Consumer Protection and Financial Advice

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Policy

- "Consumer Protection in Markets with Advice", Competition Policy International 2010
- "Consumder Decision Making in Retail Investment Services", report prepared for SANCO

Theory

- "Irresponsible Lending with a Better Informed Lender", EJ 2008
- "Misselling Through Agents" (with M. Ottaviani), AER 2009
- "Intermediary Commissions and Kickbacks" (with M. Ottaviani), 2008
- "How (Not) to Pay for Financial Advice" (with M. Ottaviani), 2009

Empirical

- "Trading on Advice" (with A. Hackethal, S. Meyer), 2009
- "Financial Advice and Stock Market Participation" (with D. Georgarakos), 2010.
- Ongoing experiments...

Roadmap

1. Key features of the market for Retail Financial Services (RFS)?
2. Importance of professional advice?
3. Shortcomings of professional advice?
4. Some policy conclusions

Sophistication and Financial Literacy

- For UK and US, in particular, several studies document "deficiencies" in basic knowledge and cognitive skills.
- Trading & investment mistakes seem to depend on education, wealth, past experience.

"Behavioral Biases"

- Clearly, common mistakes (arising from simple heuristics) **also** apply to market for RFS.
- Are some possible biases (particularly) relevant for RFS?
  How pervasive are they at all?
  - Narrow framing. Mental accounting. Loss aversion.
  - Overconfidence. Etc.

Markets and Products

- Large, complex decision space.
- Opaque expenses and fees.
  –> Even for relatively "plain" products (equity index options, S&P 500 index funds, money market funds, retail municipal bonds, life annuities, etc.)
- How do consumers buy retail financial products?
  –> Surveys suggest very limited search, often consulting only one source of information.

Role of Financial Advice

- Europe ("Eurobarometer 2003"): More than 90% of customers in, for instance, Austria, Germany or Finland *expect* to receive financial advice. Overwhelming majority *trusts* financial advice.

- US: 80% of mutual fund investors (outside employer-sponsored plans) receive financial advice (Inv. Company Institute, 2005).

Biased Advice ?

“Impartial advice represents one of the most important financial services consumers can receive. . . . .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.” *Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation, US Department of Treasury, June 2009 (page 68)*

Biased/Unsuitable Advice ? "Misselling" ?

- What drives advice and sales?
  - US mutual funds: Bergstresser et al. (2007), Edelen et al. (2008), Chen et al. (2007)
  - Mortgage brokers: Bergstresser and Beshears (2010)
- German bank: Hackethal/Inderst/Meyer (2010).

Evidence from a Large German Bank

- Data for *advised* customers combining:
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- Who relies more on advice?
  - Less informed, less educated.
  - Perceive advisor as more knowledgeable.
  - Feel less "pushed".

	ln_revenues	
VARIABLES	Coefficient	Stand. Err.
ln_trade_volume	0.752***	(0.045)
frac_inc	0.382***	(0.075)
ln_portfolio	0.150***	(0.052)
risk_attitude	0.085***	(0.024)
Constant	-2.513***	(0.244)
Observations	345	
R-squared	0.885	

Figure 1: Revenue Drivers

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- Impact of (strongly) relying on advice?
  - "Incentivized" products in portfolio: 40% compared to average 30%.
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- Causality?
  - 50% of customers say that "initiative for talks" comes overwhelmingly from advisor.
  - Trade volume up in Euros, **not** in number of transactions.
  - Length of relationship does not affect reliance on advice, only affects trade volume when <1 year ("friction")

Customer "Naivité" ?

- Inderst/Ottaviani "How (Not) to Pay for Financial Advice"
  - Naive (in contrast to wary) customers do not rationally anticipate commissions or how they affect adviser's incentives.
  - Model rationalizes pervasiveness of "indirect" payment for advice as a way to *exploit naive customers*:
    –> Naive customers do not pay up-front for advice.
    –> But pay higher product prices. And commissions are higher.

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    –> Naive customers do not pay up-front for advice.
    –> But pay higher product prices. And commissions are higher.
- There, even general "health warning" *could* act as an "eye-opener"
  –> **Not** in firms' interests, but increases consumer surplus.

How "Naive" are Customers?

- **Online incentivized experiment with 6000 subjects across Europe:**
—> Subjects are told whether their "advisors" are put on flat pay or commission.
  - *Game of cheap talk:* Only strong "health warning" generates difference in response, and only for subjects who take enough time.
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- **Laboratory experiment with ca. 500 subjects across Europe:**
  - *Cheap talk:* Strong effect of *precisely* disclosed adviser incentives!
  - *Strategic disclosure*: Free communication allows biased adviser to make advisee significantly "less wary" (higher investment).

Can Mandatory Disclosure Backfire?

- Inderst/Ottaviani "Intermediary Commissions and Kickbacks" 2008
  $>$ Yes. Makes advice less sensitive to "supply side differences" (in cost).

- "Information overload" and "knee jerk" reaction:
  –$>$ Lab experiments show that "free communication" mitigates this.

- But: IF there is "loss of trust", then can backfire due to key role of trust
  –$>$ Inderst/Georgarakos (2009)

Trusting Advisors or your Consumer Rights

- Data source: Eurobarometer 2003 ($>$ 7000 households, representative).
- Key questions:
  - Hold risky assets (stock or collective investment)?
  - Trust financial advice / Expect to receive financial advice?
  - Rights as consumers of financial services protected?
  - And: Many good IVs !

	Total Sample	College Graduates	Less than College Education
Total Stocks	0.27	0.35	0.18
Trust in financial advice	0.60	0.62	0.59
Consumer rights are protected	0.51	0.51	0.51
Age	45.79	41.60	50.90
Male	0.51	0.52	0.49
Couple	0.61	0.61	0.61
Single	0.21	0.25	0.15
Divorced	0.10	0.09	0.10
Children	0.31	0.34	0.26
Self Employed	0.10	0.11	0.08
Retired	0.26	0.17	0.37
Unemployed	0.09	0.10	0.08
High School	0.28	-	-
College	0.55	-	-
Median Income band	7	7	6
Number of observations	7527	4146	3381

Figure 2: Sample Descriptives

	Total Sample			College Graduates			Less than College Education		
	Marg. Eff.	z-stat		Marg. Eff.	z-stat		Marg. Eff.	z-stat	
Trust in financial advice	0.0259	*2.45*	**	0.0152	*1.04*		0.0400	*3.07*	***
Consumer rights are protected	0.0324	*3.49*	***	0.0509	*3.60*	***	0.0122	*0.96*	
Age	0.0029	*7.23*	***	0.0052	*8.84*	***	0.0010	*1.68*	*
Male	0.0682	*7.12*	***	0.0656	*4.57*	***	0.0684	*5.27*	***
Couple	-0.0520	*-2.75*	***	-0.0343	*-0.94*		-0.0629	*-2.63*	***
Single	-0.0214	*-0.97*		0.0230	*0.57*		-0.0709	*-2.39*	**
Divorced	-0.0884	*-3.92*	***	-0.0876	*-2.23*	**	-0.0804	*-2.96*	***
Children	-0.0135	*-1.13*		-0.0070	*-0.41*		-0.0251	*-1.59*	
Self Employed	0.0718	*4.27*	***	0.0656	*2.90*	***	0.0817	*3.05*	***
Retired	0.0180	*1.14*		0.0353	*1.27*		-0.0015	*-0.08*	
Unemployed	0.0197	*1.07*		0.0455	*1.64*		-0.0175	*-0.72*	
High School	0.0191	*1.24*							
College	0.1049	*6.62*	***						

Figure 3: Sample Split

Summary: Importance of Financial Advice

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  - *Normative*: Low literacy, complexity, possible biases?
- But advice has been largely overlooked by academics
  - Household finance: "Asset pricing" perspective.
    –> But financial products are often **sold not bought**.
  - Hackethal/Inderst/Meyer 2010:
    >> Reliance on advice is key determinant of trading behavior!
    >> And of asset choice!

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    –> Mandatory disclosure of "hard" performance data?
- Or making advice less important!

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