Retail Finance: Rethinking Regulation and Consumer Protection in the Shadow of the Financial Crisis

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1. Baseline Remarks

At least from the beginning of 2007, the growing problems in the US subprime market became evident. This has focused international attention on the area of retail finance – an area that typically receives much less attention than the fancier world of wholesale finance and investment banking. As the crisis deepened, however, attention quickly shifted back towards the wholesale end, such as the markets for asset-backed securities and credit default swaps. Only occasionally did the retail side of the crisis resurface, for instance when it came to protecting banks' retail deposits.

Still, the present crisis provides an opportunity to carefully rethink existing legislature and regulation that govern 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. Only then can we hope to create a consistent body of legislative and regulatory work that serves the people of Europe.

To rethink the principles of consumer protection more generally is also overdue in the light of past as well as ongoing initiatives of the European Commission. I do not have the time to comment in detail on this activity. Clearly, on a general level the consumer directive represents a cornerstone. More specifically, with MiFID much progress has been made in the area of financial instruments, including retail finance. But how do these various directives fit together, say 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 case of the initiative to harmonize across countries the law governing early-repayment clauses for mortgages. Presumably, one side effect of such a harmonization may have been the creation of a European market for mortgages and mortgage-related products. I guess that presently there is 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 wave, 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 vary widely. An understanding of what drives these national differences is clearly a necessary first step before drafting a plan to harmonize existing laws or even imposing contractual uniformity across Europe.

In this talk, I will, however, comment briefly on a different policy instrument: Disclosure of conflicts of interest and thus, in particular, of commissions and "kickbacks" that financial intermediaries or advisors 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. But I will also talk about contractual lock-ins and the potential role of statutory provisions for early cancellation. What will tie these two topics together is that in both cases my focus will be the role of financial advice.

I will conclude my talk with some remarks on competition and innovation. There and also in the preceding remarks, I will repeatedly stress one and the same view: That viable competition, when governed by an adequate set of rules, is the best recipe for the protection of almost all consumers, generally and also with respect to financial and insurance products. That being said, this leaves ample scope for an active consumer protection policy that sets rules and sanctions misbehavior.

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; 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 key. Retail financial and insurance 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 advisors play a key role. 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 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 advisor, 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 thus have 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, I have looked into the multiple functions that commissions play and the impact of policy intervention. 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, 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. While reducing bias in advice, such disclosure may also stifle the acquisition of information by advisors. Overall, this may imply that the quality of advice deteriorates.

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 advisors or an independent sales force become more severe, misselling is more likely. Competition can also be inducive to problems of misselling, as fiercer competition among agents forces firms to restructure their commissions more aggressively. Furthermore, consumers may still benefit. When consumers are more complacent, more of the burden of being vigilant shifts to supervision.

Furthermore, when advisors 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 favoring a particular way of paying for advice. Earning a commission on a subsequent sale may be necessary to provide an agent with sufficient incentives to really exert effort and provide valuable advice. This is the subject of ongoing research.

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.

Based on an large grant from the European Research Council, we are presently building up a center for the research on the regulation of retail finance at the Institute of Financial Stability in Frankfurt. This will be in close cooperation with other European universities and legal scholars. The issue of consumer protection is here at the core.

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, say, misleading advertising and aggressive sales strategies.

The other view holds that consumers must be protected from themselves: 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 a 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.

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 behavior of mortgage holders.[1] Literature on behavioral finance documents further "biases", at least among some investors, such as overconfidence.[2]

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 regards to field studies, it must be born 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-serviced 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 behavior is often justified by households' low savings rate. Needless to say that this is view 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, in my view 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 still be to ask why does the market not provide a solution without intervention.

Take the case of, to use here a general term, mandatory minimum cancellation rights. 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.

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[1] E.g., Campbell (2006).
[2] E.g., Odean (1999).

As I 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 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 through higher prices they can extract any additional value that is created by commitment to better advice. 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, we show that a minimum statutory right of cancellation may then be effective even when it is not binding, given that many or even all firms offer 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.

4. Competition and Innovation

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 higher default risk, which brings us back to the present financial crisis. More recent work qualifies this view, however, both theoretically and empirically.[3] Moreover, in cases where such a negative trade-off between competition and stability exists, policy and supervision are first blame: either because regulation and government intervention created exploitable situations in the first place; or because supervision did not react flexibly enough.

The present financial crisis can not 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.

Regulation and supervision has failed by shying away from addressing the problems early enough: The large exposition of banks to ever more complex off-balance sheet risk was not an "unknown unknown", but a "known unknown". Supervisors failed to be proactive. Regulatory capture may have been one reason for this.

In the remaining time, I will preach the virtues of the market. In some European countries there is clearly the risk that the present financial crisis will stifle market forces for a long time. The two main forces are industry consolidation where there is already high concentration and, as I fear, regulation and supervision that frame vigorous competition and the development of new business models as "systemic risk factors" that need to be subdued.

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[3] On the theoretical side, see Inderst et al. (2008). On the empirical side, see Boyd et al. (2006).

A case in place is clearly the tie-up between HBOS and Lloyds'. HBOS is the UK's biggest mortgage lender, writing one in five of all new home loans, while Lloyds' is the third biggest lender overall. The two groups may end up having a combined mortgage book of, at first count, three times the size of the next biggest rival, Nationwide. HBOS is also the biggest savings provider, while Lloyds' is the third largest. Recent inquiries into the UK's banking market, as well as decisions by the UK's Competition Commission, all shared one view: Further consolidation should not be permitted, even under wide-ranging remedies.[4]

3.1 Too much innovation?

I view competition as a main force to generate innovations. While central bankers may wish for more "boredom", as expressed by the UK's governor, even in the case of finance and banking I regard innovations as something that must be fostered and not as something that needs to be stifled.

Even without talking about "weapons of mass destruction" in the disguise of new financial products, one could agree with Miller (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, minimize transaction costs, or respond to new risk factors or new technological developments.[5] 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.[6]

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.[7] But this shall not suggest that every newly introduced contract was to the benefits of customers.[8]

For instance, "endowment" or "savings and equity" 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 still be plenty of scope for beneficial innovations. For instance, a roll-out of fairly-priced reverse mortgages could potentially benefit many aging households.[9] 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.[10] For the

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[4] The Cruickshank report in 2000 urged the government to put a stop on the further consolidation of the industry. The Competition Commission stopped, for instance, the proposed merger of Lloyds and Abbey National.

[5] See Tufano (2002) or Merton (1992) for a more detailed discussion.

[6] E.g., Frame and White (2002).

[7] 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 Miles and Pillonca (2007).

[8] E.g., Scanion and Whitehead (2004).

[9] 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., Campbell and Cocco (2003).

[10] DeYoung et al. (2008), for instance, document this for small business lending, where the form of borrowing is similar to that of unsecured household loans.

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.[11]

But who are the main innovators? While this is a key theme in Industrial Organization, 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.[12] More recent studies suggest, however, that smaller firms are more innovative.[13] According to a recent study that exploits articles from the business press, the by far most innovative firm in the US was Merrill Lynch.

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 forebade banks from paying interest on checking deposits. The market's innovations forced regulators to phase-out Regulation Q and to override state usury ceilings.[14] The benefits that this innovation brought to ordinary savers should be obvious.

4. Concluding Remarks

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 such as psychology. I also have emphasized that vigorous competition should be seen as a key ally to consumer protection. That is not meant to say that competition policy is an adequate substitute for consumer protection policy. Healthy competition relies on a set of rules that constrain firms' opportunistic behavior, irrespective of whether these rules are self-imposed by industry standards or through policy intervention.

I 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 does not only apply to academics, but more importantly to the policy practiced 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. I would hope that a similar direction will be taken in the area of consumer protection in financial services, again with a leading role taken by the European institutions.

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[11] E.g., Gerardi et al. (2007) or Dynan et al. (2006).
[12] E.g., Frame and Wright (2002) and Tufano (2002).
[13] See Lerner (2007).
[14] E.g., Gilbert (1986) and Cocheo (2003).

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