

Regulating (Retail) Finance

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Motivating Thoughts

- Jackson 07: „Variation in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications“
- Jackson: Goals of financial services regulation (US)
 - Protection of the general public
 - Elimination of negative externalities (from financial failure)
 - Advancing various equitable and redistributive goals
 - Promoting certain aspects of political economy

Motivating Thoughts

- What are costs and benefits? How to measure?
 - Jackson: (Cost-based) Measure of intensity of regulation
- And are costs/benefits country specific?
 - Jackson: “Number of reasons why countries should be cautious in importing regulatory structures from foreign jurisdictions”

Themes...

1. Need for (formal) frameworks to study cost & benefits
(Jackson: “Living with under-theorized benchmarks”)
2. Identify cost/benefit channels (knock-on effects etc.)
3. Identify need for “residual” role of regulation
4. “Comparative statics” analysis:
E.g., in industry/market characteristics

Focus: Sale of financial products to households
(Investment products, insurance, consumer credit / mortgages)

Regulating (Retail) Finance

- Focus: “Unsuitable selling” / Misselling
- “Typically, misselling is associated with investment products when there may have been a failure to disclose all the associated risks or where an investment product is inappropriate to a customer’s needs.”
(Group Code of Conduct, Standard Chartered Bank 05)
- FINRA Conduct Rule 2310(a) on “Suitability”: must have “reasonable grounds for believing that the recommendation is suitable”; Rule 2310(b) on “Duty of Inquiry” about customer’s financial status, investment objectives...
- UK “Misselling Scandals”: Private pension sales (£12bn compensation in 94), endowment mortgages, etc.

Regulating Retail Finance: Background

- My perspective:
 - Uninformed but perfectly rational consumer
 - Profit maximizing firms
 - Welfare standard for regulator / policy maker
- Are consumers “uninformed but rational”?
- Current policy of authorities? Differs extremely.
- One extreme: UK
 - Principles-based regulation
 - Active authorities (incl. OFT, CC)
(e.g., on overdraft charges, payment protection insurance)

Framework to Study Regulation of Misselling

- Firm (principal) hires employee/dealer (agent) to prospect for customers and to advise customers.
- Prospecting: Private “effort cost” c . Generates interested customer with probability g .
- Suitability is customer specific (“high” or “low”) with respective net utilities: $u_l < 0 < u_h$.
- Ex-ante probability of “good fit” is q .
- Baseline: Suitability is perfectly observed by the agent.

Firm's Internal Compliance Problem

- Incentivize agent to (1) market product and (2) advise customers.
- Tools: (1) Compensation and (2) internal monitoring.
- Firm detects “misselling” with probability $m < 1$.
- Compensation:
 - Agent obtains (base wage) w if no sale is made
 - Compensation $w + b$ if uncontested sale is made
 - Compensation $(1 - a) \cdot w$ (with $a > 0$) if sale contested

Incentive Constraints

- Agent only advises “good-fit” customers to purchase:

$$b \leq w \cdot \left(\frac{m}{1-m} \right) \cdot a$$

- Agent undertakes effort to prospect for customers:

$$b \geq c \cdot \frac{1}{g \cdot q}$$

- Equilibrium cost of compliance: “Monitoring costs” plus “agency rent”

$$k(m) + c \cdot \frac{1}{g \cdot q} \cdot \left(\frac{1-m}{m} \right) \cdot a$$

“Closing the Model”

- Firm’s incentives to sell?
 - Depend on price **p** and “penalty/fine” **F**
- Generalized model:
 - Through *compensation contract* plus *compliance expenditures* firm shifts its internal “standard of sales”
- Customer’s Willingness to Pay (and to follow advice)?
 - Depends on price and expected (!) standard.

Key Findings from the General Model

- *Firm's internal agency problem:*
Generates higher need for (self-)regulation
(higher **F** needed to implement given suitability standard)
- *Direct marketing:*
Products needing “direct marketing” are more prone to misselling
→ Stronger regulation
- *Policy trade-off:*
More financial innovation and

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Key Findings from the General Model

- *Competition:*
More intense competition may induce more misselling
→ Requires to step up regulation
- “*Complacency effect*”:
If larger fraction of penalty represents compensation to customers,
higher penalty is needed to enforce given standard

More Discussion

- Regulation must be “fine-tuned” to industry/market characteristics such as
 - organization of sales process
 - competitive process
- What if different firms are organized differently?
- What if different countries (in EU) have profoundly different “Industrial Organization”?
E.g. integrated channels vs. (untied) advisors/dealers

Some Special Applications

- “Contract resale”: As firm avoids “direct” consequences, higher penalty needed to induce same standard
- Withholding / clawing back (contingent) commission
 - Work in progress:
 - “Risk sharing” objective makes it optimal not to claw back all
 - Finding: Benefits of regulated minimum withholding / claw back
- Similar: Role for *mandated transparency of commission*
 - Albeit work in progress suggests: Can inefficiently “crowd out” advice intensive products.

Concluding Remarks

- Thinking through a model?
 - Be precise about objective(s) and role of regulation
 - Clear “comparative statics” of when regulation more needed
 - Interaction / complementarity of different policy measures
- Can it help in the following?
 - Enrich / inform the “*under-theorized benchmarks*” (e.g., of comparative cost-benefit analysis)
 - Provide a basis for organizing empirical findings (e.g., on the “*intensity of financial regulation*”)
 - Lay the ground for subsequent structural estimations and policy analysis

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