enforcement could benefit both firms and customers. Such a problem of opportunism is analyzed in Inderst and Ottaviani [2009a].

Recall, however, from the above that firms’ and customers’ incentives with respect to disclosing commissions are no longer aligned when, without such disclosure, customers remain naïve about the conflict of interest. As explored previously, firms may then be able to maximally exploit customers through reducing direct fees for advice and increasing product prices as well as commissions. Some recent experimental and theoretical work shows, however, that mandatory disclosure of commissions may have unintended consequences. When customers are not familiar with such disclosure, they may fail to make appropriate use of it, e.g., in that it distracts their attention from product characteristics (information overload; see Lacko and Pappalardo [2007]). Further, it has been argued that disclosing commissions could undermine the trust relationship between advisors and clients. Advisors who experience mistrust from their customers may then feel “morally licensed” to maximize only their own profits (see Cain, Loewenstein, and Moore [2005]). However, it is still unclear whether, in practice, a possible information overload of customers or a change in the framing of the advice relationship has only temporary and transitory negative effects, if any. Research is also
lacking on how advice works differently in face-to-face situations, where it may be combined with (persuasive) sales techniques (see above).

When disclosure of commissions has a dampening effect on commissions, much like a direct cap, then this can also inefficiently interfere with the positive functions that commissions serve. It is important to note that, beyond steering advisors’ recommendations towards a particular product, commissions serve a much wider range of purposes, e.g., inducing intermediaries to prospect for new clients. Dampening the use of commissions may then have negative implications as, for instance, new products are rolled out more slowly or certain segments of the market that would require more effort to reach are not covered at all. Further, as already noted above, the choice of commissions affects advisors’ incentives to generate information in the first place.INDERST AND OTTAVIANI [2008b] analyze these interactions and thereby questions the view that (mandatory) disclosure of commissions is unambiguously beneficial. There should be less need for concern about nontransparent commissions when the advisor has at his choice a wide variety of different products from competing suppliers. Then, though commissions from competing providers may overall be higher, competition leads to more balanced incentives for the advisor. Further, with such common agency, each provider has an incentive to free-ride on some of the advisor’s activities, such as locating prospective customers. Policies that dampen or cap commissions risk exacerbating the underprovision of incentives.

4.3 Regulating the Structure of Commissions

In the wake of the financial crisis, there is much debate on how to regulate compensation so as to better align the interests of top managers in financial institutions with those of society. The most common proposals are to limit the steepness of incentives and to make incentives more long-term. Interestingly, these suggestions mirror some of the policies that have already been implemented for retail financial and insurance services. For instance, as reported in FSA [2009a], the Dutch authorities have limited the initial commission in life and protection insurance businesses to 50% of the total compensation. Also, in other countries regulation seems to push in the direction of increasing the share of trail commissions. Unfortunately, economic research has, to our knowledge, not addressed much the structure of commissions and its implications for consumer welfare. However, much of what was said earlier about disclosure also applies here. To see this, take first the case of up-front versus trail commissions. Generally, when contracts are long-term and may be canceled by consumers or when the product provider can hope for more feedback by consumers in the long term, then through postponing part of an intermediary agent’s commissions the firm could, in principle, better align the interests of customers with

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those of the agent. This may, however, be costly when the agent has high (time or liquidity) preferences for being paid out immediately.

When customers are sufficiently wary and can observe the structure of commissions, they may rightly infer that short-term and steep commission pay goes hand in hand with a lower quality of advice. They should then reduce their willingness to pay for a product or service. Policy that mandates postponing a given fraction of commissions may then serve for firms as a commitment device, much like a mandatory disclosure of commissions. Further, it may provide disincentives for churning.

4.4 Regulating Contract Clauses to Increase the Quality of Advice

Policies could be directed both towards increasing the quality of advice and towards making advice less of a necessity. In the latter case, this could be achieved either by making customers better informed and more sophisticated or by reducing their need to make complex decisions. Applied to financial products, a government’s decision to rely more on private retirement provisions is also a decision to substantially increase the complexity of households’ decision space. This could again be reined in through a preselection of providers and products for which households receive tax benefits.

Regulating the products or contracts that are sold could also induce firms and their intermediary agents to provide better advice. I illustrate this next for the case of termination and cancellation clauses in contracts. The following discussion is based on the formal analysis in INDERST AND OTTAVIANI [2008a].

When it takes customers time to find out whether a particular product or service is indeed suitable for their needs, they benefit from the right to return the product or to cancel a contract. When the initial decision whether to purchase a product or to enter into a contract was made following advice, generous rights of refund or cancellation can help the seller signal that he provides fair advice or that he provides the appropriate incentives to his agents. Otherwise, he would subsequently face a large number of returns or cancellations. But for the signal to be reliable, this requires again the presence of wary customers.

Suppose instead that customers are credulous and put too much faith in an advisor’s possibly inflated statements. Then, they will wrongly presume that they will be very unlikely to terminate a contract. The advisor and product providers know, instead, that this is much more likely. In this case, firms can maximally exploit customers’ misperceptions by granting them very unfavorable terms of refund and cancellation, which in turn will lead to low quality of advice. In this case, consumer surplus and welfare can both be increased through a policy that mandates a minimum level for consumers’ right to cancel. Mandatory unconditional refund periods are commonly imposed for the sale of life insurance policies and annuity

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14 INDERST AND PFEL [2010] study such policies in the context of banking regulation, showing also when they may, however, have the unintended consequence of reducing welfare.
contracts (typically sold following advice) and are often combined with suitability rules.15

4.5 Oversight and Liability

The previous discussion of contract clauses has already highlighted the possibility that with wary customers, firms and advisors can design contracts and products so as to commit to a higher quality of advice (or, likewise, to structure commissions so as to deliver high quality of advice). Basically, this is similar to the role of warranties. With repeated interaction, also learning and reputation can play a crucial role in mitigating problems of opportunism. However, compared to the failure of physical products, with financial services it may be more difficult for customers to ascertain when a recommendation was unsuitable, particularly given their limited sophistication and financial literacy. In this case, it may fall upon policy-makers and regulators to impose and maintain high standards.

INDERST AND OTTAVIANI [2009a], as well as INDERST [2008], analyze under which conditions there should be more need to impose higher liability standards and tighter oversight. A major determinant is the severity of the (internal) agency problem between a product provider and the agent who is responsible for providing advice. This agency problem becomes more severe when the same agent is responsible both for providing advice and for eliciting new sales, e.g., through prospecting for new customers. (In economic terminology, the agency relationship then turns into a multiple-task problem.) As a consequence, the appropriate standard of liability and oversight should depend, amongst other things, on the way products are sold. Whether firms have access to (early) customer feedback, which in turn depends on customers’ sophistication and the nature of products, also affects the agency problem and, thereby, the standard of advice that would prevail without regulation.

When selling and advice are undertaken by independent agents, such as mortgage brokers or independent financial advisors, then this raises also the issue of which party is ultimately liable when an unsuitable product was sold. Clearly, some form of vicarious liability is called for when not much compensation can be expected from intermediary agents, given the size of their operations and chosen organizational form. Likewise, regulators must then decide on which party to impose certain standards of responsible selling.16

When imposing higher liability standards for particular products or channels, care must be taken that this does not have potentially a wide range of unintended

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15 For instance, the New York Insurance Department’s Regulation 60 on “Replacement of Life Insurance Policies and Annuity Contracts” grants buyers an unconditional cancellation right for sixty days.

16 For instance, even when they do not have direct contact with customers, lenders rather than intermediaries may be held responsible for establishing an “affordability standard,” in particular outside the prime market (see also FSA [2009b]). See CARLIN AND GERVAIS [2008] for a formal analysis of the team production problem when both a product provider and an intermediary contribute towards making the supply of financial products suitable for consumers.
consequences. Product providers may simply cease to develop or roll out products where they consider legal risks to be highest, irrespective of the ultimate benefits to customers. With respect to advice, agents may shift towards selling products without advice, though customers may fail to understand the distinction. Furthermore, the special treatment of independent agents may distort the market by imposing a penalty on vertical separation and open-architecture sales. This can clearly distort competition and lead to less consumer welfare. Finally, on a more general level, in the long term more active policy intervention may lead customers to think that they need not take sufficient care themselves.

5 Concluding Remarks

In this article, I have first laid out some of the stylized facts that pertain to the market for retail financial services, bringing out the role that professional financial advice plays. A key challenge is the intrinsic difficulty in evaluating the quality of advice that is tailored to the particular needs of customers. This holds not only for consumers but also for product providers, who may wish to implement a high standard of advice so as to then charge high product prices. Technological improvements in the way products are sold, e.g., through electronic platforms, may provide new opportunities for the industry as well as for policy-makers. Unfortunately, I have no space in this article to discuss the various ways financial products are delivered in different markets, e.g., through tied arrangements or open architecture. Like consumer protection, this would raise issues of competition policy.

I have also provided a short account of some of the recent literature that deals with policies directed towards advice, in particular in the area of financial services. Such policies target, in particular, the way intermediary agents are paid, through more or less disclosed commissions or other kickbacks, or through payments that they receive directly from customers. I have also dealt with the regulation of product (and contract) design. Clearly, from the perspective of consumer protection policy, in this area an immediate objective must be to design and enforce regulation, or to apply existing law, so as to make products understandable and charges transparent. The inherent complexity of financial products together with the limited financial capability of many households may justify a more interventionist policy than in other markets. To build policies on solid foundations, however, further theoretical, empirical, and experimental work is much needed.

References


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Roman Inderst
Chair of Finance and Economics
IMFS
Johann Wolfgang Goethe University
Grüneburgplatz 1
60323 Frankfurt/Main
Germany
E-mail: inderst@finance.uni-frankfurt.de